Pitfalls and Opportunities Under the New Federal Tax Law

Part 2: Income Tax Opportunities

By temporarily increasing the federal exemption from $5.5 million to over $11 million for the gift, estate and generation-skipping taxes, the Tax Cuts and Jobs Act of 2017 (the "Act") has created estate tax and income tax planning opportunities as well as traps for the unwary. In this multipart series, we explore all of these in depth.

In Part 1, we looked at potential pitfalls. In Part 2, we will look at new income tax planning opportunities. Regardless of your net worth, the increase in the federal estate tax exemption creates opportunities for significant capital gains tax savings when combined with the so-called "step-up" in cost basis applied to assets at death. First, a primer on the capital gains tax and the step-up in basis, followed by a discussion of tax-savings strategies.

Capital Gains Tax

The capital gains tax applies to realized gain upon the sale of an asset, such as a home or stocks. Realized gain is calculated by subtracting the cost basis (generally the amount paid to purchase the asset) from the net sales proceeds. Under current federal law, the capital gains tax rate is 20% if you owned the asset for at least one year. In addition, there is a 3.8% surtax added if your income levels exceed certain thresholds. If you sell an asset that you have owned for less than one year, the gain is taxed as ordinary income, which means that you pay your highest income tax rate.

Additionally, depending on your state of residence, there may also be capital gains tax due to your state as well. For example, Massachusetts charges 5.1% for capital gains and New York charges up to 12.7%.

The Step-Up

All assets that you own at your death receive a "step-up" in cost basis to the assets' fair market value at that time. This means that heirs would only pay capital gains tax on appreciation (if any) occurring between the date of death and the sale date, and not on all of the appreciation that occurred during your lifetime. This is true regardless of whether your estate is subject to an estate tax on your death. Simply owning the property at your death eliminates all capital gains taxes that would have been triggered had the property been sold immediately before your death.

Taking Advantage of the Estate Tax Exemption

Because the Act has doubled the estate tax exemption, new basis step-up strategies may be advisable.

For example, it might make sense for a spouse to transfer low-basis assets to an elderly or ill spouse, who will then own them in his or her own name. That way, the assets will receive a full step-up in cost basis at the spouse's death, thereby eliminating potentially large capital gains tax should the surviving spouse later sell the assets.

In some cases it might even make sense for wealthy adult children to make "upstream" gifts to parents who do not have enough of their own assets to make full use of the doubled estate tax exemption. With this strategy, the parents' estate plans would transfer the assets back to their children and/or grandchildren—or to trusts for their benefit—and the assets could be sold after the parents die with no capital gains tax.

Basis step-up planning can also be utilized by a family that has trusts set up by previous generations with low basis assets. Often, these trust assets are not rebalanced as often as would be optimal because selling assets and incurring capital gains tax can have such a large, negative impact on the portfolio's value. One potential solution is to distribute low cost basis assets outright to elderly beneficiaries who do not have enough of their own assets to make full use of the doubled estate tax exemption. On that individual's death, the assets will receive an immediate step-up in basis, which allows for a potential tax-free sale of the assets by the next owners of the assets. The beneficiary's estate plan could direct these assets into a new family trust that mimics the original trust terms, thereby allowing the trustees simultaneously to diversify the family's collective assets while reducing taxes.

Donors of existing irrevocable trusts might also be able to engage in basis step-up planning, even though the assets have already been transferred to the trust. Many irrevocable trusts allow for assets to be "swapped" for other assets of similar value. Although this feature was likely included for a different tax-savings opportunity, it works well as a tool to address basis step-up because it allows the trust to swap out low basis assets to an elderly donor and receive high basis assets in exchange, all with no tax consequences. The trust gains flexibility to rebalance trust assets at a lower capital gains tax cost, and when the elderly donor passes away, the low basis assets receive the step-up, thereby reducing or eliminating any capital gains when the assets are later sold. Here, the donor's estate plan could potentially return the assets to the trust from which they came or to a new trust with the same terms as the original. Further, by eliminating unrealized gains, the step-up in cost basis creates much more flexibility for the trustees of the trust to pursue prudent investment strategies.

Risks

There are several risks to consider with these strategies. The larger exemption is due to revert to approximately $5.5 million on January 1, 2026, and a future Congress may accelerate that timetable. If, after the gifts or distributions to a less wealthy individual, that person's net worth exceeds the exemption in place at his or her death, estate tax might be due. Moreover, in the case of a gift from child to parent discussed above, the "wealthier" child making the gift will be using some of his or her exemption on the transfers to a parent, rather than "downstream" to a child or grandchild. Therefore, it might make sense for the parent's estate plan to distribute the assets to a trust that "skips" over the child in favor of grandchildren. Otherwise, the child could be using his or her tax exemption on a gift that ultimately comes back to be included in his or her estate. These risks can be addressed, and

are often minimal in light of the significant capital gains tax savings and flexibility created for a portfolio to rebalance much more quickly.

Other Benefits

These tax strategies can also be employed with others to reduce potential estate taxes in your children and grandchildren's generations. For instance, trusts can include "formula" general powers of appointment that allow children and other descendants to fully utilize their estate tax exemption, which causes assets to get a step-up in basis without triggering additional tax liabilities or exposing trust assets to the beneficiaries' creditors. In addition, that child or other descendant can apply his or her own generation skipping transfer (GST) tax exemption to those assets, allowing them to pass to future generations free of estate tax.

Additional Resources

This multipart series, explores estate tax and income tax planning opportunities and pitfalls created by the Tax Cuts and Jobs Act of 2017.

- Part 1 explored pitfalls under the Act.
- Part 3 will explore advanced estate tax planning strategies to consider as a result of the Act.

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