

Leveraging to Attain Basis Step-Up; Income Tax Benefits of Losing an FLP Case

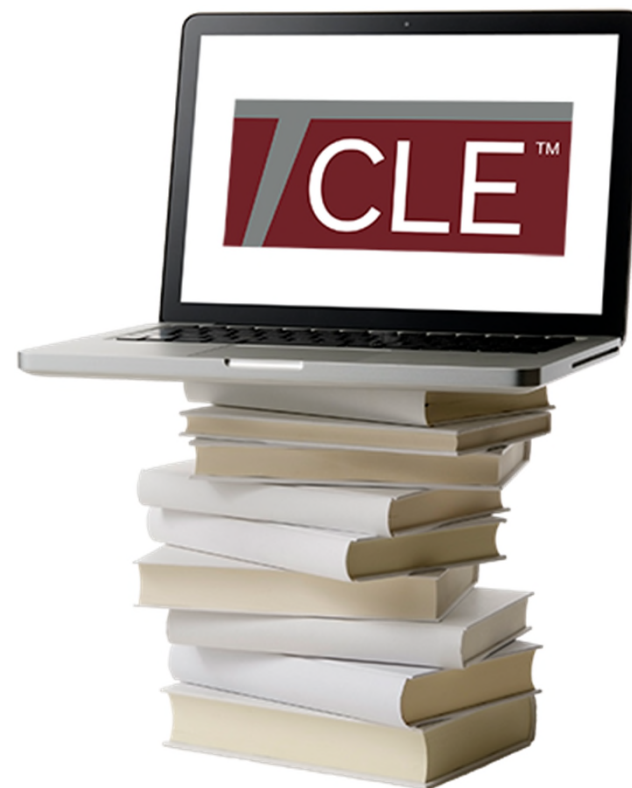
Steve Gorin

sgorin@thompsoncoburn.com

314.552.6151

<http://thompsoncoburn.com/people/steve-gorin>

<http://thompsoncoburn.com/insights/blogs/business-succession-solutions>



WELCOME

Overview

- Leveraging to Attain Basis Step-Up
- Income Tax Benefits of Losing an FLP Case

Leveraging to Attain Basis Step-Up

- Why use leverage to obtain basis step up at little or no estate tax cost
- How to strip all of the equity out of a low basis asset using a commercial loan
- Using similar transaction when low basis property is in trust

Leveraging to Attain Basis Step-Up

- When assets are included in the decedent's estate for estate tax purposes, they receive a new tax basis
- Probate estate, revocable trust, marital deduction trust for surviving spouse all create this results

Leveraging to Attain Basis Step-Up

Multiple Depreciation Opportunities

- Original owner depreciates his or her investment
- When first spouse dies, no estate tax on assets passing to surviving spouse, and stepped-up basis obtains depreciation deductions of the new basis
- When surviving spouse dies, possible estate tax, and another stepped-up basis lets children depreciate new basis

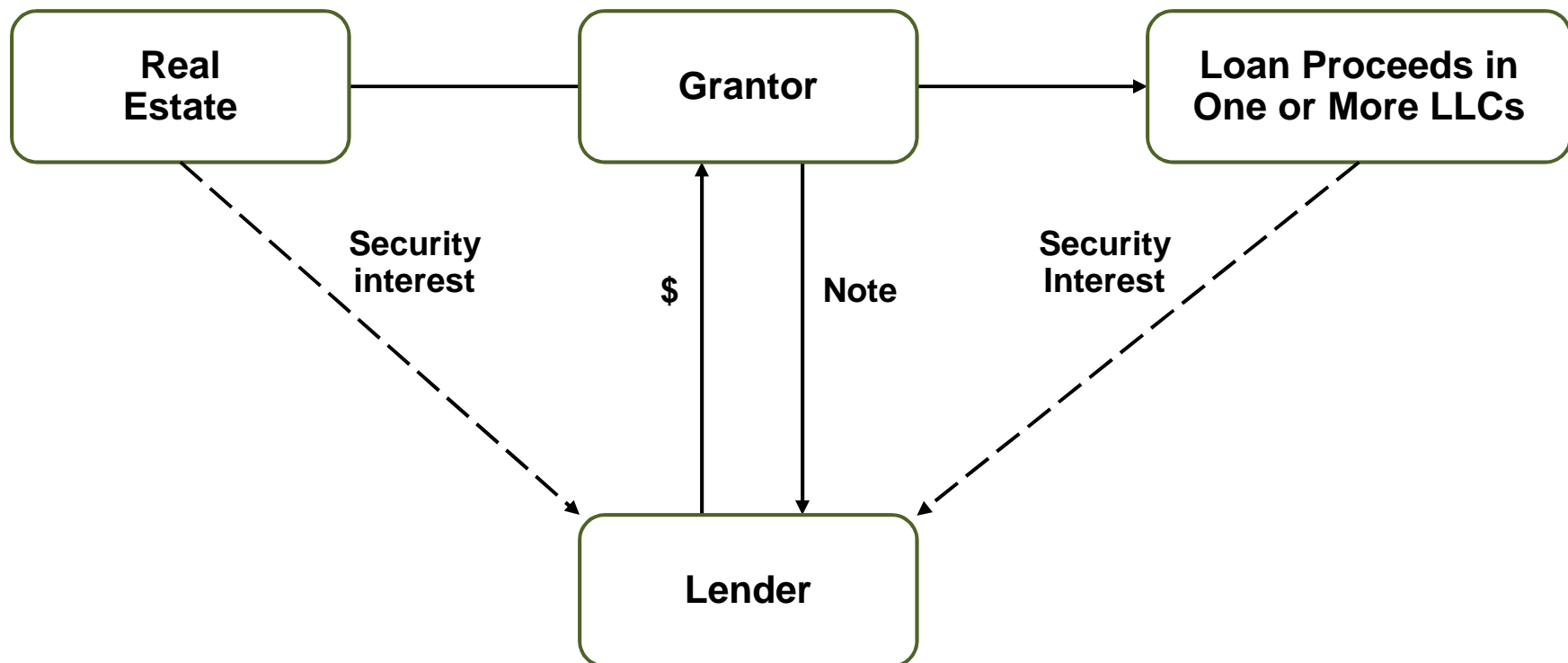
Leveraging to Attain Basis Step-Up

- Normally, one cannot borrow all of the equity in an asset
- Here, a \$10M loan against the \$10M asset and maintain a security interest in the \$10M proceeds, for \$20M collateral
- When loan proceeds are transferred using advanced estate planning techniques, make sure the security interest stays intact

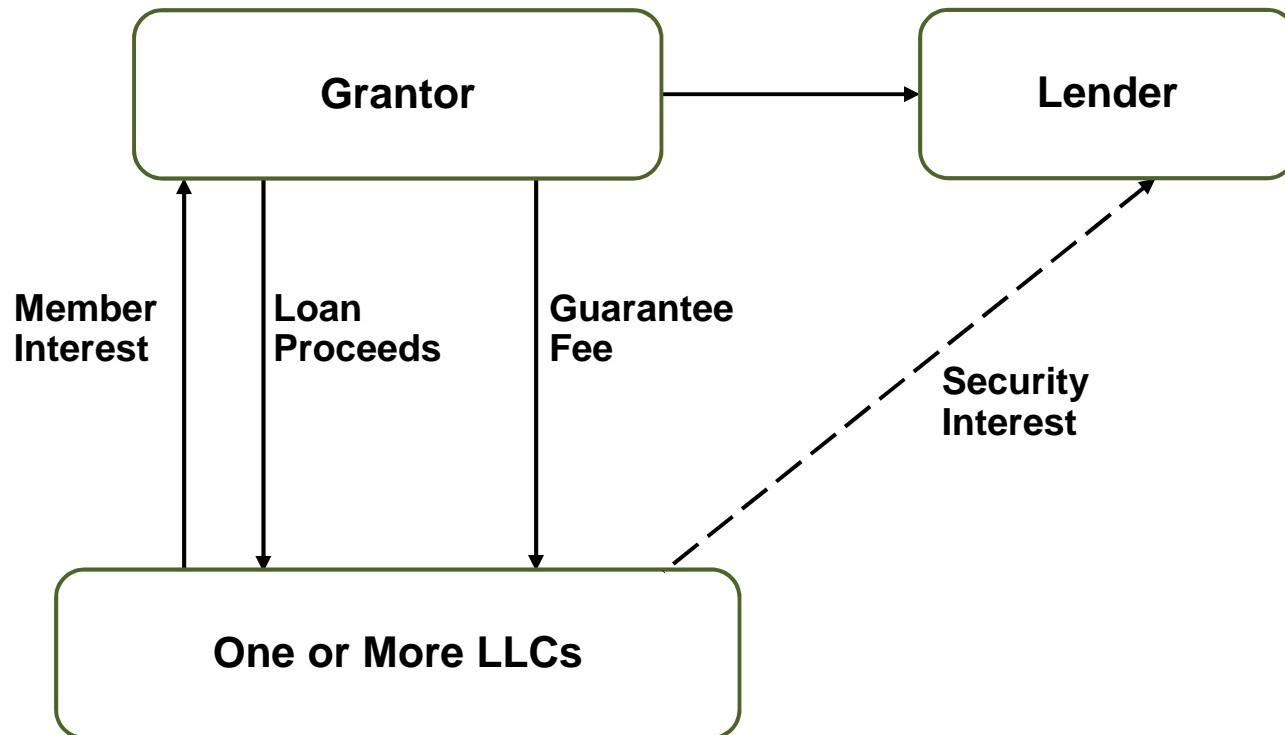
Leveraging to Attain Basis Step-Up

- Normally, one cannot borrow all of the equity in an asset
- Here, a \$10M loan against the \$10M asset and maintain a security interest in the \$10M proceeds, for \$20M collateral
- When loan proceeds are transferred using advanced estate planning techniques, make sure the security interest stays intact

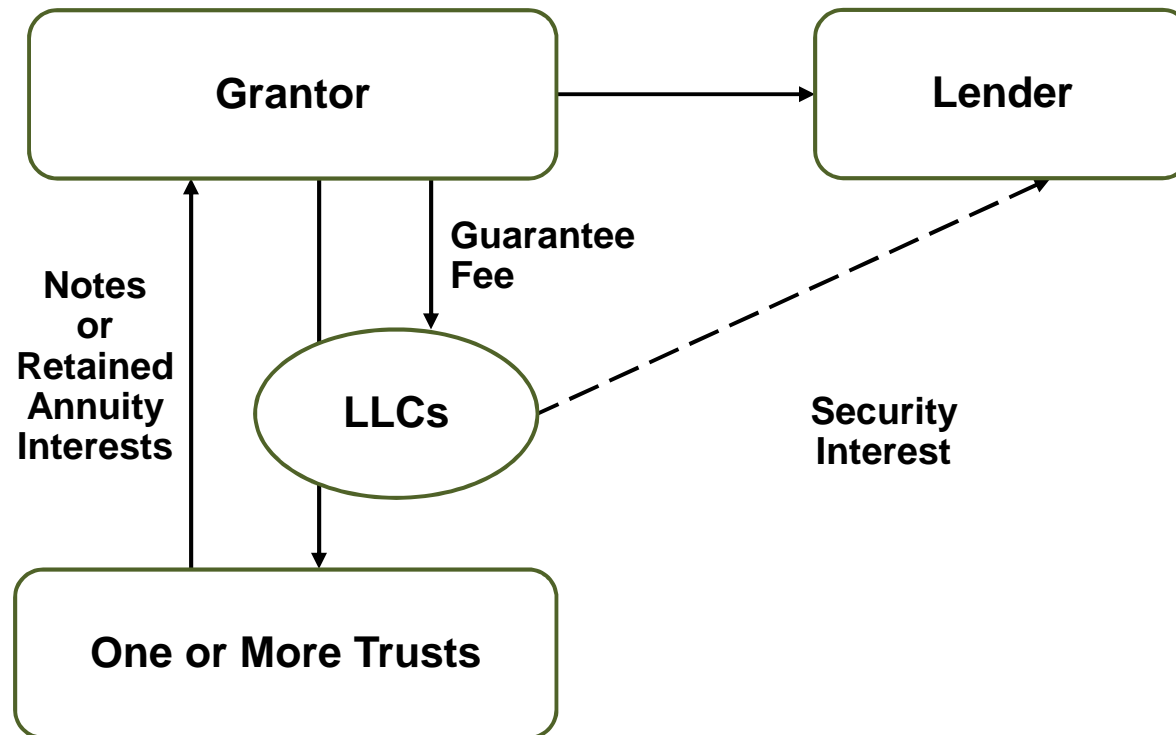
Real Estate Equity Strip: Initial Strip (II.H.10.e.i.)



Real Estate Equity Strip: Placing Loan Proceeds Into Entity (II.H.10.e.ii.)



Real Estate Equity Strip: Transfer of Loan Proceeds (II.H.10.e.iii.)



Practical Lending Strategy

- To the extent possible, make interest payments only, so that the debt can keep the taxable estate low
- Cash flow from real estate would be the primary source of repayments
- Leveraged estate planning techniques also return funds for repayment
- Extract more equity later if possible

Result of Lending Strategy

- Basis step-up
- Minimal estate tax
- Bank's security interest is protected
- Less post-mortem pressure on business client

Leveraging to Attain Basis Step-Up

- Disadvantage of irrevocable trust is no basis step-up
- Buy back assets for note; may need to convert trust to grantor trust if not one
- Question of basis if seller-financed by trust
- Use tactics similar to just described

Leveraging Marketable Securities

Prepaid variable forward contract (II.A.1.e.)

- Borrow from financial institution
- Pledge assets but have option to repay using assets
- Rev. Rul. 2003-7 approved open transaction treatment

Leveraging Marketable Securities

Open Transaction Treatment

- No gain unless settle contract using noncash assets
- Because not sure whether pledged assets will be used, the assets are not income in respect of a decedent (IRD)
- Therefore, basis step-up

Leveraging Marketable Securities

Estate of McKelvey v. Commissioner,
148 T.C. No. 13 (2017)

- Decedent extended contract due date
- Court rejected IRS claim that transaction closed when extended
- Presumably basis step-up on pledged assets; loan might have been used to buy assets from irrevocable trust

Income Tax Benefits of Losing an FLP Case

- Taxpayer loss in *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (May 18, 2017), shows how risky family business entities can be when not running a business
- Automatic inside basis step-up for assets regardless of entity, as illustrated by a recent case

Income Tax Benefits of Losing an FLP Case

Hurford Investments No 2, Ltd. v. Commissioner, Tax Court Docket No. 23017-11 (4/17/2017)

- IRD asset contributed to partnership triggered gain that partner failed to report; statute of limitations ran
- Court held that asset became capital estate, even though gain not reported

Income Tax Benefits of Losing an FLP Case

Hurford (continued)

- Partnership included in estate when partner died (prior court action)
- Court held that partner's estate received an automatic basis step-up on the partnership's assets
- Court held that Code § 1234A provided LTCG treatment

Conclusion

- October 31 webinar for Third Quarter Newsletter
- Blog: [Business Succession Solutions](#)
- Reports on Heckerling:
<http://www.thompsoncoburn.com/forms/gorin-heckerling>