

# Strategies to Obtain a Basis Step-Up

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MARVIN E. BLUM, J.D./C.P.A.

The Blum Firm, P.C.

[mblum@theblumfirm.com](mailto:mblum@theblumfirm.com)

[www.theblumfirm.com](http://www.theblumfirm.com)

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## MARVIN E. BLUM

THE BLUM FIRM, P.C.  
777 Main Street, Suite 700  
Fort Worth, Texas 76102  
(817) 334-0066  
mblum@theblumfirm.com  
www.theblumfirm.com

**MARVIN E. BLUM** is an attorney and CPA based in Fort Worth. He is Board Certified in Estate Planning and Probate Law and is a Fellow of the American College of Trust and Estate Counsel.

Mr. Blum founded The Blum Firm, P.C. over 38 years ago. The Blum Firm is one of the premier estate planning firms in the nation, known for creating customized, cutting-edge estate plans for high-net-worth individuals. The firm specializes in estate and tax planning and the related specialties of asset protection, business planning, business succession planning, charitable planning, family legacy planning, fiduciary litigation, and guardianship.

Mr. Blum serves on the Editorial Advisory Committee for *Trusts & Estates* magazine. He is Treasurer of the Fort Worth Symphony and the Texas Cultural Trust. He is Secretary/Treasurer of the Pat & Emmitt Smith Charities as well as a member of the Boards of Directors for the Multicultural Alliance and B Sharp Youth Music Program. Mr. Blum received his Accounting BBA (Highest Honors) and Law Degree (High Honors) from the University of Texas.

# Strategies to Obtain a Basis Step-Up

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## Move Appreciated Assets Back into Estate

With the higher exemption amount under the Tax Cuts and Jobs Act of 2017, the estate planning focus for many is less on saving estate tax (as most estates are no longer subject to estate tax) and more on getting a basis step-up to avoid a 23.8% long-term capital gains tax when inherited assets are later sold. If your client has transferred assets to a grantor trust to avoid estate tax, the problem is that the assets won't receive a basis step-up at death.

### Planning Idea 1: Swap Assets Back into Estate

- **Swap low-basis assets out of a grantor trust** in exchange for cash or high-basis assets so that the appreciated assets will be in the estate at death and receive the step-up.

- Example: Norman bought a ranch 60 years ago for \$500,000. He previously gifted the ranch to an irrevocable trust he created for the benefit of his daughter. The trust contained provisions allowing the grantor to swap assets to and from the trust (making it a grantor trust).

The ranch has a current fair market value of \$5 million.

At Norman's death, the ranch would not be included in Norman's estate and therefore would not receive a step-up in basis.

Recognizing that he has a short life expectancy and that the ranch has a low basis, Norman decides to exercise his swap power. Norman transfers high-basis assets with a total value of \$5 million (including some cash) into the trust and pulls the ranch out of the trust.

As a result, the ranch is includable in Norman's estate and will receive a basis step-up to \$5 million upon Norman's death.

## Planning Idea 2: Buy Appreciated Assets Back into Estate

- What if the client wants to swap assets but doesn't have enough cash or high-basis assets to swap?

**Consider borrowing cash.** The borrowed cash could be swapped for the trust's low-basis assets, or the borrowed cash could be used to purchase high-basis assets to swap.

Alternatively, the client can buy the assets from the trust and sign a promissory note. When a grantor purchases assets from his grantor trust, the sale is not subject to income tax.

- Example: Norman can buy the low-basis assets from the grantor trust with a promissory note owing to the trust. Norman should hire an appraiser to appraise the note (as well as any hard-to-value assets of the trust), and the note should be secured.

If it is likely that the assets will substantially appreciate inside Norman's estate prior to his death, Norman should use an interest rate on the note that is higher than the AFR so that the higher interest Norman pays can offset some of the growth in his estate.

- What if Norman bought the low-basis assets from the grantor trust for a promissory note but dies before he repays the note?

The unpaid balance of the note would be includible in Norman's estate for estate tax purposes.

There is no clear answer on whether the gain portion of the note payments received by the trust after the grantor's death are subject to income tax.

So, this scenario works best if the note is repaid before the grantor dies.



- What if the trust isn't a grantor trust?

If the trust isn't a grantor trust, the problem with swapping high-basis assets into the trust in exchange for low-basis assets is that it would be a taxable sale. To avoid having the exchange treated as a sale, first convert the trust to a grantor trust.

Convert by Court Reformation – The trust can be converted from a non-grantor trust to a grantor trust by court reformation.

Convert by Trust Merger – Create a new trust with all the same terms but add a power to swap assets. Then, merge the old trust into the new trust, and the assets are now in a grantor trust. Texas has a fairly liberal trust merger statute. Non-grantor trusts can be merged into grantor trusts if none of the beneficiaries will have their interests substantially impaired.

- Example: Norman creates a new trust with all the same terms as the original trust, plus it grants Norman a “swap power,” exercisable in a non-fiduciary capacity and without the approval or consent of any person in a fiduciary capacity, to reacquire trust property by substituting other property of an equivalent value.

The swap provision makes the new trust a grantor trust.

The original trust combines (or merges) with the grantor trust such that only the grantor trust survives under a non-judicial combination of trusts under Texas law.

As a result, all the assets of the original trust (including the ranch) are now held in a grantor trust.

Norman can now swap high-basis assets for the ranch without income tax consequences. Since transactions between a grantor and a grantor trust are ignored for income tax purposes, no income tax would be due on the sale or on the interest payments received by the trust.

## Planning Idea 3: Use Court Reformation to Move Assets into Estate

- Court reformation is especially useful (i) when the first spouse has died and left assets to a bypass trust, and the surviving spouse has enough exemption available to cover the survivor's own assets plus the assets in the bypass trust, or (ii) when a trust doesn't allow for swapping assets.
- Example: The court could grant the surviving spouse (the beneficiary of the bypass trust) a general power of appointment ("GPOA") over the appreciated assets, causing the assets to be included in the surviving spouse's estate
- Example: Or, the court could terminate a portion of the trust early in favor of a beneficiary.

## Planning Idea 4: Make Distribution to Move Assets into Estate

- Assume a surviving wife is the beneficiary of a bypass trust that owns low-basis assets, and her estate is below the exemption level.

Is there a way to transfer an amount of low-basis assets to the wife to **soak up her unused exemption** so that the assets will get a step-up at her death?

- Example: If the trustee of the bypass trust can justify a distribution to the wife for her health, education, maintenance, and support (“HEMS”) needs (or however the trust’s applicable distribution standard reads), the distributed assets would go back into her estate and qualify for a step-up.

## Use Powers of Appointment to Cause Inclusion

### Planning Idea 5: Draft Trust to Give Beneficiary Formula GPOA

- Wind the clock back and draft the trust to give the beneficiary a **formula GPOA** so he has a GPOA only to the extent needed.
- Example: When drafting a bypass trust, grant the surviving spouse a GPOA that applies (i) only to assets that have a fair market value greater than their tax basis and (ii) only to the extent that the GPOA does not cause increased estate tax.

The assets that the surviving spouse has a GPOA over would be included in the surviving spouse's estate and receive a step-up.

## Planning Idea 6: Trigger Delaware Tax Trap

- Normally, exercising a limited (or “special”) testamentary power of appointment does not cause estate tax inclusion. However, it does cause estate tax inclusion if the power is exercised to create another power of appointment which can be presently exercised. This is referred to as triggering the “Delaware Tax Trap.”
- Example: When drafting a bypass trust, grant the surviving spouse a special power of appointment (“SPOA”).

The surviving spouse includes in their will that they are exercising the power and appointing the assets to a trust of which some other person has a presently exercisable GPOA (sometimes referred to as a “PEG” power).

This appointment allows the property to remain in trust beyond the original perpetuities period, and that triggers IRC Section 2041(a)(3). Under IRC Section 2041(a)(3), the appointed bypass trust assets are includable in the surviving spouse’s estate for estate tax purposes and thus receive a step-up in basis upon the surviving spouse’s death.

The surviving spouse would include the following in their Will:

*I have a special power of appointment to appoint all of the property of the Bypass Trust to any one or more of my descendants. I hereby appoint the property described below to the NextGen Trust for the benefit of my children who survive me, in equal shares, and I give each of my children an inter vivos general power of appointment to appoint their share of the assets as they wish.*

- In addition to being used with a bypass trust, the Delaware Tax Trap can also be used for a GST-exempt trust that a parent leaves to the child where trust assets avoid estate tax when the child dies but do not receive a stepped-up basis.
- Example: When drafting the GST-exempt trust, grant the child an SPOA.

The child includes in their will that they are exercising the power and appointing the assets to a trust of which some other person has a presently exercisable GPOA (a PEG power).

Like with the previous example, this appointment allows the property to remain in trust beyond the original perpetuities period, and thus the appointed assets are includable in the child's estate for estate tax purposes and receive a step-up in basis upon the child's death.

The child would include the following in their Will:

*I have a special power of appointment to appoint all of the property of the GST-Exempt Trust to any one or more of my descendants. I hereby appoint the property described below to the NextGen Trust for the benefit of my children who survive me, in equal shares, and I give each of my children an inter vivos general power of appointment to appoint their share of the assets as they wish.*

- The Delaware Tax Trap **can be triggered for just some of the assets** in a trust; it doesn't have to be triggered for all trust assets.



## Planning Idea 7: Special Trustee Grant GPOA

- When drafting the trust, **include a Special Trustee** with the authority to grant the beneficiary a GPOA.
- Example: Suppose a beneficiary had an estate below the lifetime exemption amount.

The Special Trustee could grant the beneficiary a GPOA over the trust assets.

The assets that the beneficiary has a GPOA over would be included in the beneficiary's estate and receive a basis step-up.

- Exercise caution with this technique because the beneficiary could choose to exercise the power and appoint the assets to a third-party.

## Another Use of Special Trustee

### Planning Idea 8: Allow Special Trustee to Make Extraordinary Distributions

- When drafting the trust, include an independent Special Trustee with the power to make extraordinary distributions beyond the trust's applicable distribution standard.
- Example: Suppose the surviving spouse beneficiary of a bypass trust had an estate below the lifetime exemption amount.

The Special Trustee could distribute the low-basis assets to the surviving spouse outright.

The assets would be included in the surviving spouse's estate and receive a stepped-up basis at the surviving spouse's death.

# Partition Planning

## Planning Idea 9: Partition Property to Obtain Maximum Step-Up

- Example: Husband and Wife are married and own a lot of community property real estate.

Husband's health is rapidly declining.

Husband and Wife partition their real estate to be 100% Husband's separate property.

As a result, when Husband dies, Wife inherits the real estate and gets a basis step-up to the full fair market value.

Without this planning, each half of the community property would be stepped-up, but since each community property half is subject to a valuation discount, the basis step-up should be limited to the discounted fair market value.

## Planning Idea 10: Partition Property to Avoid Step-Down

- Example: George and Sarah are married and own a community property portfolio of varied stocks. Some of the stocks have increased in value, and some have decreased in value.

George's health is rapidly declining.

George and Sarah partition the stocks to be separate property. The appreciated stocks become George's separate property, and the depreciated stocks become Sarah's separate property.

Upon George's death, the appreciated stocks pass to a bypass trust for Sarah with a new stepped-up basis. George does not own any of the depreciated stocks and so a **step-down in basis is avoided**.

# Upstream Planning

If the client has appreciated assets, look “upstream” to a parent for obtaining a stepped-up basis.

“At the risk of being tactless, the death of a parent, grandparent, or other older relation or friend is a sad enough event without also wasting the opportunity for a significant basis increase.”

~Howard Zaritsky, nationally-known tax & estate planning attorney

## Planning Idea 11: Gift Appreciated Assets to Parent with GPOA

- If the client has low-basis assets and the client’s parent has unneeded exemption, the client could gift the assets to a trust for the parent and give the parent a GPOA over the assets.

- Example: The client creates a trust benefitting the parent and gifts low-basis assets to the trust.

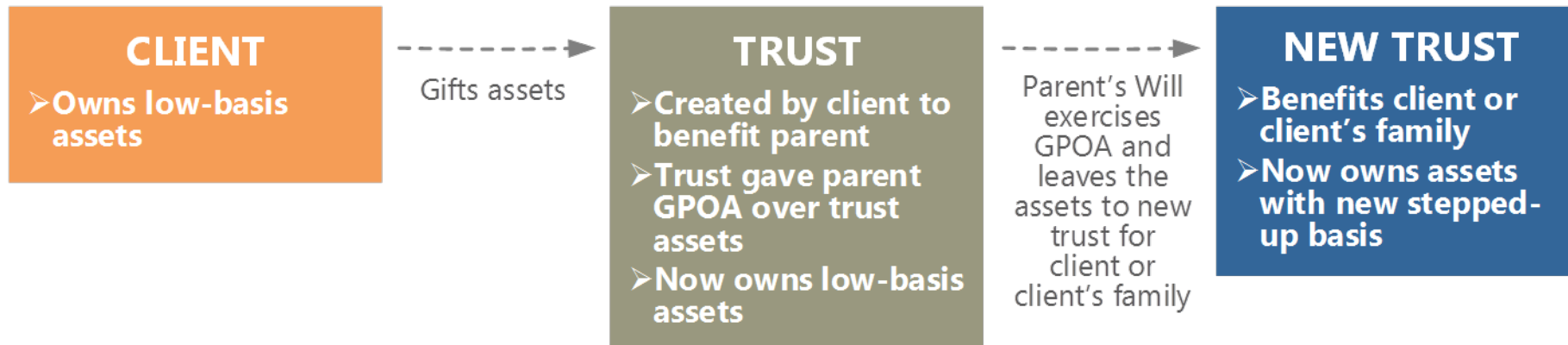
In drafting the trust, the client gives the parent a GPOA over the trust assets.

The GPOA will cause the assets to be included in the parent's estate under IRC Section 2041(a)(2).

In the parent's will, they exercise the GPOA and leave the assets to a trust for the client.

When the parent dies and the assets come back to a trust for the client, the assets will have a new stepped-up basis (under IRC Section 1014(b)(9)).

Note: The outcome is the same if the trust is drafted so that if the GPOA is not exercised, the assets pass back to the donor child or to a trust benefitting the donor child. In this case, there would be no need for the parent to even exercise the GPOA.



- Caution: IRC Section 1014(e) denies the basis step-up if the assets come back to the child or the child's spouse within one year.

This potential limitation may be avoided if the assets pass (i) to a trust for the benefit of the client and/or the client's spouse with a trustee other than the client or client's spouse or (ii) to the client's child or a trust for the child's benefit.

## Planning Idea 12: Sell Appreciated Assets to Parent with GPOA

- The prior example requires using up exemption for both the client and the client's parent. What if the client or the parent doesn't have enough lifetime exemption? Or, what if we don't want to use up their exemptions?

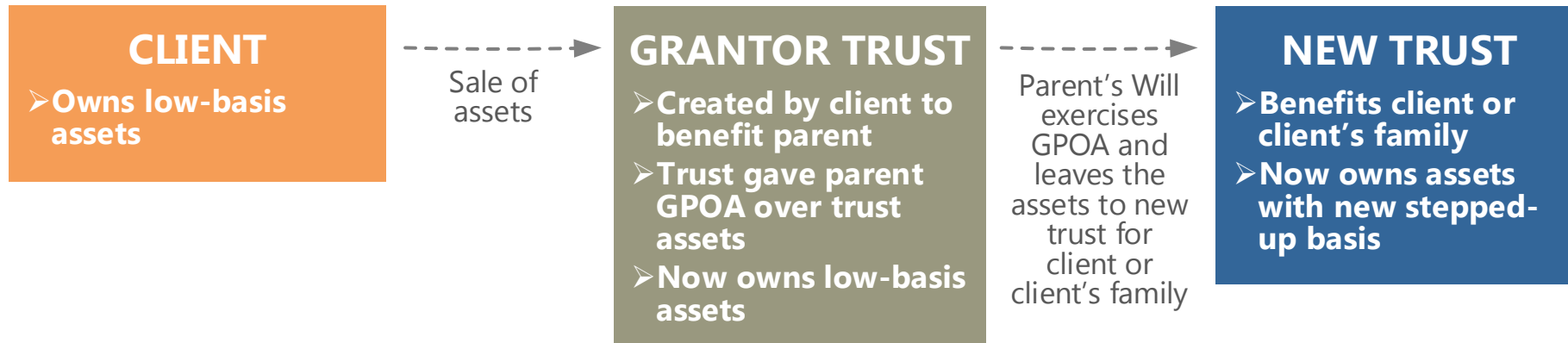
Instead of the client making a **gift** to the parent, consider a **sale** to the parent's trust.

- Example: The client sells the low-basis assets to a grantor trust, taking back a note and a security interest. By selling instead of gifting the assets, the client's exemption won't be used up. Because the trust is a grantor trust, there is no income tax on the sale.

Under IRC Section 2053(a)(4), the assets included in the parent's estate will be offset by the secured debt owing by the trust.



The assets get a stepped-up basis, but the net increase to the parent's estate is zero. Therefore, **none of the parent's exemption is used.**



## Planning Idea 13: Gift Appreciated Assets to Children's Trust and Give Parent GPOA

- In Planning Ideas 11 and 12, we moved the appreciated assets into a trust benefitting an upstream person and gave the upstream person a GPOA over the assets.
- If we instead move the assets into a trust for the client's children, can we still give an upstream person a GPOA to get a basis step-up at the upstream person's death? Yes, we can.
- Example: The client creates a trust benefitting the client's children and gifts low-basis assets to the trust.

In drafting the trust, the client gives the parent a GPOA over the trust assets.

The GPOA will cause the assets to be included in the parent's estate, and the assets will get a new stepped-up basis at the parent's death.

- Note: The upstream person **does not necessarily have to have been competent** to exercise the power during any time of having the power.

Case law provides that a decedent who lacked legal capacity to understand the power was still deemed to hold the power for estate tax purposes.

- Further Note: The client may **not even have to tell the upstream person** about the existence of the power.

There is no case law specifically on this. But, if a decedent who lacked legal capacity to understand the power was still deemed to hold the power for estate tax purposes, then it seems a decedent with capacity but unaware of the power would also be deemed to hold the power for estate tax purposes.

It is theoretically possible that the IRS could assert that a power is not taxable unless the powerholder knows of the power. But, proving someone didn't know something is difficult.

## Mixing Bowl Partnership Planning

### Planning Idea 14: Shift Basis to Avoid Gain on Appreciated Assets

- What if one family member has an asset with a low basis that he plans to sell (but doesn't want to pay tax on the gain), such as a fully-depreciated building or a stock that has climbed in value? And, another family member (or S corporation or non-grantor trust) has a high-basis asset that the family plans to hold on to until death, such as a bond portfolio, legacy real estate, or a permanent life insurance policy?

There's a way to **shift basis** from one asset to another so the family avoids gain when it sells the appreciated asset.

- Example: Dad owns a building with a fair market value of \$450,000 and a basis of \$0.

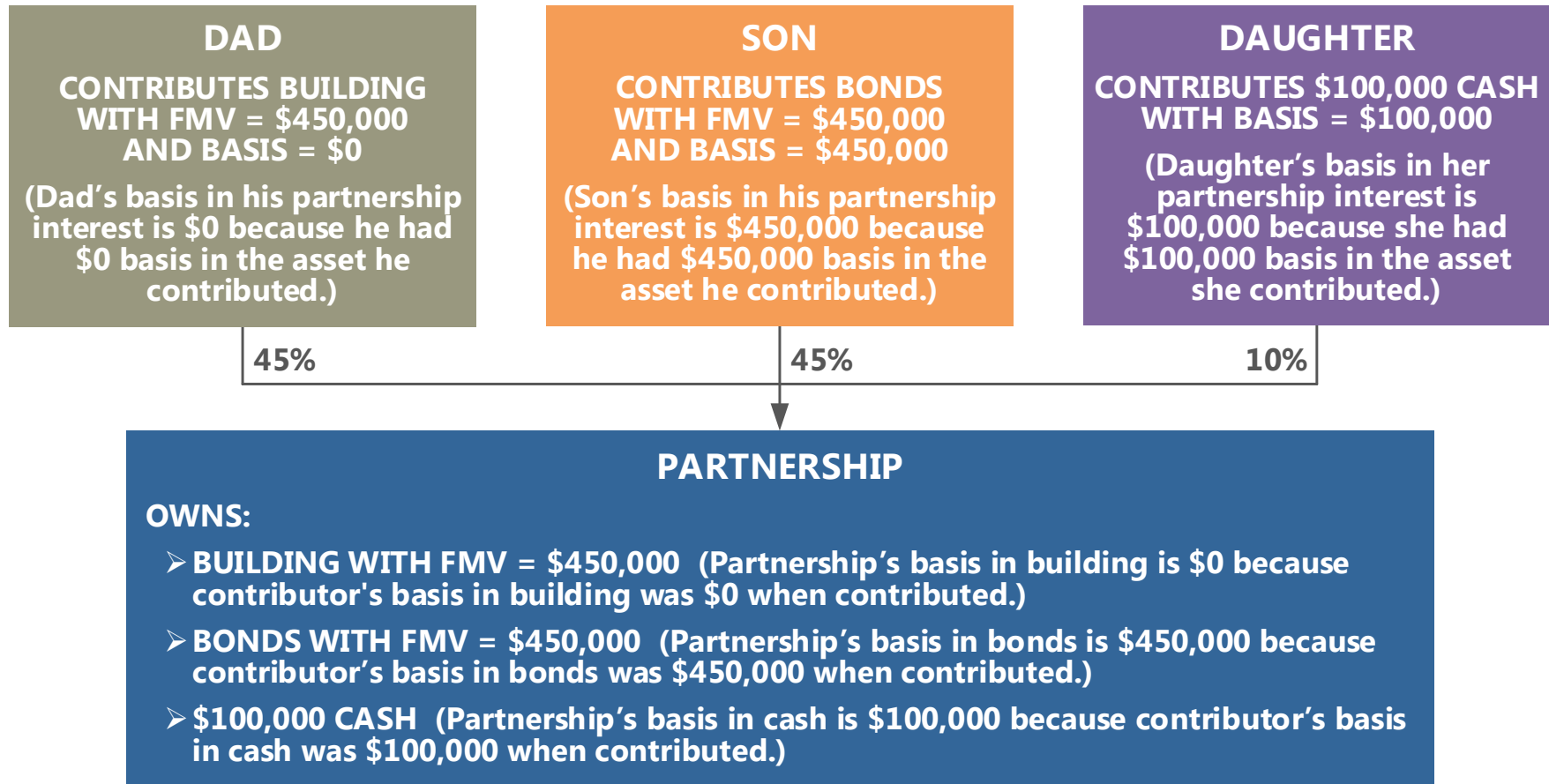
Son owns bonds worth \$450,000 with a basis of \$450,000.

Daughter has \$100,000 cash.

The family anticipates selling the building in the future (more than 7 years from now). Upon the sale, Dad would have a taxable gain.

Dad, Son, and Daughter form a partnership. Dad contributes the building. Son contributes the bonds. Daughter contributes the cash.

Partnership is owned 45/45/10.



After 7 years, they **liquidate Son's interest** in the partnership by distributing the building to Son.

Because Son's basis in his partnership interest is \$450,000 and the building was distributed to Son in liquidation of Son's interest, the basis in the building is adjusted from \$0 to \$450,000. (IRC Section 732(b) requires this basis increase; no election is needed to effect this.)

### **SON**

**Interest in partnership liquidated.**

**Building distributed to Son with  
basis of \$450,000.**

## PARTNERSHIP

### OWNS:

- **BONDS WITH FMV = \$450,000** (Partnership's basis in bonds is \$450,000.)
- **\$100,000 CASH** (Partnership's basis in cash is \$100,000.)

Because the partnership had a “substantial basis adjustment” as defined in IRC Section 734(d), the partnership now must make a **compensating downward adjustment** of \$450,000 to its remaining assets.

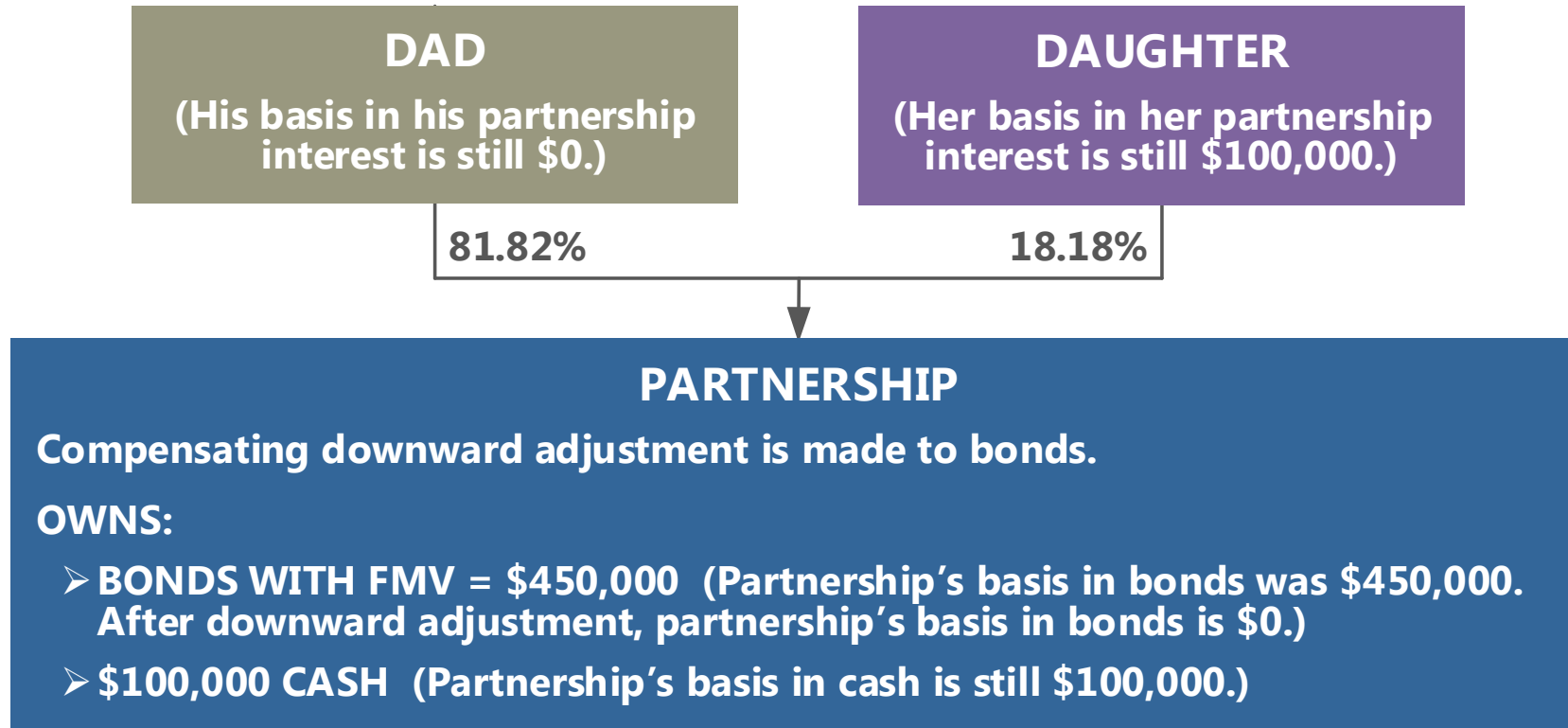
The partnership's remaining assets are the bonds and the cash.

The basis of cash is always the value of the cash. Therefore, the basis of the bonds is adjusted downward by \$450,000.

Note that this adjustment would not be required if the basis of the building had increased by less than \$250,000 which would not have constituted a substantial basis reduction (unless the partnership had previously made a Section 754 election).

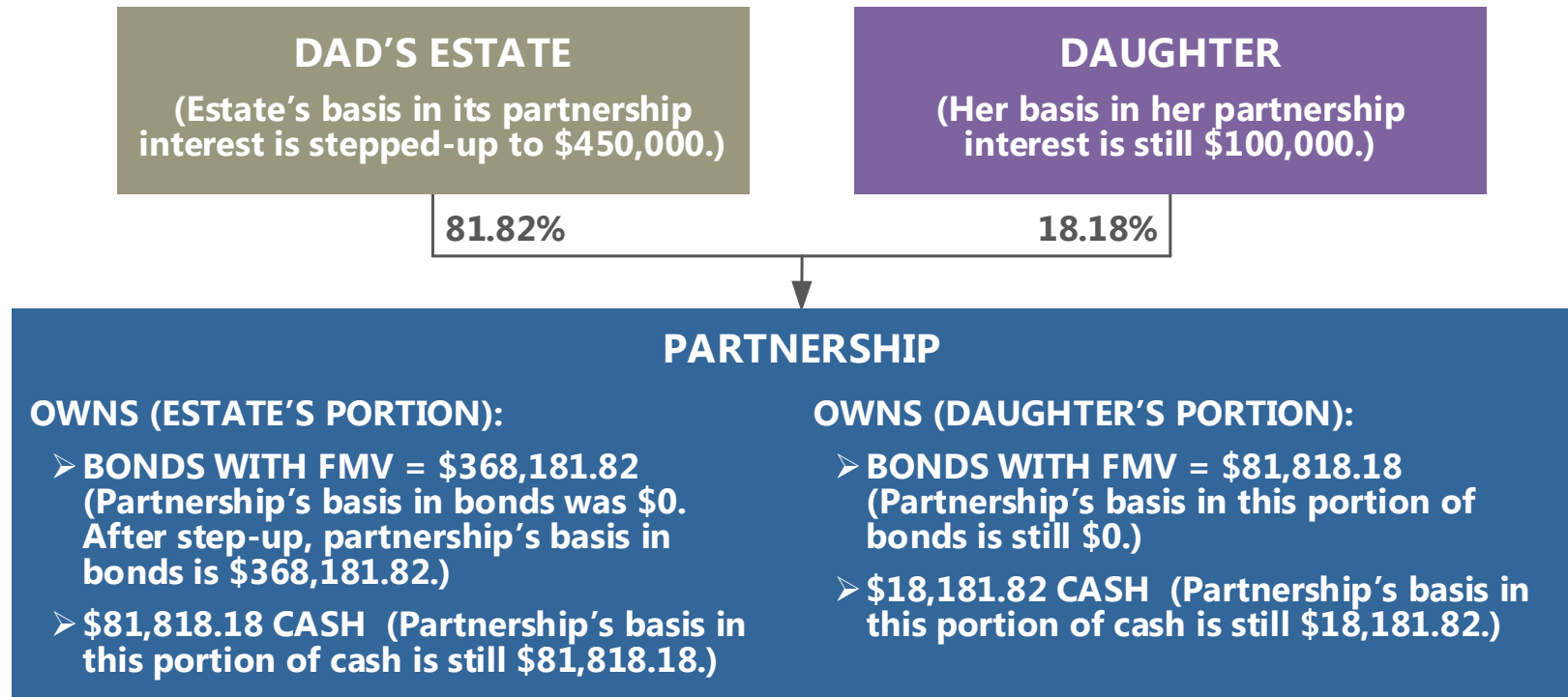


After **Son's interest is liquidated:**

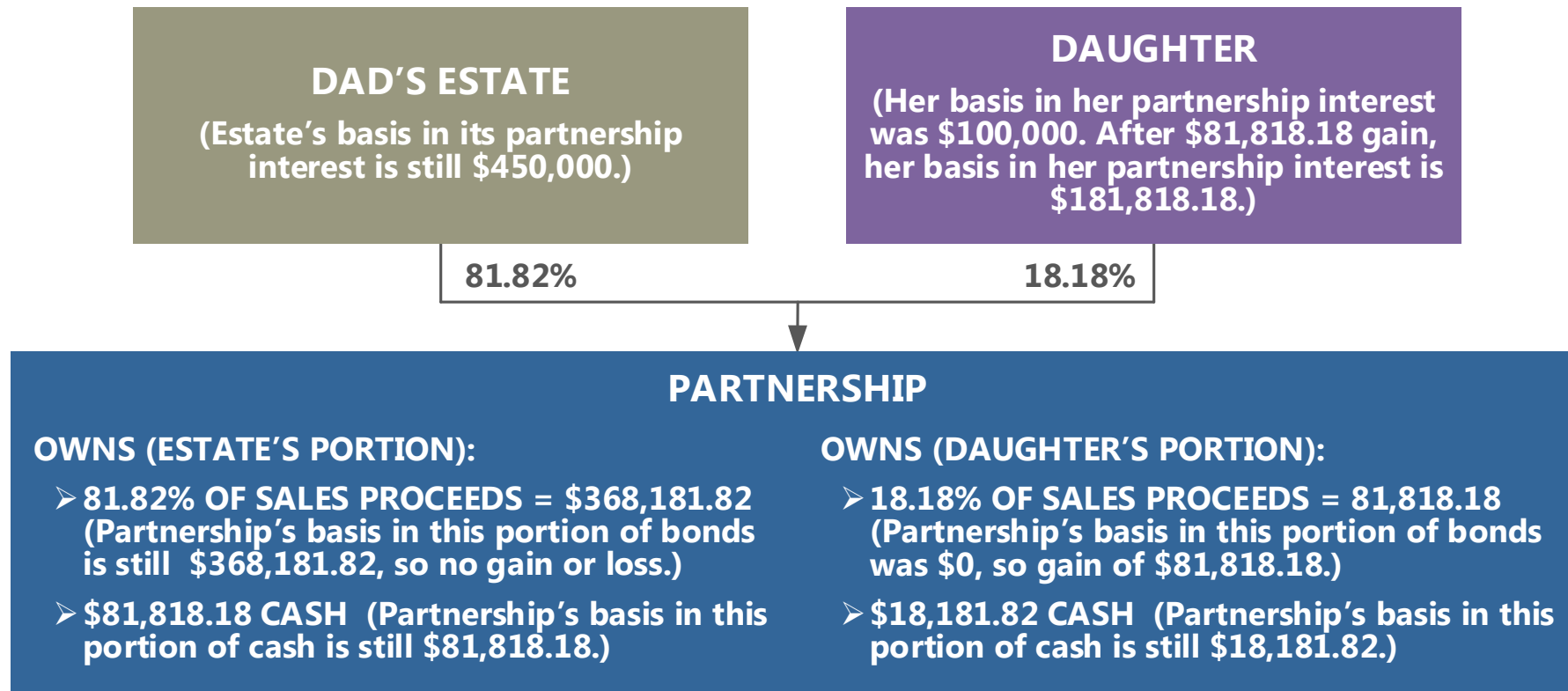


At **Dad's death**, the basis of his partnership interest is stepped-up to fair market value (assume \$450,000), and the partnership would make a Section 754 election.

Because of the Section 754 election, the assets inside the partnership with respect to Dad will receive a step-up in basis to \$450,000.



The **partnership sells the bonds** for \$450,000. Daughter has \$81,818.18 capital gain. Dad's estate has no gain or loss.



When the **partnership dissolves** later that same year, Daughter will recognize a \$81,818.18 capital loss to offset her \$81,818.18 capital gain.

The family pays no income tax on sale of bonds.

### DAD'S ESTATE

Estate's 81.82% portion of proceeds =  $81.82\% \times \$550,000 = \$450,000$

\$450,000 proceeds less estate's \$450,000 basis in its partnership interest = no gain or loss

### DAUGHTER

Her 18.18% portion of proceeds =  $18.18\% \times \$550,000 = \$100,000$

\$100,000 of proceeds less her \$181,818.18 basis in her partnership interest = \$81,818.18 loss

## Planning Idea 15: Use Appreciated Asset to Buy PPLI with No Taxable Gain

- What if a client is interested in the income tax benefits of owning Private Placement Life Insurance (“PPLI”) and wants to sell an appreciated asset, such as a building, to purchase PPLI? But, he doesn’t want to pay any capital gains tax on the sale of the building?
- Being in real estate, he wants to know if he can do a like-kind exchange whereby he sells the building, parks the funds into a qualified intermediary, and then has the qualified intermediary invest in the life insurance policy.

But, a life insurance policy is not like-kind with real estate, and like-kind exchanges only apply to real estate transactions.

- Instead, he can instead utilize the mixing bowl planning technique.

- Example: The client owns a commercial building with a fair market value of \$1,000,000 and a basis of \$100,000.

The client borrows \$1,000,000, secured by the building.

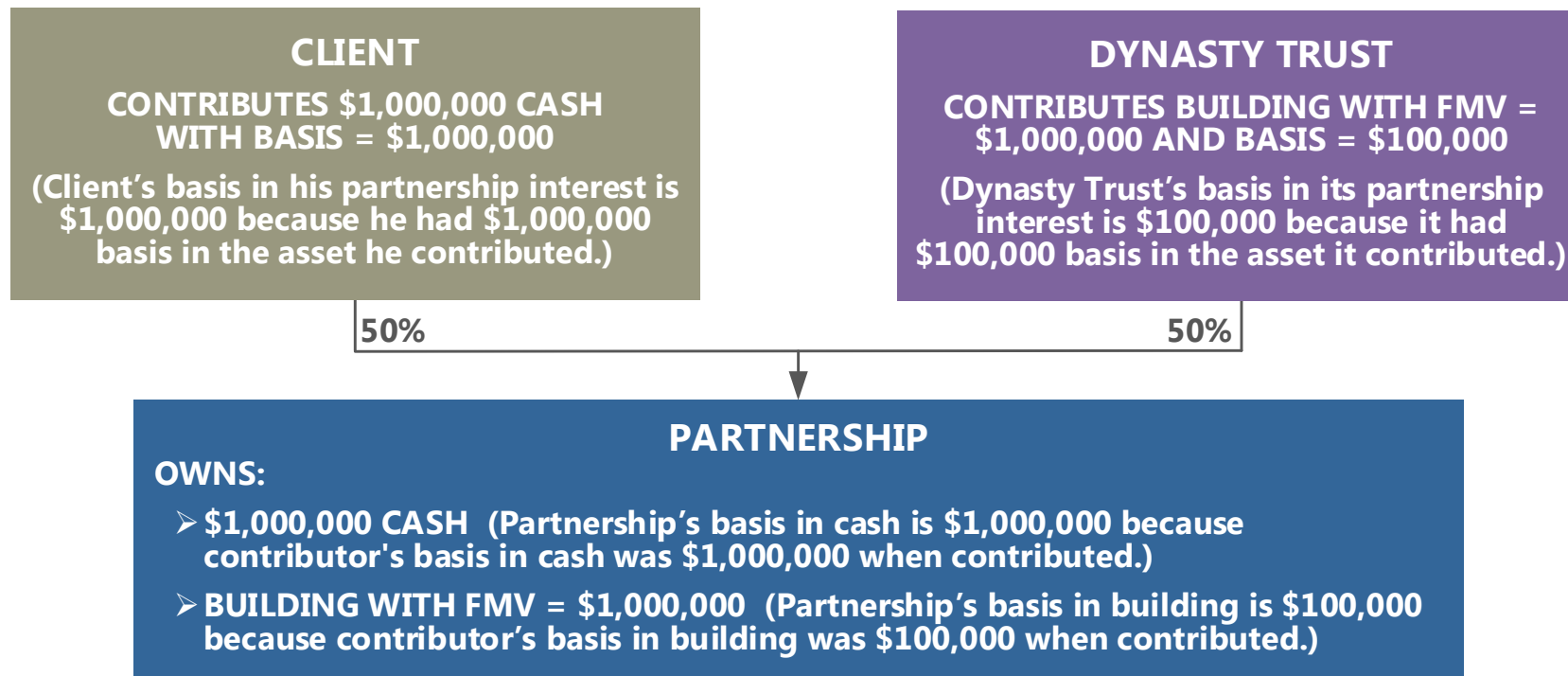
The client gifts the commercial building (with a fair market value of \$1,000,000 and a basis of \$100,000) to a dynasty trust, which retains the \$100,000 basis.



The client and the dynasty trust **enter into a Partnership Agreement.**

The client contributes the \$1,000,000 cash to the partnership in exchange for a 50% partnership interest. The client's outside basis is \$1,000,000.

The dynasty trust contributes the building to the partnership in exchange for a 50% partnership interest. The dynasty trust's outside basis is \$100,000.



The partnership uses the \$1,000,000 cash to **buy PPLI**.

## PARTNERSHIP

### OWNS:

- **PPLI WITH FMV = \$1,000,000** (Partnership's basis in PPLI is \$1,000,000.)
- **BUILDING WITH FMV = \$1,000,000** (Partnership's basis in building is \$100,000.)



Seven years later, **the Partnership is liquidated.**

The client receives the building, now with a basis of \$1,000,000. The dynasty trust receives the PPLI, now with a basis of \$100,000.

**CLIENT**  
**BUILDING**  
**WITH FMV = \$1,000,000**  
**AND BASIS = \$1,000,000**

**DYNASTY TRUST**  
**PPLI**  
**WITH FMV = \$1,000,000**  
**AND BASIS = \$100,000**

The client **sells the building** for \$1,000,000, which results in no gain, and repays the loan.

The client essentially used the building to purchase the PPLI, without recognizing any gain.

After the client's death when the dynasty trust receives the life insurance proceeds, there is **no gain or loss.**

## Planning Idea 16: Shift Basis from Minerals to Another Asset

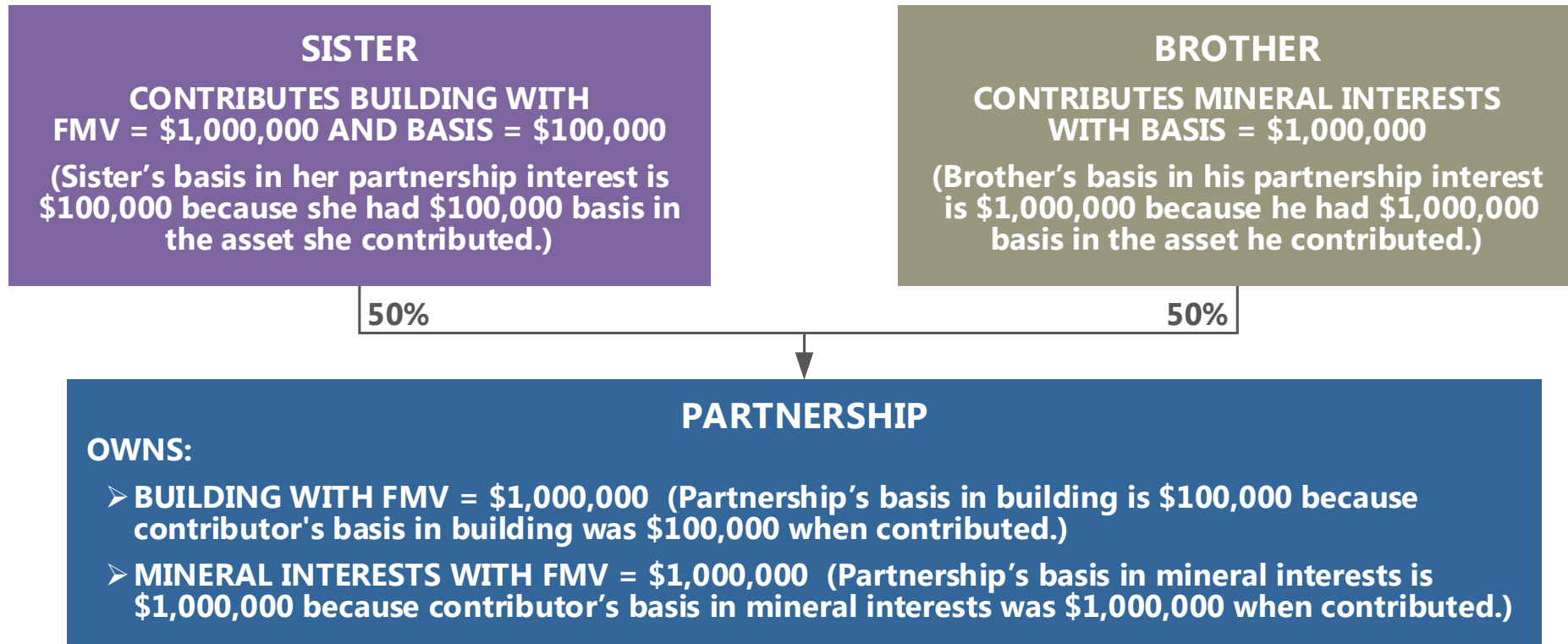
- Clients with a basis in mineral interests could benefit from shifting the basis to other assets.
- Basis doesn't matter as much for mineral interests because: (1) they're rarely sold; (2) you get a deduction for depletion even if there is no basis; and (3) the basis disappears over time anyway.
- Example: Sister owns a commercial building with a fair market value of \$1,000,000 and a basis of \$100,000.

Brother owns mineral interests with a fair market value of \$1,000,000 and a basis of \$1,000,000.

Sister and Brother **enter into a Partnership Agreement.**

Sister contributes the building to the partnership in exchange for a 50% partnership interest.

Brother contributes the mineral interests to the partnership in exchange for a 50% partnership interest.



Seven years later, **the Partnership is liquidated.**

The mineral interests are distributed to Sister, now with a basis of \$100,000.

The building is distributed to Brother, now with a basis of \$1,000,000

**SISTER**  
MINERAL INTERESTS  
WITH FMV = \$1,000,000  
AND BASIS = \$100,000

**BROTHER**  
BUILDING  
WITH FMV = \$1,000,000  
AND BASIS = \$1,000,000

Brother could now sell the building and **recognize no gain.**

Or, Brother could hold the building and begin depreciating the building over its useful life. The family will have **twice taken the depreciation** for the same building, and, when they sell it, any gain is taxed as capital gain.

## Intergenerational Loan Planning

### Planning Idea 17: Use Intergenerational Loan Planning to Preserve Step-Up While Reducing Estates Taxes

- Intergenerational loan planning can reduce estate tax without having to forego a stepped-up basis.
- Let's assume a client has a \$30 million ranch with a \$10 million basis. Can we keep the ranch in the estate to enjoy the stepped-up basis and still not pay estate tax on the full amount of the ranch?
- Example: Client has a \$30 million ranch with a \$10 million basis.

Client borrows \$30 million from a bank at short-term rates and makes a long-term loan to a child for the life of the child, unsecured, at a fixed rate (long-term AFR).

Because of the low-rate and uncertain but long-duration, the note receivable would be valued at about half the loan amount, or \$15 million.

The ranch remains in the estate and gets a stepped-up basis. We have **obtained a step-up and still reduced our taxable estate** by \$15 million.

	Before	After
Assets		
Ranch	\$30,000,000	\$30,000,000
\$30M Note Receivable	0	15,000,000
Liabilities		
Note Payable to Bank	(0)	(30,000,000)
Net Worth	\$30,000,000	\$15,000,000

## Capture Capital Losses

### Planning Idea 18: Offset Capital Gains with Losses Before Client Dies

- Assets that have a basis higher than their fair market value receive a reduced basis at death, which means these built-in capital losses are lost at death.
- Example: Suppose a terminally-ill client has incurred capital gains during the year. He should dispose of the high-basis assets at a loss during his lifetime. The recognized capital losses would shelter any gains already incurred during the year.

Moreover, if the client has previously recognized net capital losses, he could then sell appreciated assets before death with no negative consequences. Net capital losses are not carried forward to the client's estate after death, so **“use them or lose them.”**

## Incomplete Gift Trust for Basis Step-up and Pass-Through Deduction

### Planning Idea 19: Use Incomplete Gift Trust to Preserve Step-Up While Reducing Income Taxes

- Under the new Tax Act, certain business owners may deduct 20% of their Qualified Business Income from pass-through businesses (the new “pass-through deduction”). The deduction is phased out for certain taxpayers beginning with income above \$157,500 (single) and \$315,000 (married).
- A way to get more QBI eligible for the pass-through deduction is to create one or more complex trusts for the benefit of your children and gift interests in the business to the trusts so that each trust’s share of income is less than \$157,500.

Each trust’s income will qualify for the pass-through deduction with a maximum **annual tax savings per trust of \$11,655** ( $\$157,500 \times 20\% \times 37\%$ ). The business owner’s income may also now be under the \$157,500/\$315,000 threshold and also qualify for the pass-through deduction.



- Normally when you make a gift to a trust, the assets are outside the grantor's estate and don't qualify for a basis step-up. However, by making the transfer an "incomplete gift," the assets will be taxed in the grantor's estate and get a basis step-up at death. For those under the lifetime exemption amount, there's no downside.

A common way to make it an incomplete gift is to give the grantor an inter vivos SPOA to appoint the trust principal to trust beneficiaries for HEMS purposes (but never to the grantor, the grantor's estate, the grantor's creditors, or creditors of the grantor's estate). Be sure that the power is limited by an ascertainable standard, such as HEMS, to avoid the trust inadvertently being a grantor trust.

Because it was not a completed gift during life, the trust assets will be included in the grantor's estate at death and **receive a basis step-up.**



## MARVIN E. BLUM

THE BLUM FIRM, P.C.  
777 Main Street, Suite 700  
Fort Worth, Texas 76102  
(817) 334-0066  
mblum@theblumfirm.com



*www.theblumfirm.com*

777 Main Street, Suite 700  
Fort Worth, Texas 76102  
(817) 334-0066

300 Crescent Court, Suite 1350  
Dallas, Texas 75201  
(214) 751-2130

303 Colorado Street, Suite 2550  
Austin, Texas 78701  
(512) 579-4060

2800 Post Oak Blvd., Suite 4100  
Houston, Texas 77056  
(713) 489-77270