John Hancock

Planning in Action

The cost of lost basis step-up

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An agent was working with his married clients, Jim and Sue, on creating an estate plan, and reached out to John Hancock Advanced Markets for assistance. Jim and Sue were considering transferring ownership of a rental property to their defective irrevocable life insurance trust (ILIT) either by gift or loan (i.e., Sale of an Asset to a Grantor Trust or SAGT). They liked that the current rental property value, $5 million, would be frozen for estate tax calculation purposes and that all future rental property appreciation and income would flow into the ILIT, which would pass more to their heirs. Further, they liked that the trustee could use the rental property income to purchase life insurance to provide liquidity for the cost of estate taxes.

However, when they learned that the rental property would receive a basis step-up at death only if it was part of their estate, not if it was in the ILIT, they hesitated to transfer the property to the ILIT. They were concerned that, if the heirs were to sell the property, their heirs' income tax cost (due to losing the basis step-up if the property were in the ILIT) would be more than the cost of the estate tax on the property if it were in the estate.

Looking at the numbers, using a $5 million asset value with a $2.225 million cost basis, if Jim and Sue sell the rental property for $5 million, they would have a gain of $2.775 million ($5 million – $2.225 million) subject to 20% capital gains tax, which would equal $555,000. However, if they died, the rental property would receive a basis step-up to $5 million and if the kids sell the property for $5 million, they will have no gain and therefore no capital gains tax. If the rental property were in the ILIT, it would not get a basis step-up at their death and their kids would incur the $555,000 tax cost if they sold the rental property.

Fact finding

- Jim, 65, and Sue, 63
- $20 million estate
- $5 million rental property, growing at 3%
- $2.225 million rental property cost basis
- Goal of reducing estate tax exposure by transferring estate assets to an Irrevocable Life Insurance Trust (ILIT) and purchasing life insurance in the ILIT for liquidity

Jim and Sue have a total estate value of $20 million, which is less than their total combined lifetime exemption of $25.84 million ($12.92 million per spouse). This means that their federal estate tax would be zero if they died today. If they were to transfer the rental property to the ILIT, it would be as either a gift applied to their lifetime exemption or as a loan. Either way, their federal estate tax would be zero because their combined estate is below their total lifetime exemption.

From the perspective of dying today, it would make sense for Jim and Sue to keep the rental property in their estate — paying zero estate tax and getting a basis step-up with the rental property in the estate is better than their kids potentially owing $555,000 in income taxes upon sale if the rental property were transferred into the ILIT. Jim and Sue wondered if this same result would apply in all future years considering that the agent and attorney told them the federal estate tax exemptions should decrease in 2026.

When reviewing the options with their attorney, they learned that the ILIT language would allow them to swap higher basis assets in their estate with the rental property in the ILIT, which could potentially give them the benefits of removing the value of the rental property from their estate without losing the step-up in basis. While this approach has some risks, knowing about it made Jim and Sue more comfortable with the idea of transferring the rental property to the ILIT. However, they remained interested in understanding the impact of the potential cost of the lost basis step-up over time.

In addition to preparing **Gifting** and **Sale of an Asset to a Grantor Trust (SAGT)** proposals for the agent, the Advanced Markets Specialist prepared a **Cost of Lost Basis Step-Up** presentation. This presentation compares, over time, the income tax cost of the lost basis step-up (if the asset is in the ILIT) with the estate tax cost on the growth of the asset (if the asset is in the estate) to determine a cross over year, if there is one.

The presentation demonstrated that in year 15 the estate tax cost of the growth on the rental property in the estate is greater than the tax cost of the lost basis step-up if the asset is in the ILIT. In other words, Jim or Sue need to live at least 15 years for a cost advantage if they transfer the asset into the ILIT today. Here is a summary of what the results demonstrated:

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Year	Asset EOY	Asset basis	Asset gain (1) – (2)	Tax on gain (3) X (20%)	Cumulative asset growth after transfer to trust	Estate tax on asset growth (5) X 40%	Saving or (cost)* (4) – (6)
5	$5,796,370	$2,225,000	$3,571,370	$714,274	$796,370	$318,548	$(395,726)
10	$6,719,582	$2,225,000	$4,494,582	$898,916	$1,719,582	$687,833	$(211,084)
14	$7,562,949	$2,225,000	$5,337,949	$1,067,590	$2,562,949	$1,025,179	$(42,410)
15	$7,789,837	$2,225,000	$5,564,827	$1,112,967	$2,789,837	$1,115,935	$2,967
20	$9,030,556	$2,225,000	$6,805,556	$1,361,111	$4,030,556	$1,612,222	$251,111
25	$10,468,890	$2,225,000	$8,243,890	$1,648,778	$5,468,890	$2,187,556	$538,778
30	$12,136,312	$2,225,000	$9,911,312	$1,982,262	$7,136,312	$2,854,525	$872,262

*A negative number means a lower cost by keeping the property in the estate, paying the estate tax, and the kids sell the property with the basis step-up. A positive number means a lower cost by transferring the property to the trust, avoiding the estate tax on the property growth, the kids sell the property in the trust, and pay the tax on the lost basis step-up.

Jim is age 65 and Sue is age 63. Life expectancy is 23 years for Jim and 26 years for Sue. Joint life expectancy (at least one of them will live) is 30 years.[1] Considering their life expectancy, Jim and Sue became comfortable with the risk of having a cost of lost basis step-up of 14 years. Additionally, the Gifting proposal showed that Jim and Sue are projected to have estate taxes due beginning in 2026 when the sunset of the lifetime exemption occurs. Thirty years from now their estate tax is projected to be anywhere from $5.8 million to $7.3 million. Having all the information and discussing it with their attorney, including the option to swap assets from the estate to the ILIT, helped Jim and Sue decide to transfer the rental property to the ILIT and to purchase $5 million of survivorship life insurance for liquidity to pay either estate taxes or for the kids to use to pay the tax on the lost basis step-up.

Why it works

The agent and attorney were able to help the clients address their concerns about the impact and risk of the cost of the lost basis step-up if they transferred an asset to an ILIT. The clients became comfortable that the duration of the risk was manageable. They transferred the asset to the ILIT and purchased a $5 million life insurance policy.

Call Advanced Markets at **888-266-7498, option 3** or email **advancedmarkets@jhancock.com** today.

1. Based on the 2015 Valuation Basic Table (VBT) of mortality rates. This is a generic calculation, not based on either person's medical status.

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