

High Net Worth Individuals: Outdated Estate Plans

Estate and asset protection plans drafted under prior law may now be working against your clients rather than for them. This course zeroes in on basis planning strategies designed to identify and correct outdated structures that could trigger unfavorable tax consequences under current law. If you regularly work with high-net-worth individuals who have existing arrangements that haven't been revisited in years, this course offers the analytical framework and practical tools to help you spot problems and guide clients toward better outcomes.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize estate planning techniques for the asset protection of high net worth taxpayers.

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TABLE OF CONTENTS

CHAPTER

01

Basis Planning: Fixing Outdated Estate/Asset Protection Plans 4

1.01 3.01 Generally — The New Tax Environment 4

1.02 3.02 What Is Basis? 6

Test Your Knowledge..... 35

Final Exam Copy 46

Index

Chapter 1: BASIS PLANNING: FIXING OUTDATED ESTATE/ASSET PROTECTION PLANS

Chapter Objective

After completing this chapter, you should be able to:

- Recognize estate planning techniques for the asset protection of high net worth taxpayers.

3.01 GENERALLY — THE NEW TAX ENVIRONMENT

Since the passage of the American Taxpayer Relief Act of 2012 (ATRA), the Tax Cuts and Jobs Act of 2017 (TCJA), and the One Big Beautiful Bill Act (OBBBA), the tax focus of estate planning and asset protection planning has shifted from transfer tax planning (i.e., estate, gift and GST tax planning) to income tax planning, and, in particular, income tax basis planning. Today, basis planning is the primary focal point of tax planning for asset protection and estate planners.

This chapter focuses on tax basis management and planning in the context of estate/asset protection planning and how to repair outdated estate/asset protection plans to reflect this shift in focus.

This change in focus began with legislative changes beginning in 2001 and culminated with the enactment of the OBBBA. More specifically, in 2001, before the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the federal estate and gift tax exclusion amount was \$675,000, just a fraction of the current \$15 million exemption for 2026. Moreover, the top marginal transfer tax rate was 55 percent as opposed to today's 40 percent rate. In contrast, the prevailing combined state and federal income tax rates at the time were substantially lower than the top marginal transfer tax rates, especially for capital gains property. Therefore, the primary focus of estate and asset protection planners was to reduce clients' transfer tax exposure and any cost in terms of lost income tax basis due to such estate planning was generally outweighed by the transfer tax savings.

Since 2001, the following key tax changes have occurred, which have contributed to today's paradigm shift:

- EGTRRA gradually increased the unified credit from \$675,000 to \$3.5 million, albeit temporarily due to a sunset provision. It also eliminated the dollar for dollar credit for state estate taxes. This, in turn, contributed to the reduction in the number of states with estate taxes from approximately 50 states to the present number of approximately 11 states that currently have a state estate tax. This reduction is due to the fact that the state estate tax is no longer completely offset by the reduction in the federal estate tax.

- The passage of the ATRA permanently increased the applicable exclusion amount for taxpayers to \$5 million per person, indexed for inflation. This resulted in the federal estate tax being a non-issue for approximately 995 individuals out of 1,000. The ATRA also set the maximum estate and gift tax rate at 40 percent.
- The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRA 2010) added, and the ATRA made permanent, estate tax portability. Portability allows the unused estate tax exemption amount (i.e., the applicable exclusion amount) to be transferred to a surviving spouse without the necessity of using a credit shelter trust. This allows a married couple to obtain a basis step up upon both the death of the first spouse to die and the surviving spouse on assets equal to the combined applicable exclusion amount, which is significant. Importantly, portability allows for a second step up in basis for assets covered by the applicable exclusion amount on the surviving spouse's death. Previously, it was difficult to obtain a second step up in basis on the surviving spouse's death for assets in a credit shelter trust.
- The passage of the so-called Obamacare legislation (Health Care and Education Reconciliation Act of 2010 and the Patient Protection and Affordable Care Act) increased the top marginal income tax rates by enacting the 3.8% Net Investment Income Tax, thus increasing the importance of income tax planning vis a vis estate tax planning by increasing the marginal income tax rates applicable to affluent individuals and making such rates closer to the marginal transfer tax rates.

As a result of the foregoing legislative developments, in many cases it is more advantageous for planners to focus on income tax planning than on estate tax planning. This is especially the case for married couples owning less than a combined \$30 million in 2026, as there is zero estate tax exposure for such couples but there is income tax exposure. Such clients generally consider the estate and gift tax to be a non-issue.

Note

For taxpayers with assets exceeding the applicable exclusion amount, planning has become much more complicated. For such taxpayers, planners must now consider the following factors, among others, for their clients:

- Net worth and the estimated size of the estates at death;
- Estimated life expectancy, and costs of maintaining the client's lifestyle and spending habits;
- Estimated income and return on investments;
- Tax nature of the client's assets and anticipated future assets;

This would include consideration of whether the client's assets are high-basis or low-basis assets. Low basis assets could, for example, include depreciated real estate, self-created assets such as intellectual property or artwork created by the client. In addition, whether such assets are income in respect of a decedent (IRD) should be considered;

- The taxpayer's domicile (e.g., is it in a high-tax jurisdiction such as California or New York, or a low-tax jurisdiction such as Florida);
- The beneficiaries' anticipated domiciles; and
- The domicile of any fiduciary, especially where the fiduciary's domicile may trigger state taxation of trusts.

This chapter will discuss the following aspects of basis planning:

- A summary of tax principles applicable to basis, especially basis of assets received from a decedent and by means of gifts; and
- Strategies to maximize basis as part of an asset protection/estate plan.

3.02 WHAT IS BASIS?

Generally

"Basis" is the starting amount on which gain or loss on a sale or exchange is determined.

Generally, gain or loss equals the difference between the amount that a taxpayer paid for the property (less certain required adjustments for such items as claimed depreciation and amortization) and such property's sale proceeds. However, in some cases, a taxpayer has no cost basis. For example, when the property has been acquired by gift or inheritance, the property will have no cost basis. In these situations, the Code provides special deemed basis rules, which are discussed below.

Caution!

The Code provides extensive basis rules to cover numerous special situations, such as stock splits, tax-free transfers, etc. Most of these rules are not discussed in this Guide. Instead, this Guide will focus primarily on basis of property received from a decedent or by gift. Planners are referred to the following Code Sections and regulations thereunder for these additional rules:

- Code Sec. 1011 – adjusted basis for determining gain or loss;
- Code Sec. 1012 – basis of property – cost;
- Code Sec. 1013 – basis of property included in inventory;
- Code Sec. 1016 – adjustments to basis;
- Code Sec. 1017 – discharge of indebtedness;
- Code Sec. 1019 – property on which lessee has made improvements;
- Code Sec. 1021 – sale of annuities.

Basis of Property Received from a Decedent; Generally

Code Sec. 1014 provides the rules that determine the basis of property acquired from a decedent.

The general rule under Code Sec. 1014 is that the tax basis of property acquired from a decedent equals the fair market value of the property on the date of the decedent's death. The basis of property received by reason of a decedent's death must be consistent with the value for estate tax purposes.

Special Situations

Caution!

The following situations require special treatment.

- *Alternate valuation date.* If the decedent's estate uses the alternative valuation date for estate tax purposes (generally six months after the date of death), the basis of the property equals its fair market value on the alternate valuation date.
- *No federal estate tax applies.* If the estate is not subject to federal estate tax, the basis of property acquired from the decedent is its appraised value at the date of death for state inheritance or transmission taxes.
- *Real Property Used in a Farm/Closely Held Business Subject to a Section 2032A.* If the estate makes a Code Sec. 2032A election to value qualified real property on the basis of its use as a farm or in a closely held business, rather than on its fair market value, then the tax basis of the property is the basis elected under Code Sec. 2032A.
- *Stock in a foreign personal holding company or a Domestic International Sales Corporation (DISC).* Special rules apply in order to determine basis in a foreign personal holding company or DISC.
- *Conservation Easement Property.* Where an estate has elected to exclude from the taxable estate some of the value of certain land that is subject to a qualified conservation easement under Code Sec. 2031(c) then, to the extent that the value of such land is excluded from the taxable estate, the basis of the land acquired at death is carried over from the decedent. In other words, to the extent of the exclusion, the basis of the property is not stepped up to its fair market value at death.

Fair Market Value

The basis of property acquired from a decedent is the fair market value on the date of death or alternative valuation date, whichever applies. For this purpose, fair market value is the price for which a willing seller would agree to sell and a willing buyer would agree to buy.

Treasury regulations provide that fair market value is not to be determined by the price of an item in a market other than that in which it is commonly sold to the public. Thus, if an article is commonly sold at retail, the retail value, and not the price which could be obtained from a dealer, is the fair market value.

Note

This rule works to a taxpayer's advantage for income tax purposes, because ordinarily the retail value would be higher than the price which could be obtained from a dealer and would give the taxpayer a higher basis. Conversely, this would be a disadvantage if the taxpayer is subject to estate tax. However, as noted earlier, the estate tax today only applies to less than four in 1,000 taxpayers. Therefore, this rule is generally beneficial to most taxpayers.

Consistent Estate and Income Tax Basis Reporting

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 enacted Code Sec. 1014(f), which provides that the basis of property received by reason of a decedent's death must be consistent with the value for estate tax purposes. Specifically, Code Sec. 1014(f) provides that the basis of any property to which the stepped-up basis rules of Code Sec. 1014 apply is the lesser of: (1) the estate tax value, and (2) in the case of the value of property that is not finally determined for estate tax purposes and with respect to which a statement is provided by the executor in accordance with Code Sec. 6035(a), the value reported on that statement.

The basis consistency rules are only applicable to property includible in the decedent's gross estate that resulted in increased estate tax liability (reduced by applicable credits) on the estate.

General Powers of Appointment; Generally

A general power of appointment ("GPOA") is a key planning tool for tax basis management. This results, because Code Sec. 1014 provides a stepped up basis equal to fair market value on the date of death to property that is the subject of a general power of appointment.

In general terms, a GPOA is a power a donor confers on a donee that enables such donee to determine who will enjoy or own the property. For tax purposes, Code Sec. 2041(b) defines a GPOA as power exercisable "in favor of the decedent, his estate, his creditors, or the creditors of his estate. "Generally, when decedents possess a GPOA, such decedents are treated as owning the property subject to the GPOA, and therefore such property is included in the decedent's gross estate.

For purpose of these rules, the "donor" is the person who creates the GPOA. The person who holds the power and is authorized to exercise it is the "donee" (sometimes called the power holder). The potential recipient of the property controlled by the power of appointment is the "appointee."

Two Types of Powers of Appointment: General and Limited/Special

There are two types of powers of appointment, general powers of appointment and limited powers of appointment, sometimes called special powers of appointment. Note that limited and special powers of appointment basically mean the same thing.

In contrast to GPOAs, which cause the property subject to the power to be included in the donee's estate and, therefore, to receive a step up in basis at the donor's death, property that is subject to a limited power of appointment is not includible in the donee's estate and does not receive a step up in basis.

A general power of appointment is a power that may be exercised in favor of any one or more of the following:

- The donee;
- The donee's estate;
- The donee's creditors;
- The creditors of the donee's estate.

Example 1

Kanye and Taylor are married. Kanye dies and leaves his estate to a testamentary credit shelter trust for Taylor and Kanye's two daughters, Kim and Chloe, with the remainder passing in equal shares to his two daughters. The trust also includes a general power of appointment over the credit shelter trust principal at Taylor's death. Specifically, the credit shelter trust includes the following language:

The balance of the property then held in this Credit Shelter Trust shall be distributed to such persons (including my Wife, her estate, her creditors, or the creditors of her estate), on such terms as my Wife may appoint by a Will specifically referring to this power of appointment; or, in default of appointment or insofar as an appointment is not effective, distributed to my descendants in per stirpital shares.

Here, this power is a GPOA and causes state inclusion in Taylor's estate at her death.

A limited power of appointment is a power that is not a GPOA. Specifically, it is a power whose permissible appointees do not include the donee, the donee's estate, the donee's creditors, or the creditors of the donee's estate.