IMMEDIATE PRE-MORTEM ESTATE PLANNING

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I. PRELIMINARY CONSIDERATIONS

A. Introduction - Immediate pre-mortem estate planning involves difficult situations for both the client and the estate planning professional, as time is short, the stress levels are high and the client may not be making thoughtful and/or rational decisions. However, the opportunity exists to accomplish the client's wishes and greatly improve things for the client's beneficiaries. For a good non-tax resource on elder law issues, see *Colorado Senior Law Handbook* (Colorado Bar Association, 2019), available for free as a PDF download at http://www.cobar.org/seniorlawhandbook.

B. Life Expectancy - For purposes of this outline, the client will be deemed to have a short (and often indeterminate) life expectancy, typically ranging from a few days to a year.

C. Client Physical, Psychological and Family Issues

1. The client must be psychologically ready and willing to participate in the estate planning process. To get an idea of the psychological issues that the client is

experiencing and stages they are going through, consider reading the book *On Death and Dying* (1969), by Dr. Elisabeth Kubler-Ross.

a. Denial - "No, not me. It can't be!"

b. Anger - "Why me?"

c. Bargaining - "OK, but please..."

d. Depression - "Poor, poor me!"

e. Acceptance - Calm, peace, reflection, acceptance.

f. Hope - Hope runs through all of the above 5 stages of grieving, even if it is merely the hope for a dignified death.

2. The client must be physically and mentally able to participate in the estate planning process, perhaps with special accommodations.

a. The planner may have to travel to the client to get the estate planned and the documents signed.

b. The planner may have to catch the client when he or she is not overly medicated (or otherwise find a good time of the day).

c. The planner may need to bring the witnesses and a notary to the client's location to get the documents signed and witnessed.

d. The planner may need to take steps to validate the client's competency, perhaps with an evaluation by a medical professional.

3. Hopefully the client's family is supportive and not overreaching.

D. Planner Professional Responsibility Issues

1. Who is the client?

2. Are there conflicts of interest that need to be addressed?

3. Is the client legally competent?

4. Is the client being unduly influenced?

5. Available Resource - See *Commentaries on the Model Rules of Professional Conduct*, Fifth Edition (ACTEC, 2016), available for free PDF download at http://www.actec.org/publications/commentaries/.

E. Available Resource - Consider acquiring the book *Pre-Mortem Estate Planning Checklist*, Second Edition (ALI-ABA, 2003) by Edward S. Schlesinger and Robert D. Howard, for useful coverage of many relevant issues (although it is not updated for recent tax law changes).

II. PLAN FOR LIFETIME NEEDS

A. Advanced Medical Directives and Guardianships

1. Stand-alone HIPAA release - A document that allows medical professionals to disclose otherwise confidential medical information to the designated party, but does not allow such person to make medical decisions for the patient.

2. Durable medical power of attorney - A document that allows the designated person to make medical decisions for the patient regarding what treatment is or is not to be administered.

3. Living will (a/k/a "declaration as to medical or surgical treatment" in Colorado) - A declaration by a person indicating that, if comatose and terminal, heroic measures should not be used to prolong life.

4. "No Code" or DNR (Do No Resuscitate), DNI (Do Not Intubate), DNH (Do Not Hospitalize), and POLST (Physician Orders for Life Sustaining Treatment) - instructions issued or approved by a medical professional relating to end of life treatment.

5. If a person is unable to effectively make and communicate their own decisions relating to medical and personal matters and no effective advanced medical directives are in place, then a court appointed guardian may become necessary.

B. Day-to-Day Living Assistance - There are many available options other than nursing homes to assist a client with day-to-day living needs, including adult day care, home care agencies, care managers, home hospice visitation, meals on wheels, home grocery delivery, ordering necessities from Amazon Prime, etc.

C. Resources, Asset Management, and Bill Paying Options

1. Available Resources - What cash, health insurance, disability insurance, salary continuation benefits, long-term care insurance or VA benefits does the client have?

2. Informal arrangements - Often finances can be simply handled by autopay of bills, having someone prepare checks for the client's signature, a second signer on the bank account, using a bill payment service, a child or friend having computer access to financial accounts, etc.

3. Durable powers of attorney - Durable limited and general powers of attorney can empower another person to handle financial matters.

4. Conservatorships - A court appointed and supervised conservator may manage the finances of a person who has not otherwise effectively planned for bill paying, asset management, etc.

5. Revocable trusts - A revocable trust can be used for asset management and bill paying if funded by the client or by others on the client's behalf via a power of attorney.

D. Plan for Last Arrangements

1. Who should be notified?

2. What information should be in the obituary?

3. What services are desired?

4. Is the client a veteran, and if so, is use of veteran funeral or burial benefits desired?

5. Is the client to be buried or cremated, and what should be done with the remains or cremains? Determine the client's desire re a gravesite or mausoleum, and for a gravestone or marker.

6. Does the client have burial insurance or pre-need arrangements?

7. Does the client want to be an organ or tissue donor, or is there a desire to harvest sperm or preserve a DNA sample?

III. PLAN FOR IMMEDIATE POST-MORTEM ISSUES

A. Care of Living Things - Will there be a need for immediate care of children, pets, livestock, plants, etc.? Is the client acting as guardian for someone else and, if so, should alternative arrangements be made?

B. Safeguarding of Assets - Will there be a need to immediately safeguard assets (house sitter, remove valuable assets from house, etc.) or provide for business continuity?

C. Immediate Liquidity - Will surviving dependents have immediate access to cash?

D. Planning for Asset Sales - Should arrangements be made to facilitate the immediate post-death sale of volatile assets?

IV. GATHER PERTINENT INFORMATION AND DOCUMENTS

A. Get People Information

1. Family tree, including deceased relatives. You want to be able to identify the client's heirs-at-law for purposes of the required probate proceeding disclosures and notices.

2. Useful relationship information - Stepchildren, adopted children, illegitimate children, common law marriages, prior marriages and divorces, relevant deceased descendants and other relatives, new biology issues (stored sperm, stored eggs, etc.).

3. Professional advisors - Lawyers, accountants, bankers, financial planners, life insurance agents, etc.

B. Get Asset and Liability Information

1. Get balance sheet showing assets and liabilities. Get information to verify exactly how title is held where relevant.

2. Get life insurance policies and verify beneficiary designations.

3. Get retirement plan information and beneficiary designations.

4. Any safe deposit boxes or safes?

5. Any hidden assets, such as cash, gold, jewelry or foreign bank accounts?

6. Any documented or undocumented loans payable or receivable?

7. Any documented or undocumented outstanding charitable pledges?

8. Any oral contracts outstanding?

9. Any pending business deals, asset purchases or sales, etc.?

10. Any outstanding pending or possible lawsuits?

11. Any prenuptial agreements, post-nuptial agreements, cohabitation agreements, or prior marriages?

12. Any history of gifts made or prior gift tax returns?

13. Any history of residence in a community property state? See IRC ¶2014(b)(6).

14. Any inheritances received within past ten years? See IRC ¶2013.

15. Any pre-1977 spousal joint tenancies where tracing of contribution might be helpful? See Gallenstein v. U.S., 975 F.2d 286 (6th Cir. 1992);

16. Any unclaimed property being held by a state for the client's benefit?

17. Any old jobs where there may be benefits payable at death?

18. Is the client a beneficiary of any trusts or estates?

19. Are there any old family assets trusts where the title to assets may not have been properly cleaned up?

C. Locate and Safeguard Documents

1. Wills and codicils.

2. Memorandum dispositions of tangible personalty.

3. Prenuptial, postnuptial and cohabitation agreements.

4. Trusts and trust amendments.

5. Powers of attorney.

6. Advanced medical directives.

7. Burial deeds, burial insurance, pre-need contracts, and veterans discharge papers.

8. Life insurance policies (on self or others) and annuity contracts.

9. Physical stock certificates.

10. Car titles.

11. Real estate deeds, abstracts and title insurance policies.

D. Get Other Information

1. Where are the keys (to houses, businesses, cars, safes, safe deposit boxes, etc.)?

2. Where are any safes and what are the safe combinations?

3. What are the alarm codes and passwords?

4. What are the computer account user ID's, passwords and security questions?

5. What comments and instructions does the client have concerning the management and sale of assets, people to trust or not trust, etc.

6. Is there family history and reminiscences, or a statement of values (i.e., ethical will), that should be perpetuated (perhaps in recorded audio form), pictures that should be labeled, etc.?

7. Does the client hold any positions that need to be dealt with (e.g., as an officer, director, general partner, LLC manager, guardian, conservator, personal representative, trustee, etc.)?

8. Does the client have contacts with multiple states that may raise questions concerning the client's domicile?

V. REVIEW EXISTING TESTAMENTARY ESTATE PLAN

A. Existing Documents - Review and, if needed, update all existing estate planning documents, including wills, trusts, powers of attorney and advanced medical directives.

B. Asset Titles - Check all asset titles to ensure that they are as wanted.

C. Beneficiary Designations - Check all beneficiary designations to ensure that they are as wanted.

D. Building in Flexibility - The client may feel unsure or uneasy about the decisions being made which become irrevocable and unalterable at the client's death, so it may be desirable to build flexibility into the estate plan.

1. Trustees can be given a great deal of discretion to manage and distribute the assets.

2. Beneficiaries (or others) may be given powers of appointment to later amend the dispositive provisions of trusts.

3. Trust protectors can be named to later make amendments to trusts or take other actions (such as hiring and firing trustees).

VI. OVERVIEW OF CURRENT RELEVANT TAX ISSUES

A. Current Income Tax Rates - The 2019 maximum federal income tax rate is 37% for individuals; it applies to single individuals with taxable income in excess of $510,300 and married individuals (filing jointly) with taxable income in excess of $612,350. The 2019 maximum federal income tax rate of 37% applies to trusts and estates with taxable income in excess of $12,750.

B. Current Estate Tax Exemption - In 2019, a flat 40% federal estate tax applies to taxable estates in excess of $11,400,000. Colorado has no separate state death tax. Additionally, the portability election allows the unused estate tax exemption (but not the

unused GST tax exemption) of a deceased spouse to be transferred or "ported" to the surviving spouse.

C. Planning Impact of Recent Tax Law Changes

1. **Historically the federal estate and gift tax laws impacted many clients (i.e., the exemption was lower and the rates higher than now) and saving transfer taxes by keeping assets out of one's taxable estate at death was the primary tax planning objective of the estate planner**.

   a. Use of lifetime gift tax exclusions (i.e., the annual exclusion and the exclusion for certain payments of medical and tuition expenses).

   b. Use of the unified gift and estate tax exemption.

   c. Use of valuation discounts (for lack of marketability, lack of control, fractional interests, etc.) and value shifting techniques (such as GRITs, GRATs, QPRTs, installment sales, etc.) to cause future growth in asset values to occur outside of the grantor's/donor's estate.

   d. Use of grantor trusts (to allow the grantor/donor to pay income taxes on gifted property held in such a trust without such payment being a gift for gift tax purposes).

   e. Use of marital deduction planning at the death of the first spouse (i.e., the first spouse to die creates a trust for the surviving spouse, called a family trust, credit shelter trust or

B trust) with available estate tax exemption, with excess assets passing to or for the surviving spouse in a way that qualified for the marital deduction. The amount in family trust at the surviving spouse's later death, including appreciation in such trust's value during the surviving spouse's lifetime, escaped taxation at the second death. The estate tax was deferred on assets qualifying for the marital deduction until the surviving spouse's death.

2. Such techniques to minimize and defer estate taxation in the estates of the husband and wife had an income tax detriment, as **assets kept from being included in a decedent's taxable estate at death retain their historic cost basis and do not get their basis adjusted to FMV (hopefully a stepped-up basis) in a decedent's estate**.

3. Higher estate tax exemptions and portability cause far fewer clients (in fact a small fraction of 1% of decedents) to be subject to federal estate and gift taxes, so techniques to keep assets out of one's taxable estate at death are no longer the game plan in most estates - instead, **in the vast majority of client situations where estate and gift taxes will not be due, the new primary tax planning objective is to have assets included in a decedent's taxable estate at death so that their historic cost basis will be adjusted to FMV**.

VII. INCOME TAX AND BASIS IMPLICATIONS OF NON-CHARITABLE GIFTS

A. Introduction - In order to appreciate why the planning techniques to be discussed matter, it is essential to understand the income tax rules impacting lifetime gifts.

B. Income Shifting Opportunities

1. Income shifting has been made less useful and more difficult in recent years by bracket compression, kiddie tax, trust throwback rules (albeit with limited application now), prohibitions against multiple trusts, and the elimination of many income shifting devices (Clifford trusts, Rushing trusts, spousal remainder trusts, etc.).

2. Little is gained by shifting taxable income to a trust. For 2019, a trust's taxable income will be taxed as follows: at 10% on the first $2,600, at 24% on the next $6,700, at 35% on the next $3,450, and at 37% on amounts in excess of $12,750. The 3.8% tax on net investment income will also apply to trusts in the top income tax bracket.

3. Many factors besides bracket differential may impact the amount of tax savings achieved through income shifting, including the kiddie tax rules, trust throwback rules, the limitations on various deductions (medical expenses, charitable deductions, casualty losses, miscellaneous itemized deductions, etc.), the phase out of itemized deductions impacting high income taxpayers, capital and net operating loss carry forwards, phase out of the $25,000 real estate exception to the PAL rules.

C. Income Tax Consequences to Donor

1. Any income generated on gifted property after the date of the gift is shifted from the donor's income tax return to the donee's income tax return (unless the donee is a grantor trust).

2. Any unrealized gain in appreciated gifted property becomes the donee's problem (as the donee receives a carryover basis) unless the gift itself is characterized as a taxable disposition triggering gain to the donor (such as is the case of a gift of an installment obligation).

3. Gift loans (i.e., those containing a below market rate of interest) cause the lender to have imputed interest income for income tax purposes, subject to a de minimis rule. IRC §7872.

4. Where a "net gift" is made (i.e., the gift taxes on the transfer, which are the legal obligation of the donor, are instead to be paid by the donee), the donor will realize gain to the extent the gift tax paid exceeds the donor's adjusted cost basis in the property. <u>Diedrich v. Commissioner</u>, 643 F.2d 499 (8th Cir. 1981).

5. Where a gift is made of property subject to nonrecourse indebtedness, the donor will realize gain to the extent that indebtedness exceeds the basis of the property. <u>Winston F.C. Guest</u>, 77 T.C. 9 (1981). The "amount realized" is equal to the outstanding balance of the nonrecourse obligation, and the fair market value of the property is irrelevant to the computation. <u>Tufts v. Commissioner</u>, 103 S.Ct. 1826 (1983).

6. The transfer of an installment obligation by lifetime gift will constitute a disposition and cause an acceleration of the deferred gain for income tax purposes. IRC §453B.

7. The transfer of a passive-activity asset by lifetime gift does not trigger the recognition of suspended passive activity losses. IRC §469(j)(6).

D. Income Tax Consequences to Donee

1. Donee's gross income does not include the value of property acquired by gift, bequest, devise or inheritance. IRC §102(a).

2. Donee's gross income does include the income derived from any property acquired by gift, bequest, devise or inheritance (unless the donee is a grantor trust). IRC§102(b)(1).

3. Gross income does include the amount of such income where the gift, bequest, devise or inheritance is of income from property. IRC §102(b)(2).

4. In the case of the gratuitous forgiveness of indebtedness, the Code contains conflicting provisions relating to whether the donee has received gross income. IRC §§61(a)(2) and 102(a). It has been held that the forgiveness of indebtedness which is a true gift made gratuitously and with donative intent is not included in gross income. Helvering v. American Dental, 318.U.S. 322 (1943).

5. Gift loans (i.e., those containing a below market rate of interest) cause the borrower to have imputed interest expense for income tax purposes. IRC §7872.

E. Adjusted Basis of Property Gifted During Life

1. The donee of property which is received in a lifetime gift transaction where no gain is recognized receives such property with a carryover of the donor's cost basis and acquisition date. IRC §1015.

2. The basis of gifted property is increased for pre-1977 gifts by the gift tax paid. For gifts made after 1976, the basis of gifted property is increased by that portion of the gift tax paid attributable to the donor's net appreciation in the gifted assets. IRC §1015.

> **Example:** Assume that the donor gives stock having a basis of $200 and a fair market value of $1,000 to a child, and pays $400 of gift tax. The basis adjustment for the gift tax paid is [(1,000 minus 200)/1,000] times $400, or $320. The donee's basis becomes $200 plus $320, for a total basis of $520.

3. The basis of gifted property is increased (but not to above fair market value) by generation-skipping transfer taxes paid. IRC §2654. This basis adjustment for GST taxes paid is applied <u>after</u> the basis adjustment for gift taxes paid pursuant to IRC §1015.

4. Any suspended passive activity losses attributable to a gifted asset are added to the donee's adjusted cost basis and benefit the donee (although a dual basis may exist, and such addition to basis, to the extent it causes basis to exceed the fair market value of the property at the time of the gift, will not benefit the donee in a loss transaction). IRC

§469(j)(6).

Example: Assume that the donor has an asset with a fair market value of $100, an adjusted cost basis of $70, and a suspended PAL of $40. When the asset is gifted, the donee will have a $100 basis for loss purposes and a $110 basis for gain purposes.

5. For purposes of determining loss in a subsequent sale of a gifted asset by the donee, the donee's basis cannot exceed the fair market value of the gifted property at the time of its receipt by the donee. IRC §1015.

Example: Assume the donor gives stock having a basis of $1,000 and a fair market value of $200 to a child. the stock will have a dual basis (i.e., a $1,000 basis for gain purposes and a $200 basis for loss purposes).

F. Basis Adjustments at Death

1. General Rule - The basis of property acquired from a decedent generally becomes the fair market value of that property at date of death unless one of the exceptions outlined below applies. IRC §1014.

2. Property Acquired From a Decedent

a. Property in Which the Decedent Had an Interest - Any property owned by the decedent (i.e., probate property) is caught under this provision. IRC §2033.

b. Dower or Curtesy Interests - The estate cannot ignore property which the surviving spouse can demand under

dower, curtesy, or other state law provisions creating statutory or elective property rights. All of the decedent's property is thus included, although an offsetting marital deduction may be allowed. IRC §2034.

c. Gifts Made Within Three Years of Decedent's Death - Certain property and rights no longer held by the decedent are taxed as part of the decedent's estate, including life insurance on the decedent's life where incidents of ownership were given away within three years of the decedent's death, gift taxes on gifts made within three years of the decedent's death, and property in which the decedent released a IRC §2036, 2037, or 2038 power or interest within three years of his or her death. IRC §2035.

d. Transfers With Retained Life Estate - Property given away by the decedent is nevertheless included as a part of the decedent's estate where the use of (or income from) such property was retained until the decedent's death. IRC §2036.

e. Transfers Which Take Effect at Death - Property given away by the decedent is nevertheless included as a part of the decedent's estate where the decedent retained a reversion worth more than 5% and someone else can get the

property by surviving the decedent (i.e., donor to beneficiary for life, remainder to donor if then living, otherwise to beneficiary's descendants). IRC §2037.

f. Revocable Transfers - Property given away by the decedent is nevertheless included as a part of the decedent's estate where the decedent retained a prohibited power to alter, amend, or revoke the transferred property until the decedent's death. Property given away by the decedent is nevertheless included as a part of the decedent's estate where the decedent retained a reversion worth more than 5% and someone else can get the property by surviving the decedent (i.e., donor to beneficiary for life, remainder to donor if then living, otherwise to beneficiary's descendants). IRC §2038.

g. Annuities - Annuities (including IRAs and other qualified plan benefits) passing to another at the decedent's death which arose from contributions made by the decedent (or an employer on behalf of the decedent) are included in the decedent's estate (although such assets will usually constitute income in respect of a decedent and get no basis step-up). IRC §2039.

h. Joint Interests - Some portion of property in which the decedent has an interest as a joint tenant (or tenant by the entirety) is included in the decedent’s estate. IRC §2040.

i. Powers of Appointment - Property over which the decedent held too broad a power of appointment (as defined in this section) will be deemed owned by the decedent for estate tax purposes. IRC §2041.

j. Proceeds of Life Insurance - The proceeds of life insurance on the decedent’s life where the decedent held a so-called “incident of ownership” is included in the decedent’s estate for estate tax purposes. IRC §2042.

k. Transfers for Insufficient Consideration - Some portion of an asset otherwise included in the decedent’s taxable estate may be excluded if a third party co-owner contributed separate funds towards the acquisition or maintenance of such property. IRC §2043.

l. QTIP Property - The assets in a QTIP marital trust established by a prior spouse of the decedent for the decedent’s benefit are taxable as assets of the decedent at the decedent’s death. IRC §2044.

3. Exceptions to General Basis Rules

a. Alternate Valuation Exception - If alternate valuation has been elected under IRC §2032, the IRC §2032 value becomes the new basis. IRC §1014.

(1) Alternate valuation can only be elected where the gross estate and estate tax due are both reduced as a result of the election.

(2) If alternate valuation is elected, all estate assets are subjected to the alternate valuation rules (i.e., no “pick and choose”).

(3) Alternate valuation causes the value of the assets six months after date of death to be used, unless the assets are disposed of or distributed sooner, in which case their value at such earlier date of disposition or distribution is used.

(4) Joint tenancy property is treated like probate property for alternate valuation purposes. Death (and the resulting passage of ownership to the surviving joint tenant) is not a disposition for alternate valuation purposes, but the subsequent disposition (by gift or sale) by the surviving joint

tenant within the six months after the decedent's death is such a disposition. Rev. Rul. 59-213, 1959-1 CB 244.

b. Special Use Valuation Exception

(1) If special use valuation has been elected under IRC §2032A, the §2032A value becomes the new basis. IRC §1014.

(2) If the special use property is disposed of so as to result in additional estate tax being due, making an election is necessary to increase the property's basis to its date of death value. IRC §§1016(c)(1) and 1016(c)(5)(B); Treas. Reg. §301.9100-4T(f). If no election is so made, there is no adjustment to the property's basis. Conf. Rept. No. 97-215 (PL 97-34), p. 251.

(3) It should be noted that no similar provision applied to the former IRC §2057 qualified family-owned businesses receiving a valuation break (that provision is structured as an exclusion, rather than as a deduction), so such qualified family-owned businesses did get full date of death fair market value basis.

c. Exception for IRD Items

(1) Items of income in respect of a decedent under IRC §691 are not entitled to stepped-up basis at the decedent's death. IRC §1014©. Examples of such items include traditional IRA and pension plan proceeds, renewal commissions, deferred compensation, and installment notes receivable.

(2) The basis of a partnership interest acquired from a decedent is the date of death (or alternate) value, increased by the estate's (or other successor's) share of partnership liabilities and reduced by the income in respect of a decedent attributable to such partnership interest. Treas. Reg. §1.742-1.

(3) The basis of S corporation stock is date of death or alternate value, reduced by the income in respect of a decedent attributable to such stock. IRC §1367(b)(4), effective with respect to decedents dying after August 20, 1996.

(4) Certain lifetime constructive sales, amounting to hedging (constructive sale) transactions, such as going "short against the box" during lifetime in order to lock in profit and pull out cash, will no

longer be able to be closed out income tax free after death, as the pre-death portion of the gain will be considered IRD taxable to the estate or other successor. TRA '97, §1001(d)(3), adding IRC §1259, effective (with complex exceptions) to constructive sales made after June 8, 1997.

d. Exception for Qualified Conservation Easement - A carryover of the decedent's income tax cost basis will occur with respect to that portion of a property which is excluded from the decedent's estate by reason of a qualified conservation easement. TRA '97, §508, amending IRC §§170,1014, 2031, and 2032A, effective for decedents dying after 1997.

e. Exception for Certain Recently Gifted Property - Property received as a gift by the decedent within one year of the decedent's death which is gifted by the decedent back to the donor will not receive an adjustment to basis by reason of the decedent's death. IRC §1014(e).

f. Exception for Previously Gifted Property

(1) Property gifted during lifetime that is nevertheless included in the decedent's estate for estate tax purposes (such as IRC §§2035, 2036, 2037, or 2038

property) will be entitled to an IRC §1014 basis adjustment by reason of the decedent's death, but the transferee must reduce such new date of death basis by any depreciation, depletion, or amortization taken by such transferee. Treas. Reg. §1.1014-3(d).

(2) Conceptually difficult issues are raised when previously gifted property included in the decedent's estate (such as IRC §§2036, 2037, or 2038 property) has been sold and reinvested in something else prior to the decedent's death. For estate tax purposes, the original property is deemed included in the decedent's estate. But if it has been sold, can the donee file an amended income tax return and claim the date of death value as the adjusted basis? See Humphrey's Estate v. Commissioner, 162 F.2d 1 (5th Cir), cert. denied, 332 US817 (1947); Rev. Rul. 72-282, 1972-1 CB 306.

g. Exception for Certain Spousal Joint Tenancies

(1) The current rules relating to estate taxation of joint tenancy interests provide that one-half of a spousal joint tenancy asset is included in the deceased

spouse's estate under IRC §2040, which results in the deceased spouse's one-half of the asset having its basis adjusted under IRC §1014 and the surviving spouse's one-half of the asset being left with its historic cost basis.

(2) Prior to 1982 (pursuant to TRA '1981), the portion of a spousal joint tenancy asset included in the deceased spouse's estate was determined with reference to the deceased spouse's relative contribution to the acquisition of the asset (the so-called "tracing of contribution" test). Accordingly, before 1982 as little as 0% or as much as 100% of a spousal joint tenancy asset might have been included in the deceased spouse's estate under IRC §2040 (and have its basis adjusted in IRC §1014).

(3) The case holds that the TRA '1981 amendments to IRC §2040(b)(2) did not repeal the effective date of IRC §2040(b)(1), the net impact of which is to still apply the tracing of contribution rules to spousal joint tenancy assets acquired before 1977. See Gallenstein v. U.S., 975 F.2d 286 (6th Cir. 1992); Patten v. U.S., 116 F3d 1029 (4th Cir., 1997);

Anderson v. U.S., 78 AFTR 2d 96-6557 (DC MD 1996), and Hahn v. U.S., 110 TC 14 (1998).

h. Exception for Community Property Interests

(1) The survivor's one-half interest of community property, as well as the decedent's one-half interest in such property, gets new basis (equal to the fair market value of such assets) at the decedent's death. IRC §1014(b)(6).

(2) It is thus essential to ascertain whether or not the decedent and his or her spouse ever lived in one of the community property states (i.e., Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin) or Puerto Rico, and if so, if community property was thereby created (and subsequently preserved) --- even if the client resided in a non-community property state at death. Additionally, Alaska and Tennessee have adopted an elective form of community property.

(3) Historically a married couple had to live in a community property state in order to create community property in such state. That is apparently no longer the case in Arizona, so your

Colorado clients may be able to own their Arizona home as community property.

i. Property acquired from a decedent prior to 1954 may be subject to a number of special basis transitional dates dealing with changes in the law. IRC§1014(b).

4. Other Basis Issues

a. The applicable date for determining fair market value is "as of" the decedent's date of death, unless alternate valuation date is elected under IRC 2032. The appropriate values will appear on the Form 706. An appraisal is the best evidence of value unless the asset is sold to a third party in an arms length sale taking place shortly after death.

b. Successors to the decedent's property are entitled to new basis even if no estate tax was due by reason of the decedent's death. The fiduciary should obtain an appraisal or other proof to support the new cost basis even if no Form 706 is required (i.e., even if the decedent's gross estate totals less than the estate tax exemption-equivalent).

c. Be mindful of the need to recompute future depreciation, depletion, and amortization relative to assets (or that portion of an asset) included in the decedent's gross estate for federal estate tax purposes. Such assets will get a new

basis and date of acquisition after the decedent's death, which may also result in a new useful life and method of depreciation as to such asset (or portion of an asset). Consider electing cost depletion where appropriate.

d. A partnership (or other entity taxed as a partnership, such as an LLC) may elect to adjust the inside basis of its assets to reflect the outside basis adjustment occurring by reason of a partner’s death. IRC §754.

e. The death of a beneficiary due undistributed appreciated assets as beneficiary of another estate may or may not result in such undistributed assets having their basis adjusted, depending upon which authority you believe. Compare Manufacturers Hanover Trust Company v. U.S., 410 F.2d 767 (1969) and Connecticut National Bank v. U.S., 937 F.2d 90 (1991).

f. It has been suggested that husband and wife can create a single trust with their collective assets (called a "joint spousal trust”), wherein the first to die has a general power of appointment over the entire trust, with the result that all of their collective assets will have their basis adjusted to fair market value upon the death of the first spouse to die. The IRS has ruled that this doesn’t work. PLR 200203045.

VIII. SO WHAT DO WE DO?

A. Traditional Estate Tax Techniques - If the client (or client and surviving spouse combined) will have an estate tax problem, the traditional techniques (use of gift exclusion, creation of discount opportunities, utilizing long-term trusts to avoid future estate taxes in beneficiary estates, etc. will still apply). Inasmuch as few clients will now be in such a situation, the focus of this Section VIII will instead be on income tax saving opportunities.

B. Maximize Income Tax Benefits

1. Retirement Plan Contributions - Maximize deductible contributions to retirement plans prior to death.

2. Accelerate Certain Charitable Gifts - Make charitable gifts planned to be made at death instead as lifetime gifts, so as to both get a charitable income tax deduction for such gift and remove such gifted property from the taxable estate. Charitable gifts at death may be taken as an estate tax deduction, but are not entitled to be taken as an income tax deduction.

3. How Satisfy Testamentary Charitable Gifts - The client making charitable gifts of cash at death in his or her will may wish to instead designate specific property to satisfy charitable gifts, such as IRA proceeds, pension benefits, other items of income in respect of a decedent (such as zero basis crops in storage, renewal commissions receivable, and installment notes receivable). The charity won't have to pay income tax upon receipt of the cash from such items, but family members would.

4. Which Spouse makes Charitable Gifts - Have the expected surviving spouse make large charitable contributions, so that any carryforward of unused charitable deductions will carryforward to future tax returns of the surviving spouse.

5. Realize Tax Losses - Realize losses to the extent usable to offset gains (plus $3,000), as the basis of loss property is stepped down to its fair market value at the client's death. IRC §1014. Passive activity loss assets must be disposed of to a third party in a taxable transaction to utilize suspended passive activity losses that would otherwise be lost at death. IRC §469(g).

6. Sometimes Accelerate Income - Accelerate income to avoid wasting tax benefits, such as where net operating losses, charitable deductions, unused investment tax credits, unused capital losses, or other tax benefits exist that will be lost upon the taxpayer's death. Ideally, such tax benefits will be used to offset the tax liability from items of income in respect of a decedent which will not qualify for stepped up basis at death (such as pension benefits, renewal commissions receivable, and installment notes receivable). The client could accelerate income by electing out of installment sales treatment on sales, collect pension and IRA proceeds while still alive, elect to be taxed on accrued E and EE bond interest, etc.

C. Maximize Income Tax Cost Basis

1. Retain Appreciated Property - The dying client will want to retain appreciated property that will be entitled to stepped up basis at death. IRC §1014.

2. Cancel Installment Sales - The client who has recently entered into a large installment sale of an asset may wish to terminate the sales agreement and reacquire or retain the property in order to avoid the loss of stepped up basis at death on an IRD item.

3. Distribute Trust Assets to Dying Client - If the client is beneficiary of a trust (such as a family trust created by a former spouse) and such trust contains appreciated assets, try to find a way to get the low basis assets into the client’s name (via a distribution to the client or termination of trust in favor of the client).

4. Finalize Pending Trust Distributions - If the client is the beneficiary of a distributable but yet undistributed trust containing appreciated property, accelerate the distribution of such trust to get the appreciated assets into the client's name. The death of a beneficiary due undistributed appreciated assets as beneficiary of another estate may or may not result in such undistributed assets having their basis adjusted, depending upon which authority you believe. Compare Manufacturers Hanover Trust Company v. U.S., 410 F.2d 767 (Ct. Cl. 1969) and Connecticut National Bank v. U.S., 937 F.2d 90 (6th Cir. 1991).

5. Grantor Trust Issues - If grantor trusts are in existence, have the client/grantor exercise the swap power in order to put full basis assets in the trust and get back low basis assets to be in the client's estate. Also, if an installment sale of appreciated assets was made to a grantor trust, have the trust payoff the note prior to the grantor's death.

6. Undo Discount Arrangements - Undo prior estate planning steps that will result in unwanted discounts. This may include dissolving partnerships, reacquiring controlling interests in corporations, buying partial interests in real estate to eliminate fractional interest discounts, etc.

7. Dying Client Might Receive Gifts - The dying client without an estate tax problem (i.e., because his or her gross estate is under $11,400,000 (in 2019), or because the marital deduction will be used to eliminate the estate tax) may wish to receive gifts of appreciated property prior to death. Such property will be entitled to stepped up basis at the decedent's death unless reacquired by the transferor by inheritance within one year. IRC §1014(e). It appears that such property could be given to the dying spouse by the other spouse within one year of the dying spouse's death and qualify for stepped up basis if such property were left to a wholly discretionary family trust.

D. Minimizing Basis Step-Down at Death

1. Gift Loss Assets - A client may wish to make gifts of loss assets during life, to the extent that the client cannot utilize such losses during life. The donee will have bifurcated basis for gain and loss purposes and can thus have such asset subsequently appreciate in the donee's hands and avoid some gain that would otherwise be taxed to the donee upon later disposition of such asset. IRC §§1014 and 1015.

2. Sell Loss Assets to Related Party - Loss Assets can be sold to a related party, even a spouse, and the purchaser will have a bifurcated basis as in the previous paragraph.

3. Loss Assets in Marital Trust - Assets with unrealized losses held in a marital deduction trust will have their cost basis adjusted downwards (to fair market value) at the death of such trust's beneficiary. IRC §§1014; 2041; 2044. But if such losses are realized prior to the beneficiary's death, they will be preserved for succeeding beneficiaries and, if not used within the trust, will pass out to the ultimate beneficiaries upon termination of the trust. IRC §642(h).

E. Structuring or Rearranging Business Interests

1. Require an IRC ¶754 Election - Where an interest in a partnership holding appreciated assets is owned, it will be beneficial to negotiate to require the partnership to make an IRC §754 election so that an inside basis adjustment can be made pursuant to IRC §743(b) upon the death of a partner. In the alternative, it may be possible to achieve the same result (i.e., stepped up basis) under IRC §732 if a liquidation of the partnership or sale of the partnership's appreciated assets can be accomplished within two years of the deceased partner's death.

2. Negotiate Short S Corporation Tax Year - S corporation shareholders are taxed on their pro rata share of income, deductions, and credits for the year of death on their final Form 1040. However, an option exists to prorate the income on a per day basis, or to close the books upon a shareholder's death and use an exact method. IRC §1366. In the case of a seasonal business it

may be desirable to agree in a shareholder agreement which method is to be used.

3. Plan to Maintain S Corporation Tax Status - Certain individuals and trusts do not qualify to hold stock in an S corporation, and the client's estate plan must be carefully examined to assure that S corporation stock will pass to a qualified shareholder upon the client's death. Generally, a Qualified Subchapter S Trust (QSST) must have a single beneficiary during such beneficiary's lifetime and must distribute all of its accounting income on an annual basis. IRC §1361.

F. Rearrange Joint Tenancy and Community Property Interests

1. Sever Certain Joint Tenancies With Non-Spouses - It may be desirable to sever certain joint tenancies between owners who are not married to each other. This is because IRC §2040, dealing with the taxability of joint tenancy interests between owners who are not married to each other, requires a tracing of contribution.

2. Sever Certain Joint Tenancies Between Spouses

   a. Current tax rules now in effect provide that one-half of property held by husband and wife as joint tenants is included in the estate of the first spouse to die and that the deceased spouse's one-half interest is subject to having its basis adjusted. IRC §§1014 and 2040.

   b. However, it has held that joint tenancy property acquired by a husband and wife prior to 1977 is subject to the pre-1977 rules which require a tracing of contribution to determine what portion of it is included in the deceased spouse's gross estate and subject to basis adjustment. Gallenstein v.

United States, 91-2 USTC ¶60,088 (D.C. Ky. 1991), affirmed 92-2 USTC ¶60,114.

c. Accordingly, pursuant to Gallenstein (and District Courts in the Patten and Anderson cases in the 4th Circuit), if husband and wife have loss property acquired prior to 1977 which is held by them as joint tenants, and if the spouse who is about to die contributed most (or all) of the consideration, then it will be desirable to destroy the joint tenancy prior to death in order to preserve more basis in the hands of the survivors. Likewise, if the client who is about to die made no contribution to the purchase of appreciated pre-1977 property, an application of Gallenstein would suggest that such joint tenancy ownership should be terminated prior to such spouse's death in order to allow basis step-up to occur that would otherwise be denied.

3. Create Community Property With Appreciated Separate Property - It may be desirable to convert appreciated separate property into community property if the client is married and lives in a community property state (or to convert appreciated separate property to community property via the Alaska elective community property statute and an Alaska trust). Tennessee has a similar law. This will be appealing because under IRC §1041 the conversion of separate property to community property is not a taxable event, and under IRC §1014(b)(6) both the decedent's interest and the survivor's interest in community

property has its basis adjusted to fair market value at the death of either spouse.

4. Partition Community Property Which Has Depreciated - Conversely, it may be desirable to convert depreciated community property into separate property if the client is married and (because they lived in a community property state at some time) has community property. This results because IRC §1014(b)(6) results in a stepped down basis adjustment for both halves of community property at the death of either spouse, and such a conversion to separate property will allow the surviving spouse to perpetuate his or her higher historic cost basis in property which has declined in value.