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Upstream Basis Planning

Utilizing the unneeded estate/gift tax exemption of an older family member or friend to eliminate unrealized capital gains upon the older individual's death

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Estate, Gift, and GST Taxes

- 2019 Estate/Gift and GST tax exemption - $11,400,000/person
  - Expires January 1, 2026
  - Use it or lose it
  - No clawback
  - No scheduled repeal

2017 Tax Cuts and Jobs Act

- Estate, gift and GST taxes are irrelevant to most estates now.
- Less than 1%.
- The estate/gift tax exemption is relevant to everyone as a tool to increase income tax basis.

2019 Federal Ordinary Income Taxes

Highest Tax Brackets

- 37% Single ($510,300+)
- 37% Married Filing Jointly ($612,350+)
- 37% Married Filing Separately ($306,175+)
- 37% Trusts ($12,750+)

2019 Capital Gains Taxes

- 3.8% Net Investment Income Tax (NIIT) on interest, dividends, rents, royalties, capital gains, and trade or business income that is a passive activity
- Avoiding NIIT (2019 Thresholds - Trusts $12,750; married filing jointly $250,000; married filing separately $125,000; single $200,000)
- 20% Long-Term Capital Gains and Qualified Dividends (**2019** 20% thresholds – trusts over $12,950; single over $434,550; married filing jointly over $488,850; married filing separately over $244,425; head of household over $461,700)
  - 15% thresholds: trusts ($2,650-$12,950); single ($39,375-$434,550); married filing jointly ($78,750-$488,850); married filing separately ($39,375-$244,425); head of household ($52,750-$461,700)
  - 0% rate if under above thresholds

State Income Taxes

- State income tax rates range from 0% – 13.3%

- California – highest rate (13.3%)

- 7 States with no Income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming

- Tennessee and New Hampshire only tax dividends and interest. N.H. Admin. Code Rev. § 902.07; Tenn. Code Ann. § 67-2-102.

2019 State Income Tax Rates (alphabetically)

Alabama	5.00%	**Illinois**	**4.95%**	Mississippi	5.00%	Oklahoma	5.00%
Arizona	4.54%	Indiana	3.23%	**Missouri**	5.40%	Oregon	9.90%
Arkansas	6.90%	Iowa	8.98%	Montana	6.90%	Pennsylvania	3.07%
California	13.30%	Kansas	5.70%	Nebraska	6.84%	Rhode Island	5.99%
Colorado	4.63%	Kentucky	6.00%	New Hampshire	5.00%	South Carolina	7.00%
Connecticut	6.99%	Louisiana	6.00%	New Jersey	8.97%	Tennessee	3.00%
District of Columbia	8.95%	Maine	7.15%	New Mexico	4.90%	Utah	5.00%
Delaware	6.60%	Maryland	5.75%	New York New York City (in addition to state tax)	8.82% 3.876%	Vermont	8.95%
Georgia	6.00%	Massachusetts	5.10%	North Carolina	5.499%	Virginia	5.75%
Hawaii	11%	Michigan	4.25%	North Dakota	2.90%	West Virginia	6.50%
Idaho	7.40%	Minnesota	9.85%	Ohio	4.997%	Wisconsin	7.65%

Upstream Basics

- Give a parent or person of older generation a general testamentary power of appointment over appreciated assets to obtain a basis adjustment at the older person's death.

- Presently exercisable power of appointment would subject the assets to the powerholder's creditors.

Basics

- "General power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. IRC section 2041(b)(1)

- IRC section 1014(a)(1) & (b)(9): **the basis of property in the hands of a person "acquiring the property from a decedent" … shall … be the fair market value of the property at the date of the decedent's death**
- "acquiring from a decedent" includes property acquired through the exercise or non-exercise of a <u>power of appointment</u>, if by reason thereof the property is required to be included in decedent's gross estate under the federal estate tax

Example 1. Simple But Risky

- John and Jane Smith live in Missouri and own a $2,000,000 office building.
- They purchased the building for $1,000,000 and it is now fully depreciated and has a $0 basis.
- John is 60 and is living off of the rental income from this building and several others.
- To diversify and have greater liquidity, they would like to sell this building in about 5 years and invest the proceeds. John and Jane earn $400,000/year and have a net worth of $5,000,000.

Example 1

- If they sold the building today:
  - 25% depreciation recapture on $1,000,000
  - 15% capital gain rate on $1,000,000
  - 3.8% NIIT on $2,000,000
  - 5.4% Missouri tax on $2,000,000
- 29.2% effective rate
- Total tax: $584,000

Example 1

- Jane's parents, Sam and Pat, are in their early 90's, have a net worth of $2,000,000, and have four children. John and Jane gift the real estate to Sam who they think will not live as long as Pat. John and Jane use $2,000,000 of gift tax exemption.
- Sam dies in two years. Sam's Will leaves the real estate to John and Jane. At Sam's death, the real estate's basis is adjusted to its fair market value of $2,100,000. John and Jane sell the real estate for $2,100,000 and pay no capital gain tax.

- John and Jane die in 30 years, living in Missouri, when the estate tax exemption is still $11,400,000/person. At that time they have a net worth of $10,000,000.

- Result: No capital gains tax on sale of zero basis real estate and no estate taxes paid by John/Jane or Sam/Pat.

What Could Have Gone Wrong

- Jane’s relationship with her parents deteriorates and they leave the real estate to their other children.
- Jane’s parents make poor financial decisions, and accumulate substantial debt. The real estate is seized by a creditor of her parents.
- Jane’s parents divorce and Pat gets the real estate in the divorce. Pat quickly remarries a much younger spouse who convinces Pat to put the real estate into the new spouse’s name without the knowledge of John and Jane.
- Congress reduces the estate tax exemption to $1,000,000/person with a 55% rate. The transaction saved $584,000 of income taxes but triggered $550,000 of estate taxes.
- Sam becomes incapacitated and never executed a durable power of attorney.
- Sam dies within one year of receiving the real estate from John and Jane.

IRC Section 1014(e)

1014(e): If appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and such property passes back to the donor of such property (or the spouse of the donor) after the decedent's death, then

- no basis step-up

Avoiding 1014(e)

- What if the property passes back to the donor in an irrevocable trust? Does it matter if the donor is the trustee?

- What if the decedent purchases the appreciated property, instead of receiving it by gift?

- No caselaw and only 4 relevant rulings: PLR 200210051, 200101021, 9026036, and TAM 9308002

1014(e)

- In PLR 200210051, 9026036, and 200101021 the IRS states that 1014(e) applies if the appreciated property passes to the donor, "directly or indirectly"
    - This is not the law.
- Options for Avoiding 1014(e)
    - trust
    - cash
    - not immediate beneficiary
    - comes back to spouse

Example 2. Use a Trust

- Spouse 1 and Spouse 2 are in their 50’s, have 3 children, and run a successful family business worth $5,000,000. They would like to sell the business to a third party in the next 10 years and retire, but their basis in the business is only $500,000.
- Spouse 1 is very close to her uncle who is in poor health. Uncle is not married and has no children. Spouse 1 would like to provide funds to Uncle in the event his personal assets are depleted.

Example 2

- Spouse 1 creates an irrevocable grantor trust for the benefit of Spouse 2, their children and Uncle. Spouse 1 is the trustee and can make distributions to Spouse 2 and their children for support. Distributions can also be made to Uncle, in the Trustee's <u>sole</u> discretion.
- Spouse 1 transfers 100% of the stock in the family business to the trust and gives Uncle the power to appoint all of the assets of the trust to his creditors.

Example 2

- Spouse 1 and Spouse 2 continue to live from the cash flow of business through distributions from the trust to Spouse 2. Upon Uncle's death, the entire business receives a step-up in basis to fair market value.
- Uncle does not exercise the power of appointment. Upon Uncle's death, the trust continues in trust for Spouse 2 and their children. The trust then sells the business without incurring capital gains tax.
- The trust assets (proceeds from the sale of the business) are protected from the beneficiaries' creditors and are available for distributions to Spouse 2.

Result

- The business is sold with no capitals gains tax, no estate taxes, and the proceeds from the sale of the business are now protected from their creditors.

Risk

- What if the estate tax exemption is reduced to $3,000,000/person and the gift to the trust exhausted all of Spouse 1's exemption?
- The assets are now outside of their gross estate so the exemption was not wasted.
- What if they get divorced?
- How do we provide Spouse 1 with access to the trust assets?

Sale of Assets to Trust for a Note

- Instead of Spouse 1 gifting the business to the trust, what if she sells it to the trust in return for a $5,000,000 promissory note payable from the trust and secured by the stock in the business?
- If they divorce, Spouse 1 is still entitled to the proceeds of the $5 million note and is not excluded from benefiting from the transaction
- The sale will not trigger gain as the trust is a grantor trust.
- The sale will preserve their gift/estate tax exemption.

Potential Issues

- Do you receive a full basis adjustment or does the debt against the property reduce the basis adjustment? Unclear. Crane v. Commissioner says yes, but Treas. Reg. Section 20.2053-7 is unclear.
    - A formula general power of appointment may fix the problem.
    - If the person with the general power of appointment guarantees the debt, then there should be a full step-up
    - But does the powerholder have sufficient assets to guarantee the debt?
- Is a 10% seed gift required? Probably not.

Example 3. Donor is a Trust Beneficiary

- Client is in her 50s and has a net worth of $5,000,000, which includes $3 million of Berkshire Hathaway with a nearly zero basis. Client would like to sell the Berkshire Hathaway stock but does not want to pay the capital gains tax.
- Client's life-long family friend, Friend, is in her 80s and is in a nursing home. Client would like to help Friend by supplementing her income from time to time.

Example 3

- Client transfers the Berkshire Hathaway stock to a Missouri asset protection trust. The trust is irrevocable and allows distributions to Client and Friend in the Trustee's discretion.
- The transfers to the trust are <u>incomplete</u> gifts because Client retains a testamentary power of appointment and the ability to veto distributions.

Example 3

- Friend also has a testamentary power to appoint to her creditors at Friend's death. SHOW CHART
- Upon Friend's death, the assets remain in trust for the benefit of Client <u>and Client's children</u>, protected from her creditors as long as Client is not the Sole Trustee.
- WHAT IF DON'T TRUST HER TO NOT APPOINT OR MAY MOVE OUT OF MISSOURI

Example 3. Result

- Trust can continue to provide protection from Client's creditors.
- Assets in trust received a basis step-up at Friend's death.
- No gift tax exemption was used by Client, except to the extent distributions were actually made to Friend, and these gifts could be covered by the $15,000 annual exclusion.
- Trust can be structured to avoid estate tax at Client's death, if that is important.
- But does IRC Section 1014(e) apply? Yes. According to PLR 200101021

Example 3

- Instead of transferring the Berkshire Hathaway stock to the trust, Client could obtain a loan from a bank or family entity and transfer cash to the trust. The trust can then purchase the stock from Client with the cash and Client can repay the bank.
- 1014(e) should not apply as ”appreciated property” was not acquired by Nicole as a gift.
- Other 1014 sale rule?

Naked Powers?

- Are distributions required to be made to the individual with the general power of appointment?
  - Not required by IRC Section 2041
- Does the individual with the general power of appointment need to be a beneficiary of the trust while he/she is alive?
  - Not required by IRC Section 2041
  - Contrast with Crummey Powers and the requirement that the beneficiary have a “present interest” in the trust.

Naked Powers?

- But what about the step transaction, sham transaction, and substance over form doctrines?
  - Optics look a lot better if distributions were made to the beneficiary?
- Do you need an irrevocable trust or can I grant my mother a general power of appointment over certain assets in my revocable trust and not even tell her about the power?
  - Possibly, but riskier.

Example 4

- Brian and Amy are in their 50s, are happily married and have three children. They have a net worth of $25 million, but $10 million of it consists of farmland distributed to Amy from a family trust. The farmland has a very low basis as it was gifted to the family trust more than 60 years ago.
- Brian is a very successful executor and expects the value of his estate to substantially increase over the next 10 years.

- Brian’s mother has died, but his father, Stan, is 85 and has a net worth of $2 million.
- Amy and Brian would like to liquidate the farmland and diversify their assets.

- The farmland is currently owned by Amy.
- Amy creates an irrevocable grantor trust for the benefit of Brian, their children, and Brian’s father. Amy sells $10 million of her farmland to the trust in return for a note paying interest only with a balloon payment of principal in nine years.
- The trust grants Brian’s father a testamentary general power of appointment over the maximum value of the trust that will not cause federal or state estate taxes to be due.

- The general power of appointment allows Brian’s father to appoint the assets among Brian, Amy, their descendants, and Brian’s father’s creditors.
- Upon Brian’s father’s death, he exercises his power of appointment and leaves the assets to a new irrevocable trust for Amy, Brian, and their descendants, with Amy and Brian as the Trustees.

Result

- Farmland gets a basis adjustment at Brian’s father’s death and can be sold with no gain.
- The trust will not be subject to estate tax at Brian or Amy’s death, unless they want it to be.
- The assets of the trust will be protected from Amy and Brian’s creditors.
- 1014(e) should not apply

Example 5. Annual Exclusion Gifts

- Matt and Jessica are married and have 4 children and 12 grandchildren. All 4 of their parents are living.
- Matt owns a $1 million fully depreciated rental property they would like to sell. Their net worth is $2 million. Jessica's parents have a net worth of $2 million and Matt's parents have a net worth of $4 million.

Example 5

- Matt transfers ½ of the rental property to an irrevocable trust for the benefit of Jessica, their descendants, their siblings, and their parents.
- The trust grants each of the beneficiaries, other than Jessica, a Crummey withdrawal right allowing for $600,000 of value to be transferred to the trust each year by Matt if they split gifts.

- Matt transfers the entire rental property to the trust over two years without using any gift tax exemption. However, Matt and Jessica are not overly concerned about the use of exemption as they do not believe the value of their estate will ever be more than the estate tax exemption.
- The trust provides that the first to die of their parents will have a testamentary general power of appointment.

- Matt's father dies 2 years after the transfers to the trust and the rental property receives a full step-up in basis to fair market value.
- Upon Matt's father's death, the assets remain in trust for the same beneficiaries, except that Matt also becomes a beneficiary at that time and can receive distributions in the sole discretion of the Trustee (Jessica).

- As long as Matt is not Trustee, the trust assets will be protected from Matt's creditors (the assets are protected from the other beneficiaries' creditors irrespective of the identity of the Trustee).
- Trust qualifies as a Missouri asset protection trust under Mo. Rev. Stat. Sections 456.5-505.3 and 456.5-504.

Result

- No exemption is used.
- 1014(e) does not apply.
- Property is sold with no gain and proceeds are protected from creditors.
- Matt and Jessica have full use of the proceeds from the sale.

What could have gone wrong?

- What if Matt's father moves to Montana and dies with health care debt that exceeds his assets, making him insolvent.
- Under Montana law, the trust assets subject to the general power of appointment are available to Matt's father's creditors if his estate is insolvent. Montana Code Section 72-7-502.
- What if Matt's father died within a year of the transfer of the property to the trust?

Example 6. Client Doesn’t Need Access to the Low Basis Assets

- Client started a successful technology company that is worth $25 million. Client has two children and would like to transfer $11.4 million to a trust for their benefit to lock-in the existing gift tax exemption.
- Client creates an irrevocable trust and transfers $11.4 million of family limited partnership units to the trust.

Example 6

- Client includes his parents as discretionary beneficiaries and grants the first of them to die a formula testamentary general power of appointment (POA).
- The POA only allows his parents to appoint to creditors that are consented to by a non-adverse Trustee.

Example 6

- Upon the first to die of Client's parents, the trust assets will receive a basis step-up to the extent of the parent's unused estate tax exemption.
- What is the downside?
- Why doesn't every trust include a similar provision if the client has an older family member they would like to be a discretionary beneficiary?

Existing Irrevocable Trusts

- Modify trust to add older family members as beneficiaries and grant the first of them to die a formula general power of appointment
- Downsides other than gift tax risk

General Power of Appointment Risks

- Can the power to appoint to your creditors or estate subject the assets of the trust to your creditors at your death if your estate is insolvent?
- Not under Missouri law
  - Mo. Rev. Stat. Section 456.5-508.1(1)
  - Mo. Rev. Stat. Section 456.1105.2
- Unclear what state's law will apply

Creditors & General Powers of Appointment

- See Restatement, Third, Trusts Section 56, cmt b; Uniform Powers of Appointment Act Section 502(a)(2); and Restatement, Third, Property Section 22.3(b) (property subject to a general power of appointment is subject to the powerholder's creditors if the estate is insolvent)
- Wasn't this always an issue with formula GST general power of appointment clauses?
- Use a savings clause to undo the general power of appointment if the beneficiary's estate is insolvent

Protecting from an Actual Exercise of the GPOA

- What if you do not want the beneficiary to leave assets to a creditor or his/her estate
  - Limit the general power of appointment to creditors who are consented to by a non-adverse Trustee; IRC Section 2041(b)(1)(C)(ii)
  - Trustee will never consent

Suggestions

- Use a trust protector
- Allow for a private decanting
- Always use a formula general power of appointment.
- Consider requiring consent to the appointment to a creditor.
- Provide the general power is not general if powerholder’s estate is insolvent and lives in State that would otherwise subject the trust assets to the powerholder’s creditors.