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Estate Inclusion Techniques: Gifts and Transfers, Powers of Appointment, Life Insurance Assets, Portability, Trusts

TUESDAY, JANUARY 28, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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ESTATE INCLUSION TECHNIQUES

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Why Do We Care

When the Federal gift and estate tax exemption amounts was lower, the focus was on avoiding a part of deceased grantor's assets being subject to Federal estate taxes at a rate of 40% by "estate exclusion" techniques.

As the exemption amounts increased over the years, the focus moved to avoiding future capital gains taxes for beneficiaries by "estate inclusion" techniques.

Cost Basis

Cost Basis

- Internal Revenue Service Publication 551 – "Basis is the amount of your investment in property for tax purposes. Use the basis of property to figure depreciation, amortization, depletion, and casualty losses.

  Also use it to figure gain or loss on the sale or other disposition of property.

  You must keep accurate records of all items that affect the basis of property so you can make these computations."

Cost Basis

- Cost Basis
  - The basis of property you **buy** is usually its cost.
  - The cost is the amount you pay in cash, debt obligations, other property, or services.
  - Your cost also includes amounts you pay for the following items.
    - Sales tax.
    - Legal and accounting fees (when they must be capitalized).
    - Real estate taxes (if assumed by the buyer for the seller).

Increases to Cost Basis

1. Capital improvements;
2. Assessments for local improvements;
3. Casualty losses - Restoring damaged property;
4. Legal fees - Cost of defending and perfecting title; and
5. Zoning costs.

Decreases to Cost Basis

1. Casualty or theft loss deductions and insurance reimbursements;
2. Certain vehicle credits;
3. Section 179 deduction; and
4. Nontaxable corporate distributions.

Basis of Assets Transferred Upon Death

Inherited Assets

IRC section 1014(a) – "stepped up basis" - The basis of property inherited from a decedent is generally one of the following.

1. The FMV of the property at the date of the individual's death.
2. The FMV on the alternate valuation date if the personal representative for the estate chooses to use alternate valuation.

Think of it this way – if the assets walk though the estate tax door (even if not actually taxed), the basis is stepped up.

Inherited Assets – Exceptions

First: Stepped up basis does not apply to an asset inherited from a decedent if you or your spouse originally gave the property to the decedent within 1 year before the decedent's death.

Your basis in this property is the same as the decedent's adjusted basis in the property immediately before his or her death, rather than its FMV at death.

A transfer to a terminally ill person who then gives the property back to you by will or trust will not work to achieve stepped up basis. IRC section 1014(e)

Inherited Assets –Exceptions

Second: Stepped up basis does not apply to income in respect of a decedent (“IRD”).

IRD refers to untaxed income that a decedent had earned or had a right to receive during his or her lifetime. IRD is taxed to the individual beneficiary that inherits this income.

- Retirement Income
- Uncollected salaries
- Bonuses, Commissions
- Uncollected rent

Community Property

Community Property

One special stepped up basis rule to be aware of:

IRC section 1014(b)(6) – the Magic Double Basis Step Up.

- In simple terms, “both-halves” of a community property asset receives a basis step-up.
- Example: Wife inherits an asset early during the marriage with a value and basis of $1,000,000.
- All assets acquired during marriage are community property, except for gifts and inheritances (and income on such assets).
- Wife keeps the asset as separate property, and at the time of Husband’s death (he is going to die first in this example) it has a value of $5,000,000 – a significant built in capital gains tax liability.

Community Property

- If Husband dies first with the asset as Wife's separate property, Wife's basis is not stepped-up.
- In Wife dies first, the basis is stepped-up.
- There is only a full basis step up if the separate property spouse dies first.
- In contrast, if the asset is converted to community property, then on either death, there is a full basis step-up.

Community Property

- This is a significant planning opportunity, but also presents a significant conflict of interest issue.
- If you suggest a conversion of separate property to community property, you must advise the clients that the spouse now has an interest in the asset.
- Although the separate property spouse may have a right of reimbursement, a portion of the appreciation will pass to the spouse upon a divorce.
- In addition, the other spouse can will away his or her share.

Transferred Basis Of Gifts

Basis of Gifts

If you receive an asset by gift (meaning it did not pass through the estate tax door – **this will apply to assets that are inherited by reason of a death but are not subject to estate tax by reason of that death**), then "carryover basis" applies. IRC section 1015 – basis in the hands of the recipient is the same as in the hands of the donor.

Recipient basis is not "stepped up" and "built in gain" is preserved.

Sometimes carryover basis can be very "old and cold" (and low).

Basis of Gifts

The contrast with stepped up basis (which means "estate tax inclusion" – remember, basis is only stepped up if the asset walks through the estate tax which occurs at death) **is stark**:

EXAMPLE: Grandma bought the equivalent of one share of Apple Stock in 1980. Her basis is $1.00.

GIFT: She gives you the share for a New Years gift of December 31, 2019. The closing price is $292.65. You have a basis of $1.00 and if you sell, you have a capital gain of $291.65 (with capital gains tax as much as 37% state and federal).

Basis of Gifts

INHERITANCE: Instead assume that she wanted to make the gift to you, but died on December 31, 2019. Her trust or will leaves the share to you.

Your basis is now the FMV on date of death (the average of the high and low on December 31, 2019, or $291.075).

If you sold the next business day at $292.65, you only have a gain of $1.57 (less than 1% of the gain on carryover basis).

Basis of Gifts

APPLICATION TO IRREVOCABLE TRUSTS:

This contrast between stepped up basis and carryover basis applies to many irrevocable trusts.

Often, an irrevocable trust is designed so that its assets are **NOT** included in the estate of the lifetime beneficiary.

For example, a "bypass trust" created for the benefit of a surviving spouse under a joint revocable living trust, is generally not included in the surviving spouse's estate.

Its assets' basis are not stepped up on the surviving spouse's death.

Basis of Gifts

Similarly, a "GST" trust is designed so that it is not included in the child's estate. The terms might be established by grandmother's trust, as follows:

- Income to child for life and principal distributions for the child's support needs.
- Remainder at child's death to the child's children.
- At child's death, the assets of the GST Trust are not included in the child's estate and do **NOT** receive a basis step up.

Basis of Gifts

Be mindful of the technical rules for intervivos gifts for gain/loss calculation for depreciated asset.

- If the FMV of the property at the time of the gift is less than the donor's adjusted basis, your basis depends on whether you have a gain or a loss when you dispose of the property.
- **GAIN**
- Your basis for figuring gain is the same as the donor's adjusted basis plus or minus any required adjustment to basis while you held the property.

Basis of Gifts

- **LOSS**

Your basis for figuring loss is its FMV when you received the gift plus or minus any required adjustment to basis while you held the property.

- **IN BETWEEN**

If you use the donor's adjusted basis for figuring a gain and get a loss, and then use the FMV for figuring a loss and have a gain, you have neither gain nor loss on the sale or disposition of the property.

Basis of Gifts

- Example - At the time of the gift, gold brick had an FMV of $8,000. The donor's adjusted basis was $10,000. After you receive the gold, no events occurred to increase or decrease your basis.
- **SALE AT GAIN**:
- If you sell the gold for $12,000, you will have a $2,000 gain because you must use the donor's adjusted basis ($10,000) at the time of the gift as your basis to figure gain.

Basis of Gifts

- **SALE AT LOSS:**
- If you sell the gold for $7,000, you will have a $1,000 loss because you must use the FMV ($8,000) at the time of the gift as your basis to figure a loss.
- **NO GAIN / NO LOSS:**
- If the sales price is between $8,000 and $10,000, you have neither gain nor loss. For instance, if the sales price was $9,000 and you tried to figure a gain using the donor's adjusted basis ($10,000), you would get a $1,000 loss. If you then tried to figure a loss using the FMV ($8,000), you would get a $1,000 gain.

The Benefit of Estate Tax Inclusion

Benefit of Estate Tax Inclusion

Now that we understand basis and its importance, we can appreciate the benefit of estate tax inclusion:

If an asset is subject to estate tax in the decedent's estate, then the basis of the asset in the hands of the recipient (unless an exception such as IRD applies) is the stepped-up basis.

This means you want the asset to remain in the decedent's estate, and not be transferred out via gift.

What happened to traditional estate planning that emphasized gifting??

Benefit of Estate Tax Inclusion

What happened is the Tax Cuts and Jobs Act of 2017 (the “Act”).

The Act increased the estate tax exemption to $11,180,000 for deaths occurring in 2018, and increasing for inflation annually.

The exemption is now (2020 deaths) $11,580,000.

The effect on estate planning is often a complete 180 degree turn.

Benefit of Estate Tax Inclusion

If a client has a $10,250,000 net worth, with a basis of $2,250,000, what would your advice be:

PRIOR ESTATE PLANNING ADVICE

- In 2013, when the estate tax exemption was $5,250,000 with a possible estate tax $2,000,000 (40% of the $5,000,000 estate above the exemption), you would advise a gift of perhaps as much of $5,000,000, leaving the beneficiary with a $4,000,000 built in gain (but no estate tax).

Benefit of Estate Tax Inclusion

CURRENT ESTATE PLANNING ADVICE:

- In 2020, when the estate tax exemption is $11,580,000, you advice would be to do "mostly" nothing (at least for the present). If the client dies holding the low basis asset, the best of both worlds are achieved:
- No estate tax because the $10,250,000 is below the estate tax exemption.
- No income tax for the beneficiary because her basis is stepped up to $10,250,000.

Benefit of Estate Tax Inclusion

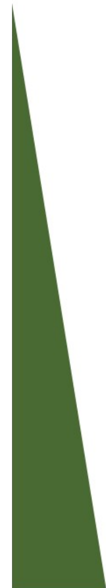
- What if a client made a gift in 2013 by transfer to an irrevocable trust for a child and the irrevocable trust will not be included in the client's estate?
- Can you "re-include" the asset in the client's estate to achieve the basis step up and avoid the built in gain?
- Do you need to be wary of a possible change in the estate tax exemption (the Act sunsets on January 1, 2026).

Benefit of Estate Tax Inclusion

- Looking at this retroactively:
- What are the ways to "intentionally" include assets that may be in an irrevocable trust to achieve a basis step up?
- Looking at this prospectively:
- Is there a way to have it both ways, *i.e.*, create a trust now that is irrevocable and that will avoid estate tax on the death of the beneficiary or settlor, but perhaps can be reincluded in the beneficiary or settlor's estate to achieve a step up.

The Power of a Power of Appointment for Basis Planning

The Power of a Power of Appointment for Basis Planning



- A **power of appointment** is a power to dispose of property that is subject to trust.
- A power of appointment can be invaluable in basis planning.
- That is, a trust created by Eve can state “the trustee shall distribute income to Abel for life, and at Abel’s death, the trustee shall distribute the assets among persons named by Abel in a writing, and if Abel does not execute such an instrument, then to Cain.”
- Abel has a power of appointment.
- The power can be as broad or limited as the creator desires depending on whether the creator chooses to give a general power of appointment or special (“limited”) power of appointment. A power of appointment can also be presently exercised or postponed until a specified event occurs or a condition is met (usually the death of the present beneficiary)

The Power of a Power of Appointment for Basis Planning

- Some technical terms:
- According to Black Law's Dictionary, the definition of a power of appointment is, "a power or authority conferred upon one person by deed or will upon another (called the "donee") to appoint….the person or persons who are to receive and enjoy an estate or an income therefrom or from a fund, after the testator's death, or the donee's death, or after the termination of an existing right of interest."

The Power of a Power of Appointment for Basis Planning

- California Probate Code Section 610(d) defines the donee as, “the person to whom a power of appointment is given or in whose favor a power of appointment is reserved.” The donor, according to Probate Code § 610(e) is the, “person who creates or reserves a power of appointment.” The appointee is the person in whose favor a power of appointment is exercised (Probate Code § 610(a)) and the appointive property means the property or interest in property that is the subject of the power of appointment (Probate Code § 610(b)).
- Powers of appointment should not be confused with powers of attorney, which appoint another person to act for the client, or durable powers of attorney, which are also a useful estate planning device.

The Power of a Power of Appointment for Basis Planning

- **Types of Powers of Appointment:**
- A power of appointment can be either "presently exercisable" at the time in question to the extent that an appointment can be made or it can be "not presently exercisable" if it is postponed.
- The donor can choose to create a **general power of appointment** which is defined in IRC section 2041(b)(1) and Probate Code § 611(b) as a power, "exercisable in favor of the donee, the donee's estate, the donee's creditors, or creditors of the donee's estate, whether or not it is exercisable in favor of others."

The Power of a Power of Appointment for Basis Planning

- A "power of appointment that is not "general" is "**special**" or sometimes referred to as "**limited**." (Probate Code § 611(d)) Reg. § 20.2041-1(c)(1) states "a power of appointment is not a general power if by its terms it is either – (a) exercisable only in favor of one or more designated persons or classes other than the decedent or his creditors, or the decedent's estate or the creditors of his estate, or (b) expressly not exercisable in favor of the decedent or his creditors, or the decedent's estate or the creditors of his estate."
- A special power of appointment cannot be exercised in the donee's favor. Therefore, a power to appoint anyone other than the donee, the donee's estate, the donee's creditors, or the creditors of the estate is a special (or limited) power of appointment.

The Power of a Power of Appointment for Basis Planning

- A **power of appointment by a will** generally is considered to be created on the day of the testator's death and is a power created by the Will of the deceased. A **power of appointment created by inter vivos instrument** (a document created specifically for the establishment of the power or the power is contained in a trust) is considered to be created on the date on which the instrument takes effect. (Reg. § 20.2041-1(e))
- The power must be in writing and must be specific in its terms and description.
- Also, if you are drafting an exercise document**, you must follow the requirements of the instrument. The instrument may need to be notarized and/or delivered in a certain way, and you should always specifically reference the power of appointment.**

The Power of a Power of Appointment for Basis Planning

- **Practical Uses:**
- Looking over the massive changes that can occur, it is important to realize that the world does not stop at death, and one may need to take into account events occurring after death, especially if assets are left in trust. If the client wants to adjust what happens with her wealth after death, a power of appointment is necessary.
- Typically, the power states the person holding the power may adjust what goes to the children or grandchildren taking into account certain subsequent events, but limits the gifting to only the children and grandchildren and often limits the amount of the change allowed, e.g. only half of a person's share may be altered, etc.

The Power of a Power of Appointment for Basis Planning

- **Practical Uses:**
- Basis Step-Up. The mere existence of a general power of appointment, even if it lapses at death and was not exercised, results in the assets of the trust being included in the estate of the beneficiary that held the power of appointment.
- If a trust is being created for a beneficiary for life (or even for an age that is not very close to the current date), consider giving the beneficiary a general power of appointment. Of course, the beneficiary may exercise such power to alter the planned distribution at the beneficiary's death.
- Consider having a Trust Protector/Special Trustee with the power to create powers of appointment.

Post Mortem Planning Techniques for Low Basis Assets

Post Mortem Planning Techniques for Low Basis Assets

- What happens if you are faced with an irrevocable trust with very low basis assets, and the beneficiary's estate is small enough that even with the addition of the trust, the beneficiary would not be subject to estate tax?
- Is there a way to boost the basis of such trust's assets.
- This is common with existing Bypass Trusts, especially those funded in the 1990s – the basis may be well below $600,000.
- Similarly, a beneficiary who received assets in trust for life with remainder to his children, may want to find a way to obtain a basis step-up so that upon the beneficiary's death there is a step-up.

Post Mortem Planning Techniques for Low Basis Assets

- This type of problem is why trusts drafted currently should include a "decanting" provision by which a Trust Protector can change the terms of a trust, perhaps with the consent of all beneficiaries. Some states allow this as a matter of right (e.g., NRS section 163.556 https://www.leg.state.nv.us/NRS/NRS-163.html#NRS163Sec556)
- Without such a provision or law, a court petition might be required, and there may be adverse tax consequences.

Post Mortem Planning Techniques for Low Basis Assets

- Practical Example: Eve, who survived Adam (he died in 1998) has two trusts that benefit her.
- A Survivor's Trust that holds her share of her assets has a value of $3,000,000, and upon her death, the assets will receive a basis step-up. Further, there will be no estate tax because she has a $11,800,000 estate tax exemption.
- The Bypass Trust holds appreciated securities with a value of $2,500,000, but a basis of only $625,000 (the exemption from 1998). At Eve's death, there will be no estate tax because the Bypass Trust is exempt, but there will be no basis step-up.
- The problem is that the Bypass Trust is a bit antiquated. While it is good that the Bypass Trust is irrevocable (preventing problems with a second family or creditor issues), the loss of a second basis step-up is a problem. The prime feature of the Bypass Trust, namely, the estate tax avoidance, is unnecessary – Eve has plenty of estate tax exemption!
- Can you perform an act of estate planning CPR, or, as we call it Bypass Trust Rescue?

Post Mortem Planning Techniques for Low Basis Assets

- Can there be a distribution to Eve of the assets so that they are included in her estate? The Trust may allow for "discretionary" distributions to Eve's Survivor's Trust, but is that really enough? Do the beneficiaries of the Bypass Trust have a say (certainly they may not like the terms of the Survivor's Trust).
- If a distribution is to be made, a family meeting would be a very good idea.
- To give substance to the process, deeds and accounts should be re-titled.
- The remainder beneficiaries may be deemed to be making a gift of their future interest if they consent.
- If a court petition is needed (there is no trust provision allowing for distributions of principal), you will want to mention the changed circumstances.

Post Mortem Planning Techniques for Low Basis Assets

- Delaware Tax Trap – if a bypass trust (or other non-includable trust) has a power of appointment, the Delaware Tax Trap can perhaps be used to include the trust in the beneficiary's estate.
- In the context of a bypass trust, this technique allows the surviving spouse to wait until soon before death to decide whether to trigger estate tax inclusion or not by providing for the exercise of the power of appointment.
- The rule states that a limited power of appointment will cause the subjected property to be included in the power holder's gross estate at death (by converting the power to a general power of appointment) if the power is exercised to create another power of appointment which, under the applicable local law, can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power. (§§2041(a)(3), 2514(d)).

Post Mortem Planning Techniques for Low Basis Assets

- These provisions, enacted under the local law of most states, were designed to prevent the holders of limited powers in trusts to avoid the limited time frame that a trust may be in existence under the rule against perpetuities.
- Now many states have either greatly extended the rule against perpetuities period or have abolished it entirely.
- Only works in states that allow for the second power to start the perpetuities “fresh”.
- Many states do not allow the power of appointment to start a fresh perpetuities period.

Portability and Basis Planning

Portability and Basis Planning

- Since January 1, 2011, when a spouse dies, the surviving spouse can acquire the deceased spouse's remaining unused estate tax exemption.
- This is a great tool for basis step up and a lot of other reasons.
- In its simplest application, if the estate tax exemption remains at its current $11,800,000 in 2020, and a spouse dies and leaves all his or her property to the survivor, then the survivor may have an estate tax exemption as great as $22,600,000.
- All that is necessary is to file a timely estate tax return for the deceased spouse and elect to give the survivor the unused exemption.
- It gives the frugal client an apparently good excuse to forego the creation of a two trust structure (the so-called "A-B Trust"), which requires the increased cost of its maintenance during the period only one of them is living.

Portability and Basis Planning

- Portability with outright distribution to the surviving spouse offers (1) simplicity and (2) basis step up of the deceased spouse's property on death of the survivor.
- Contrast this with a Bypass Trust: (1) asset protection and/or (2) asset control (e.g., second marriages when there are children of a prior marriage), (3) maximization of generation-skipping potential for descendants' estate tax purposes, (4) sheltering future appreciation of deceased spouse's property from estate tax by avoiding inclusion in the surviving spouse's estate; (5) generally no need to file an estate tax return if under the filing threshold; and, (6) if a return is filed with a Bypass Trust plan, the statute of limitation contesting the value of the deceased spouse's estate may prevent the IRS from second guessing that value – in contrast, the DSUEA is perhaps subject to IRS contest.

Portability and Basis Planning

- There are numerous considerations that may compel implementing or retaining the existing Bypass Trust technique, even though portability has certain benefits.
- The estate plan may permit the survivor or others to “wait and see” if concerns may appear or recede subsequently to the signing off on the plan, and elect different options at the passing of the first spouse.
- Any trust drafted should include a “disclaimer” option to allow the surviving spouse to disclaim into a Bypass Trust.
- In addition, give strong consideration if using a Bypass Trust to give a Trust Protector the power to confer a general power of appointment on the surviving spouse so as to include assets of the Bypass Trust in the surviving spouse’s estate.

Portability and Basis Planning

- We are going to discuss three options:
- First option – **Opt Out with potential Opt Back IN**
- For wealthier clients ($20,000,000 and up), the Bypass Trust is probably the correct choice.
- The decedent's property interest and rights are held in a Bypass Trust (a/k/a, the "credit shelter trust").
- The surviving spouse can be the sole trustee.
- The trust is available to the survivor for any one or more of: (1) the income of the trust, (2) the annual option to withdraw up to five percent of the value of the trust, plus (3) amounts distributed for the health, education, maintenance and support of the spouse.
- The spouse could have the right to appoint or distribute the property to any one or more persons or trusts, but not to or for the spouse, the estate of the spouse and the creditors of either.

Portability and Basis Planning

- In spite of all those powers none of the trust assets are includable in the estate of the survivor, and are not generally reachable by his or her creditors.
- Appreciation in the trust escapes estate tax.
- All is great, except that because the assets are not included in the estate of the survivor, the Bypass Trust's basis in those assets do not step up to fair market value at the survivor's death.
- To achieve a basis step up, a Trust Protector should be given the power to grant a general power of appointment over at least the assets of the Bypass Trust that have a fair market value in excess of basis.
- The disadvantages (other than basis issues, which can be addressed by a power of appointment) are cost and complexity.
- See SAMPLE CLAUSES below regarding power of appointment.

Portability and Basis Planning

- Second Option – **Opt In, Outright Distribution.**
- The disadvantages of outright distribution should be presented to the client, and they include:
- No protection from creditors;
- No assurance that assets will not pass to a second family
- Wasting of decedent's GST tax exemption – this exemption is not portable.
- Many practitioners believe that these disadvantages militate heavily in favor of either the Bypass Trust option, or a potential third option discussed below.
- As noted above, if you are drafting a plan that provides for Opt In, Outright Distribution, always include a Disclaimer Trust.
- Remember, even with outright distribution, the surviving spouse (or executor) must file a Form 706 to claim the DSUEA.

Portability and Basis Planning

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Portability and Basis Planning

- Third Option – **QTIP the Credit and Forget it.**
- We have discussed the disadvantages of each of outright distribution (too much freedom) and the Bypass Trust (possible loss of basis step up).
- Is there an option to restrict control of the surviving spouse but guarantee a basis step up?
- Yes – a trust for the surviving spouse that would qualify as a QTIP Trust and a QTIP election made on a timely filed Form 706.
- Revenue Procedure 2016-49 confirmed that a QTIP election can be made even if not necessary to reduce estate tax.
- If this option is chosen, make sure the Bypass Trust pays all income to the surviving spouse and that the trustee is obligated to make the property productive.
- The QTIP Trust is included in the survivor's estate.

Portability and Basis Planning

- If GST tax is an issue, then make a "reverse QTIP election."
- This keeps the decedent's GST tax exemption available for use to fund GST trusts.
- This third option may be the best way to obtain a basis step up but still protect the assets of the deceased spouse.
- It may be possible to give a third party Trust Protector the power to opt between a true Bypass Trust as opposed to a Bypass Trust with mandatory income. The surviving spouse would not have this power.

Distributing Assets Into the Estate

Distributing Assets Into the Estate

- Recall that assets transferred by gift (in trust or outright) have a carryover basis. The donor's basis is carried over and becomes the donee's basis. Upon the donor's death, there is NO step up in basis. **The donee's basis is "old and cold."**
- If the donee wants to sell, she will realize and likely recognize (more on possible "nonrecognition" strategies below) a capital gain. The old basis also does not allow for a new depreciation schedule.
- For most taxpayers, the best way to avoid all taxes on appreciated assets is to buy, hold, and die. The owner never pays capital gains tax and, assuming the owner's estate is less than the exemption, there is no estate tax. Upon death, the owner's beneficiaries receive a stepped up basis. All capital gain is wiped out.

Distributing Assets Into the Estate

- Federal long term capital gains rates (long term assets are those held for more than 12 months) have a maximum rate of 20%, plus the 3.8% "net investment income tax". We will assume the donee is in the highest income tax bracket, so that a 23.8% capital gains tax applies.
- State income tax can also be imposed, and recall that state income taxes are no longer fully deductible against the federal estate tax. My home state of California imposes a 13.3% tax on capital gains over $1,000,000.
- If a parent is not (and never going to be) subject to estate tax, gifting is a poor income tax strategy. Although the child's income tax rate may be lower than the parent's income tax rate, the loss of stepped-up basis may be a major loss.

Distributing Assets Into the Estate

- **What are the best ways to avoid capital gains taxes**
- **De-funding a trust.** Putting assets that were once gifted into a trust back into an estate can help avoid capital gains taxes.
- This is easier said that done. Gift trusts are almost certainly irrevocable, and the trustee would be violating his principal fiduciary duty if he gave the assets back to the donor.
- State law may allow for a revocation of an irrevocable trust by Court petition.
- The trust (and some jurisdictions) may allow for "decanting" a trust into another trust with better tax aspects. Check the trust instrument for the power of a Protector/Special Trustee.

Distributing Assets Into the Estate

- **Consider 'upstream gifting.'** This unique practice involves transferring an asset up the generational chain to an older family member such as a parent. You can also set a trust up for an older relative with this tactic. An asset transferred to an older relative allows the asset to achieve a step-up in basis at the time of the relative's death because even though it is considered a gift (gifts have no "step-up"), it is also considered an inherited asset which do receive a step up upon death.
- Beware of the IRC code section 1014(e) issue – if the parent is terminally ill or actually dies within one year, there is no basis step-up.

Distributing Assets Into the Estate

- **Home sale gain exclusion.** This exclusion permits an exclusion of up to $250,000 of capital gain per spouse when a couple sells their home. The only stipulation is that the client and the client's spouse must have lived in the home you are selling for two of the last five years before the sale. Note that only one spouse's ownership is enough.
- **Use a Section 1031 exchange if the Client has a real estate investment.** The Client can delay capital gains taxation (perhaps indefinitely until death) another way by using a section 1031 exchange which rolls over the gain from an original asset in to a new, similar piece of property or artwork. In this "like kind" swap of assets, the newly owned asset is assigned the cost basis of the original asset. The gain on the sale of the original asset will be deferred until you ultimately dispose of the new asset.

Life Insurance

Life Insurance

- The "Irrevocable Life Insurance Trust" or ILIT was (and still is) a critical estate planning tool.
- An ILIT, if properly structured and administered, allows a client to pay the premiums on a life insurance policy on his or her own life and have the policy proceeds excluded from his or her estate. The funds can then be used to provide liquidity for payment of estate tax.
- With an estate tax exemption of $11,580,000), the ILIT is far less relevant than it once was.
- "Normal" insurance coverage to protect children and surviving spouses in the event of an untimely death is no longer the trigger for estate taxes they once were.
- In most cases, ILITs are no longer necessary unless the family *already* has a net worth to expose them to estate taxes, for which any additional life insurance death benefits just compound the problem.

Life Insurance

- **UNWINDING AN OLD ILIT AND RESCUING ILIT-OWNED LIFE INSURANCE**
- So what can be done to revoke an irrevocable life insurance trust, either because the life insurance itself is no longer needed, or if the life insurance is still desirable, the ILIT structure around it is no longer necessary?
- Notwithstanding the name, the reality is that there often *are* paths to make adjustments (or even outright terminations) for ILITs that may no longer be needed. However, the exact options vary depending on the precise terms of the trust, as well as what may be permitted (or not) under state law.

Life Insurance

- **ILIT RESCUE: BUY BACK (OR SUBSTITUTE OUT) THE LIFE INSURANCE POLICY**
- Often the simplest way to unwind an ILIT is to extract the life insurance policy out of it by having the grantor either buy the policy back or "substitute" another asset for an equivalent value in exchange for the life insurance policy.
- In fact, the power to substitute replacement assets of equivalent value into a trust under IRC section 675(4) is often used as one of the key powers to *make* an ILIT into a grantor trust in the first place. Especially since Revenue Ruling 2011-28 affirmed that the power of substitution is *not* treated as an "incident of ownership" that would cause the life insurance to be included in the decedent's estate under IRC section 2042 in the first place.

Life Insurance

- Accordingly, one of the most straightforward ways to extract a life insurance policy out of an ILIT is to simply swap out the life insurance policy for an asset of equivalent value (e.g., cash).
- On the plus side, because (confirm this) the ILIT is a grantor trust – which means the trust itself is treated as an extension of the grantor's own identity for income tax purposes – there's no taxable event associated with the substitution to extract the life insurance policy out.
- Alternatively, if the ILIT doesn't have a substitution power, it may also be feasible for the grantor to *buy* the policy back from the trust for its fair market value.
- Because the grantor is the insured who's purchasing the policy, the death benefit will remain tax-free and not be subject to the transfer-for-value rules under IRC section 101(a)(2)

Life Insurance

- Notably, though, while a substitution or purchase of the life insurance policy does extract it out of the ILIT, and eliminates the need for future premium gifting and Crummey notices, it doesn't fully eliminate and unwind the ILIT itself.
- The ILIT will still end out holding the *cash* (or other substituted value) proceeds from the transaction. Completely unwinding the ILIT will require additional steps to extract *all* of the assets out of the trust. This is discussed further below.

Life Insurance

- **LAPSE THE (TERM) POLICY THAT'S NO LONGER NEEDED**
- The next option to "unwind" an ILIT, especially if the life insurance itself is no longer needed, is simply to stop making premium payments and allow the insurance policy itself to lapse.
- As typically the *only* asset in an ILIT is the life insurance policy that it owns. So at the point that the policy lapses – especially if it's a term insurance policy with no cash value – the ILIT may technically still be in existence, but it will literally own nothing, so practically speaking the ILIT can simply be ignored from that point forward.

Life Insurance

- Unfortunately, though, the situation is more complicated if the ILIT owns a permanent insurance policy, as there again is existing cash value that must be contended with.
- If the ILIT policy is a universal life policy, it *is* feasible to simply stop making premium payments, and allow the cash value to cover the policy expenses as long as it can. Whenever the cash value runs out, the universal life insurance policy will lapse.
- In the case of a whole life insurance policy, though, premium payments *must* be made to continue the policy in force. And while loans can be made against the policy to then re-deposit in the form of new premiums, doing so will accrue a loan against the life insurance policy that more quickly erodes its remaining cash value and hastens its demise.

Life Insurance

- **SURRENDER (OR SELL) THE CASH VALUE LIFE INSURANCE POLICY**
- The alternative for permanent life insurance policies with cash value is simply to proactively surrender the policy instead.
- This eliminates the need for any new premiums and preserves the existing cash value (rather than letting the permanent policy lapse by eroding the cash value down to $0 for life insurance coverage that ostensibly was no longer needed anyway).

Life Insurance

- For policyowners who are at least 60-something years old, another option is to *sell* the life insurance policy, rather than merely surrender it, as life settlement transactions can sometimes pay even more to the policyowner (in this case, the ILIT) than just the cash value alone.
- NOTE - both surrendering and selling the life insurance policy can also trigger a taxable gain (to the extent the surrender/sale value exceeds the premiums paid), and once an ILIT's life insurance policy is surrendered or sold, the ILIT again may no longer need to deal with premium gifts and Crummey notices, but as in the case of a substitution or sale back to the grantor, the ILIT will still continue to exist… simply owning a pile of cash, instead of the life insurance policy the cash came from!

Life Insurance

- **DISTRIBUTING THE LIFE INSURANCE CASH (OR EVEN THE POLICY ITSELF) OUT OF THE ILIT**
- For those who don't want to just terminate the life insurance policy itself (to end premium gifts and Crummey notices), or have ended the life insurance but still have cash in the ILIT and are looking to eliminate the ILIT altogether, another option is to distribute the life insurance (or its surrender/sale cash proceeds) *out* of the ILIT to the beneficiaries.
- Unfortunately, though, the trustee of an ILIT is still bound to the terms of the ILIT itself regarding what can and cannot be distributed to the beneficiaries. Which means the ILIT trustee can't just "decide" to disband it. Instead, the ability to eliminate the trust altogether depends entirely on the terms of the ILIT and its flexibility to *make* those liquidating distributions in the first place.

Life Insurance

- In many (or even most) cases, ILITs are limited from making any distributions until the death of the insured, as the whole point was/is that the ILIT won't have any cash *to* distribute until the insured dies anyway!
- However, in some cases, the ILIT may actually allow an outright distribution to the beneficiaries *before* the owner passes away, at least at the discretion of the trustee.
- In other situations, the trustee may have been granted the discretion to make principal distributions from the trust (separate from or regardless of the age of the beneficiaries), which similarly makes it feasible for the trustee to either distribute the life insurance policy in kind (as part of the trust's principal), or its cash proceeds after sale or surrender.

Life Insurance

- **<u>PETITION THE COURT TO TERMINATE THE ILIT ALTOGETHER</u>**
- If it’s not feasible under the terms of the trust to simply distribute its assets under the trustee’s discretion, the next option is to “force” a termination of the trust.
- In practice, the exact rules and conditions under which a trust can be terminated will vary by the terms of the trust itself, and/or the state in which the ILIT is based (according to the terms of the trust).
- In general, though, there are four common pathways to terminating an ILIT:

Life Insurance

- 1) **Trustee's Power To Terminate.** Some ILITs grant trustees the flexibility to make distributions of some or all of the trust's assets. Others may grant the trustee the discretion to terminate the trust altogether. Although the ability to terminate an ILIT is not common and may be subject to additional restrictions (e.g., a special independent trustee who must affirm the decision to terminate), it is a possibility that merits reading the trust document to find out.

Life Insurance

- 2) **Trustee's Power To Terminate A Small Trust.** Because there are ongoing accounting and tax filing costs, sometimes along with trustee fees that must be paid to maintain a trust, it is common for most trust documents to have a provision that allows the trustee to terminate in the event that it is no longer "economical" to maintain the trust because it is too small. In the case of an ILIT with a cash value life insurance policy with material value, this may not be feasible, but an ILIT owning a term insurance policy with no cash value may fit the trust document's "small trust" requirement, permitting a termination (and distributing the term insurance policy to the beneficiaries).

Life Insurance

- 3) **Consent Termination By Grantor And Beneficiaries.** Although the exact rules vary by state, most states allow trusts to be terminated by the mutual consent of the trust beneficiaries *and* the trust's original grantor.
- However, a consent termination requires the affirmation of *all* (current and even distant remainder) beneficiaries, which may be difficult or impossible if some of the beneficiaries are uncooperative or hard to reach, or simply are children who are minors and may not be able to give consent under state law (or may require a Guardian Ad Litem to do so).

Life Insurance

- 4) **Beneficiary-Directed Court Termination.** The last (and typically most costly) pathway to terminate, when the beneficiaries wish to do so but the grantor will not (or cannot) consent, is to seek a court to agree to terminate (or otherwise modify) the trust.
- A court termination still requires all beneficiaries to agree to the termination, and the courts will generally not approve a termination that would otherwise violate a "material purpose" of the trust (e.g., if the ILIT was designed to pay for kids to go to college and some of the children haven't gone to college yet, a termination will be denied as it would frustrate the material purpose of the trust to fund college) unless the beneficiaries can demonstrate other factors that "substantially outweigh" the original material purpose

Sample Clauses

SAMPLE CLAUSES

- **1.1 <u>Special Trustee's Limited Power to Amend Trust.</u>**

Subject to the provisions of section 1.2 below, at any time or times the Special Trustee (as defined below) may amend any provision of this instrument in any manner to (a) construe or modify any provision of this trust that the Special Trustee determines to be ambiguous or to not carry out the settlor's intent as stated herein in light of circumstances existing at the time such provision is required to be implemented; (b) add or delete any administrative provision of this trust that the Special Trustee determines to be appropriate for the administration of any trust; and (c) modify any provision of this trust to result in better conformity between the settlor's intent as stated herein and the applicable provisions of federal and state tax laws.

SAMPLE CLAUSES

- **1.2 <u>Limitations on Special Trustee's Power</u>**

The Special Trustee's power to amend the trust shall be subject in all cases, to the following limitations:

No power to amend shall exist if, as a result of holding or exercising such power, any part of the trust will be included in the estate for federal estate tax purposes, of the Special Trustee exercising such power.

The power granted to the Special Trustee under section 1.1 shall not be exercised in a manner that causes any trust or beneficiary that owns stock in an S corporation to be ineligible to hold such stock without terminating such corporation's S election.

The date upon which any trust is to terminate cannot be later than the expiration of the maximum duration period allowed under applicable law.

SAMPLE CLAUSES

The provisions of sections 1.1 and 1.2 may not be changed, except to further restrict the amendment powers conferred upon the Special Trustee under section 1.1.

No amendment shall alter the terms of this instrument so as to affect adversely the status of any trust as exempt from generation-skipping transfer tax.

Any provisions hereunder relating to powers held by the Settlor in any capacity may not be changed at any time the Settlor holds such powers, except to further restrict such powers as applicable to the Settlor.

Any amendment by the Special Trustee shall be made by written instrument signed by the Special Trustee and delivered to (i) the trustee, and (ii) the settlor, during the settlor's lifetime, and (iii) to each adult beneficiary whose interest in the trust has vested. If any adult beneficiary is incapacitated, such instrument shall be delivered to a legal representative of such beneficiary.

SAMPLE CLAUSES

All decisions made by the Special Trustee pursuant to section 1.1 shall be made in the Special Trustee's sole and absolute discretion and shall be final and binding on all parties. The Special Trustee shall not be liable to the trustee, any beneficiary, the settlor, or to any other person or entity for any action the Special Trustee takes or declines to take in good faith under section 1.1.

The Special Trustee may at any time completely or partially release any one or more of the foregoing powers or may suspend it for a specific period of time. Unless otherwise specified in the release or suspension, if any such power is released or suspended, it shall cease to exist and it shall not pass to any successor Special Trustee. Unless otherwise provided in the release or suspension, any such release or suspension shall be effected in the same manner as an amendment, shall be irrevocable, and shall bind all trustees and Special Trustees serving at any time.

SAMPLE CLAUSES

- **1.3 <u>Special Trustee's Power to Appoint in Further Trust.</u>**

During the existence of this trust or any trust created hereunder, subject to the provisions of section 8.1 below, the settlor specifically authorizes the Special Trustee to appoint such portion or all of the income and/or principal of any irrevocable trust hereunder in favor of any existing trust or any trust to be established for the current beneficiary or beneficiaries (excluding the Special Trustee and any person related to the Special Trustee by blood, marriage, or adoption), and for any additional beneficiaries ("Other Trust"), in which case such appointment shall supersede the provisions of the trust hereunder for any current beneficiary or beneficiaries;

SAMPLE CLAUSES

provided, however, that (a) no portion of a trust with a GST tax inclusion ratio greater than zero that is directed to continue in a trust shall be added to a trust with an inclusion ratio of zero or to any Other Trust if doing so would cause the Other Trust to lose its status of being exempt from the GST tax for any reason, and (b) no portion of any trust hereunder that is a "qualified subchapter S trust" (as defined in Internal Revenue Code Section 1361(d)(3)) or an "electing small business trust" (as defined in Internal Revenue Code Section 1361 (e)(1)) may be paid to any Other Trust if such payment would cause the termination of an S corporation election (as defined in Internal Revenue Code Section 1362(a)) in effect at the time of the exercise of the power.

SAMPLE CLAUSES

All decisions of the Special Trustee shall be final and binding, and the Special Trustee shall not be liable to the trust, any beneficiary, or any other person for any consequence of the Special Trustee's exercise of the powers vested in the Special Trustee under this section 1.3 or the non-exercise of such powers by the Special Trustee. The Special Trustee may at any time or times release, in whole or in part, the powers vested in the Special Trustee under this section 1.3. Each appointment made pursuant to this section 1.3 shall be made by a written instrument signed by the then acting Special Trustee and delivered to the trustee (if the Special Trustee is not also the trustee). Notwithstanding the foregoing, the settlor confirms that (i) the Special Trustee may confer on a beneficiary a general power of appointment by which such beneficiary may appoint the assets in favor of any one or more of the beneficiary, the beneficiary's estate, the beneficiary's creditors, and/or the creditors of the beneficiary's estate, (ii) such Other Trust may be for the benefit of one or more of the current beneficiaries to the exclusion of the others, and (iii) the remainder beneficiaries of the Other Trust may be different from the remainder beneficiaries under this instrument.

SAMPLE CLAUSES

- **1.4 <u>Special Trustee</u>**

The "Special Trustee" shall be the trustee then acting who is not (a) the settlor, (b) a person deemed related or subordinate to the settlor under IRC Section 672(c), (c) a beneficiary of any trust created hereunder, or (d) a person deemed related or subordinate to such beneficiary under IRC Section 672(c). If the trustee then acting does not qualify as a Special Trustee, the trustee may appoint a Special Trustee by giving written notice to the settlor (if he is living) and the current beneficiaries of the trust. The trustee may remove a Special Trustee in the same manner as the appointment was made. All provisions of the trust shall apply to the Special Trustee.