

TYPES NOT MAPPED YET August 07, 2019 | TTR not mapped yet | Steve B. Gorin

Basis step-up: Planning for married couples

Previously, I described key ideas used in [reducing or eliminating gain subject to tax](#) when you sell an interest in your business. For example, suppose you buy stock for \$10 and sell it for \$50. The sale generates a \$40 gain, the excess of the \$50 sale price over your \$10 purchase price. Your \$10 purchase price is referred to as your tax “basis.” However, if you die holding this stock, its basis will increase to the \$50 date-of-death value. This increase and other basis increases are referred to as “basis step-up.” (Of course, if the value at death is less than pre-mortem basis, the basis decreases, which you don’t want.) Basis changes apply to assets that are not income in respect of a decedent (IRD); the most common IRD asset would be IRAs or other retirement plans.

When a married person dies and passes assets outright or in a qualifying trust for the surviving spouse, those assets receive a new basis (hopefully a step-up instead of a reduced basis) but, due to an unlimited marital deduction, are not subject to estate tax. At the surviving spouse’s death, for estate tax purposes the assets are treated in most ways as passing from the surviving spouse, giving them a new basis again and potentially subjecting them to estate tax.

Under 2017 tax law changes, each decedent has an \$11.4 million estate tax exemption, which can be applied toward lifetime taxable gifts or used at death. That exemption is scheduled to increase for inflation through 2025, then revert to around \$6-\$7 million, which is scheduled to increase for inflation after that.

Tax law changes effective in 2013 made permanent the idea of portability. Under portability, when a decedent does not use his or her estate tax exemption, the surviving spouse adds the decedent’s unused exemption to the surviving spouse’s exemption. For example, suppose Harry died in 2019 with a \$5 million estate, leaving \$1.4 million to children and the balance to his surviving spouse, Wanda. Harry used \$1.4 million of his exemption through his bequest to his children, leaving \$10 million unused (\$11.4 million minus \$1.4 million not qualifying for the marital deduction). Thus, the deceased spouse’s unused exemption (DSUE) of \$10 million passes from Harry to Wanda.

Wanda can use Harry’s \$10 million DSUE against the assets passing from Harry to her, which start at \$3.6 million (Harry’s \$5 million estate minus the \$1.4 million passing to Harry’s children) but may grow in the future. Wanda may also use Harry’s \$10 million DSUE to make taxable gifts during her life or to pass other assets at her death. Additionally, she may use her own estate tax exemption, whether \$11.4 million or \$6 million or whatever other amount it may be from time to time, to offset taxable gifts she might make or assets she may pass at her death. Wanda is required to use the DSUE first and her own exemption later.

In the above example, portability is likely to have a great result. The \$3.6 million of assets that Harry leaves Wanda will likely be less than \$10 million when Wanda dies, allowing them to remain protected by Harry’s DSUE, avoiding estate tax and receiving a new basis – hopefully a step-up – at Wanda’s death. When I graduated law school, portability didn’t exist and the exemption was much lower, so estate planners were more concerned about protecting assets from estate tax. We would pass assets to a trust for the surviving spouse that used the first spouse’s exemption and protected any growth in the assets from estate tax – a “bypass trust” because it bypassed estate tax at the surviving spouse’s death.

Now let’s return to Wanda. If Wanda remarries and her new spouse predeceases her, she will lose any of Harry’s DSUE that remains as of her second spouse’s death (but may receive her second spouse’s DSUE). Thus, if she remarries, she needs to do some sophisticated estate planning to use Harry’s DSUE before her new spouse dies. We have ways of allowing her to lock in part or all of his DSUE while keeping access to most of the assets that Harry left her and perhaps to use his DSUE against her assets as well if she comes in for planning that is completed before her new spouse dies. These tools may or may not fully address Wanda’s concerns; I’m pretty optimistic in many cases but cannot provide assurances.

Now let's suppose that Wanda does not remarry but moves to a state that imposes its own estate tax, such as Illinois, which has a \$4 million estate tax exemption and I mention because our firm has an office there. Even if Wanda can use Harry's DSUE to save federal estate tax, she cannot use it to save Illinois estate tax, which does not apply portability. Given that Wanda has \$3.6 million of assets from Harry and assets of her own, she may be concerned about Illinois estate tax and needs to weigh that potential tax against the possible benefits of basis step-up. If she is more concerned about Illinois estate tax, she may wish that some or all of Harry's assets had passed to a bypass trust instead of using Harry's marital deduction.

When we draft Harry's estate plan, we don't know what his and Wanda's estates will look like when he dies. If when we draft they live in my home state of Missouri (which does not have an estate tax), we don't know whether they might move across the river to Illinois one day (but that may be easier to predict than their assets or changes that politicians make). As Yogi Berra said, "It's tough to make predictions, especially about the future."

Ideally, we would be able to decide shortly after Harry's death whether to use the unlimited marital deduction, whether to use only a bypass trust, or some combination. My favorite way to do that is to take advantage of the qualified terminable interest property (QTIP) election. Harry's estate plan passes all of his assets to a Marital Trust. On an estate tax return filed up to 15 months after Harry's death (9 months plus a 6-month extension), Wanda can make a QTIP election to qualify none, part, or all of the Marital Trust for the marital deduction. To the extent that she does not make the QTIP election, the trust is taxed the same as a bypass trust, and my documents call that a Nonqualified Marital Trust.

If these ideas intrigue you, consider calling me or, if you are a CPA, lawyer, trust officer, family office professional, or financial advisor, subscribing to my free quarterly "[Gorin's Business Succession Solutions](#)" newsletter. My second quarter 2019 newsletter discussed and included links to many aspects of basis step-up planning. The last segment of my free webinar July 23, 2019 presented those ideas.

This article is not intended to provide legal or tax advice. Please consult an appropriate professional to advise you whether these ideas might help your particular situation.

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