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Estate Planning for Income Tax Reduction: Strategies for Maximizing New Basis

Leveraging Estate Tax Inclusion, Partnerships, Trusts, and Powers of Appointment

WEDNESDAY, AUGUST 24, 2016

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

Today's faculty features:

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Estate Planning for Income Tax Reduction: Strategies for Maximizing New Basis

Presented by: Edwin P Morrow III, JD, LL.M., CFP®,

L. Paul Hood, Jr., J.D., LL.M.

8/24/2016 Stafford CLE Teleconference on Basis Planning

Key Private Bank

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Agenda

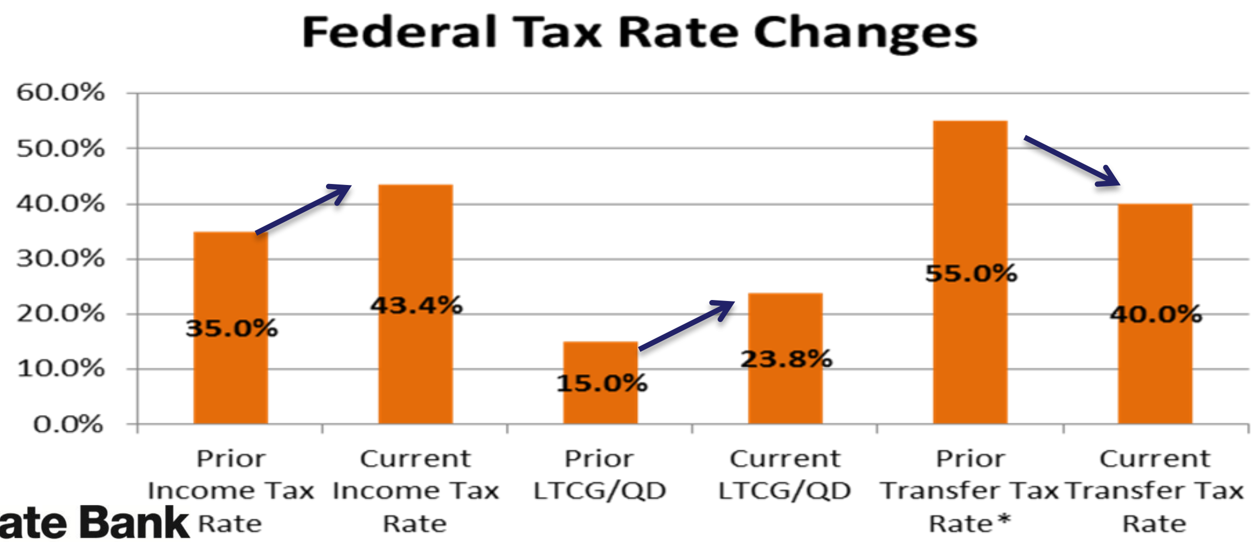
- Tax law changes, the increased importance of basis and income tax planning, & portability
- The huge *BENEFIT?* of proposed 2704 regulations
- Marital trusts – loopholes, hidden problems
- Adapting/administering bypass trust for better basis
- Re-designing bypass trusts for better basis
- Narrowly crafting GPOAs for optimal basis effect
- Using the Delaware Tax Trap to increase basis
- Seizing basis opportunity for irrevocable trusts
- Full basis at *first* death; comparing the options
- How disclaimers can *increase* basis
- “Upstream” basis planning at *older relative’s* death

What's New in Estate Tax Planning?

- "Permanent" $5 million estate/gift/GST, adjusted for inflation adjusted for inflation, up to $5.45 million in 2016), $10.9 w/ portability
- "Greenbook" proposals, endorsed by the Democratic nominee, Secretary Clinton, propose to make $3.5 million estate/gst excl., $1 million gift excl., 45% top rate – unlikely to pass, but possible with a new Congress?
- Newly proposed 2701/2704 valuation regulations affecting entity valuation

Income Tax Planning for Estates?

- With the federal estate tax exclusion at $5.45 million in 2016, indexed for inflation, plus double with portability, and considering many taxpayers leave assets to charity, the number of estates actually paying estate tax is far less than 1% of the population, a few thousand returns nationwide at most. For the 99%, it's the income tax! The chart does not even factor in PEP/Pease phaseouts or state income tax!



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Proposed 2701/2704 Regulations: *Treasury's Gift to the Middle Class*

- Newly proposed regulations may, *if* made final as proposed *and upheld*, severely restrict valuation discounts (details beyond this CLE), curtailing popular techniques for wealthy
- Although the bar will fight the validity and fairness of the regulations, it may save thousands of attorneys and accountants from malpractice claims for failing to address the *income* tax disaster of valuation discounts for the upper-middle class who own LP/LLCs and other closely held businesses, but will NOT pay an estate tax (i.e. they don't WANT valuation discounts and prefer higher basis).
- E.g. H&W each own 50% of XYZ, LLC, with $6 million of low basis real estate, $2-4 million of other assets. H dies and leaves his 50% share to trust (discussed herein)

The Challenge for Sub $10.9 Million Estates

- The popular financial press, even sophisticated CFPs, CPAs, and yes, even attorneys are questioning bypass trusts or even the need for trusts at all for the “99%”

- The most common “solutions” cited are to ditch the trust altogether, use disclaimer funding, or use an “all marital” approach – **all of these have significant flaws**.

Three Key Tax Problems of Trusts to Address

1. Lack of 2nd basis “step up” that a simple “I love you will” or even intestacy would probably provide the family

2. Potentially higher trust income tax rates

3. Unique assets may get worse tax treatment

See page 3-4 of CLE outline – goal of this CLE is to **turn these negatives into positive tax *advantages* over outright dispositions, focusing on #1 above**

What's Now Involved in Estate Planning?

- Inter-vivos gifting is more complex and has to include income tax issues. Assets that most benefit from a new basis at death (inclusion in gross estate):
  - Self-created intellectual property (copyrights, art, etc.) (ordinary)
  - "Negative basis" or highly depreciated property (25% recapture or ord.)
  - Gold, artwork and collectibles (28% rate)
- Trade off now is between transfer tax not affecting 99% of taxpayers and capital gains tax (55%->40%, 15%->23.8% (plus state income taxes up to 13.3%), affecting over 90% of taxpayers.
- Income tax is more important now for many clients than estate tax even in "estate" planning.

What’s Now Involved in Estate Planning?

Bottom line: there’s a new paradigm in town - income tax basis management and management of ongoing income tax:

- Rethink giving away significantly appreciated assets during lifetime due to carryover basis rules of IRC § 1015 (but, what if we could get a step up at an older relative’s death, “upstream?”, discussed later)
- However, ATRA **significantly** complicated the analysis --- M**alpractice risk? Must** we point out the income tax perils of AB trusts - similar to the old warning about not using the unified credit in the estate of the first spouse to die before portability – do your memos explain basis, discounting, tax shifting and other ***income*** tax issues of AB trusts?!

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Section 1014

- Very convoluted statute, with surprisingly many controversies and unanswered questions – general rule: new basis for assets included in taxable estate
- Some argue (but query whether anyone has taken the position on a return), that irrevocable grantor trust assets OUTSIDE a decedent grantor's estate get a step up in basis.
- Some argue 2036 inclusion does not trigger 1014
- New § 1014(f) complicates taxable estates
- § 1014(e) uncertain in application to trusts

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Section 1014

- **(a) IN GENERAL** Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be—**(1) the fair market value of the property at the date of the decedent's death**,

Full statute with notations on page 164 of outline

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Why not ditch the trust?

- Traditional Asset Protection/Family Bloodline

- State Estate/Inheritance Tax Bypass 12-19%

- Quirks of Portability, DSUE, simultaneous death, remarriage
- Income Tax Benefit? - state, spray, etc

See page 4-8 of CLE outline

A False Dilemma – Thinking Outside the Box

- Not a choice between outright v. bypass trust

- Neither is it a choice between bypass v.marital

- A *Clayton* QTIP offers some advantages over *disclaimer* planning, but they both simply *delay* the ultimate choice of what type of trust, and trust terms, are ultimately desired

See page 8-9 of CLE outline, example page 9

Marital Trusts – Simple Solutions?

- QTIP marital trust – most common choice – requires 706 and election and has Rev. Proc. 2001-38 “issues”, enables separate state QTIP election in many states
- GPOA marital trust – less common, but may have various advantages over QTIP – no 706 filing required to get 2nd step up, no valuation issues, no Rev. Proc. 2001-38 issues – but a rigid GPOA is required
- **Both force a Step DOWN (as well as “up”) in basis, force out income (“leaky” for asset protection), *cannot use broad lifetime limited powers of appointment (LPOAs) or spray/shift income***, not as ideal for state/federal estate tax savings since most states w/ estate tax have not adopted portability

See page 11-15 of CLE outline, example page 12

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Marital Trusts – Simple Solutions?

- Overlooked problems with businesses, LLCs, real estate where fractional interests go into trust:
- Example: John leaves ½ of home, ½ of LLC (underlying value $500,000 each) to QTIP. His wife *Jane has the other half*. She lives 8 years, the value doubles. Is the basis to the heirs (be it in trust or otherwise) $1,000,000 for the home, $1,000,000 for the LLC? Well, **this depends on the type of marital trust**. At 30% valuation “discount” for a non-controlling 50% share (LLC>TIC), it may be as low as $350,000 FMV basis for each 50% share, $1.4 million, not $2 million – at $600,000 lost basis times 23.8% (28.8%) plus up to 13% state capital gains tax - that’s **nearly a two hundred thousand dollar mistake**

See page 11-15 of CLE outline, example page 12; § 2704

Understanding Powers of Appointment

- Powers of Appointment (POA) have TREMENDOUS income tax planning potential for both stepping up basis (at death) and spraying income (lifetime).

- GPOA (general power of appointment) – power to appoint to yourself, your estate, or creditors of either – can be lifetime, or testamentary (only effective at death) – triggers gift tax/estate inclusion
- LPOA (limited powers of appointment) – power to appoint that excludes power to appoint to self, estate, or creditors or either – usually does NOT trigger gift tax or estate inclusion, except special circumstance

See further definitions page 163

Other Ways to Adapt Bypass Trusts for Basis

1. Trustee or trust protector's discretion to distribute the entire trust to spouse

2. Adding GPOA by Private/Non-Judicial Settlement, court ordered amendment or reformation, decanting (like GM deciding it's best to add a seat belt later)

3. Using "collateral power" LPOA held by non-fiduciary family member to distribute/decant to surv. spouse

4. Late QTIP? Really, really late?? (cite page 15)

See page 16-18 of CLE outline – comparison chart

Other Ways to Adapt Bypass Trusts for Basis

5. Use LPOA that defaults to GPOA to the extent not exercised (do not default to powerholder's estate), exercise LPOA over IRD/high basis assets/cash, or more if needed to reduce estate

6. **Use LPOA over entire trust, but exercise the power in a way so as to trigger the Delaware Tax Trap (IRC Section 2041(a)(3)). Exercise can be triggered by formula.**

7. **Use a formula testamentary GPOA with caps and ordering rules to prevent a step "down" yet enable a "step up", without incurring estate tax.**

See page 16-21 of CLE outline – **Optimal Basis Increase Trust**

Who cares about "step down"?

- First, understand that the "step up" is a "step down" as well. People forget this at their peril. Marital trusts?
- John Bogle (Vanguard founder, former CEO), opined on CNBC in May 2013 that, while he recommends stocks for the long haul, he still estimates **not one but two 50% drops** in the market over the next decade.
- Sound crazy? – what about decedents who died in 2008-2009? (see simple example on page 9)
- Think the bond market is safe from drops? Consider a 10 year duration bond fund would lose 25% from a mere 2% interest rate increase – anyone remember the 70s-early 80s or think rates cannot go up?

See page 17 of CLE outline – **the chart page 21-22**

Traditional AB Trust - Basis Effect

John and Mary Doe Trust
(could be joint or two separate trusts)

At John's Death

John Doe Bypass
Fbo Spouse (& children?)
< $5.45mm (or basic exclusion amount)

John Doe Marital Trust
Fbo spouse only,
> $5.45mm (or basic exclusion amount)

At Mary's Death

Trust for children
No change in basis for any asset (when children/trust sell property, capital gains on any post-death appreciation)

Trust for children
All new basis except IRAs, Qualified plans, annuities (including step down)

Marital (QTIP) Trust – Basis Effect

John & Mary Doe Trust
(could be joint trust or two separate trusts)

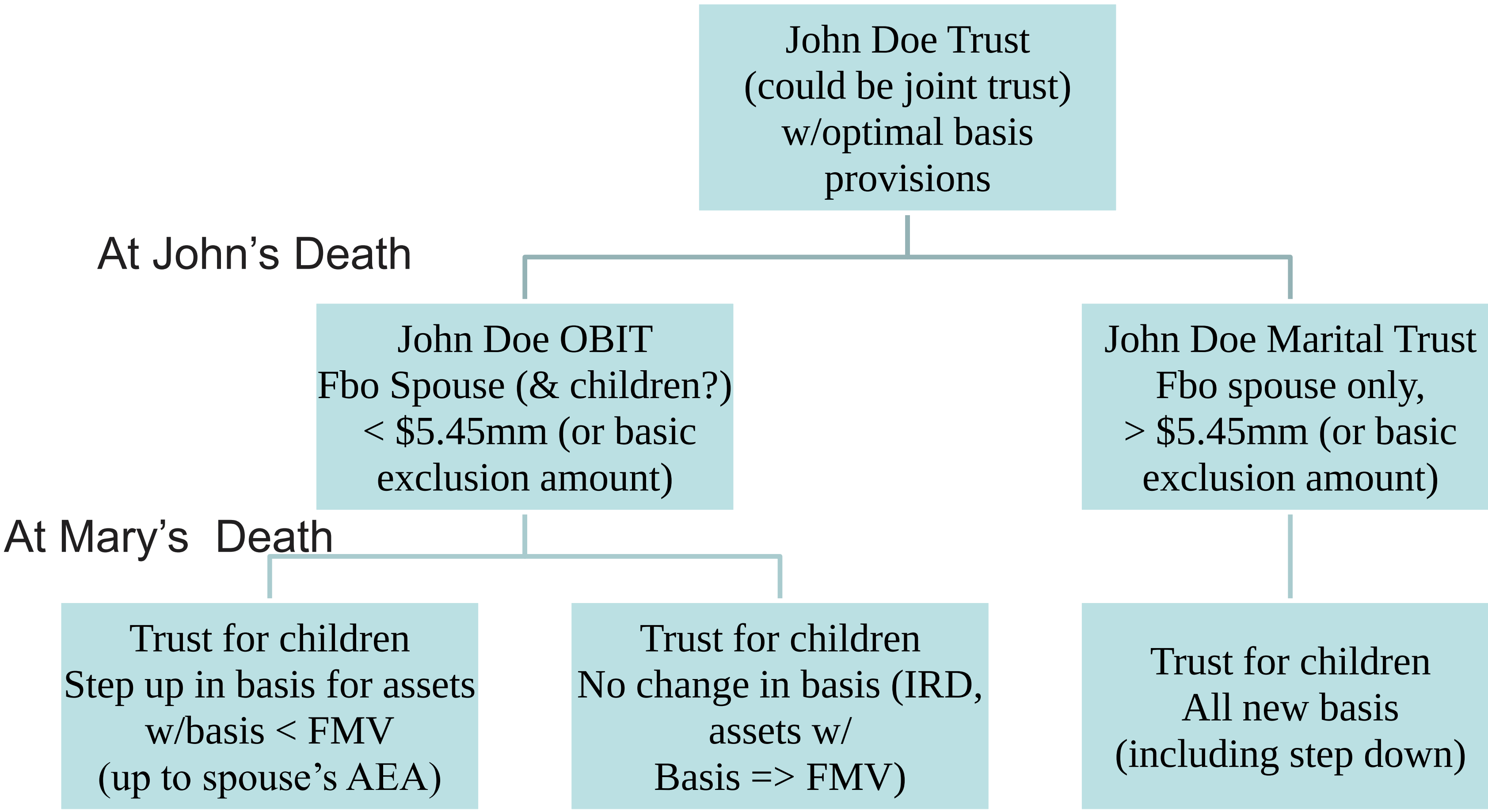
At John's Death

John Doe Marital Trust
Fbo Mary only,
Entire estate goes to QTIP or outright, $5.45 million DSUE "ported"

At Mary's Death

Trust for children
All new basis except IRAs, annuities, qualified plans (including **step down in basis, and discounted basis if fractional interests owned between Mary and QTIP**)

Optimal Basis Increase Trust – Basis Effect



Uses GPOA or LPOA, Section 2041
To trigger estate inclusion and 1014 step up

Optimal Basis Increase Trust

- See page 21 of CLE outline example, a simplified list and columns of assets in bypass trust from $2 million left to spouse in bypass trust, 8 years later:

Traditional deductible IRA	*basis $0,*	*FMV $700,000*
Total "IRD" Property	**basis $0**	**FMV $700,000**
Apple Stock (the iPhone 9 flopped),	basis $500,000,	FMV $200,000
Condo in Florida (hurricane depresses value),	basis $1,000,000,	FMV $600,000
LT Bond portfolio (inflation depressed value)	basis $400,000	FMV $300,000
Various stocks that have decreased in value	basis $150,000,	FMV $100,000
Total "loss" property	**basis $2,050,000,**	**FMV $1,200,000**
Rental Real Estate	basis $200,000,	FMV $600,000
Various stocks that have increased in value	basis $400,000,	FMV $900,000
ST Bond Portfolio, Money market, Cash	*basis $400,000,*	*FMV $400,000*
Gold	basis $100,000	FMV $200,000
Total "gain" property	**basis $1,100,000**	**FMV $2,100,000**
Total at Jane's death	basis $3,150,000	FMV $4,000,000

- Ideally, clients want a step up for appreciated assets that would benefit from basis increase, and keep existing basis on assets that would otherwise be "stepped down" if in the estate

See page 21-22 of CLE outline

Optimal Basis Increase Trust

Differing Basis Results at surviving spouse’s death under three planning structures:

New Basis at Surviving Spouse’s Death if using:	Ordinary Bypass	QTIP/outright	OBIT
Traditional deductible IRA	*$0*	*$0*	*$0*
Apple Stock (the iPhone 9 flopped),	$500,000	$200,000	$500,000
Condo in Florida (hurricane depresses value),	$1,000,000	$600,000	$1,000,000
LT Bond portfolio (inflation depressed value)	$400,000	$300,000	$400,000
Various stocks that have decreased in value	$150,000	$100,000	$150,000
Rental Real Estate	$200,000	$600,000	$600,000
Various stocks that have increased in value	$400,000	$900,000	$900,000
ST Bond Portfolio, Money market, Cash	*$400,000*	*$400,000*	*$400,000*
Gold	$100,000	$200,000	$200,000
Total Basis for Beneficiaries at Jane’s death	**$3,150,000**	**$3,300,000**	**$4,150,000**

Capping Inclusion/GPOA to Soak Up AEA

- Adding/drafting GPOAs is easy when both spouses have estates under $5.45 million (one AEA)
- Just as we do with "AB" splits, we want to cap the amount of the GPOA, as we typically cap the amount going to a marital trust, to optimize tax benefits.
- Trickier - Which assets do we want to soak up the "coupon" if the available exclusion amount is limited, and can we have assets chosen at the trustee's discretion, the powerholder's discretion? Could this force pro-rata inclusion? Do we want a $500,000 block of stock with $490,000 basis to soak up the same "coupon" as a $500,000 building with basis of $180,000? Only matters for mid-size/larger estates.

See page 25-29 of CLE outline

Crafting GPOAs For Fidelity/Protection

- GPOAs in marital trusts must be very narrow

- However, all other GPOAs can be narrowly crafted to prevent any unwanted exercise as a practical matter

- Can be conditioned on consent from a "non-adverse" party, essentially, a non-beneficiary – can even be a trustee!!! (though I personally would not use trustee)
- Testamentary GPOA not necessarily subject to powerholder's estate's creditors (except e.g. CA, -difference in uniform act draft, 2nd/3rd restatements)

See page 33-37 of CLE outline

Adapting GPOA Caps for STATE estate taxes

- You don’t want to incur $12-$20 state estate tax for a mere $1 in basis increase. Most formulas will base cap on STATE as well.

- It would be more complicated of a formula to cause *state* estate tax if the federal and state income tax benefit outweighs the state estate tax – practitioners will probably opt for simplicity and prevent any formula GPOA from causing additional state estate tax (even if there would be state and federal income tax benefit that might outweigh any state estate tax)

- Perhaps client would only want real estate or depreciable assets with substantial difference between basis and FMV to justify inclusion and state estate taxes

See page 31-33 of CLE outline

Potential Issue with Formula GPOAs?

- Could the IRS claim that by the spouse manipulating his/her available applicable exclusion amount, that the “formula” GPOA’s cap is illusory? After all, spouse could spend all his/her money, or leave it all to new spouse/charity and now have more power over the bypass trust in theory (although those factors should have “independent significance”)
- The *Kurz* case could give some pause in this regard, but it is a completely different scenario and should not give cause for concern. Still, you might eliminate by omitting marital/charitable.

See page 50-55 of CLE outline

Drafting Options with Formula GPOA Caps?

- Base the cap on the power holder's gross estate, so no return would be required per § 6018 (avoiding Form 706 filing and Form 8971 risk and hassle), but losing some step up
- Base it on net taxable estate after **all** deductions
- Base it on net taxable estate, but without consideration of marital/charitable bequests
- Base it on available GST *exemption* (since GST exemption could in theory be less, maxing GST)
- Allow the cap to cause a dollar tax to allow for choice of alternate valuation date
- Allow trustee pick and choose?

See variations in the appendix of CLE outline

Using the Delaware Tax Trap In Lieu of GPOA

- Sounds crazy? What the heck is the Delaware Tax Trap (DTT)?

- IRC 2041(a)(3) – *complicated* – extending rule against perpetuities via LPOA – if you appoint to a trust granting a powerholder a POA, can this new power be ***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***
- ***Most states require limited powers of appointment to refer back to the creation date of the first power, foreclosing use.*** I propose "opt-in" state statutes that would enable this. ***However, most states permit GPOAs to postpone vesting, ownership without regard to the date of the creation of the first power.***

See page 42-46 of CLE outline

Using the Delaware Tax Trap In Lieu of GPOA

- So, similar to the formula GPOA discussion, why not simply use a LPOA to appoint assets for which a basis increase/estate inclusion is desired, to a “Delaware Tax Trapping Trust” (sounds complicated, but you have all drafted these before without knowing it).

- Similarly, any IRD/cash/assets with basis higher than FMV might go to beneficiary and/or ordinary trust avoiding DTT
- Spouse can later pick and choose, amending the exercise, to choose assets children are most likely to sell
- Chief drawback of “PEG” power is reduced asset protection, flexibility, increased estate inclusion for children – but, consider ideas in outline to mitigate these risks.

See page 42-46 of CLE outline, extensive comparison page 55

OBIT Techniques: Existing Irrevocable Trusts

- This is a **HUGE opportunity** to provide significant value for widows, widowers having bypass trusts, or anyone else who has inherited an interest in a GST exempt trust (often a non-exempt trust would have a GPOA anyway, but those are ideal)
- How many widows/widowers as beneficiaries of bypass trusts have over $5.45 million of their own assets (or, whatever their AEA is, if their late spouse died recently, they may have more from DSUE, or could have less from prior taxable gifts). 1%?
- If they already have an LPOA, use the Delaware Tax Trap, unless GST concerns or the family situation rules out granting a presently exercisable GPOA (but consider mitigating ideas in outline).

See page 103 of CLE outline; review checklist for basis increase

OBIT Techniques: Existing Irrevocable Trusts

- If there is not an LPOA, DO NOT GIVE UP, there are many ways to effect an amendment, decanting, or reformation under the UTC or common law, even if no amendment/protector provision

- *This is not the same* as reformations to marital trusts, “see-through trusts” designed to qualify as a designated beneficiary, charitable trusts, done *after the taxable event*

- Doing nothing ensures no step up – a simple reformation may save family hundreds of thousands of dollars in capital gains tax

- Remember, LPOA/GPOAs do not have to be as broad as people often make them – we would make such a POA added for this purpose very narrow indeed

See page 103-118 of CLE outline

OBIT Techniques: Existing Irrevocable Trusts

Considerations amending irrevocable trusts:

- *Keeping fidelity to settlor intent*
- Practical non-tax, e.g. virtual representation or guardian ad litem?
- Gift/estate tax, if beneficiary could be deemed to make gift
- GST, if amendment delays vesting, etc.
- Income tax – clear that effect is prospectively honored, but when amendments, settlements etc. become “sale or other disposition” under IRC § 1001 and *Cottage Savings* case can be tricky – usually it would not be – but check out cases.

See page 103-118 of CLE outline

Better Ongoing Income Tax Planning

- The **biggest issue is that capital gains are defaulted under § 643 in most cases to be trapped in trust and not carried out onto the beneficiaries' Form K-1, *even if substantial distributions equal to or more than taxable income are made***. See comparison chart.

- Example: Jane is a widow otherwise in 15%-25% tax bracket, beneficiary of her husband's trust, which generates $100,000 of capital gains and $40,000 of interest, dividends or rents. She takes $140,000 to live on from the trust – the trust issues a K-1 for $40,000, taxed to her. The remaining $100,000 is taxed, after $12,400, at 23.8% to trust (43.4% if short term capital gains!). That's 59% higher LTCG tax, 189% higher STCG tax

If Jane makes > $406,750 taxable income anyway, there is no "tax negative" to the trust, but this brings up other better options!

Ordinary "A/B" Trust – Ongoing Tax Effect

John Doe Trust
(could be joint trust or two separate trusts)

At John's Death

John Doe Bypass Trust fbo spouse (& children?) < $5.45mm (or basic exclusion amount)

John Doe Marital Trust (QTIP) fbo spouse only, > $5.45mm (or basic exclusion amount)

Tax Effect to Spouse and Doe Family, during spouse's lifetime

Capital Gains taxed at 23.8% (long term)/43.4% (short term) even if arguably distributed;
Ordinary income at 23.8% (QD)/43.4% if not distributed

Capital Gains taxed at 23.8% (long term)/43.4% (short term) even if arguably distributed;
Ordinary income at 23.8% (QD)/43.4% if not distributed

Above rates refer to trust income above $12,400 in 2016 (top rates), ignoring state income tax, AMT, or special tax rates for collectibles, depreciation recapture

Income Tax Efficient Trust– Ongoing Tax Effect

John Doe Trust
(with different trust provisions and/or trustee actions to shift tax)

At John's Death

John Doe Bypass Trust fbo wife (& children?) < $5.45mm (or basic exclusion amount)

John Doe Marital Trust (QTIP) fbo spouse only, > $5.45mm (or basic exclusion amount)

Tax Effect to spouse and Doe Family during spouse's life

All income can be taxed at spouse's, children's or even charity's rates to the extent distributed (appointed), or subject to unfettered withdrawal power

All income can be taxed at spouse's rates if distributed or subject to unfettered withdrawal (*probably* no ability to spray to children or charities)

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Conclusions – Optimizing Basis and Income Tax Efficiency for "AB" Trust Planning

- In order to concentrate on basis, we are skipping the various § 643 exceptions, and § 678 provisions that permit capital gains to be taxed to a beneficiary, but see white paper for more discussion.

- Optimal basis increase trusts (OBITs) have all the upside of a traditional bypass trust, but negate the two principal downsides, even turning them into positives (optimizing basis, reducing income tax by spraying income)

- Avoids all the negatives of outright bequests or marital trusts (step down in basis, fractional discounting, trapping income with no spray/gifting ability);

- Negative? – No "off the shelf", NOLO press online trust form, these require new drafting!

Optimizing Basis at *First* Death?

- For residents of **community property** states, community property receives a new basis at one spouse's death under IRC **§** 1014(b)(6), but with so many second/later marriages, it is not uncommon for married residents in these states to have significant *separate* property.

- A post-nup might convert certain property that is separate to community (conversely, a post-nup might also do the *opposite* for asset protection or income tax reasons)

- Community property does not necessarily get the same income tax "step up" as other techniques where fractional interest lack of control/marketability "discounts" apply.

See page 71-76 of white paper

Optimizing Basis at *First* Death?

However, there are several additional techniques that those in non-community property states might use to achieve the same or even superior results (residents of community property states who do not want to convert their separate property, or are not married, might also consider these):

- Simple cross-spousal § 2036 gift transfers
- Qualified disclaimers of joint bank/brokerage accounts
- TN/AK Community Property Trusts
- Using cross-GPOAs in revocable trusts (JESTs)
- Irrevocable Marital Estate Trusts
- Irrevocable Spousal *Optimal Basis Increase Trust*

  including the ***Upstream*** Optimal Basis Increase Trust including older relatives

See page 71-107 of CLE outline, and comparison chart

Can Taxpayers Exploit § 2036 Against IRS to Increase Basis at 1st Death?

- Can taxpayers without a taxable estate now use IRC 2036 to argue “prearrangement” and retained interests must cause estate inclusion/step up?
- E.g. I don’t pay rent back to my QPRT after the end of the term. Is it included in my estate (step up in basis)? Ditto, if I own a home, I gift it to my wife but stay living in it. She gifts me the vacation home, and she still uses it. Are both homes in the first to die’s estate now, per either Section 2033 or 2036?? Or will the IRS say we cannot argue substance over the form of our own transaction?
- Some argue this “works” – I doubt it. It sounds unfair, but the IRS can use arguments we can’t!

Using Qualified Disclaimers to Increase Basis at 1st Death

- John provides all the funding for a $ 4 million ***joint*** brokerage account (*not* community property), with:
- Fund Q: $1.6 million, basis of $1 million
- Fund X: $1.2 million, basis of $800,000
- Fund Y: $800,000, basis of $1 million
- Fund Z: $400,000, basis $500,000
- Typically when John dies, IRC § 2040 includes 50% in his estate ($2 million), and his wife Mary now gets a partial step *up* in basis for funds Q and X, and a partial step *down* in basis for funds Y and Z: **$3.65 million**
- *Contrast*, if Mary *disclaims* Funds Q and X, 100% is now in John's estate, therefore these are stepped up to $1.6 million/$1.2 million, **total** basis **$4.15 million**.
- Contrast, if community property, basis only **$4 million**.

Using Community Property Trusts to Increase Basis at 1st Death

- Residents of non-community property states can establish an Alaska or Tennessee Community Property Trust, transferring lower basis, non-IRA type assets into such a trust. Requires Alaska or Tennessee trustee. Makes more sense for long term marriages where any asset would be "marital" in a divorce anyway. Still may have less step up for fractional interests.

- Since 1998, untested in courts, but at least no negative PLR or case. IRS Publication 555 says: "Note. This publication does not address the federal tax treatment of income or property subject to the "community property" election under Alaska state laws."

- Conflict of Law principles should permit a married couple to choose which state law to apply to their property interests – provided it does not violate public policy of the home state

See page 71 of CLE outline

Using Presently Exercisable or Testamentary General Powers of Appointment in Rev. Trust

- What about a Joint GPOA Trust? Give each spouse a general power of appointment over the other spouse's assets? (fka "poorer spouse funding technique") – this can also be two separate trusts w/cross GPOA
- Alan Gassman refers to this as JEST – **J**oint **E**xempt **S**tep Up **T**rust – see Oct/Nov 2013 two part article in *Estate Planning*, which he co-authored with Tom Ellwanger and Kacie Hohnadell
- Jim Blase wrote an excellent article advocating a version of the trust with a presently exercisable rather than testamentary general power of appointment

See page 76 of CLE outline

Optimizing Basis at *First* Death: the JEST

- Under the JEST plan, a couple would first create a jointly funded revocable living trust (two separate trusts could work as well - my own preference)
- Each spouse would provide the other with a testamentary GPOA, so that some of the assets of the trust, to the extent that there are sufficient assets in the trust, even if originally contributed by the surviving spouse, are included in the estate of the first spouse to die under IRC Sec. 2041. Accordingly, the assets of the **entire** trust obtain a new basis under IRC Sec. 1014 because they are **deemed** to have emanated from the deceased spouse.
- According to the JEST proponents, none of the credit shelter trust formed by the estate of the first spouse to die would be included in the surviving spouse's estate, even though the contributing surviving spouse is a beneficiary.

See page 76 of CLE outline

Optimizing Basis at *First* Death: § 2523/1014

Risks of JEST:

- Inclusion of the credit shelter trust in the estate of the surviving spouse under either IRC Sec. 2036 or 2038.
- Potential loss of creditor protection as to the surviving spouse unless the trust is formed in a DAPT jurisdiction.
- The above are highly unlikely since exercised GPOAs make the powerholder the settlor/grantor for state and tax law.
- The gift on death to the surviving spouse might not qualify for the lifetime marital deduction under IRC 2523. This one is the **most likely risk**, but there are several PLRs which allowed it. With $10.9 million exclusion, most clients couldn't care less.
- IRC 1014(e) could **deny the step up** because the assets go back to a trust for donor within one year of the death of the first spouse to die. Of course, there are arguments against this and techniques to avoid this even if those arguments fail.

See page 76 of white paper outline, comparison chart

Optimizing Basis at *First* Death: Estate Trust

One spouse transfers assets to a trust for other spouse, qualifies for marital deduction **if** there is no other beneficiary and it pays to that spouse's estate *in all events*, without need to pay income annually - it is not "terminable".

Grantor spouse keeps limited powers per 2038 to alter enjoyment to retain inclusion, but not so much to cause incomplete gift.

If beneficiary-spouse dies, it's in estate per 2033, steps up via 1014(a).

If grantor spouse dies, it's in estate per § 2038 regulations.

See page 86 of white paper, comparison chart

Optimizing Basis at 1st Death (or earlier): "Upstream OBIT" Technique

- Create Irrevocable Trust even for non-taxable estates and place LOW basis assets inside (unlike current thinking) with even older relatives as Crummey and lifetime benes. Think of a spousal lifetime access trust (SLAT) w older bene added
- *Grant older relatives a formula testamentary GPOA to use their AEA coupon, or a testamentary LPOA exercised to trigger the Delaware Tax Trap.*
- If no older relatives, spouse can have a formula GPOA or LPOA to trigger the DTT for step up.
- If no older relatives, settlor spouse can have formula 2038 power over assets to trigger step up

Upstream *Crummey* Optimal Basis Increase Trust

(during client/parents life)

Parent #1 (has $ 20 million estate, no creditor issues)

Parent #2 (has $ 2 million estate, has LTC insurance, no creditor issues)

Parent #3 (has $1,000 estate, is on Medicaid)

$14,000 Crummey

NO Crummey Power

Client has $8 million estate, $2 million of which is really low basis stock and real estate that has been depreciated. He worries about 43.4% income tax (and 28.8% recapture rate), not estate tax, is told to "forget trusts"

Gift $140,000

Buys low basis LLC

Client transfers annual exclusion gifts to a Crummey trust for parents, spouse and descendants with various **grantor trust** provisions
10 beneficiaries times $14,000 (not counting spouse). Gift splitting may be possible, but let's ignore here.

$14,000 Crummey

Spouse (normally Crummey powers limited to 5%/$5000 for ETIP and GST, but no need to waste GST allocation

8 X $14,000 Crummey powers

Child #1, Child #2, Child #3,
Grandchild #1a, #1b, #3a, #3b, #3c

Typically Crummey powers have 30-60 day withdrawal window. Some complexity can be avoided if *Crummey* powers are limited to $5,000/5% of corpus (here, $50,000/yr), which avoids having to use "hanging powers". However, with $10.9 million of applicable exclusion amount to burn, many clients could avoid the complexity of hanging powers or even *Crummey* powers altogether. Parents, spouse and descendants are named beneficiaries, "wholly discretionary" probably needed to avoid Medicaid issue for Parent #3.

Key Private Bank

Upstream Crummey Optimal Basis Increase Trust (at parent/in-law's death)

Parent #1
(has $ 20 million estate, no creditor issues). **No** GPOA

Parent #2
(has $ 2 million estate, has LTC insurance, no creditor issues)

Parent #3
(has $5,000 estate, is on Medicaid)

Parent #2 has formula GPOA over $3.45M

Parent #3 has **LPOA** over $5.445M

At parent #2, 3's death, inclusion/step up

Client has note from installment sale to the grantor Trust.

Trust makes Note payment

Trust continues as grantor trust, either by the parent's POA lapsing, or by parent's LPOA being exercised in favor of another grantor trust for the benefit of settlor/spouse. Can elect NG trust treatment if desirable.
If 754 election, **LLC may now have $2 million inside and outside basis**!!!

Income/Dist.

Spouse
Can still be the primary/preferred beneficiary of the trust, getting income/principal

Spouse has formula GPOA

After spouse's death, another step up in basis to extent of AEA, of course, only for assets whose basis would increase under IRC 1014

Child #1, Child #2, Child #3,
Grandchild #1a, #1b, #3a, #3b, #3c

Uncertainties under 1014(e) if parent dies within one year of gifts and property reverts to client/spouse or trust for client/spouse – avoid by either requiring one year "curing", purchase assets rather than keep donated assets, do not sell the property (1014(e)(2) addresses "sale") or, parents might appoint (or lapse causes to pass) property to trust for client's descendants, and children might have LPOA to appoint to mom/dad (though even that may not be needed). In this scenario, irrelevant whether debt deductible to Parent #1, #3's estate

How does “the Upstream OBIT” *differ* from “JEST” techniques?

- Uses a *completed* gift during lifetime to avoid any IRC § 2523, 1014(e) and step transaction issues
- Older relatives can (should) be granted formula testamentary GPOAs (or LPOAs) to trigger step up in basis during the settlor’s lifetime
- Clear that formula powers only apply to assets that benefit from step up (prevent “step down”)
- Can also be established as *non-grantor trust* to enable better lifetime income tax shifting/state income tax avoidance – these are not as controversial as DINGs, and more likely to avoid state income taxation (especially in New York).

Upstream Planning with *Revocable* Trusts?

Why can't we add upstream testamentary general powers of appointment in *revocable* trusts?

- Uses gift/estate exclusion 2-3 times, first as deemed gift from settlor to powerholder at death, then in powerholder's estate, and possibly back into settlor's estate.

- **More importantly, it triggers IRC Section 1014(e) if property passes to grantor, spouse or trust therefore**

- Simultaneous gifts/transfers more likely to be challenged under step transaction analysis, and it's more like a "naked Crummey" – no *vested* benefit for power holder

Why not simply gift to upstream parent ***outright*?**

- No asset protection at all
- No protection from later disinheritance
- Ease of income tax reporting for grantor trust and getting depreciation deduction. Active/passive income
- Can't use multiple *Crummeys* for annual exclusion gift
- Medicaid/VA or means tested benefit eligibility
- Ease of management
- Does not enable distributions to other beneficiaries
- Transfer may invoke various loan/contract violations
- All the reasons we use trusts in lieu of outright gifts!

Upstream OBIT v. Other Techniques

- If there is no "upstream" beneficiary, only spouses, TN/AK CP trusts or Estate Trusts hold promise for the ultra high net worth, because "Upstream OBITs" are limited to amount of gift exclusion available for seed gift. But, probably more certain, especially since *Harmon* and state law make CP trusts more uncertain.
- Better from a creditor protection and fidelity to the estate plan perspective than other alternatives.
- Unlike others, can generate significant benefits for the settlor and spouse BEFORE either of them die, since many of our clients still have a parent or parent in law living and it's not uncommon to see 90 or even 100+.

Conclusions – Optimizing Basis and Income Tax Efficiency

- Optimal basis increase clauses in Trusts have all the upside of a traditional trusts, but negate the income tax downsides.
- Don’t ignore the huge potential of ***upstream*** planning
- Despite common wisdom, trusts are not tax sinkholes, but vehicles for income tax advantages. ***Don’t waste the $5.45 million coupon Uncle Sam gives you to increase basis!***
- Negative? – Many of the standard Trust templates do not have these features! This requires paying attention to income tax rules that many attorneys tried to avoid in law school. However, there can be a huge value added through such planning – for ***all*** size estates!

Questions?

- Ed will periodically add and update to the white paper at http://ssrn.com/abstract=2436964.
- Information about Paul's books and treatises is available at http://www.paulhoodservices.com.
- Look for future articles from both Ed and Paul for Leimberg Information Services Estate Planning, Income Tax Planning and Asset Protection Planning Newsletters at www.leimbergservices.com

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