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INCOME TAX PLANNING FOR HIGH WEALTH INDIVIDUALS

Fort Worth CPA Tax Institute
August 1, 2014

by Marvin E. Blum

Written materials prepared by John R. Hunter and Anna K. Selby

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The Blum Firm, P.C., established by Marvin Blum over 30-years ago, has law offices in Fort Worth, Dallas, Austin, and Houston and specializes in the areas of estate planning and probate, asset protection planning, planning for closely-held businesses, tax planning, tax controversy, and charitable planning. The company has grown to be the largest group of estate planning attorneys in the State of Texas.

Mr. Blum is known for creating customized, cutting-edge estate plans, now serving hundreds of high net worth families, several with a net worth exceeding $1 billion. Mr. Blum was chosen as one of the "Nation's Top 100 Attorneys" by New York's *Worth* magazine, and was also named one of the Top 100 *Super Lawyers* in Texas by *Texas Monthly* magazine. He is a highly sought-after speaker, has served as a national commentator for *The Wall Street Journal* and *The New York Times*, and also serves on the Editorial Advisory Committee for *Trusts & Estates Magazine*.

Mr. Blum is dedicated to his community and currently serves as Secretary/Treasurer and one of three Board members (along with Emmitt and Pat Smith) of the Pat & Emmitt Smith Charities, a public charity devoted to creating opportunities for disadvantaged children. Mr. Blum is in his 35th year as Treasurer of the Fort Worth Symphony and served as Presiding Chair for numerous terms of The Multicultural Alliance, formerly The National Conference of Christians and Jews, a service organization fighting bias, bigotry and racism. Mr. Blum also serves on the Texas Cultural Trust Board of Directors to help raise public and legislative awareness of the importance of the arts in Texas.

Mr. Blum, an attorney and Certified Public Accountant, is Board Certified in Estate Planning & Probate Law and is a Fellow of the American College of Trust and Estate Counsel. He earned his BBA (Highest Honors) in Accounting from the University of Texas in 1974, where he graduated first in his class and was named Ernst & Ernst Outstanding Student in Accounting. Mr. Blum received his law degree (High Honors) from the University of Texas School of Law in 1978, where he graduated second in his class and was named the Prentice-Hall Outstanding Student in Taxation. Mr. Blum and his wife, Laurie, reside in Fort Worth, Texas.

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I. OVERVIEW

Although there are many issues to consider when planning for clients with high incomes or large estates, one issue that must not be overlooked is the fact that many clients will have assets that have appreciated greatly over time and thus have large built-in gains. This scenario is especially prevalent in families that have accumulated their wealth over several generations. In years past, we may have sacrificed income tax planning in favor of estate tax planning.

Under the American Taxpayer Relief Act of 2012, the differentials between income tax rates and estate tax rates are significantly reduced. Additionally, the extremely large estate tax exemption allows the potential basis step-up for over $10 million for a married couple using only the most pedestrian basis planning. Both income and estate tax planners must therefore be keenly aware of the increased importance of basis planning.

One day estate planners will look back on today as "the good old days," when an individual could potentially increase his or her income tax basis by as much as $5,340,000 without any creative planning whatsoever. With creative planning, we can multiply the amount that could potentially be stepped-up without generating an estate tax. In this outline, we'll look at planning tools for disposing of low-basis assets, as well as techniques available for basis adjustment.

II. USING TRUSTS TO MITIGATE THE PEASE LIMITATION ON CHARITABLE DEDUCTIONS

A. <u>Pease Limitation</u>. The Pease limitation on charitable deductions is back! Although the Pease limitation was previously eliminated, the American Taxpayer Relief Act of 2012 brought back the limitation but raised thresholds above those set under previous law. This pesky Pease limitation is taking the fun out of charitable giving by reducing itemized deductions by 3% of a couple's AGI exceeding about $305,000. Interestingly, this limitation on itemized deductions is known as the Pease limitation after Donald Pease, the Ohio congressman who helped create it.

Fortunately, the Pease limitation does not apply to estates or trusts. Unfortunately, creating an estate to take advantage of this exception requires a greater commitment than most of our clients possess. Not so with a trust!

B. Charitable Lead Trusts. An individual who is predisposed to give a certain amount of assets to a charity each year may be an ideal candidate for the charitable lead trust technique. A CLT is a trust that makes an annual payout (either a fixed amount (a "CLAT") or a variable amount (a "CLUT")) to a charity for a fixed term of years (such as 10, 15, or 20), and at the end of the term, the trust assets pass to the donor's family (typically to the donor's children). CLTs are one of the most underutilized estate and charitable planning vehicles.

1. Pease Limitation and CLTs. Utilizing a CLT allows us to get around the Pease limitation if structured as a non-grantor trust. Even if the trust income is unrelated business taxable income, these trusts can allow substantial relief from the Pease limitation. CLTs are subject to the prohibited transaction rules in Chapter 42 of the Code. Although gifts to trusts that do not qualify as CLTs receive no gift tax charitable deduction, they can be effective in particular cases. Trusts which were funded in such a way that no deduction is allowed receive the same income tax deductions for gifts to charity as a non-grantor CLT, but are not subject to any of the self-dealing rules of Chapter 42.

2. Tax Advantages of a CLT. The CLT removes assets from the donor's estate so that the donor avoids estate tax on the assets, but when the term ends, the assets pass to the donor's children. With careful planning, a CLT can be structured so there is no estate or gift tax on the portion of the assets passing to the children at the donor's death.

3. When CLTs are Beneficial. As noted above, the best time to create a CLT is when interest rates and asset prices are low. Currently, interest rates are historically low, which serves to reduce the present value of the remainder interest that passes to the children and makes it easier to avoid paying gift tax on this amount. In addition, when asset prices are low, the assets have more potential to appreciate, which also increases the amount that later passes to the children.

4. Income Tax Consequences of a CLT. The income tax consequences of a CLT depend on whether the CLT is structured as a grantor trust or a non-grantor trust. If the CLT is a grantor trust, the donor receives an income tax charitable contribution deduction when the CLT is created, but pays income tax each year on the trust's entire taxable income (with no deduction for the amount passing to charity each year). If the CLT is a non-grantor trust, the donor receives no upfront income tax deduction, but the CLT gets a deduction each year for the amount passing to charity.

Example: Husband and Wife own a working interest and mineral interest that, together, are valued at $18,080,000. Husband and Wife are involved in charitable activities and give approximately $100,000 per year to their favorite charities. Additionally, they would like their children to ultimately receive a portion of the working interest.

If Husband and Wife have a net income before taxes ("NIBT") of $3,829,249, they will be over the 3% cutback threshold of $300,000. But because the cutback is capped at 80% of the deduction, if Husband and Wife gift $100,000 to the charity, they will be able to deduct $20,000 (20%). As a result, Husband and Wife will pay $31,680 in taxes on the $80,000 (80%) they were unable to deduct due to the cutback (assuming 39.6% tax bracket). Thus, if Husband and Wife give the charity $100,000 outright every year for ten years, the cutback would cost them an additional $316,800 in taxes.

Suppose instead, however, Husband and Wife decide to create a CLT which the charity receives an annuity for ten years, naming their children as remainder beneficiaries. They gift a portion of the working interest worth $1,808,000 (10%) to the CLT. Assuming the working interest continues to produce income and the CLT plays out 5.531% of its initial assets per year to the charity, the charity would receive an annuity payment of $100,000 per year. At the end of the ten-year term, the charity will have received $1 million.

Because Husband and Wife gifted a working interest, income produced from the interest will be considered UBTI and will be subject to the 3% cutback and 50% limitation on charitable deductions. The 3% cutback threshold for trusts is $11,950. Therefore, by way of comparison, assuming the trust has a NIBT of $382,925 (which represents 10% of Husband's and Wife's total NIBT prior to the 10% gift to the CLT), the 3% cutback amount will be $11,129.25. Comparing this cutback amount to the $80,000 cutback amount applicable to Husband and Wife as individuals, use of the CLT has reduced the cutback by $68,871, which results in a $27,273 tax benefit. Over ten years, the tax savings would be $272,728.18.

Moreover, suppose in Year One the CLT has an adjusted gross income of $384,924. The 50% limitation amounts to $192,462. The 3% cutback amount would be $11,189.22, which means that with a charitable annuity of $100,000, the CLT could actually take a charitable deduction of $88,811. If the CLT earns $1,840,321 over the next nine years (see CLT Income Chart, below, for individual annual calculations), over ten years, the charitable deductions taken by the CLT will amount to $830,549.

CLT Income Chart:

Year	CLT AGI	50% Limitation	Cutback Amount	Charitable Annuity	Charitable Deduction
1	$384,924	$192,462	$11,189.22	$100,000	$88,811
2	$321,451	$160,726	$9,285.03	$100,000	$90,715
3	$276,090	$138,045	$7,924.20	$100,000	$92,076
4	$241,026	$120,513	$6,872.28	$100,000	$93,128
5	$214,312	$107,156	$6,070.86	$100,000	$93,929
6	$191,916	$95,958	$5,398.98	$100,000	$90,559
7	$172,800	$86,400	$4,825.50	$100,000	$81,575
8	$155,566	$77,783	$4,308.48	$100,000	$73,475
9	$140,368	$70,184	$3,852.54	$100,000	$66,331
10	$126,792	$63,396	$3,445.26	$100,000	$59,951
					$830,549

If Husband and Wife had kept the working interest in their own name and gifted $100,000 outright every year for ten years, the total amount of charitable deductions they would be able to take would be $200,000. Therefore, using the CLT has allowed a $630,549 increase in allowed deductions, which results in a tax benefit of $249,697.

Additionally, if Husband and Wife gifted 10% of their mineral interest rather than of their working interest, the tax savings would be even greater. Because income from mineral interests is not treated as UBTI, the CLT would have no 3% cutback or 50% limitation and could deduct 100% of the $100,000 charitable annuity each year. Over ten years, this would be a $1,000,000 deduction, which is $800,000 more than the deduction available to Husband and Wife as individuals making the same gifts. This would save $347,200 in taxes.

The following table illustrates the results of using a CLT:

	Without a CLT	With a CLT (Working Interest)	With a CLT (Mineral Interest)
Charitable Deduction Over Ten Years:	$200,000	$830,549	$1,000,000
Income Tax Savings:	$79,200	$328,897	$434,000
Amount Passing to Charity:	$1,000,000	$1,000,000	$1,000,000

Note: Illustration does not take into account potential estate tax benefits of charitable giving.

III. DISPOSING OF LOW-BASIS ASSETS

The Call. We have all experienced it. The client is either planning to market a low-basis asset, or, more commonly, an agreement has already been reached between your client and a third party buyer. (We are going to ignore for today the calls that begin "This is what we did! Can you help us?")

What we need to be able to do is give our client options. In the end the client may decide to just pay the tax. Our job is to give the client the best options available. Also, if we are more aware of what options exist, we can start helping our client proactively prepare for that day. If we can do that, "The Call" will be more like seeing an old friend than meeting a complete stranger.

Here is a scenario. Your client has a business with a fair market value of $20 million and a $0 basis. The client is looking to sell the business. He is considering whether to donate 10% of the proceeds to charity, but would rather make that decision later.

A. Pay Tax. The first option for the client would be to simply pay tax on the gain, often at long-term rates. The long-term capital gains rate for those in the highest tax bracket is 20%, but the client could pay as much as 23.8% in tax if the income from the gain is subject to the 3.8% net investment income tax. In our example above, the client would pay at least $4 million in long-term capital gains tax if he sells the business and makes no charitable contribution. This is not a recommended course of action, in light of the possible planning tools discussed below, but it is, an option that the client may choose.

B. Strategically Using Charitable Gifts. Because the client has some charitable intent, he should consider now whether he really wants to make a charitable donation. A donor can generally deduct contributions of money or property made to or for the use of a "qualified organization" (defined as those organizations described in Code Section 170(c)). Although the foregoing statement is an oversimplification of the rules related to charitable giving (there are many restrictions on, and rules governing, the deductibility of charitable gifts), there are multiple techniques available to structure charitable gifts. When working with clients who hold appreciated assets, it is important to use these charitable techniques in a way that provides the client with the greatest tax benefit.

1. Gifting Cash After the Sale. Using our example above, the client could sell the business for $20 million and later give $2 million to charity. In that case, the client and take the $2 million charitable deduction (a Pease cutback of approximately $590,000 would apply). Assuming the client materially participates in the business, there will be no net investment income tax, and the long-term capital gain rate will be 20%. The client will have a net capital gain of $20 million, a $1.41 million deduction, and would pay approximately $3.7 million in taxes. Put another way, because of the Pease limitation, the $2 million gift only saves about $300,000 in Federal income taxes. If the client has sufficient ordinary income during the year of sale to utilize the charitable deduction, the income tax savings would amount to approximately $560,000. For this

reason, the client might want to structure the sale late enough in the year to ensure that he had sufficient ordinary income during the year of sale to utilize all of the charitable deduction.

2. Gifting Before the Sale is Better. Suppose the same client gifted a 10% interest in his company to the charity and then entered into a contract to sell the business for $20 million. The client will have only $18 million in proceeds from the sale and will be able to take a $2 million deduction, reduced by a $530,000 cutback. The capital gain will be $18 million and the taxable income only $16.53 million. The client will only pay $3.3 million in taxes, which amounts to a $700,000 in tax savings related to the charitable giving and is $400,000 better than giving cash after the sale. Put another way, Uncle Sam would pay $700,000, or 35% of the total amount passing to charity. If the client has sufficient ordinary income during the year of sale to utilize the charitable deduction, the income tax savings would about to about $980,000.

3. Gifting Where No Sale is Expected. While some clients are aware of the benefits of making a charitable gift prior to a sale of an asset, many are not aware that, even if a sale of the asset is not imminent, charitable gifting can still provide a valuable step-up in basis. For example, suppose the client above does not want to sell his business but does want to give $1 million to a public charity. Assuming the client earns $4 million per year, giving $1 million cash outright will result in a deduction of $890,000, which will save roughly $352,000 of taxes saved through the charitable deduction.

If instead the client gifted to the charity a $1 million interest in the company, the client could take the $1 million charitable deduction and then buy back the interest from the charity for $1 million. The client's basis in the company has risen from $0 to $1 million.

If the company is not a partnership, the client would eventually save around $200,000 in taxes upon the sale of the business. But, if the company is a partnership, it could make a Section 754 election and push the new basis onto the partnership assets, possibly goodwill. Because goodwill is amortizable (at ordinary tax rates), the client will receive the $352,000 tax savings described above, plus a $396,000 income tax savings over the next 15 years as the additional goodwill is amortized. The client will have received almost $750,000 in income tax savings from a $1 million charitable gift. Put another way, the IRS will fund $750,000 of the client's $1 million charitable gift.

C. Using Charitable Remainder Trusts. In addition to the more traditional charitable gifting options discussed above, utilizing charitable remainder trusts ("CRTs") can also provide significant income tax benefits. Below is a discussion of the two general ways CRTs can provide tax advantages: "traditional" CRT planning and "enhanced" CRT planning.

1. Traditional CRT Planning. When an individual creates and funds a CRT, income from the trust is distributed back to the donor (either a fixed amount (a "CRAT") or a variable amount (a "CRUT")), and at the end of the trust term (either the death of a

fixed number of years), the remaining principal passes to the named charity. The CRT can also be structured to continue after the donor's death for the benefit of the donor's family members (for either their lives or a fixed period of time), and at the death of the named family members, the remaining principal passes to the named charity.

a. Tax Advantages of a CRT. When a CRT is established, the donor receives an income tax deduction for the value of the remainder interest (with special rules applying to property with a basis that is lower than the property's fair market value). A CRT is not a tax paying entity. If appreciated assets are contributed to a CRT, the CRT can sell them with no tax due at the time of the sale. This provides an excellent opportunity to convert low income-producing assets to cash without a capital gains tax. In many plans, taxpayers use the savings to purchase life insurance (to be owned by an irrevocable trust for the benefit of family members) to "replace" the assets going to charity at the donor's death.

b. When CRTs are Beneficial. The best time to create a CRT is when interest rates are high and the donor owns an asset that is highly appreciated. When interest rates are high, it is easier to meet the requirement that the CRT have a charitable remainder with an actuarial value of at least 10% of the value of the property transferred to the CRT. Because a CRT can sell property without income tax consequences (as noted below), a CRT provides the most benefit when a donor contributes property with a high fair market value but with a low income tax basis. Additionally, if capital gains rates are increased, CRTs may become even more effective for donors with highly appreciated assets.

c. Income Tax Consequences. As noted above, the donor receives an up-front charitable contribution deduction equal to the value of the remainder interest when the CRT is created. The CRT is exempt from tax, so it does not pay capital gains tax or income tax as a result of its transactions. When the donor receives (or other family members receive) annual distributions from the CRT, the distributions may be subject to income tax based on a tiering system. The tiering system carries out trust income to the beneficiaries, with the tax treatment determined by the original character of the income when it was generated inside the trust. For example, if the CRT distributed income to the donor that was generated when the CRT sold stock with a long holding period, the donor would pay tax on the income at long-term capital gains rates.

Example: Husband and Wife, ages 65 and 64, own $3 million in highly appreciated stock that pays 3% in dividends each year ($90,000). They have a $200,000 basis in the stock and are in the 39.6% federal income tax bracket. Husband and Wife decide that, given their age, they should maximize their income during retirement. They also want to make a charitable contribution to their favorite charity. Husband and Wife have

three options with respect to the stock – keep the stock, sell the stock and use the proceeds to diversify their investments, or utilize a CRT.

If Husband and Wife merely keep the stock, they retain their $90,000 income stream, which will not increase unless the stock begins paying more dividends. Any charitable contribution that they make would potentially decrease this income stream.

If Husband and Wife sell the stock, they will be required to pay a capital gains tax of over $666,400 (proceeds of $3 million, less $200,000 basis, multiplied by 23.8% capital gains tax rate and net investment income tax). Therefore, only $2,333,600 will be available to reinvest in a higher income-yielding investment. Assuming the investment earns 6% before taxes, the sales proceeds of $2,333,600 would produce about $140,000 in pre-tax income, or about $79,240 net of income taxes (39.6% income and 3.8% net investment income tax).

If Husband and Wife create a CRT, they can contribute the stock to the CRT, and the trustee of the CRT can sell the stock tax-free and reinvest the proceeds. Therefore, the CRT would have a total of $3 million to invest (as opposed to the $2,333,600 that Husband and Wife would have to invest had they sold the stock themselves). Assume that the CRT earns 8% and pays out 5% annually in an annuity to Husband and Wife. Husband and Wife would receive a payment of $150,000 per year. In addition, in the first year, they would receive a charitable contribution deduction of $547,290 (equal to the present value of the charity's remainder interest).

If Husband and Wife die in twenty years, the charity is projected to receive assets outright with a value of approximately $7,118,000.

A CRT can also be combined with an irrevocable life insurance trust, commonly known as a "wealth replacement trust." Husband and Wife can use their income tax savings (generated by the charitable contribution deduction) and some of their extra annual cash flow to pay premiums on life insurance owned by the wealth replacement trust. The wealth replacement trust can be structured to benefit their children, thereby "replacing" the assets passing to charity through the CRT. An added benefit of a wealth replacement trust is that it can be structured so that it is excluded from Husband's and Wife's estates, allowing the assets inside the trust to pass tax-free to the children.

Summary: Husband and Wife transfer their stock, valued at $3 million, to the CRT. Husband and Wife receive an income tax charitable contribution deduction of $547,290 upon the transfer. Husband and Wife receive

income from the CRT of $150,000 per year, totaling approximately $3 million during their lives (assuming a constant 8% growth rate and a survival period of twenty years). When Husband and Wife both die, the CRT assets of approximately $7,118,000 pass to the charity of their choice (assuming a constant 8% growth rate and a survival period of twenty years).

2. Enhanced CRT Planning. CRTs can also serve as a vehicle for a specific tax planning strategy that is not widely used but that could potentially offer significant tax savings. Generally, distributions from a CRT are treated as income on what is essentially a worst-in-first-out basis.[1] But, if there is no trust income or if the trust income has already been distributed, then any distributed amount will be treated as a return of principal.

Although CRTs are subject to an excise tax on unrelated business taxable income ("UBTI") which includes income from debt-financed property, there is a way for a CRT to borrow money and make the first annual distribution to the beneficiary as a tax-free return of principal.

Example: A client has a marketable security with a Fair Market Value of $1 million. Client has $0 basis in the stock, and he would like to diversify and avoid capital gain. On January 2, Client establishes a CRUT with a four year term and 43.75% payout and donates the stock to the trust. At the end of Year One, on December 30, the trust gets a margin loan and pays out to the beneficiary (client) 43.75%. Because the trust had no income in Year One, the distribution is treated as return of principal, and the beneficiary (Client) owes no tax on the distribution.

Then on January 1 of the following year (Year Two), the trust sells the stock for $1 million (assuming no appreciation) and pays back the loan. The trust continues the 43.75% payout over the next three years in the following amounts: Year Two—$246,093.75; Year Three—$138,427.73; Year Four—$77,865.60). The beneficiary (Client) has therefore received a total amount of $899,987.08. Assuming a 23.8% long-term capital gain ("LTCG") tax on the distributions from Years Two, Three and Four, Client will pay a total of around $110,048.13 in capital gains tax, which means that the total net to Client will be $789,939.47.

Had Client simply sold the stock without the CRT planning tool, he would have netted $762,000, after taking into account the 23.8% LTCG tax. Therefore, using the trust saves Client $27,939.47. Moreover, upon expiration of the trust, the $100,112.92 remaining in the trust will be distributed to a charity. Thus, Client has been put in a slightly better

[1] IRC § 664.

position, and the charity has received over $100,000 of what would have gone to the IRS. Essentially, the strategy results in about $128,052.39 of taxes saved.

D. <u>Private Placement Life Insurance</u>. A less common (but potentially significantly advantageous) option for high-wealth clients is private placement life insurance ("PPLI"), which is a type of variable universal life insurance. In addition to a death benefit, PPLI also provides cash value appreciation based on the performance of investments within a segregated asset account. The investment earnings accumulate tax-free within the policy, and upon the death of the insured, the proceeds are paid out as a non-taxable death benefit. Policy purchasers must meet the qualified purchaser and accredited investor standards, and the insured must medically qualify for the life insurance coverage.

Generally, there are two ways to make investments within a PPLI policy: (1) the client utilizes an established insurance-dedicated fund ("IDF") or (2) the client selects an investment advisor who creates his own IDF. An IDF is essentially a mutual fund used exclusively by insurance accounts. There are many existing IDFs with proven track records in which a client may choose to invest the policy assets. Alternatively however, the client may choose an investment advisor who can establish his own IDF, typically through companies that create IDFs as a turn-key package. This option is especially appealing to more sophisticated investors because not only can the client pick who they would like to serve as the investment manager of the fund (subject to approval by the insurance company), but also the client can set the investment strategy. The strategy can be as narrow or as broad as the client prefers, but the client may not actually pick any particular investments.

One of the main attractions of PPLI is the broad range of investments available, including hedge funds, real estate investment trusts, private equity funds, and commodity funds, to name a few. A PPLI owner cannot, however, take part in any conduct that could be deemed to be investor control. According to the investor control doctrine, a contract owner who does engage in such conduct will cause the contract to forfeit its tax-preferred treatment.[2]

When large amounts are at stake, it often opens the door to exotic or creative investments. State regulations, however, generally require certain levels of liquidity within the insurance company's assets, which is why high-income clients often look to offshore PPLI companies where liquidity limitations are typically more flexible.

Another advantage high net worth clients have when establishing a PPLI contract is their ability to use money outside of the policy to pay insurance agent's fees and administrative fees which increases the cash value available for tax-free build up. Additionally, the client may be able to negotiate down the standard agent's fees or offer an up-front flat fee that could also end up saving a significant amount of money long-term. Regardless, the fees associated with establishing and maintaining PPLI are often significantly lower than those of other insurance options.

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[2] *See* Rev. Rul. 2003-91.

In addition to the tax-free build-up of assets within the insurance policy and the tax-free death benefits provided upon the death of the insured, there is another beneficial use to life insurance contracts: borrowing against the policy. Owners of a life insurance policy can borrow against the cash value of the contract without the loan amount being taxable to the owner. The loan does not have to be repaid during life, but there will be interest due on the amount withdrawn. It is critical to always leave enough cash inside the policy to continue paying the mortality charges. However, if the policy is a universal life policy, then the owner of the policy may have the ability to decrease the face value of the policy to ensure enough cash is on hand.

A PPLI policy can be especially beneficial for clients who have a large built-in gain in an asset, especially where the gain will result in ordinary income—such as a gain in a foreign currency. PPLI can allow the client to effectively remove himself economically from the position by serving as a vehicle through which the client can hedge against the gain in a tax-free environment.

Clients with an illiquid asset with a high value and low basis may also greatly benefit from PPLI. For example, the clients may be able to borrow against the asset, investing the loan proceeds within the policy. In addition to the tax benefits, the client has also achieved better portfolio diversification. This is especially likely if the assets are marketable securities because margin loans may be available.

IV. BASIS ADJUSTMENT PLANNING

A. <u>Basis Adjustment at Death.</u> Generally, Section 1014 of the Internal Revenue Code provides that the value of a recipient's basis in property acquired from a decedent shall be the fair market value of that property as of the date of the decedent's death. The Code specifically defines what constitutes property acquired from a decedent. For example, any property received without full and adequate consideration under a general power of appointment exercised by the decedent by will qualifies as property acquired from the decedent.[3]

Additionally, a surviving spouse's one-half share of community property held by the surviving spouse and decedent will constitute property acquired from the decedent, but only so long as at least one-half of the total value of the property is includible in the gross estate of the decedent regardless of whether the estate of the decedent is required to pay estate tax or file an estate tax return.[4]

Low-basis assets held at death receive a step-up in basis. If those same assets are gifted or sold to a grantor trust or 678 trust, they receive no step-up in basis at death. On the other hand, gifting or selling high basis assets to grantor or 678 trusts can be an effective way to preserve the high basis by avoiding a step-down adjustment at the time of death.

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[3] IRC § 1014(b).
[4] IRC § 1014(b).

For example, if a client sells a business and places the proceeds into a partnership for asset protection, there may be a step-down in basis if the decedent's interest is properly valued with marketability and control discounts. The step-down could have particularly adverse implications in the event that a Section 754 election is in place. Gifting or selling to a grantor or similar trust would preserve the outside basis of the partnership and the inside basis of the partnership assets.

To achieve the best results for clients, any strategy, but especially those involving high or low-basis assets, requires a thorough understanding of the client's goals with respect to the effected property.

> *Example*: Suppose a husband and wife own several real estate assets properly characterized as community property. Owning these assets as community property would ordinarily result in each spouse's interest being discounted because of the undivided interest. Note that this situation is unacceptable whether the real estate has a high basis or a low basis. If the real estate has a high basis, the real estate basis could actually decrease. If the basis is low, the valuation discount on a 50% undivided interest in the property would prevent the client from increasing the basis to its highest value. Further, the surviving spouse's basis in her one-half community property would also be affected.
>
> In this situation, it would typically be better to grant each spouse, as separate property, his own real estate assets of equivalent value. This would avoid the discounts associated with undivided interests and prevent negative basis adjustments.
>
> Furthermore, if one spouse is in significantly better health (or significantly younger) than the other it may be advantageous to grant the spouse in poorer health the low-basis assets as his or her own separate property. In the event of that spouse's death, the assets receive a basis step-up. The healthier spouse retains the high basis assets as his or her own separate property and could sell the assets for a loss, thereby receiving a loss deduction that could potentially carry over for several years.

Additionally, it may be beneficial to review previous planning. Depending on the circumstances, some clients should consider moving (or buying) low-basis assets that were moved outside of the estate to avoid federal estate tax liability back into the estate. The clients could then receive a basis step-up on the assets at death, and with the increased exemption amount, may still avoid any federal estate tax liability.

B. G1-G2 Basis Planning. G1-G2 basis planning is complicated, but it offers two substantial benefits: wealth transferred out of the estate for estate tax purposes while preserving a basis step-up for income tax purposes. This tool is especially well-suited for clients with high value assets that have a very low tax basis. Used correctly, this type of planning allows the client

to achieve a basis step-up for assets valued well above the estate tax exclusion but still greatly reduce the estate tax on those assets.

To illustrate how this planning tool works, let's use the example of Phil and Roberta Minton.

> *Example*: Phil and Roberta are an elderly married couple (Generation 1 or "G1") who own marketable securities worth $25 million and a large ranch worth $45 million. The Minton family has owned the ranch for generations, and Phil and Roberta will not sell the ranch during their lifetimes. Moreover, the Mintons have a very low tax basis in the ranch, and both the ranch and the marketable securities are held in an LP.
>
> If Phil and Roberta move the assets out of their estate to save estate taxes, they will lose the step-up in basis at death. But, if they leave the ranch in their estate, at the death of G1, **their taxable estate could be as high as $45 million** ($70 million estate with a 35% discount for lack of marketability and lack of control for assets held in an LP). They could, therefore, have a federal estate tax liability of around $18 million ($45 million x 40%). Phil and Roberta have approximately $3 million estate tax exemption remaining. Accordingly, we recommend G1-G2 basis planning.
>
> In the simplest iteration of this technique, the Mintons borrow $70 million from the bank, and then loan the $70 million to the Minton Trust, a grantor trust, in exchange for a promissory note (at the Section 7872 rate) which is due at the death of the Mintons' children ("G2"). Using the $70 million from the loan, the Trust purchases life insurance policies on G2, and the bank takes a collateral assignment in the policies, which allows it to charge a reasonable interest rate on the note owing from G1 (typically a LIBOR based rate). Note that the insurance policies will be unusually structured in that they will have a very high cash surrender value while also having the least amount of death benefit possible without violating required insurance funding ratios of the Internal Revenue Code.
>
> After applying a 40% lack of marketability and lack of control discount, the ranch will have a value of $27 million. Because the ranch is still held in the estate, it receives a step-up in basis. Although the step-up will not be to the full fair market value because it is held in an entity, the estate has now increased its basis in the ranch to $27 million. After applying a 30% valuation discount to the marketable securities, they have a value of $17.5 million.
>
> In addition to the ranch and marketable securities, the estate also holds the $70 million note owing from the Minton Trust. However, because of the

low interest rate, the note's long term, and the uncertainty of the note term (term ends at death of G2), the note would be discounted by as much as 60%. Therefore, at the death of G1, the note would have a value of $28 million ($70 million less a 60% discount), and the total estate assets would be valued at $72.5 million ($27 million ranch + $17.5 million marketable securities + $28 million note receivable).

After deducting the $70 million note owed by the estate to the bank, the **net worth of the estate is reduced to $2.5 million** ($72.5 million estate less the $70 million note obligation). After accounting for Phil's and Roberta's remaining $3 million estate tax exemption, the estate will now not be subject to any federal estate tax liability, and the basis step-up has been preserved.

Balance sheet after planning:

Ranch (discounted value)	$27,000,000
Marketable Securities (discounted value)	$17,500,000
Promissory Note (discounted value)	$28,000,000
Total Assets	$72,500,000
Debt	($70,000,000)
Net Worth of Estate	$2,500,000
Exemption Remaining	($3,000,000)
Estate Tax	**$0**

The following chart illustrates this technique.