Estate Planning for Income Tax Reduction: Strategies for Preserving Basis Step-Up

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

TUESDAY, FEBRUARY 11, 2014

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

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Optimizing Basis – Making AB Trusts Income Tax Efficient After ATRA

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2/11/2014 Stafford CLE Teleconference on Basis Planning

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What’s New in Estate Tax Planning?

• “Permanent” $5 million estate/gift/GST, adjusted for inflation ($250,000 added in just two years with LOW inflation, up to $5.34 million in 2014), with spousal “portability”

• 2014 “Greenbook” proposals propose again to make $3.5 million estate/gst excl., $1 million gift excl, 45% top rate – unlikely to pass, but possible that Congress caves in on gift tax or other “loophole closers” (GRATs, IGTs, entity valuation). In recent tax reform/budget talks, estate tax not even “on the table”.
What’s New in Income Tax Planning?

• For 2013, new tax law (ATRA and ACA):
  • New ordinary income rate of 39.6% and 20% LTCG/QD on taxable income (not AGI) over:
    $400,000 (single) (in 2014, $406,750)
    $450,000 (married) (in 2014, $457,600)
    $11,950 (trusts/estates) (in 2014, $12,150)
  Medicare Surtax of 3.8% (net investment income) or 0.9% (wages)
  • Hits taxpayers with AGI over $200k/$250k
  • Trusts/estates AGI over only $11,950 ($12,150 in 2014)
  • Together, investments top at 43.4%/23.8%
    (not counting Pease limitations or state income tax!)
The Challenge for Sub $10.5 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.
What’s Now Involved in Estate Planning?

- Estate planning has morphed into granular income tax basis planning. Assets that most benefit from a new basis at death (inclusion in gross estate):
  - Self-created intellectual property (patents, copyrights, art, etc.)
  - Negative basis depreciable property
  - Gold, artwork and collectibles subject to 28% LTCG
- Trade off now is between transfer tax and capital gains tax
- The gap between federal and state death tax and capital gains tax rates differs considerably by state, necessitating a state by state analysis for both clients and the ultimate recipients
What’s Now Involved in Estate Planning?

Estate planning is now far more complicated and nuanced than in the past and could vary significantly based upon many variables, including:

• Size of the gross estate (taxable v. non-taxable)
• Future return (income and appreciation) of the assets
• Current tax basis and nature of the types of assets (e.g., to what extent will a new basis (hopefully, a step-up) benefit the client and the likely beneficiaries?)
• Time horizon or life expectancy of the client and the likely recipients
• Spending/lifestyle of the client and likely recipients
What’s Now Involved in Estate Planning?

Factors (cont.):

- Expected time to income tax/monetization realization event of the assets
- The client’s state of residence
- State(s) of residence and marginal state income tax bracket(s) of the likely recipients-estate/inheritance tax-capital gains tax rate differentials vary **widely** from state to state
- Expectations about future inflation and how that affects AEA
- Other factors, such as expected future law changes, etc.
What’s Now Involved in Estate Planning?

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

- It probably will be far fewer times that we’ll advise a client to give away *significantly* appreciated assets during lifetime because of the carryover basis of IRC Sec. 1015
- It could behoove clients to **exchange** cash or other high basis assets with an IDGT that has substantially appreciated property in it so that trust property obtains the new basis at death
- However, ATRA *significantly* complicated the analysis ------- will clients **pay** to have us sort it all out? That is unknown at this point, but many clients may opt for simplicity at the cost of higher taxes - **malpractice risk** -must point out the perils of not going through the analysis for **CYA** purposes - similar to the old warning about not using the unified credit in the estate of the first spouse to die before portability
Portability?

• Since the overwhelming majority of clients will not have taxable estates, the utility of portability will continue to be present now that ATRA made it permanent.

• Some commentators have even called portability a “game changer” because of the post-first death planning that it allows - However, it’s also been called a “fraud on the public”.

• Specifically, by giving a surviving spouse or a QTIPable trust a legacy, possibly even in a non-taxable estate (although this is far from certain because Rev. Proc. 2001-38 might ultimately have some limits – we should have some guidance on this issue in 2014), you create the opportunity to get a new basis at the surviving spouse’s death, which you can’t get from a bypass trust without some advance planning.
Portability?

Advantages of portability include:

- Simplicity
- It can create a better result than attempting to fund a credit shelter portion with an IRD asset such as an IRA
- It provides protection for the poorer spouse being able to use the full AEA if that spouse dies first without having to give the poorer spouse enough assets to fully use that spouse’s AEA, which the wealthier spouse may not want to do (no need for intervivos QTIPs to equalize, unless to exploit GST)
- Portability may better handle appreciating assets (although not necessarily if the surviving spouse lives for a long time after the death of the first spouse without some added planning that we will discuss later in this presentation).
Portability?

Disadvantages of portability include:

- Not indexed like the Basic Exclusion Amount - it is **fixed**
- Does **not** apply to the GST tax, so the use of portability could cause the loss of the GST tax exemption of the first spouse to die
- Outright bequests to the surviving spouse could cause the assets to pass in a manner other than what the first spouse to die wanted or expected, which could be a **killer** in blended families
- Outright bequests to a surviving spouse **expose** the assets to the creditors of the surviving spouse and, potentially, a new spouse
- Bequests to or for the benefit of a surviving spouse will cause a step-down in basis to assets that have lost value since the death of the first spouse to die because **IRC Sec. 1014 works both ways**
Portability?

Disadvantages of portability include (cont.):

- A surviving spouse will **lose** the first-passing spouse's DSUEA if he or she remarries and the new spouse predeceases him or her.
- Does **not** apply, at least at present, to state death tax, which can cost a lot of state death tax at the death of the surviving spouse.
- Appreciation during the surviving spouse’s overlife is included in the surviving spouse’s estate, which could be **substantial** if the surviving spouse lives for a long time and the assets are properly invested.
- Expense of **filing** estate tax return.
- Statute of limitations remains **open** as to the DSUEA until the surviving spouse’s death.
Portability?

Disadvantages of portability include (cont.):

- A bypass trust locks in the value of the AEA and can result in even more wealth transfer if the surviving spouse remarries and gift splits or harvests a DSUEA from the subsequent spouse.
- Tax Apportionment (IRC 2207A plus state statutes) with QTIP/portability hurts first to die’s kids and favors the in-laws (e.g. – H leaves $10 million to QTIP, W has $10 million – H’s kids pay!)
- It can offend the descendants of the deceased spouse.
- Portability only works with a surviving spouse, so a simultaneous death could be disastrous (future regs?)

**Bottom line:** Portability has its benefits and its place, but there might be better options to harvest basis adjustments at or prior to the surviving spouse’s death.
Three Key Tax Problems Post-ATRA

1. Lack of second basis “step up” (or “step down”) 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

Goal– turn these negatives into POSITIVES
This CLE focuses only on #1, but see outline
Why not ditch the trust?

- Traditional Asset Protection/Family Bloodline
- State Estate/Inheritance Tax Bypass <=20%
- Quirks of Portability discussed earlier
- Income Tax Benefit? - state tax, spray income

See page 4-8 of CLE outline
A False Dilemma – Thinking Outside the Box

- Not a choice between outright and bypass trust
- Neither is it a only a choice between bypass and marital
- A Clayton QTIP offers some limited advantages over disclaimer planning, but not enough to become comprehensive tool

See page 8-9 of CLE outline, example page 10
Marital Trusts – Simple Solutions?

• QTIP marital trust – most common choice – requires 706 and election and has Rev. Proc. issues, enables separate state QTIP election in many states (for those, it’s almost a “gimme”)
• GPOA marital trust – less common, but may have various advantages over QTIP – no 706, no valuation issues, no Rev. Proc issues – but rigid GPOA required
• Both force a STEP DOWN in basis, force out income, cannot use broad lifetime limited powers of appointment (LPOAs), spray income, not as ideal for state/federal estate tax savings even w/portability, for all the reasons previously discussed

See page 11-14 of CLE outline, example page 12
Understanding Powers of Appointment

• Powers of Appointment (POA) have TREMENDOUS income tax planning potential for both stepping up basis and spraying income

• 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 (Delaware Tax Trap)
Other Ways For Bypass Trusts to Seize Basis

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

2. Adding GPOA by Private/Non-Judicial Settlement, court ordered amendment or reformation, decanting

3. Using “collateral power” LPOA held by non-fiduciary family member to distribute/decant to surviving spouse or trust for spouse with GPOA

4. Late QTIP? Really, really late?? (see pages 14-16)
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 asset/formula.

7. Use a formula testamentary GPOA with caps and ordering rules.

See page 15-16 of CLE outline – Optimal Basis Increase.
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?)
< $5.25mm (or basic exclusion amount)

John Doe Marital Trust Fbo spouse only,
> $5.25mm (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

At John’s Death

John Doe Marital Trust
Fbo Mary only,
Entire estate goes to QTIP or outright, $5.34 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

At John’s Death

- John Doe OBIT
  - Fbo Spouse (& children?)
  - $5.25mm (or basic exclusion amount)

- John Doe Trust
  - (could be joint trust)
  - w/optimal basis provisions

At Mary’s Death

- Trust for children
  - Step up in basis for assets w/basis < FMV (up to spouse’s AEA)

- Trust for children
  - No change in basis (IRD, assets w/ Basis => FMV)

- John Doe Marital Trust
  - Fbo spouse only,
  - $5.25mm (or basic exclusion amount)

- Trust for children
  - All new basis (including step down)

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

Key Private Bank
Optimal Basis Increase Trust

• See page 17 of CLE example, a simplified list and columns of assets in bypass trust from $2 million left to spouse in bypass trust, 8 years later:

<table>
<thead>
<tr>
<th>Asset Description</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Traditional deductible IRA</strong></td>
<td>basis $0</td>
<td>FMV $700,000</td>
</tr>
<tr>
<td><strong>Total “IRD” Property</strong></td>
<td>basis $0</td>
<td>FMV $700,000</td>
</tr>
<tr>
<td>Apple Stock (the iPhone 9 flopped),</td>
<td>basis $500,000</td>
<td>FMV $200,000</td>
</tr>
<tr>
<td>Condo in Florida (hurricane depresses value),</td>
<td>basis $1,000,000</td>
<td>FMV $600,000</td>
</tr>
<tr>
<td>LT Bond portfolio (inflation depressed value)</td>
<td>basis $400,000</td>
<td>FMV $300,000</td>
</tr>
<tr>
<td>Various stocks that have decreased in value</td>
<td>basis $150,000</td>
<td>FMV $100,000</td>
</tr>
<tr>
<td><strong>Total “loss” property</strong></td>
<td>basis $2,050,000</td>
<td>FMV $1,200,000</td>
</tr>
<tr>
<td>Rental Real Estate</td>
<td>basis $200,000</td>
<td>FMV $600,000</td>
</tr>
<tr>
<td>Various stocks that have increased in value</td>
<td>basis $400,000</td>
<td>FMV $900,000</td>
</tr>
<tr>
<td><em>ST Bond Portfolio, Money market, Cash</em></td>
<td>basis $400,000</td>
<td>FMV $400,000</td>
</tr>
<tr>
<td>Gold</td>
<td>basis $100,000</td>
<td>FMV $200,000</td>
</tr>
<tr>
<td><strong>Total “gain” property</strong></td>
<td>basis $1,100,000</td>
<td>FMV $2,100,000</td>
</tr>
<tr>
<td>Total at Jane’s death</td>
<td>basis $3,150,000</td>
<td>FMV $4,000,000</td>
</tr>
</tbody>
</table>

• 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 17-19 of CLE outline

Key Private Bank
## Optimal Basis Increase Trust

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Ordinary Bypass</th>
<th>QTIP/outright</th>
<th>OBIT</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Traditional deductible IRA</em></td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Apple Stock (the iPhone 9 flopped),</td>
<td>$500,000</td>
<td>$200,000</td>
<td>$500,000</td>
</tr>
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<td>$400,000</td>
<td>$300,000</td>
<td>$400,000</td>
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<td>$150,000</td>
</tr>
<tr>
<td>Rental Real Estate</td>
<td>$200,000</td>
<td>$600,000</td>
<td>$600,000</td>
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<tr>
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<td>$900,000</td>
<td>$900,000</td>
</tr>
<tr>
<td><em>ST Bond Portfolio, Money market, Cash</em></td>
<td>$400,000</td>
<td>$400,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Gold</td>
<td>$100,000</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td><strong>Total Basis for Beneficiaries at Jane’s death</strong></td>
<td><strong>$3,150,000</strong></td>
<td><strong>$3,300,000</strong></td>
<td><strong>$4,150,000</strong></td>
</tr>
</tbody>
</table>
Capping Inclusion/GPOA to Soak Up AEA

• Adding/drafting GPOAs is easy when both spouses have under one’s AEA
• First, has the IRS blessed a simple cap, and what would be wrong with that, anyway?
• 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?

See page 21-22 of CLE outline
Capping Inclusion/GPOA to Soak Up AEA

• Trustee choice might work and would be ideal if it did (because property anticipated to be sold in the near future could be chosen first and it is simpler). My take is that IRS may require pro-rata inclusion - because it’s such a novel use, an ordering rule applying to the most appreciated property first may be the most conservative route

• See example on page 23, as well as the sample language

See page 23-24 of CLE outline
Adapting GPOA Caps for STATE estate taxes

• There may be millions in bypass trusts that are state exempt – you don’t want to incur, for example $16 state estate tax for a $100 asset with basis $98 - a mere $2 in basis increase.

• It would be more complicated of a formula to allow causing state estate tax if the 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)

• 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 26-27 of CLE outline

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Crafting GPOAs For Fidelity/Protection

• GPOAs in marital trusts must be 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 we would not use trustee)

• Testamentary GPOA not necessarily subject to powerholder’s estate’s creditors (except e.g. CA, note a difference in uniform act draft, 2nd/3rd restatements)

See page 28-30 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

• Nutshell - in apparently all states, if you exercise a LIMITED power of appointment to appoint to a trust which grants a beneficiary a PRESENTLY EXERCISABLE GPOA, it will trigger the DTT- 2041(a)(3), hence trigger estate inclusion, hence trigger a step up in basis. In some states (apparently Arizona) it may be possible to do so by appointing to a trust with only an LPOA, but most states have closed this possibility to prevent inadvertent taxation – states should consider an “opt-in” state RAP statute that would enable this for better income tax planning for residents.

See page 32-33 of CLE outline

Key Private Bank
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 – it’s easy)
• 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 first
• 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 32-33 of CLE outline, extensive comparison page 40
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.

- The Kurz case could give some pause in this regard, but it is a completely different scenario and should not give cause for concern.

See page 35-39 of CLE outline.
Busting Spousal Disclaimer Myths

• You have all been taught that spouses using any disclaimer funding have to disclaim any powers of appointment in trusts receiving disclaimed assets.

• This is wrong, or at least, overbroad.

• A POA that can only trigger estate/gift tax, or that is limited by ascertainable standard, **CAN BE** retained. OBIT clauses meet this requirement.

See page 46-47 of CLE outline.
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 (usually a non-exempt trust would have a GPOA anyway, but those may also be considered).

- How many widows/widowers as beneficiaries of bypass trusts have over $5.34 million of their own assets (or, whatever their AEA is, if their late spouse died recently, they may have more from DSUE, or less from prior taxable gifts).

- If they already have an LPOA, use the Delaware Tax Trap, unless family situation rules out granting a presently exercisable GPOA (but consider mitigating ideas such as only granting a PEG power over the remainder interest in the trust, which offers significant protections).

See page 62 of CLE outline
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

• Bosch, et al, should not apply here the same as reformations for marital trusts, “see-through trusts” designed to qualify as a designated beneficiary, charitable trusts, etc.

• Doing nothing ensures no step up – a simple reformation may save hundreds of thousands of dollars for the family

• Remember, LPOA/GPOAs do not have to be as broad as people often make them – if either of us were a beneficiary or attorney for one, we would make such a POA added for this purpose very narrow indeed

• What about “naked” powers to soak up and optimize basis?

See page 60-66 of CLE outline

Key Private Bank
Optimizing Basis at *First* Death?

- For those in Community Property States, this is a relatively easy issue, but even then many second/later marriages with prenups, post-nups etc may have significant separate rather than marital property.

- Post-nup might convert certain property that is separate to community (conversely, a post-nup might do the opposite for asset protection reasons).

See page 48-49 of CLE outline.
Optimizing Basis at *First* 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. Makes more sense for long marriages where any asset would be “marital” in a divorce anyway.

- Requires Alaska or TN trustee, such as Key Trust Co of Anchorage, Alaska – H&W can be co-trustees, direct investments.

- Since 1998, untested in courts, but at least no negative PLR or case, IRS silent on whether this works for IRC Sec. 1014(b)(6) double new basis (hopefully, a step up). Conflict of Laws indicates that a married couple can choose which state law to apply to their property interests – should not violate public policy.

- Remember, community property can be double “stepped down”, but with a revocable trust, due diligence/monitoring can often prevent.

See page 49 of CLE outline.
**Optimizing Basis at *First* Death?**

- What about a Joint GPOA Trust? Give each spouse a lifetime GPOA over the other spouse’s assets? (fka “poorer spouse funding technique”)

- Alan Gassman refers to this as JEST – Joint Exempt Step Up Trust – see Leimberg LISI commentary #2086, which he co-authored with Tom Ellwanger and Kacie Hohnadell

- Several PLRs would deny step up (and even force a step down), but maybe the IRS is wrong

- Our take is that the Alaska/TN Community Property Trust is slightly safer at least for mid-size or larger estates, but time will tell….consider nuances to complement Gassman’s article

See page 50-58 of CLE outline
Optimizing Basis at First Death?

- Under the JEST plan, a couple would first create a jointly funded revocable living trust (two separate trusts could work as well)
- 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 50-58 of CLE outline
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 gift on death to the surviving spouse might not qualify for the marital deduction under IRC 2523.
- The assets in the survivor’s share of the trust may not get a new basis for those assets because the real contributor is the surviving spouse despite the existence of the testamentary GPOA under IRC Sec. 1014(e) because the transfer is deemed to occur within one year of the death of the first spouse to die.
- However, there are arguments against all of the above, but there is little authority that would safely sanction JEST.

See page 50-58 of CLE outline
Optimizing Basis for Bypass Trusts

- Optimal basis increase trusts (OBITs) have all the upside of traditional bypass trust, but negate the two principal downsides, even turning them into positives (avoiding basis step down, better income tax with spraying income).

- Avoids all the negatives of outright bequests or marital trusts, but QTIPs may still be optimal in narrow situations.

- Negative? – No “off the shelf”, NOLO press online trust form, these require a real attorney, new drafting, CYAs!

- And….while somewhat complicated, this stuff is easier than partnership tax!!!
Slide Intentionally Left Blank
Estate Planning for Income Tax Reduction: Strategies for Preserving Basis Step-Up

By Stephen M. Breitstone, Esq.

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Mineola, New York

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Comparison of Rate

- Different Tax Base (Federal)
  - Estate Tax: 40% Net Equity
  - Income Tax: 20-43.4% of Gain

- Amount realized includes nonrecourse debt

- Lifetime planning can sacrifice basis step up to save estate and gift taxes – may not be a good tradeoff.

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COMPARISON OF FREEZE TECHNIQUES

- Grantor Retained Annuity Trusts (GRATs)
- Installment Sale to Intentionally Defective Grantor Trusts (IDGTs)
- Partnership and LLC Freezes under Section 2701
Preferred Stock Returns in the Market

- Hotels: 7.32% to 10.93% Median - 8.96%
- Retail: 6.81% to 9.97% Median - 8.09%
- Multi-Family: 6.64% to 8.22% Median - 8.08%
- Office: 7.01% to 8.45% Median - 7.73%

Market data courtesy of Anchin LLC
FREEZE TECHNIQUES

• Freeze Partnerships under Section 2701

  • Must weigh higher hurdle rate v. basis step up on negative capital

  • See Rev. Rul. 83-120 (closely held business preferred returns)
Negative Capital a/k/a Liabilities in Excess of Basis

• Tufts v. Commissioner, 461 U.S. 300 (1983) (codified in section 7701(g))

• IRC section 7701(g) (in determining gain or loss, fair market value of property is deemed to be not less than the nonrecourse liabilities to which the property is subject)
## Liabilities in Excess of Basis

**Illustrated**

**AB Partnership**

**Assets**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate (fmv)</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Real Estate (adjusted basis)</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

**Liabilities**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage</td>
<td>($8,000,000)</td>
</tr>
</tbody>
</table>

**Capital**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity (cash proceeds from a sale)</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Gain Subject to Taxation</td>
<td>($9,000,000)</td>
</tr>
</tbody>
</table>

**Tax on Gain if Real Estate is Sold For**

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>20%</td>
<td>$1,800,000</td>
</tr>
<tr>
<td>25%</td>
<td>$2,250,000</td>
</tr>
</tbody>
</table>

**Add State and Local Taxes and 3.8% net investment income tax**

**Assuming 35% overall rate tax is $3,150,000**
Grantor Trust Authorities

- IRC section 671 and Treas. Reg. 1.671-3(a)(1) – requires the grantor to include all items of income, deduction, and credit of the trust as though the trust were not in existence during the period the grantor is treated as the owner.

- Rev. Rul. 85-13, 1985-1 C.B. 184 – For income tax purposes no sale is deemed to occur as long as the trust remains a grantor trust.
GRANTOR TRUSTS

• Grantor trusts and negative capital do not mix well
  • Termination of grantor trust status during lifetime of grantor can trigger gain
    ▪ Negative capital
    ▪ Outstanding installment obligations
Termination of GT Status upon the Death of the Grantor

- Does death cause gain recognition on negative capital?

  - See Crane v. Commissioner, 331 U.S. 1 (1947) (often cited for the proposition that death is not an event that triggers gain)

  - See CCA 200923024 (stating “We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event”)
Termination of GT Status upon the Death of the Grantor

- Does termination of GT status on death cause a basis step up? Under section 1014?; Section 1012?
  - See Crane v. Commissioner, 331 U.S. 1 (1947) (property acquired from decedent subject to nonrecourse debt equal to the FMV of asset; IRS argued no step up under predecessor to 1014; Court found step up and analogized to a sale subject to debt)
  - This case has been argued to provide for a basis step up under either section 1014 (assets included in estate) or section 1012 (property purchased subject to debt)
  - See CCA 200937028 (no basis step up under 1014 unless asset is included in the decedent’s estate)
Elements of the Freeze Partnership

- There are typically two classes of partnership interest:
  - Preferred interest, which is entitled to a preferred return and a liquidation preference (like preferred stock).
  - Junior equity interest, which is entitled to growth and appreciation (like common stock).

  (a) The preferred interest is typically retained, and the junior equity interest must be worth at least 10% of the value of the partnership at the time of the transfer.
Elements of Section 2701

• Is there a transfer? Capital contribution, reorganization, etc.

• Is it to or for the benefit of a “member of the family?” See Treas. Reg. Section 25.2701-1. (generally, of an equal or lower generation)

• Did the Transferor (or “applicable family member”; generally of an equal or higher generation) retain an “applicable retained interest”?

• “Applicable Retained Interest” means
  • distribution rights in family controlled entity; or
  • liquidation, put, call or conversion right.
Elements of Section 2701 (Cont.):

- **Zero Value Rule:**
  
  - If there is a “transfer” the retained interest will be valued at zero for gift tax purposes unless the transferor retains
    
    - a “Qualified Payment Right”; or
    - a liquidation, put, call or conversion right.
Elements of Section 2701 (Cont.):

- Straight Up Allocation Exception to Zero Value Rule –
  - All Membership Interests are of the Same Class
  - All Allocations are Straight up
  - Differences in Voting Rights are Permitted
  - Differences in Liability Permitted (e.g., GP v. LP)
  - Marketable Securities can be of a Different Class.
  - Vertical Slice for Fund Managers
Elements of Section 2701 (Cont.):

- Qualified Payment Rights are periodic (at least annual) cumulative fixed payment rights.
  - Qualified payment rights are valued according to fair market value (FMV).
  - Lower of Rule: If a qualified payment right is held along with an extraordinary payment right the rights are valued as if each was exercised in the manner resulting in the lowest value for all such rights.
- Four Year Rule: Any payment of a qualified payment made (or treated as made) either before or during the four-year period beginning on the due date of the payment but before the date of the taxable event is treated as having been made on the due date.
Entity Level Valuation - Family Matter:

The 2701 Regulations promulgated in 1992 provide that all family owned interests are valued as if held by a single person:

• Exception for Capital Contributions. See, Treas. Reg. 25.2701-3(b)(1)(i).

• Contrast Rev. Rul. 93-12 (recognizing intra family valuation discounts).

• Unless 100% family owned, lack of marketability discounts should apply regardless of 1992 Regulations.
Subtraction Method

Deemed Gift is determined as follows:

Step 1 - value all family-held interests as if held by one person (except capital contributions).

Step 2 - subtract the value of senior equity interests (as if held by one person).

Step 3 - allocate the remaining value among the transferred interests and other family-held subordinate equity interests.

Step 4 - apply certain discounts and other reductions as provided for by Treas. Reg. 25.2701-3(b)(4); Treas. Reg. 25.2701-3.
Subtraction Method (Cont.)

- Minimum Value Rule:

  Junior equity interests cannot be valued at less than 10% of:

  a) the total value of all equity interests in the entity, and

  b) the total amount of indebtedness of the entity to the transferor.
Liabilities Must be Allocated to Preferred to Obtain Step Up on Negative Capital
Structure to keep Liabilities with Senior

- **Senior Preferred**
- **Contributed Property**
  - $10,000,000 FMV
  - $8,000,000 debt
  - $2,000,000 equity
  - $1,000,000 basis
- **Family Trust Grantor**
  - 99%
- **Children 1%**
- **Junior Equity**
  - $222,222 Cash Contributed for Junior Equity (10% of $2,222,222)
- **FREEZE PARTNERSHIP**
- **Leveraged Real Estate**

**IRC 704 (c)**
**IRC 752**
Treatment of Liabilities

• The way liabilities are allocated determines partnership “outside” basis – and what gets stepped up upon death.

  • Section 752 (a) increase in a partners share of liabilities is considered to be a contribution of cash to the partnership

  • Section 752(b) decrease in a partners share of liabilities is considered to be a distribution of cash

  • If the shifting of liabilities causes a partner to be deemed to have received a distribution in excess of that partner’s basis in its partnership interest gain is recognized under section 731(c) of the Code.

  • Inside basis is stepped up if there is a section 754 election.
Allocation of Liabilities among Partners

• Section 752 governs allocations of liabilities among partners – who bears risk of loss?

• Treatment of Nonrecourse debt – three tiered approach
  • Tier 1 – Minimum gain
  • Tier 2 – Section 704 (c) minimum gain
  • Tier 3 – allocation based upon other significant partnership item with substantial economic effect
Forcing Debt Allocations by Agreement

- Wraparound Debt Structures on Contributed Property
- Indemnification Agreements
Leveraging the Partnership to Reduce Qualified Payments
Leveraging Up Example

- Real Estate contributed to Freeze LP
- Asset (FMV) $10,000,000.00
- Adjusted Basis 1,000,000.00
- Mortgage 8,000,000.00
  Net Equity $ 2,000,000.00
Leveraging Up Example  
(continued)

- Balance Sheet
  
  Asset (FMV) $10,000,000.
  Mortgage - (8,000,000.)
  Equity $ 2,000,000.

- Capital Accounts
  
  Senior $ 1,800,000.
  Junior + 200,000.
  $ 2,000,000.

- Preferred return @ 8% = 1,800,000 x .08 = $144,000
Leveraging Up Example

BEFORE

Senior

$1.8 Million Preferred

Freeze LP

10% Common ($200,000)

Trust
Leveraging Up Example (continued)

• Borrow against separate stock portfolio

$1.5 Million Margin Loan

$1.5 Million Distribution To Senior
Leveraging Up Example
AFTER

• New Balance Sheet
  Asset (FMV) $10,000,000.
  Liability (Mortgage) $ 8,000,000.
  Liability (AFR Loan) $ 1,500,000.
  Equity $  500,000.

• Capital Accounts
  Senior $  300,000.
  Junior $  200,000.

Preferred return @ 9% = $300,000 x .09 = $27,000.
**Leveraging Up Example (continued)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred Return</td>
<td>$27,000</td>
</tr>
<tr>
<td>Interest on Mid Term AFR Loan (1.64%)</td>
<td>$24,600</td>
</tr>
<tr>
<td>Total Leveraged Return to Senior</td>
<td>$51,600</td>
</tr>
<tr>
<td>Compare Unleveraged Return</td>
<td>$144,000</td>
</tr>
<tr>
<td>Compare Installment Sale</td>
<td>$128,000</td>
</tr>
</tbody>
</table>
Debt Financed Debt Distributions

- Non Qualified Nonrecourse Liabilities

- Considered related to the transfer to the extent not allocated to the transferor under Section 752 like principles but without tier one or tier two. Thus, allocated in accordance with the manner in which a significant item is allocated under nonrecourse debt regulations under Section 752. Treas. Reg. 1.707-5(a)(2)(ii).
Contributions of Encumbered Property and Leveraged Distributions

Disguised Sale Rules of Section 707(a)(2)(B):

Under regulations prescribed by the Secretary -- . . . If (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property . . . .
Disguised Sale Rules

Under Treas. Reg. § 1.707-3(b)(1):

• Contribution and distribution will be treated as a sale if the facts and circumstances indicate that (1) the transfer of money would not have been made but for the transfer of the property, and (2) the distribution was not dependent on the "entrepreneurial risks" of the partnership's operations.

• Additionally, if within a two-year period there is a contribution by and distribution to a partner, the transfers are presumed to be a sale of the property to the partnership. This presumption is rebuttable only if "the facts and circumstances clearly establish that the transfers do not constitute a sale."
Will Pre or Post Contribution Borrowings Be Deemed Disguised Sales?

Categories of Borrowings:

- Recourse
- Nonrecourse
  - Qualified Nonrecourse
  - Non Qualified Nonrecourse

See Treas. Reg. Section 1.707-5(b)
Disguised Sale Rules

Recourse Debt

- Recourse debt is allocated to the partner who bears the risk of loss (e.g., the guarantor)

- See *Canal Corp. v. Comm’r* 135 T.C. 9 (2010) (guaranties must not be illusory)
Disguised Sale Rules (Cont.)

Non Recourse Debt

- Qualified Nonrecourse
- Non Qualified Nonrecourse
Debt Financed Debt Distributions

• Qualified Nonrecourse –

• Non incurred within 2 years of property contribution or if determined not incurred “in anticipation of the transfer” (Old and Cold). Rebuttable presumption that connected to the transfer if incurred within 2 years prior the transfer.

• Not old and cold (within past two years) but not in anticipation of the transfer.

• Liability allocated to capital expenditures to the contributed property.

• Liability incurred in the ordinary course of the trade or business.
Simple Real Estate Partnership Freeze

Senior

Preferred Interest (6% qualified payment and Liquidation Preference)

Freeze Partnership

Junior Equity (Growth Interest)

Family Trust Grantor Trust

Managing Member Interest

RE LLC

RE LLC

RE LLC

Rev. Rul. 93-12
Reverse Freeze – Remember when there was a return on investment?

- Family Trust that includes spouse
- Preferred Interest (8% qualified payment and Liquidation Preference)
- Senior
- Junior Equity (Growth Interest)
- Freeze Partnership
- Undiscounted Assets.

1992 Regs do not allow intra family discounts!
Leaky Freeze Solution

Capital Structure

- $1,000,000 AFR Loan to Senior
- $1,000,000 equity contributed
- Preferred return @ 8% = $80,000
- Interest on AFR Loan @ 1.0% or $10,000
- Total Payments to Senior $90,000

Preferred Return = 8% of $1 million or $80,000

Junior Equity

$220,000 Cash Contributed for Junior Equity

Real Estate

FMV $10,000,000
AB 1,000,000
DEBT (8,000,000)
CASH $220,000

Children 1%

99%

Family Trust Grantor

Seniors

Preferred

Overview of the Freeze Solution
Best Discount Scenario (Contribution of Non-controlling Interest)

FREEZE PARTNERSHIP

- Senior
- Preferred
- Junior Equity

- Family Trust
- Unrelated Parties

40% Membership

Real Estate Entity