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DEATH AND TAXES:

When the Wealthy Unexpectantly Perish

December 08, 2020
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"Let me tell you about the very rich. They are different from you and me."
The Rich Boy, by F. Scott Fitzgerald, 1926.

If there is one absolute certainty in life, it is one day all of us will have our last day. The unfortunate reality is that death does not just come calling for the aged and infirm. Every day in the United States thousands of people die from causes that are not natural, such as auto accidents, accidental poisoning (mostly drug and alcohol related), falls, drowning, boating and aircraft accidents, and even animal attacks. Some years ago, not far from this author's home in Southern California a jogger was killed by a mountain lion. Not long after this incident, another runner was killed by an alligator in Florida. In fact, Florida seems to have more than its share of gruesome unnatural deaths. In 2013, Jeffrey Bush, a 37-year-old resident of Hillsborough County, Florida, was at home in bed, and a giant sink hole swallowed the entire house—with him in it. They never found the body.

In the vast majority of cases involving sudden deaths, Federal Estate Tax is not an issue due to the current $11.58[1] Million Estate Tax exemption (as of the date of this writing) that is granted to each natural person[2]. Most people do not have estates that come anywhere near this amount. But what of the ultra-wealthy? Those 1/10 of one percent who fly through rarified air at 40,000 feet in their private Gulfstream

[1] Rev. Proc. 2019-44
[2] On October 26, 2020, the IRS announced that the Estate Tax Exemption will increase to $11.7 Million per individual for 2021 (Forbes.com, 10-26-2020), Rev. Proc. 2020-45

and Lear Jets and take their summers in the Hamptons? What happens when they make their final exit without the chance to say goodbye? At least as far as Federal Estate Taxes are concerned the answer may be—not much. On the other hand, it may be—quite a lot. Which answer applies to any particular case depends on the quality and quantity of the estate planning done by the recently departed.

What follows are two scenarios, the first being a case where virtually no estate planning was in place at the date of death. The second assumes that there was at least some modest planning in place to protect the inheritance of the first-to-die spouse's children in the event the surviving spouse remarries. In both cases we will assume the deceased is married with children. We will assume that net marital estate is $100 Million, which is well above the current Estate Tax exclusion of both spouses combined.

CASE 1: NO ESTATE PLANNING DONE (ALL TO THE OTHER)

Ricky, a famous band leader was on an overnight boating trip with his wife, Lucy. Having had a little too much to drink Ricky decided to go topside for a little air. While strolling the deck he slipped and fell banging his head on a piece of nautical equipment protruding from the deck. By the time he was discovered, he was already dead.

Prior to 1982, this could have been an estate planning disaster. Back in those days, there was no Unlimited Marital Deduction, so one-half of the marital property, and 100% of the deceased spouse's separate property was immediately subject to Estate Tax. Also, the Estate Tax Exemption was quite low, just $175,000. As such, it was not just a matter of the super rich who were caught in the grasp of the Estate Tax. This often resulted in the surviving spouse losing the family business, farm, or even home. However, even back then there were a variety of ways the Estate Tax could be mitigated. One of the most common was the liberal use of life insurance so as to ensure there was enough cash available to cover the Estate Taxes.

In 1982 Congress took a major step toward Estate Tax reform when it passed legislation allowing for an Unlimited Marital Deduction between spouses.[3] Thus, if the first-to-die spouse left all of his or her property to the surviving spouse, there would be no Federal Estate Tax on the death of the first spouse. This is still the law as of the date of this writing. Therefore, as odd as it may sound, even with almost no estate planning, it is possible that under the current Federal Estate Tax regime, the unexpected death of an ultra-wealthy married individual may result in no Federal Estate Tax liability because of the Unlimited Marital Deduction. However, in such a case, the assets of the deceased spouse will be subject to Estate Tax at the death of the surviving spouse, assuming he/she has not otherwise disposed of them. As such, the Estate Tax has not been avoided, but merely postponed—sometimes to the detriment of the combined estate of both spouses.

[3] IRC Section 2056(a)

For example, suppose Ricky owned stock in a technology startup company called WECU. At the time of his death, the WECU stock has a Fair Market Value of $1 Million. If the stock is passed to Lucy (his surviving spouse) using the Unlimited Marital Deduction, there will be no Estate Tax due on the transfer.

Suppose Lucy survives Ricky by 40 years and dies when the Fair Market Value of the stock is $1 Billion. Assuming no interim estate planning by Lucy, the Estate Tax on the WECU stock under the current rules would be $400 Million. Had Ricky simply made provision to use $1 Million of his $11.58 Million basic exclusion amount to place the stock in an irrevocable trust, or even passed the stock directly to his children, all of the stock's appreciation during Lucy's remaining lifetime would bypass her estate, and the Estate Tax on the stock at her death would be zero instead of $400 Million.

To give the other side of the equation a fair shake, removing assets from the estate before they appreciate can be great for saving Estate Taxes, but can have negative consequences in terms of income taxes.

The upside to including assets in the taxable estate at death is that they will receive a Step Up in Basis for income tax purposes. To continue with the above example, if the WECU stock was included in the estate of the 2nd to die spouse with a Fair Market Value of $1 Billion, it would generate an Estate Tax of $400 Million, assuming the current Estate Tax regime is still in place.

Assume that Lucy leaves the stock to her two children Fred and Wilma. After the taxes are paid and the estate is closed, they decide they no longer wish to retain ownership of the WECU stock. They subsequently sell the stock for its Fair Market Value, which has held at $1 Billion since Lucy's death. Many people might think Fred and Wilma will pay a whopping Capital Gain tax on the sale of this stock. In fact, they will pay no Federal taxes whatsoever—Capital Gain or otherwise.

When an asset is included in the taxable estate of the decedent it receives a Step Up in Basis to its Fair Market Value for purposes of determining gain on its sale.[4] Basis is simply the tax term for what is considered to be your investment in the property for tax purposes. In the above example since the WECU stock was included in Lucy's taxable estate at its Fair Market Value of $1 Billion (thus generating $400 Million in Estate Tax), Fred and Wilma's basis in the stock will be $1 Billion. If their basis is $1 Billion, and they sell the stock for $1 Billion—they have a taxable gain of zero. A taxable gain of zero, means they pay zero income tax.

The Step Up in Basis rule exists to mitigate what would otherwise be double taxation on the sale of appreciated assets previously subject to the Estate Tax, at least for larger estates. However, the Step Up in Basis rules apply to both large AND small estates. For estates that do not exceed the current lifetime gift and Estate Tax exclusion the planning often centers on keeping assets of $11.58 Million in the estate

[4] IRC Section 1014

to obtain a Step Up in Basis to reduce the gain on a subsequent sale by the beneficiaries.

In other circumstances the planning emphasis may be on removing the assets from the estate prior to death so as to avoid the Estate Tax. At first glance this may appear to be an easy call since the current Federal top Capital Gains tax rate is effectively 23.8% (20 percent Capital Gains plus 3.8% Net Investment Income Tax)[5] and the Estate Tax is 40%.[6] Since the estate tax is almost double the effective Capital Gains tax, it would seem the Estate Tax is the one to avoid. However, in states that have no Estate Tax and high Capital Gains tax rates, the gap between Capital Gain tax and the Estate Tax is much narrower. For example, California has no Estate Tax, and Capital Gains are taxed at the same rate as ordinary income at up to 13.3%. The top effective Federal Capital Gains rate of 23.8% plus the California effective Capital Gains rate of 13.3% equals 37.1%. Thus, in California the margin between the Federal Estate Tax and the combined Federal and State effective Capital Gains tax has narrowed to only 2.9% (40% - 37.1%). As this article goes to press the California Legislator is considering raising the tax rate on top earners by 3.5%. Thus in California, the combined Federal and State effective Capital Gains Tax would exceed the Estate Tax.

As a result, Estate Planners for the wealthy will continue to struggle with the historic question—is it better to remove the assets from the estate and avoid the 40% Federal

[5] Rev. Proc.2018-57, IRC Section 1411
[6] 26 U.S. Code Section 2001

Estate Tax, or allow the assets to remain in the estate and achieve the Step Up in Basis to mitigate the Capital Gains tax when the assets are sold?

For those in the 1% who would not be considered super rich, with estates under $11.58 Million per spouse, the decision to remove assets from the estate to avoid Estate Tax, or hang onto them to achieve a Step Up in Basis is generally much easier. Since there would be effectively no Estate Tax on the estate (as of the date of this writing), keeping the assets in the estate to achieve the Step Up in Basis would generally be the best move. This is as close as it gets in tax law to "having your cake and eating it too"—no Estate Tax, and most likely no Capital Gains tax if the assets are disposed of shortly after the death of the surviving spouse. In fact, for married couples with estates under $23.16 Million ($11.58 Million x 2) there is an added bonus known as Double Step Up in Basis on the death of the first spouse.[7] In this instance marital assets held as community property receive a full Step Up in Basis on the death of the first spouse, and then again on the death of the surviving spouse. For example, suppose that Barney and Betty are married, and they buy 100 shares of stock in Boulder Mining Company for $1,000 and hold it as community property. Five years later Barney dies at which time the stock is worth $10,000. Since the stock is community property, Betty's basis in it becomes $10,000. If Betty sells the stock a month later when its value is $10,050, she will only recognize $50 in taxable gain ($10,050 - $10,000). Even though the stock appreciated $9,000 from the date of purchase until the date of Barney's death, the resulting economic gain is not taxed.

[7] IRC Section 1014(b)(6)

This rule applies to all assets held as community property: stock, real estate, jewelry—everything. For depreciable assets used for the production of income (i.e. Real Estate Rental Property), the basis for depreciation gets boosted up to the Fair Market Value of the property at the date of death of the first spouse, and the surviving spouse gets to take additional depreciation deductions at the higher value of the property. This is a tax windfall for the surviving spouse that is sometimes missed by people who do not have Tax Advisors who are familiar with this area of the tax law. It is important to note that the Double Step Up in Basis rules only apply in Community Property states, of which there are only seven (7) in total, including California. In non-community property states the surviving spouse generally will receive a partial Step Up in Basis for property that was included in the deceased spouse's estate.

The Double Step Up in Basis for community property is a tax benefit that is enjoyed by all taxpayers—even the super rich. Take for example the case of Steve Jobs. Since Jobs started Apple literally in his parents' garage, it is safe to assume his basis in the stock was nil. When he died in 2011, his estimated net worth was $7 Billion. At the time of his death Jobs and his wife were residents of California. If he had placed all of his assets in community property and left his share to his wife, had she so desired, she could have sold everything the day after he died and walked off without paying a penny in Federal or State Income Tax. This is not a bad result considering the only estate planning that would have been necessary to achieve it would have been placing everything in community property and leaving it to his spouse.

This so called “All to the Other” approach is possible because of the Unlimited Marital Exemption previously mentioned. It has the advantage of being simple to implement, avoids the Estate Tax on the death of the first spouse, and gives the surviving spouse the option of selling off assets with little or no tax burden.

There are however disadvantages to this approach. For openers, all of the assets of both spouses may end up being included in the taxable estate of the second to die spouse. If the assets exceed the combined basic exclusion amount of $23.16 Million (as of the date of this writing) then the overage will be subject to Estate Tax. Also, one should be aware that the basic individual exemption amount is scheduled to drop down to $5 Million per person (adjusted for inflation) after December 31, 2025. This means that a married couple will have a combined exemption of only $10.0 Million ($5 Million in the case of an individual) instead of the $23.16 Million available today. Married couples as well as individuals with estates likely to exceed $10 Million and $5 Million respectively, and who plan of living beyond December 31, 2025, should understand that they are in a position of “use it or loose it” with respect to the relatively large exclusion that exists today. Short of dying, one obvious as well as simple way would be to make gifts to friends and relatives. There are other more sophisticated estate planning moves available, but they all take time, and the clock is ticking.

In short, the “all to the other”” approach has the advantage of no hassle simplicity, but it piles all of the marital assets into the estate of the surviving spouse, wherein a greater portion may ultimately be subject to the Estate Tax due to appreciation. This is especially true for the super rich for whom the basic exclusion amount of $11.58 Million is mere pocket change.

There are also considerations that go beyond taxes. Leaving the entire marital estate to the surviving spouse means the assets will be subject to financial predators as well as the surviving spouse’s creditors. Perhaps most worrisome of all is the scenario where the surviving spouse remarries, has children with spouse number two, and the children of the deceased spouse find themselves disinherited.

CASE 2: QTIP TRUST TO THE RESCUE

One way to avoid this problem would be for the first-to-die spouse to leave his share of the marital estate in trust for the children. This also has the advantage of removing the future taxable appreciation out of the marital estate and thus avoiding Estate Tax on these assets on the death of the second spouse. However, there are significant downsides to this approach, the most obvious of which is the assets will not be available for the support and enjoyment of the surviving spouse. Furthermore, it may be at best cumbersome, and at worst impossible as a practical matter to separate the marital assets because doing so could create potential adversarial interest. This is especially true where complex ownership structures are in place,

which are often the case with closely held businesses, professional sports teams, and the like.

One possible solution to the problem is to set up a special type of trust known as a QTIP Trust. QTIP stands for Qualified Terminal Interest Property. QTIP Trust can be complicated and may vary somewhat depending on the particular post death wishes of the first-to-die spouse. However, the basic theme of a QTIP Trust is that it allows the first-to-die spouse to leave his or her share of the marital estate in trust for the benefit of the surviving spouse, within certain limits. Upon the death of the surviving spouse the remaining assets are passed onto the beneficiaries of the QTIP Trust—usually the children of the first-to-die spouse. Thus, a QTIP Trust meets the need of ensuring that the surviving spouse has access to the entire marital estate for his or her care. At the same time it provides some protection against the depletion of the assets over the remaining lifespan of the surviving spouse, and at least some assurance that the assets of the first-to-die spouse will eventually be passed onto his or her children or other designated beneficiary.[8]

Upon the death of the surviving spouse whatever assets remain in the QTIP trust will be included in his or her taxable estate at Fair Market Value. Therefore, if the assets have appreciated since the death of the first spouse, and the overall estate exceeds whatever basic exclusion amount is in place, a QTIP Trust might result in substantially

[8] IRC Section 2056(b)(7) and 2044(a)

more Estate Tax being paid than would otherwise be the case. On the other hand, the assets that remain in the QTIP Trust receive a Step Up in Basis upon the death of the surviving spouse. Thus, planners for large estates will still be faced with the question of: Is it better to remove the assets from the marital estate at the death of the first spouse even if it means paying some immediate Estates Tax; or is it better to place the assets in a QTIP Trust and risk paying more Estate Tax at the death of the surviving spouse, but receive a Step Up in Basis on the death of the surviving spouse? If the combined estate is clearly below the basic exclusion amounts, the latter will probably be the best choice. For the super rich with estates far above the basic exclusion amounts, the issue is more complex, and may ultimately be driven by a combination of both tax and nontax issues. It should be noted that a QTIP Trust is not necessary to delay paying estate tax on the assets of the first-to-die spouse until the death of the surviving spouse. This can easily be done by taking advantage of the Unlimited Marital Deduction as previously mentioned. The QTIP Trust takes estate planning to the next level by holding the assets in trust for the beneficiaries, while allowing the surviving spouse to receive income (and perhaps limited distributions of principle) from the QTIP Trust. At the death of the surviving spouse the assets that remain in the QTIP Trust are included in his/her taxable estate, and ultimately distributed to the beneficiaries.

For example, assume that Lucy and Ricky have an estate valued at $100 Million at the time of Ricky's death. All property is held in community property. Prior to his death Ricky had arranged, as part of his estate planning, for his share of the

community property to go into a QTIP Trust. The Trust provides that Lucy is to be given all of the income generated by the property in the Trust for life. The Trust also provides for limited distributions of principle at the discretion of the Trustee for Lucy's health and other support needs. At Lucy's death any assets that remain in the Trust will be distributed to their children, Fred and Wilma. Thus, even if Lucy remarries and has additional children by husband number two, Ricky's children by Lucy are protected from being disinherited from Ricky's share of the community property placed in the Trust upon his death.

At Lucy's death, whatever assets remaining in the QTIP Trust will be included in Lucy's taxable estate even though they will be distributed to Fred and Wilma. Lucy's estate will be responsible for paying the Estate Tax attributable to these assets but will have the right to be reimbursed from Fred and Wilma. This could certainly take a bite out of their inheritance, but at least they will have whatever remains after the taxes are paid, which is far preferable to having been disinherited. Thus Ricky, even though he has been dead for many years, has managed to provide some financial security for his children from beyond the grave.

The Take Away

With the advent of the Unlimited Marital Deduction, large Basic Exclusion amounts, and the Portability of the Unused Basic Exclusion amount of the first-to-die spouse,

the unexpected death of a spouse will probably not be the tax disaster that it could be in times past.

Even for the super rich, the sudden demise of a spouse may not have any immediate tax cost—in fact, it might even have a tax benefit from the Step Up in Basis of the assets in the marital estate. The real cost of the lack of planning may not be realized until years later upon the death of the surviving spouse. Unlike death, which often has a knock that is loud and sudden, the sound of tax planning opportunity knocking may be faint and take place over many years. Listen closely for it, and don't waste the day, for the days are numbered for us all.

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