



An Independent Delaware Trust Company



Step It Up For Step-Up In Basis

The IRS announced the 2015 annual exclusion amount will rise to \$5,430,000. The continued rise of the annual exclusion has made U.S. taxpayers shift their focus from estate tax planning to income tax planning. At the heart of that planning is cost basis management. If applied correctly, cost basis management could be an excellent tax saving tool. In general, basis in an asset is equal to the original cost of the asset. If 100,000 shares of General Electric Company (GE) were purchased for \$25 per share, the cost basis of those shares would be \$2,500,000. Basis is used to calculate capital gain (loss) when assets are sold. Short term gain occurs when assets are held for one year or less. Long term gain occurs when assets are held for more than a year.

John bought 100,000 shares of GE for a total of \$2,500,000 on 1/1/2015. On 8/15/2015 John sold 100,000 shares for \$5,000,000. John now has a \$2,500,000 short term gain. Let's take this same example and on 2/15/2016 John sold 100,000 shares for \$7,500,000. John now has a \$5,000,000 long term gain.

All this seems pretty simple. Assets are bought and sold, capital gain calculated, and applicable tax is paid. What some people may not realize is the Internal Revenue Code (the "Code") allows basis in an asset to be increased via a "step-up" in basis. If the situation presents itself, a step-up in basis can reduce the overall gain when an asset is sold and minimizing tax on capital gains. There are several ways a step-up in basis may occur.

Half Step-Up In Basis

Step-Up in basis usually occurs as a result of the death of the owner of a particular asset. The Code allows a half step-up in basis when an asset is jointly held between two people with rights of survivorship. A half step-up in basis is calculated by taking the FMV of the asset on the date of death, plus the original basis, divided by 2.

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Brandon J. Gingery serves as a Senior Trust Accountant as a member of our Operations Department. His primary responsibilities include the oversight of several staff accountants, preparation of trust tax returns as well as ensuring compliance for the trust accounts which Commonwealth administers on behalf of our (ultra) high net worth clientele. Brandon has more than five years of experience in the areas of corporate, individual, partnership and trust accounting and taxation.

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The half step-up in basis could lower capital gain, realized by the individual, when the asset is sold. This would lead to a lower Federal and State tax liability.

John and Mary are married. They own 100,000 shares of GE. Their basis in the shares is \$2,500,000. On 4/15/2015 John dies. The fair market value (FMV) of 100,000 shares, at the time of death, was \$5,000,000. Mary's new cost basis in 100,000 shares is \$3,750,000 $(\$5,000,000 + \$2,500,000) / 2 = \$3,750,000$. On 6/15/2015 Mary sells all 100,000 shares for \$6,000,000, resulting in a \$2,250,000 gain $(\$6,000,000 - \$3,750,000)$. A significant drop from a potential \$3,500,000 gain (if John hadn't died and sold his shares on 6/15/2015: $\$6,000,000 - \$2,500,000$).

Double Step-Up In Basis

Similar to a half step-up in basis, the Code allows a double step-up in basis. Double step-up in basis generally occurs after the death of both a husband and wife, and their assets are inherited by their children. If the husband were to die first the wife would be entitled to a half step-up in basis. Then, when the wife dies, the children would receive a step-up in basis equal to the FMV of the assets at the time of the last spouse's death. The double step-up in basis could lead to lower capital gains realized by the children and reduce possible Federal and State taxes.

John and Mary are married. They have one child. They own 100,000 shares of GE. Their basis in the shares is \$2,500,000. On 4/15/2015 John dies. On 4/15/2016 Mary dies. Upon death, the child inherits the 100,000 shares of GE. The FMV of 100,000 shares, at the time of Mary's death was \$6,000,000. The son's cost basis in the 100,000 shares is \$6,000,000. On 6/15/2015 the son sells all 100,000 shares for \$7,500,000 resulting in a \$1,500,000 gain $(\$7,500,000 - \$6,000,000)$. A significant drop from a potential \$5,000,000 gain (if John hadn't died and sold his shares on 6/15/2015: $\$7,500,000 - \$2,500,000$).

Application to Trusts

Trusts can take advantage of step-up in basis. Assets held by the trust will receive a step-up in basis, upon the death of the grantor, if the trust is includable in the grantor's estate. There are also advanced planning techniques, such as the Delaware Tax Trap, which can be utilized to trigger a step-up in basis for assets held within a trust. A trust can receive a step-up in basis if assets held by the grantor are contributed to the trust at time of the grantor's death. For instance, the grantor may decide to contribute all their shares of GE, at the time of their death, to a trust. When the grantor passes, the trust will receive a step-up in basis of the GE shares.

Future step-up in basis is available even if the trust received a step-up in basis upon initial receipt of the assets. For instance, a grantor, upon death, contributes shares of GE to a trust. The trust receives a step-up in basis of those shares. The trust continues on and the beneficiary, of the trust, holds a general power of appointment over the assets of the trust. If the trust continues to hold the shares of GE, and the beneficiary dies, the trust will receive a step-up in basis.

Advantages

There are numerous advantages to obtaining a step-up in basis. Step-up in basis encourages investors to retain assets that have appreciated in value until death. It also allows a simplistic approach in determining the correct cost basis of assets that are held for numerous years (cost basis calculations can become time consuming & difficult to track).

There are also two valuation dates that can be used when step-up in basis is determined:

1. *Date of death*
2. *Six months following the date of death.*

Choosing with option could be advantageous if the assets appreciate during the 6 month timeframe.

Please keep in mind, if the assets are sold, distributed, exchanged, etc., within 6 months after the death of the individual, the asset will be valued on date of distribution, sale, exchange, etc. The most desirable advantage is making sure double taxation does not occur. The property is already subject to the estate tax on its full value. If step-up in basis is not considered, it would subject the gain to both the estate tax and the income tax.

Pitfalls

There are also pitfalls to keep in mind. A double step-up in basis cannot occur if the assets are held jointly between the parent(s) and children. Also, if the FMV at the time of death is less than the original holder's basis, a step-down will occur. This should motivate the investor to consider selling any assets that have decreased in value prior to death.

Conclusion

A step-up in basis can become a powerful tax saving tool. A step-up can reduce Federal and State capital gains tax for individuals and trusts. However, make sure every possibility is considered before making any type of decision. Contacting a local estate attorney could provide a powerful outlet for successful estate decisions. Commonwealth Trust Company, a privately-held Delaware trust Company, can then work with your advisers to provide trustee administration solutions.



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