FRONTIER
INVESTMENT MANAGEMENT COMPANY®

FRONTIER
INVESTMENT MANAGEMENT COMPANY

ALL ABOUT THAT COST BASIS

Cost basis, also referred to as "tax basis" in the lexicon of tax and investment professionals, can be a highly effective tool in reducing your overall tax burden both during your lifetime and that of your heirs. Basis has become more relevant since the federal estate exclusion has skyrocketed up to $11.4 million per person (2019 figure), especially to those who intend to leave assets for the next generation. Most estate plans prior to 2010 were designed to focus on estate tax minimization since the estate tax rates were more onerous in the past. However, with much higher federal exclusion amounts and a reduction in the estate tax from 55% down to 40%, U.S. taxpayers should be more concerned with efficiently utilizing their cost basis properly across account types.

Top Ten Practical Cost Basis Tips

1) Cost basis establishes how much gain will be realized upon sale of a capital asset. There is a reduced tax rate on long-term capital gains and qualified dividends. There are three long-term capital gains rates depending on a filer's taxable income – zero, 15% or 20%. Keep in mind the 3.8% Net Investment Income Tax could add to the tax rate at the highest income brackets. There is often a misinterpretation that the lower tranche of gain is not taxed. However, Form 1040 calculates gains in such a manner that all other forms of income drive up the applicable capital gain bracket.

2) Other than very rare situations, all tax-deferred assets (i.e. 401k, profit sharing plan, traditional IRAs including SEP and SIMPLE, qualified annuities) are considered "IRD" assets – Income in Respect of Decedent. There is no official cost basis for income tax purposes even though you may see a cost basis field on account statements referencing the price paid for a security. Any appreciation in these accounts, whether interest, dividend or growth, will ultimately be taxed at marginal ordinary income tax rates to you or beneficiary.

3) Under the U.S. Internal Revenue Code, certain types of property held by a taxpayer at death receive a basis adjustment to fair market value on the date of death. This applies to an individual (non-retirement) account with unrealized gains at date of death that receives the "step up." These assets include real estate, ownership of business entities, accounts solely in the decedent's name and investment accounts with a joint holder (usually a pro-rata basis adjustment, state specific rules apply). Please note - your custodian does not automatically adjust basis when a notice of death is given. You should work with your advisor to see that this task occurs. The end result is that during the settlement process there should not be onerous capital gains tax that would erode the proceeds. Some assets such as real estate or oil and gas interests may require an appraisal to obtain this value while market traded securities are easier to capture. While these values may still be subject to federal estate taxes (above the applicable exclusion amount), there would be no capital gains or income taxes on the vast appreciation to the decedent or heirs. Note: there may be gains or losses based on value changes from actual death of death to the date sold and distributed by executor/trustee.

4) While the step up in cost basis can be extremely valuable to minimize taxes paid, the opposite holds true. Unrealized loss positions expire with the decedent and can't be recognized following death. By adhering to a financial planning process, these tax efficiencies can be maximized as various assets fluctuate in value throughout your lifetime.

5) If an account receives a basis adjustment, that means years (or decades) of growth can escape taxation each to the original account holder and to their heirs. Even if positions need to be monetized to provide cashflow, long-term capital gains rates are preferential to ordinary income rates. For these reasons, we recommend holding long-term stocks, mutual funds or equity ETFs in after-tax accounts so that any unrealized gains at death can escape taxation. Further, holding more aggressive positions in a non-deferred account would also enable a taxpayer to deduct any resulting market losses during their lifetime. You are not able to deduct market losses within tax-deferred accounts.

6) More growth-oriented investments should be made in an account where a basis adjustment will apply. Conversely, higher income based and less volatile securities like fixed income, corporate or treasury bonds would be best held in tax-deferred accounts to defer income and limit the amount of appreciation ultimately taxed to the taxpayer and/or heirs at top marginal ordinary income tax rates.

Next Generation – Legacy Planning

7) Be mindful in your estate distribution plan to fully maximize basis adjustment accounts to family heirs and IRD assets to charities. We often find when reviewing a new client's estate plan that charities and churches are listed under the Last Will and Testament as a specific bequest, which is paid out of the general estate. It may make more sense to allocate a portion of a Traditional IRA to a qualified charity since they are exempt from federal income taxes. This way more of the overall assets would go to your heirs with the minimum amount of income tax paid.

8) While not technically a cost basis topic, the use of Roth IRAs are extremely valuable in a family legacy plan. Assuming there are multiple assets and accounts available for distribution over a range of beneficiaries, consider naming grandchildren directly on ancillary Roth accounts that may have smaller account values. You may not fully recognize the extreme power of tax-free growth and future distributions over the full lifespan of a grandchild. Note: current laws force a required minimum distribution after the primary account owner's death. But, distributions are allowed to be stretched over the life expectancy of each beneficiary, so the younger the better.

9) Understand how certain assets or accounts can be transferred or retitled during life to maximize step-up in cost basis of each decedent. With proper planning, the same asset could potentially receive multiple basis step-ups, including at each spouse's death and again at death of the next generation.

10) For taxable estate situations (2019 level would be greater than $22.8 million for a married couple), you need to weigh the income tax savings from a basis adjustment with estate taxes due on any assets that are part of the decedent's gross estate. The general rule is that the asset must be part of the gross estate to qualify for the step-up. Irrevocable Trusts that were previously established as an estate freeze mechanism would not qualify. Consider reviewing these structures with your estate attorney.

Eric C. Kordsmeier, CFP®, AEP®
Director

Securities offered through Hightower Securities, LLC member FINRA/SIPC. Hightower Advisors, LLC is a SEC registered investment advisor.

Hightower Advisors do not provide tax or legal advice. This material was not intended or written to be used or presented to any entity as tax advice or tax information. Tax laws vary based on the client's individual circumstances and can change at any time without notice. Clients are urged to consult their tax or legal advisor for any related questions.