Income Tax Planning Strategies for Estate Plans Under the TCJA

The higher transfer tax exemption amount shifts more of the focus of estate planning onto income tax minimization strategies.

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In December 2017, the President and Congress implemented sweeping tax legislation with the passage of the Tax Cuts and Jobs Act (TCJA). One such change was an increase in the lifetime estate and gift tax exemption to $11.18 million per person beginning in 2018.[1] This shifted the focus of tax planning in estate plans for most Americans from estate tax planning to income tax planning. A wide range of income tax planning techniques can now be used under the TCJA. In light of the new tax law, it is important to explore these income tax planning techniques as a part of the estate planning process. The primary focus of this article is techniques for managing low-basis assets to achieve a step-up in basis. In addition, this article addresses some other income tax planning techniques in the beneficiary deemed owned trust section.

Unwinding

Many clients are not well-suited for complex tax planning techniques. This, however, does not necessarily mean that income tax planning techniques should not be considered. One such income tax planning technique that is being used with more frequency in estate plans involves unwinding irrevocable trusts[2] that were established to remove assets from the grantor's taxable estate (such as gifting trusts) or keep assets from being included in the beneficiary's taxable estate (such as credit shelter trusts).[3]

While the techniques discussed below may be appropriate in situations in which an individual is creating or updating an estate plan, this technique is often used under circumstances in which it is desired to undo prior estate tax planning.

Terminating irrevocable trust. One form of unwinding involves terminating an irrevocable trust and distributing the assets outright to the beneficiary, so that the assets are brought into the beneficiary's estate and receive a step-up in basis at the beneficiary's death.[4] While this method allows for income tax planning for assets with significant built-in appreciation, it creates a risk that such assets may be subject to the estate tax at the beneficiary's death.[5] If the beneficiary later wanted to remove such assets from his or her taxable estate, the beneficiary would either have to use annual exclusion gifts or use some of his or her lifetime estate and gift tax exemption amount in a gifting transaction[6] or sell such assets for fair market value, which because of the built-in appreciation would likely result in a tax on the gain realized from such sale.[7] Further, caution should be used when considering a trust termination to achieve this goal, as the creditor and divorce protection provided by the trust will be lost.

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For example, if a predeceasing spouse created a revocable trust during his or her life under which, upon the death of the predeceasing spouse, a credit shelter trust[8] was created for the benefit of the surviving spouse, such credit shelter trust may own assets with significant built-in appreciation. If the surviving spouse's taxable estate is significantly below the estate tax exemption,[9] then it may be desirable to modify the credit shelter trust to give the surviving spouse a formula contingent testamentary general power of appointment over the trust assets.[10] This formula contingent testamentary general power of appointment would be structured so that the surviving spouse would only have a general power of appointment over the trust assets to the extent that it would not increase the amount of estate tax due at the surviving spouse's death. Due to this formula contingent testamentary general power of appointment, the assets of the trust will be includable in the taxable estate of the surviving spouse for federal estate tax purposes to the extent such assets do not increase the surviving spouse's estate tax liability,[11] causing such assets to receive a step-up in basis to fair market value at the death of the surviving spouse without increasing the estate taxes due.[12]

> **Unwinding techniques may include decanting, use of a trust protector, modification with consent of settlor, and a non-judicial settlement agreement.**

This method allows the beneficiary to obtain the maximum step-up in basis of assets at death without inadvertently incurring adverse estate tax consequences. In addition, unlike the trust termination, this method of unwinding maintains the asset protection provided by the trust. However, there is a risk that the surviving spouse may exercise the power of appointment such that the trust assets would pass in an unintended manner. This risk can be reduced, but not eliminated, by granting the surviving spouse only a narrow testamentary general power of appointment, so that, for example, the permissible appointees consist of only the surviving spouse's creditors and the permissible appointees of the surviving spouse's testamentary limited power of appointment, if any.[13]

Other trust modification methods. The main issues to consider when determining what method of trust modification (or termination) is appropriate in a given situation are what methods are valid under state law and what is the fiduciary liability with each method. The manner in which a trust modification (or termination) may be achieved in any given situation depends on the terms of the trust as well as the applicable state law governing the trust. Unwinding techniques may include decanting, use of a trust protector, modification with con-

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1 The lifetime estate and gift tax exemption is $11.4 million in 2019, and will be indexed for inflation each year. This is scheduled to sunset effective 1/1/2026, with reversion to the 2011 lifetime estate and gift tax exemption amounts of $5 million adjusted for inflation. See Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11061, 131 Stat. 2054, 2091 (2017).

2 See Pennell, "Notable State Law Developments," 5-10, 17-18, (2015) (50th Annual Heckerling Institute on Estate Planning, January 2018 supporting materials).

3 A trust to which the predeceasing spouse's unified credit against estate tax under Section 2010(a) is applied and which is excluded from the surviving spouse's taxable estate.

4 See Section 1014(a)(1).

5 Because the beneficiary receives the assets outright, if the value of the beneficiary's estate increases to the point that it is over the estate tax exemption, then all or a portion of such assets may be subject to estate tax.

6 See Sections 2010, 2503(b), and 2505(a).

7 See Section 61(a)(3).

8 See discussion in *supra* note 3.

9 The estate tax exemption is $11.4 million in 2019, and will be indexed for inflation each year. See discussion in *supra* note 1.

10 This general power of appointment could be as broad or narrow as the grantor wishes. For example, if a broader power is desired, the permissible appointees could include any persons or entities the parent desires, including the estate of the member of the older generation. Alternatively, if a narrower power is desired, the permissible appointees may include only the descendants of the member of the younger generation and the creditors or the member of the older generation.

11 See Section 2041(a).

12 See Section 1014(b)(9) and Reg. 1.1014-2(b).

13 In order to qualify as a general power of appointment, the power holder must be able to exercise the power in favor of at least one of (1) the power holder, (2) the power holder's creditors, (3) the power holder's estate, or (4) the creditors of the power holder's estate. See Section 2041(b).

14 For example, if the trust is modified to give the current beneficiary a testamentary general power of appointment, then the consenting remainder beneficiaries may be deemed to have given away the value of his or her remainder interest in the trust, because pursuant to the power of appointment the current beneficiary would have the ability to direct the remaining trust assets among permissible appointees other than the remainder beneficiaries and they are receiving only potential tax savings that may or may not be passed on to them. See Regs. 25.2511-1(c)(1) and 25.2512-8.

15 If the actuarial value of the interest does not exceed the annual gift tax exclusion for the year of the transaction ($15,000 in 2019), then the risk of adverse gift tax consequences from a deemed gift are reduced. See Section 2503(b).

16 See Eastland, "Using Your Estate Planning Toolbox to Fix Your Client's Income Tax Problems," 21-41 (2018) (working paper). See also Lee, "Putting It On & Taking It Off: Tax Basis Management Today (For Tomorrow)," 41-44, (2018) (52nd Annual Heckerling Institute on Estate Planning, January 2018 supporting materials).

17 A grantor trust is a trust that has certain characteristics which cause the income of such trust to be taxed to the grantor, rather than to the trust. See Sections 671 through 679.

18 See Section 675(4)(C).

19 Eastland, *supra* note 16, at 23. Any sales between the grantor and the grantor trust would be ignored for income tax purposes, because the trust is deemed owned by the grantor for income tax purposes.

20 See Section 1014(a).

21 Eastland, *supra* note 16, at 31

22 The use of these methods is not exclusive to a situation involving the use of a member of an older generation. It can involve using anyone who will have a taxable estate that is significantly less than the exemption amount; however, these methods are often discussed in connection with parents.

sent of settlor, and a non-judicial settlement agreement (generally trusts governed by the law of states that have enacted the Uniform Trust Code are able to use non-judicial settlement agreements, which require the consent of all interested parties).

If the desired method for modification would require the consent of trust beneficiaries (modification with consent of settlor and non-judicial settlement agreement), there is a risk that the remainder beneficiaries would be deemed to have made a gift, because by consenting to the modification, each of such beneficiaries is giving away something of value (his or her remainder interest) and is receiving only a theoretical benefit in return.[14] The IRS may determine that each beneficiary's act of consenting to the modification is a taxable gift. However, depending on the value of the trust assets and the number of trust beneficiaries consenting to the modification, this risk can be measured and mitigated.[15] Alternatively, if the desired method for modification (or termination) would not require the consent of the trust beneficiaries (decanting and use of a trust protector), there is a risk that the modifier could be subject to liability for a breach of fiduciary duty claim by the trust beneficiaries.

Asset swapping

A simpler income tax planning technique in an estate plan involves asset swapping.[16]

One form of asset swapping is to replace assets that have a low basis relative to their current value that are held in an irrevocable grantor trust[17] with cash or high-basis assets. Many estate plans where the client was primarily focused on transfer tax planning included the use of irrevocable trusts that are "defective" for income tax planning purposes, resulting in the income being generated by the trust assets to be taxed to the grantor. To achieve such a result, certain powers are included in the trust, including the power of the grantor to substitute assets owned by the trust with assets having an equivalent value.[18] Even if this power is not available, the grantor may still be able to purchase the low-basis assets from the trust if the trust is a grantor trust.[19] Many types of assets, including real estate, closely held business interests, and certain marketable securities, can be used if such assets have a low basis relative to their current value.

Through the swap, the grantor is able to bring the low-basis assets that are in the trust back into the grantor's estate so that they receive a step-up in basis to fair market value at the grantor's death.[20]

To engage in the asset-swapping technique, the grantor needs to have cash or high-basis assets for the swap to occur. However, if the grantor does not have sufficient cash or high-basis assets for this transaction, the grantor could consider getting a loan from a bank for cash to engage in the asset swap, because the tax savings of the asset swap technique will often outweigh the cost of the loan.[21]

Planning methods using members of an older generation

Another simpler income tax planning technique involves planning with members of an older generation,[22] which may include a member of a younger generation gifting assets that have a low basis compared to their current value to a member of an older generation and a member of a younger generation creating an irrevocable trust that

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gives a member of an older generation a general power of appointment[23] over the assets of such trust.[24]

Give assets to older relative. In one form of this technique, a member of a younger generation would gift assets with a low basis to a member of an older generation outright. Then, the gifted assets will receive a step-up in basis to fair market value at the death of the member of the older generation.[25]

There are risks involved with outright gifts. These include the transferred assets being vulnerable to the creditors of the member of the older generation and the possibility that the member of the older generation could leave the transferred assets to an unintended recipient at the member of the older generation's death. In addition, if, following the gift of the low-basis assets from the member of the younger generation to the member of the older generation, the member of the older generation dies within one year of the gift and the low-basis assets pass back to the member of the younger generation, then the low-basis assets will not receive the step-up in basis to fair market value.[26] However, there may be ways to avoid this through the use of trusts.

Designate as trust beneficiary. In another form of this technique, a member of a younger generation would create an irrevocable trust of which a member of an older generation is the beneficiary, and to which the member of the younger generation would sell or gift assets that have a low basis compared to its fair market value. The types of assets that can be transferred to the trust include real estate, closely held business interests, certain marketable securities, or other assets with built-in appreciation.

A more complex income tax planning technique in an estate plan involves the creation of an irrevocable trust known as a beneficiary deemed owner trust.

The irrevocable trust should be designed so that the transferred assets are removed from the estate of the member of the younger generation.[27] The member of the younger generation, as the grantor of the trust, would retain certain powers over the trust to make it a grantor trust for income tax purposes.[28] As a beneficiary of the trust, the member of the older generation would have the ability to appoint the assets of the trust remaining at his or her death among the descendants of the member of the younger generation, charities, and the creditors of the member of the older generation as the member of the older generation directs by will.[29]

Due to this testamentary general power of appointment, the assets of the trust will be includable in the taxable estate of the member of the older generation for federal estate tax purposes,[30] causing such assets to receive a step-up in basis to fair market value at the death of the member of the older generation.[31] Another benefit of this technique is that it allows the member of the younger generation to remove the future appreciation of the transferred assets from his or her taxable estate without using any of the estate or gift tax exemption of the member of the younger generation, allowing the member of the younger generation to engage in estate tax planning, if desired. Thus, this technique allows the member of the younger generation to engage in both income and estate tax planning.

For example, an adult child who owns marketable securities that have a low basis compared to their current value could transfer such ownership interests to a trust created by such child for the benefit of such child's parent and over which such parent has a testamentary general power of appointment among the child's descendants. Any future appreciation of marketable securities has been removed from

23 *See* discussion *supra* in note 13.

24 Eastland, "Putting it All Together: Some of the Best Estate Planning Strategies We See That Reduce Both Income and Estate Taxes in the Uncertain Age of Tax Reform," 274-278 (1/9/2018) (ACTEC Estate and Gift Committee, March 2018 supporting materials).

25 See Section 1014(a)(1).

26 See Section 1014(e).

27 For example, the child should not have a right to designate who should possess or enjoy the trust assets, the right to change the time or manner in which a beneficiary receives the trust assets, or a general power of appointment over the trust assets.

28 See Sections 671 through 679. This is an additional way to save income taxes due to trusts having a more compressed income tax schedule compared to individuals, such that trusts reach the top income tax bracket at income of $12,750 in 2019.

29 This general power of appointment could be as broad or narrow as the grantor wishes. For example, if a broader power is desired, the permissible appointees could include any persons or entities the parent desires, including the estate of the member of the older generation. Alternatively, if a narrower power is desired, the permissible appointees may include only the descendants of the member of the younger generation and the creditors or the member of the older generation.

30 See Section 2041(a).

31 See Section 1014(b)(9) and Reg. 1.1014-2(b).

32 See discussion *supra* in note 13.

33 See Section 2041 and Reg. 20.2041-3.

34 See Section 2041(a).

35 For a more detailed discussion of the BDOT, see Morrow, "IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)," (2017) (working paper). See also Eastland, "Best Estate Planning Techniques Under TCJA—Part 4: BDOT," 45 ETPL 19 (September 2018).

36 See Section 678. This means that an irrevocable trust will be treated as a grantor trust to a beneficiary of such trust if the beneficiary has the right to withdraw the principal or the income of such trust.

37 See Morrow, *supra* note 35, at 5-6.

38 See Eastland, *supra* note 35.

39 *Id.*

the child's estate without using the child's estate or gift tax exemption. Then, at the parent's death, the appreciated marketable securities will receive a step-up in basis to fair market value. In addition, unlike an outright gift to a parent, the marketable securities will not be subject to the parent's estate plan, but to the terms of the trust created by the child, as the grantor. It is, however, important to keep in mind that the parent may exercise the power of appointment over the marketable securities such that they would pass in a manner different than how the child intended. This risk can be reduced, but not eliminated, by granting the parent only a narrow testamentary general power of appointment,[32] such as among the child's descendants and the creditors of the parent that a non-adverse party consents to.[33]

Modify existing trust. An alternative to creating a new irrevocable trust is to modify an already existing irrevocable trust in a manner that brings the assets of such trust into a beneficiary's taxable estate so that such assets receive a step-up in basis at such beneficiary's death. One way that this may be achieved is by modifying the trust to give the beneficiary a testamentary general power of appointment over the trust assets.[34] This modification may be achieved using the methods discussed in the Unwinding section above.

The use of an irrevocable trust with a general power of appointment may be preferable to an outright gift, as the transferred assets will be subject to the terms of the trust chosen by the transferor, as the grantor of the trust (assuming the power of appointment is not exercised), and the trust provides a level of asset protection.

Beneficiary deemed owner trust

A more complex income tax planning technique in an estate plan involves the creation of an irrevocable trust known as a beneficiary deemed owner trust (BDOT).[35]

Section 678 provides that "a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself."[36] Traditionally, this was not used as many practitioners had focused on the right to withdraw corpus, which would undo estate planning that was done for creditor protection and estate tax planning purposes.[37] However, if the beneficiary is given the right to withdraw all of the net taxable income of the trust not to exceed 5% of the value of the trust assets, and all of the assets of the trust are available to satisfy the withdrawal right, then this will also allow the trust to be treated as a grantor trust to the beneficiary of such trust, without the creditor and estate tax issues.[38]

In one form of the BDOT technique, one individual, the grantor, would create an irrevocable trust for the benefit of the another individual, the beneficiary, that is excluded from the taxable estate of both the grantor and the beneficiary.[39] The beneficiary would have the power to withdraw all of the

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net taxable income of the trust, and all of the trust assets would be available to satisfy such withdrawal power, thus making the beneficiary the deemed owner of the trust for income tax purposes.[40] This causes the trust to be a grantor trust to the beneficiary, which allows the income of the trust to be taxed at the beneficiary's tax bracket[41] rather than the grantor's tax bracket or the trust's tax bracket. This is beneficial in the situation where the grantor of the trust is in a higher tax bracket than the beneficiary of the trust.[42]

In another variety of the BDOT technique, a predeceasing spouse would create a revocable trust during his or her life under which, upon the death of the predeceasing spouse, a marital trust[43] and a credit shelter trust[44] would be created for the benefit of the surviving spouse.[45] Under this form of the technique, both the marital trust and the credit shelter trust would be structured as BDOTs to the surviving spouse,[46] and there would be no income tax consequences for any sales between the marital trust and the credit shelter trust.[47] Appreciated assets in the credit shelter trust could be sold to the marital trust for cash, and at the surviving spouse's death the assets in the marital trust would receive a step-up in basis. In order to qualify the marital trust (1) for the marital deduction and (2) as a BDOT, the marital trust must either give the surviving spouse the right to withdraw both all of the trust accounting income and net taxable income for life or give the surviving spouse the right to withdraw the net taxable income and to require the accounting income to be distributed.

Due to the scheduled sunset of some of the provisions in the TCJA, caution should be taken when using these techniques.

There are other income tax benefits to using a BDOT.[48] One such benefit is that up to $250,000 of capital gains from the sale of the beneficiary's principal residence that is owned by the BDOT may be excluded from the beneficiary's gross income.[49] Another benefit is that because the BDOT is taxed to the beneficiary, any withdrawable income that is donated to charity at the direction of the beneficiary may be deducted from the beneficiary's individual income as a charitable income tax deduction under Section 170,[50] rather than being subject to the stricter limitations for trust charitable income tax deductions under Section 642(c).[51]

Caution must be taken when implementing the BDOT technique, however, because if the grantor retains certain powers that would cause the grantor to be treated as the owner of the trust for income tax purposes,[52] then the trust income may be taxed to the grantor rather than the beneficiary.[53] Further, it is important to ensure that any withdrawable BDOT assets that were not withdrawn by the beneficiary do not exceed 5% of the value of the BDOT property or that a hanging withdrawal power is used, in order to avoid such assets being treated as a contribution to the BDOT by the beneficiary for transfer tax purposes.[54]

Conclusion

Each of the above estate planning techniques incorporates income tax planning under the TCJA. While many clients may be able to use more than one of these techniques in their estate plan, it is important to remember that not all of these techniques will be appropriate for every client. In addition, due to the scheduled sunset of some of the provisions in the TCJA, caution should be taken when using these techniques. Practitioners should be sure to examine each client's unique needs to determine which of these techniques may be appropriate for the client. ■

40 See Section 678(a)(1). The reference to income is to net taxable income, not accounting income, so if the beneficiary has the right to withdraw net taxable income, then the beneficiary has the right to withdraw dividends and interest, as well as income normally allocated to principal (such as capital gains).

41 See Section 678(a).

42 See discussion *supra* in note 28. Individuals are generally in a more favorable tax bracket than trusts due to the compressed nature of the income tax schedule for trusts.

43 A trust which qualifies for the marital estate tax deduction under Section 2056(a) and is included in the surviving spouse's taxable estate. See Sections 2056(b)(5) and 2056(b)(7).

44 See discussion *supra* in note 3.

45 Eastland, *supra* note 35.

46 In order to qualify the marital trust (1) for the marital deduction and (2) as a BDOT, the marital trust must either give the surviving spouse the right to withdraw both all of the trust accounting income and net taxable income for life or give the surviving spouse the right to withdraw the net taxable income and to require the accounting income to be distributed. See Regs. 20.2056(b)-5(f)(8) and 20.2056(b)-7(d)(2), and Section 678(a)(1).

47 Eastland, *supra* note 35. Any sales between the marital trust and the credit shelter trust would be ignored for income tax purposes, because both trusts are deemed to be owned by the surviving spouse for income tax purposes.

48 See Morrow, *supra* note 35, at 21-68.

49 See Section 121 and Reg. 1.121-1(c)(3)(i). Because the beneficiary is the deemed owner of the BDOT for income tax purposes and the BDOT is the owner of the beneficiary's principal residence, the beneficiary is treated as the owner of the principal residence.

50 See Reg. 1.671-2(c).

51 See Section 642(c), which provides that a trust may take a charitable income tax deduction only to the extent of gross income paid to charity pursuant to the terms of the trust agreement.

52 See Sections 671 through 677.

53 See Section 678(b).

54 See Sections 2041(a)(2), 2041(b)(2), 2514(b), and 2514(e)(2). If the percentage of the unwithdrawn BDOT assets does not exceed 5% of the withdrawable BDOT assets, then such unwithdrawn BDOT assets fall under the lapse protection safe harbor. See also Eastland, *supra* note 35.