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
Importance of Estate Taxes

- Estate, gift and GST taxes are irrelevant to most estates now.
  - Less than .1% of Americans dying this year are expected to pay federal estate taxes.

- The estate/gift tax exemption is relevant to everyone as a tool to increase income tax basis.
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
  • 2019 NIIT 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: 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 of 13.3%

• New York – 12.7% after combination of state and city taxes

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

• Tennessee and New Hampshire only tax dividends and interest.
1. Increase the basis of a low-basis asset to fair market value before the asset needs to be sold.
   • Mechanism: Make the property subject to estate tax at the death of someone else ("value included in the gross estate").

2. Do not trigger federal or state estate taxes at the death of the client or the older individual.
   • Mechanism: Give an individual who has a gross estate substantially less than $11,400,000 a formula general power of appointment over the low basis asset.

3. In some cases, ensure the client has access to the sale proceeds of the low basis asset, preferably through a trust that gives the client a level of creditor protection.
   • Mechanism: Transfer low basis asset to an irrevocable trust that includes the client as a direct or indirect beneficiary.
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.

• Even if it is possible, triggering the Delaware Tax Trap is too complicated. IRC § 2041(a)(3) and § 2514(d) (exercising a power of appointment in a way that extends vesting).
Power of Appointment Basics

• The value of the gross estate includes the value of property with respect to which the decedent has at the time of his death a “general power of appointment”. IRC § 2041(a)(2).

• “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 § 2041(b)(1).

• If a power of appointment is exercisable only in conjunction with another person who has a substantial adverse interest, then it is not a general power of appointment. IRC § 2041(b)(1)(C)(ii).
Basis Step-Up Basics

• 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. IRC § 1014(a)(1).

• “acquiring from a decedent”, includes property acquired from the decedent by reason of death (including through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in decedent’s gross estate. IRC § 1014(b)(9).
  • also includes property passing under a general power of appointment exercised by the decedent’s will. IRC § 1014(b)(4).
Options for Transferring Asset to Older Individual

• How do you transfer the low basis asset to the older individual (or trust for the individual)?

  1. Gift that uses gift tax exemption
     • issue: *May* need to ensure trust avoids estate tax at client’s death to ensure the exemption wasn’t wasted.

  2. Use annual exclusion gifts with Crummey powers
     • issue: Do you have enough Crummey power holders and can anyone have a Crummey withdrawal right?

  3. Incomplete gift
     • issue: Does 1014(e) apply?

  4. Sell asset in return for a note
     • issue: Do you only get a step-up for the net equity?
Example 1. Simple But Risky

• Keith and Nina 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.

• To diversify and have greater liquidity, they would like to sell this building in about 5 years and invest the proceeds. They 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
- Total tax if California residents: $742,000 (37.1% effective rate)
Example 1

- Keith’s Grandfather has a net worth of $2,000,000. Keith gifts the real estate to Grandfather using $2,000,000 of gift tax exemption.

- Grandfather dies in two years. Grandfather’s Will leaves the real estate to Keith. The real estate’s basis is adjusted to its fair market value of $2,100,000. Keith sells the real estate for $2,100,000 and pays no capital gain tax.
Example 1

• Keith and Nina die in 30 years, living in Missouri, when the estate tax exemption is still $11,400,000 per person. At that time they have a combined net worth of $10,000,000.

• Result: No capital gains tax on sale of zero basis real estate and no estate taxes paid by Spouses or Grandfather.
What Could Have Gone Wrong?

- Grandfather leaves the real estate to his other children.
- Grandfather accumulates substantial debt and the real estate is seized by a creditor.
- Grandfather remarries and transfers the real estate into the new wife’s name without the knowledge of Keith or Nina.
- 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.
- Grandfather dies within one year of receiving the real estate.
IRC Section 1014(e)

• IRC § 1014(e)(1): 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

• 1014(e)(2)(B): If decedent dies within 1-year and the appreciated property is sold by the decedent’s estate or by a trust of which decedent was the grantor, at any time, then to the extent the donor is entitled to the proceeds:
  • No basis step-up
1014(e)

- No caselaw and only 4 relevant rulings: PLRs 200210051, 200101021, 9026036, and TAM 9308002.
- In PLRs 200210051, 9026036, and 200101021 the IRS states that 1014(e) applies if the appreciated property passes to the donor, “directly or indirectly”
  - This language is not in the Code, but is contained in Congress’ official Explanation of the 1981 tax act that enacted this provision.
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 there is no HEMS standard – it is subject to the Trustee’s absolute discretion?

• What if the decedent purchases the appreciated property with a note, instead of receiving it by gift? (no “gift”, only a sale)

• What if the donor gives cash and a trust purchases appreciated property from the donor? (then no “appreciated property” was gifted).
Example 2. Use a Trust

• Keith and Nina 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.

• Keith is very close to his Uncle who is in poor health. Uncle is not married and has no children. Keith would like to provide funds to Uncle in the event his personal assets are depleted.
Example 2

- Keith creates an irrevocable grantor trust for Nina, their children and Uncle. Keith is the trustee and can make distributions to Nina, their children, and Uncle for HEMS.
- Keith gifts 100% of the stock in the family business to the trust thereby using $5,000,000 of Keith’s $11,400,000 of exemption.
- Uncle has a testamentary power to appoint all of the assets of the trust among Keith, Nina, their descendants, and Uncle’s creditors.
Example 2

• Keith and Nina continue to live from the cash flow of the business through distributions from the trust to Nina.

• Upon Uncle’s death 6 months later, 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 Nina and their children.

• The trust then sells the business without incurring capital gains tax.
• 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.

• $5,000,000 of gift tax exemption was used, but the trust assets are now exempt from estate taxes, so no exemption was wasted.

• The trust assets (proceeds from the sale of the business) are available for distributions to Nina.
Risk

• What if the estate tax exemption is reduced to $3,000,000/person and Uncle pays estate taxes on the ownership of the business?
  • Use a formula power of appointment

• What if Nina dies?
  • How do we provide Keith with access to the trust assets?
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 better if distributions are 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 3. Annual Exclusion Gifts

• Keith and Nina are married and have 4 children and 12 grandchildren. All 4 of their parents are living.

• Keith owns low basis real estate they would like to sell.

• Keith’s parents have a net worth of $2 million and Nina’s parents have a net worth of $4 million.
Example 3

- Keith transfers the real estate to an irrevocable trust for the benefit of Nina, their descendants, and all 4 of their parents.

- The trust grants each of the beneficiaries, other than Nina, a Crummey withdrawal right allowing for $600,000 of value to be transferred to the trust each year if they split gifts.
Example 3

• The real estate is transferred to the trust over two years without using any gift tax exemption.

• The trust provides that the first to die of their 4 parents will have a testamentary general power of appointment.
Example 3

• Keith’s father dies 2 years after the transfers to the trust and the real estate receives a full step-up in basis to fair market value.

• Upon Keith’s father’s death, the assets remain in trust for the same beneficiaries, except Keith also becomes a beneficiary at that time.
Result

- The trust can be structured to be protected from both Keith and Nina’s creditors.
- No exemption is used and trust can be structured to avoid estate taxes at Keith and Nina’s death.
- Property is sold with no gain.
- Keith and Nina have full use of the proceeds from the sale.
What Could Have Gone Wrong?

• What if Keith’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 father’s creditors if his estate is insolvent. Montana Code Section 72-7-502.
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).

• Use a savings clause to undo the general power of appointment if the beneficiary’s estate is insolvent.
Example 4. Client Does Not Need Access to the Low Basis Assets

- Client started a successful technology company and 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 for his children and transfers $11.4 million of family limited partnership units to the trust.
Example 4

- 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 4

• 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.

• Risks - potential gift if current beneficiary consents to a modification that reduces the value of the beneficiary’s interest in the trust.
Keith’s Upstream Basis Planning

Keith — Gift of brokerage account

First to die of Mom and Dad, can appoint to Keith or to powerholder’s creditors (if consented to by a Trustee who is not a beneficiary).

Continuing Trust:
- Grantor trust to Keith if Dad did not exercise power of appointment
- Complex trust that must file a 1041 if Dad exercises power of appointment
- Trust is GST exempt due to automatic allocation in Dad’s estate
- Trust will avoid estate taxes at Keith’s death, unless formula general power of appointment causes inclusion for step-up
- Keith is likely still considered the settlor of the trust for asset protection purposes, so the trust continues to qualify as a Missouri asset protection trust

Keith’s Missouri Asset Protection Trust
Trustee: Keith’s brother

Income and principal to Keith, Mom, and Dad, in Trustees’ discretion.

Keith’s Missouri Asset Protection Trust
Trustee: Keith’s brother

Income and principal to Keith and Mom, in Trustees’ discretion.

Upon Keith’s Death:
Keith can appoint to anyone other than his creditors, his estate, or creditors of his estate. Formula general power of appointment for another basis step-up at Keith’s death.

- Trust is a grantor trust
- Transfer to trust is a completed gift that will use gift tax exemption
- Could give Mom and Dad Crummey withdrawal rights to qualify gift for $15,000 annual exclusion
- No GST exemption is allocated

If Dad exercises power of appointment to a trust for Keith, then Keith can be sole Trustee as Dad becomes settlor of trust for asset protection purposes.
Suggestions

• Use a trust protector

• Always use a formula general power of appointment.

• Require non-adverse party’s consent to 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.