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# G1/G2 BASIS PLANNING TO SAVE TAXES

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***by Marvin E. Blum & John R. Hunter***

## ***Benefits of G1/G2 Basis Planning***

- It's like having your cake and being able to eat it too—federal estate tax savings and a basis step-up.
- Technique is complicated but offers two substantial benefits: wealth is transferred out of the estate for estate tax purposes and basis step-up is preserved for income tax purposes.
- Especially well-suited for clients with high-value assets that have a very low tax basis but will work for anyone wanting to save estate tax.
- Allows the client to achieve a basis step-up for assets valued above the estate tax exemption amount while greatly reducing the estate tax on those assets.

## ***Scenario Facts***

- Phil and Roberta Minton are a married couple (Generation 1 or "G1") who own a major asset with a fair market value of $15 million.
- Their tax basis in the major asset is $3 million.
- They also own approximately $1 million of other assets (house, etc.).

## ***Scenario 1 – No Planning***

- Phil and Roberta keep the major asset in their estate.
- At their deaths (death of G1), their taxable estate will be $5,100,000.

| | Value |
|---|---|
| Major asset | $15,000,000 |
| Other assets | $1,000,000 |
| Total assets | $16,000,000 |
| Less combined federal exemption | ($10,900,000) |
| Taxable estate | $5,100,000 |

- Their estate will have a federal estate tax liability of approximately $2 million.
  *[Estate of $5,100,000 x 40% estate tax rate = $2,040,000]*

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- Phil's and Roberta's children (Generation 2 or "G2") will receive a full step-up in basis in the major asset.
- If G2 sells the major asset, no income tax will be due following the sale.
  *[$15,000,000 fair market value less $15,000,000 basis = $0 capital gain]*
- Scenario 1 Summary:
  - No planning: major asset remains in estate
  - Estate tax: $2,040,000
  - Income tax on subsequent sale of major asset: $0
  - Total taxes: $2,040,000

***Scenario 2 – "Squeeze" Planning***

- Phil and Roberta transfer the major asset into a limited partnership.
- Ownership of the general partner of the limited partnership will be structured so that neither Phil nor Roberta will have voting control. To achieve this structure, interests in the general partner may be owned by G2 or trusts for G2's benefit.
- The fair market value of the limited partnership interests would be discounted for lack of marketability and lack of control, assuming Section 2704 regulations (which threaten to limit such discounts) are not issued.
- At the death of G1, their taxable estate will be $0.

| | Value |
|---|---:|
| Limited partnership:<br>Major asset ($15,000,000 less 40% discount) | $9,000,000 |
| Other assets | $1,000,000 |
| Total assets | $10,000,000 |
| Less combined federal exemption | ($10,900,000) |
| Taxable Estate | $0 |

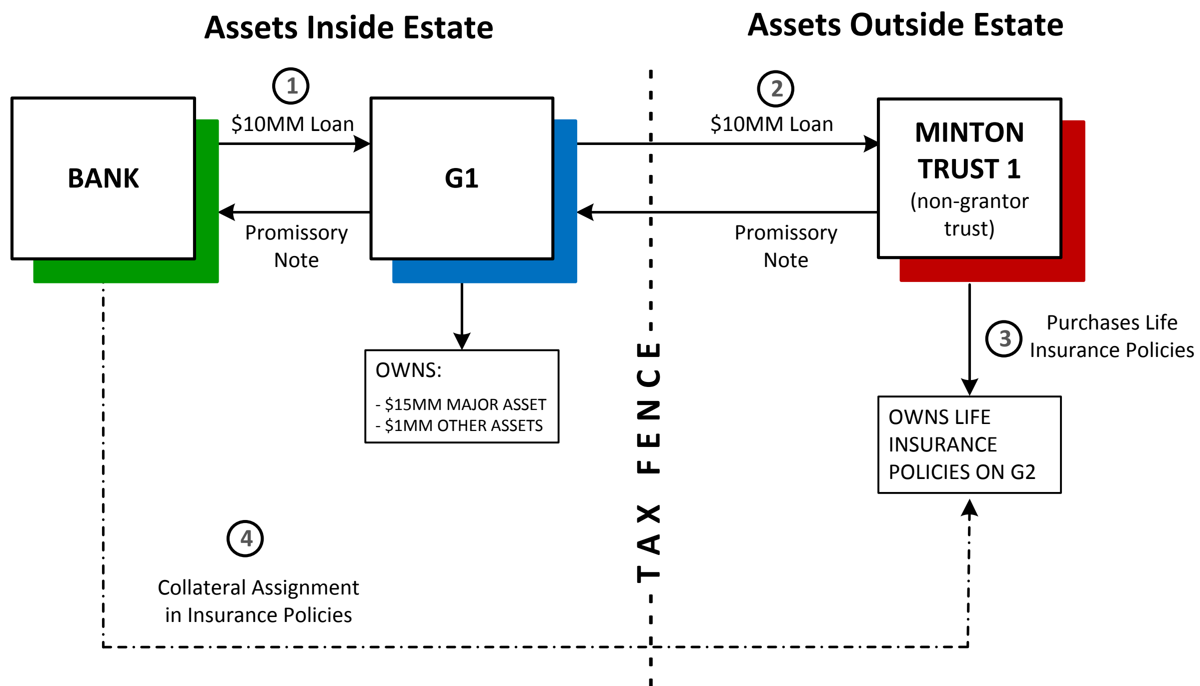
- G2 will receive a step-up in basis in the major asset to $9 million. (Because the major asset is held in an entity, the step-up will not be to the full fair market value.)
- If G2 sells the major asset, income tax will be due following the sale.

| | Major Asset |
|---|---:|
| Fair market value | $15,000,000 |
| Basis | ($9,000,000) |
| Capital gain | $6,000,000 |
| LTCG rate | x 23.8% |
| Income tax due | $1,428,000 |

- Scenario 2 Summary:
  - Squeeze Planning: major asset transferred to limited partnership outside of estate (squeezing down the value of the asset)
  - Estate tax: $0
  - Income tax on subsequent sale of major asset: $1,428,000
  - Total taxes: $1,428,000

***<u>Scenario 3 – G1/G2 Basis Planning</u>***

- (1) Phil and Roberta borrow $10 million from the bank.
- (2) Phil and Roberta loan the $10 million to Minton Trust 1, a non-grantor trust, in exchange for a promissory note (at the long-term Section 7872 rate) which is due at the death of G2.
- (3) Using the borrowed $10 million, Minton Trust 1 purchases life insurance policies on G2.
- (4) The bank takes a collateral assignment in the policies, which allows it to charge a LIBOR-based interest rate on the note owing from G1.
- 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 IRS life insurance corridor ratios.



- The estate holds the $10 million note owing from Minton Trust 1. The note would be highly discounted (assume 60%) because of the low interest rate, the note's long term, and the uncertainty of the note term (term ends at death of G2).
- At the death of G1, their taxable estate will be zero, and they will have no federal estate tax liability.

| | Value |
|---|---|
| Major asset | $15,000,000 |
| Note receivable (60% discount) | $4,000,000 |
| Other assets | $1,000,000 |
| Total assets | $20,000,000 |
| Less debt | ($10,000,000) |
| Net worth of estate | $10,000,000 |
| Less combined federal tax exemption | ($10,900,000) |
| Taxable estate | $0 |

- G2 will receive a step-up in basis in the major asset to $15 million.
- If G2 sells the major asset, no income tax will be due following the sale.
  *[$15,000,000 fair market value less $15,000,000 basis = $0 capital gain]*
- Scenario 3 Summary:
  - G1/G2 Basis Planning
  - Estate tax: $0
  - Income tax on subsequent sale of major asset: $0
  - Total taxes: $0

***Comparison of Scenarios***

| | Scenario 1: No Planning | Scenario 2: Squeeze Planning | Scenario 3: G1/G2 Basis Planning |
|---|---|---|---|
| Estate tax | $2,040,000 | $0 | $0 |
| LTCG tax | $0 | $1,428,000 | $0 |
| Total taxes | $2,040,000 | $1,428,000 | $0 |

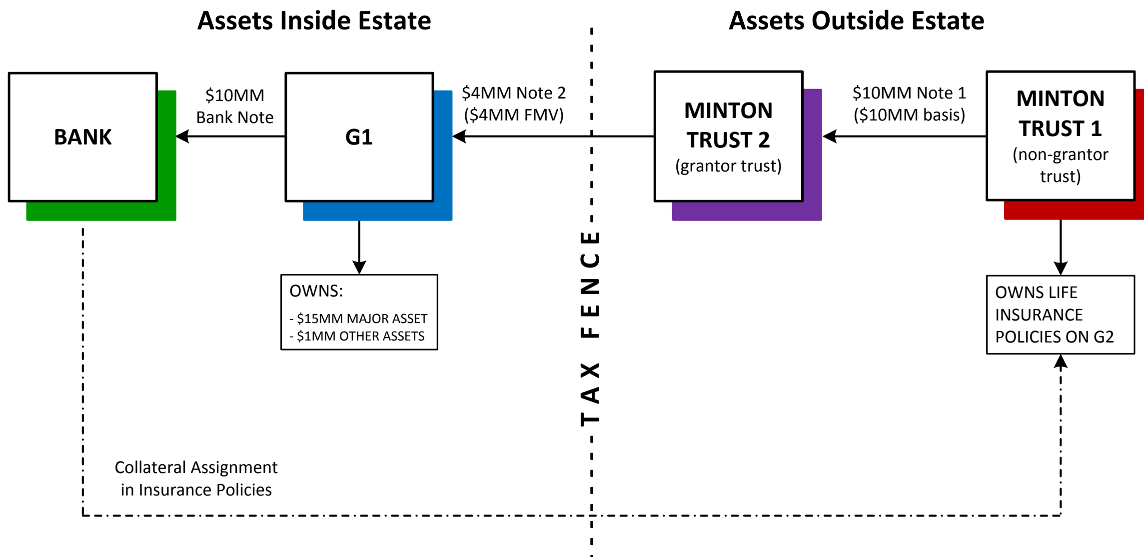
- G1/G2 Basis Planning (Scenario 3) is the best option.

### ***Why This Technique Works***

- This technique takes advantage of the inconsistency between Section 7872 of the Code and Sections 2031 and 2511 of the Code.
- Section 7872 states that loans made for the AFR rate of interest do not result in a taxable gift.
- Sections 2031 and 2511 state that assets (including promissory notes) are valued at fair market value.
- Long-term loans with an uncertain duration bearing interest at the AFR rate have a very low fair market value, but the lender is not considered to have made a taxable gift on the date of the loan.

### ***Second Stage of G1/G2 Basis Planning***

- If G1 retains the note until death, the note receivable ("Note 1") will receive a step-down in basis to only $4 million, and the estate would owe income tax of $1,428,000 when Note 1 is repaid. *[$6,000,000 capital gain x 23.8% LTCG rate = $1,428,000]*
- Consequently, two to three years after the loans are made, G1 will want to sell Note 1 to a trust for the benefit of G2 and G3 to lock in the discount and avoid a step-down in basis.
- Therefore, two years after Note 1 is created, Phil and Roberta create Minton Trust 2, a grantor dynasty trust for the benefit of G2 and G2's children (Generation 3 or "G3").
- Phil and Roberta sell Note 1 (the $10 million note receivable owing from Minton Trust 1 to Phil and Roberta) to Minton Trust 2 for a $4 million promissory note ("Note 2"). *[$10,000,000 less 60% discount = $4,000,000 fair market value]*
- Note 2 would have an adjustable rate and different terms than Note 1.



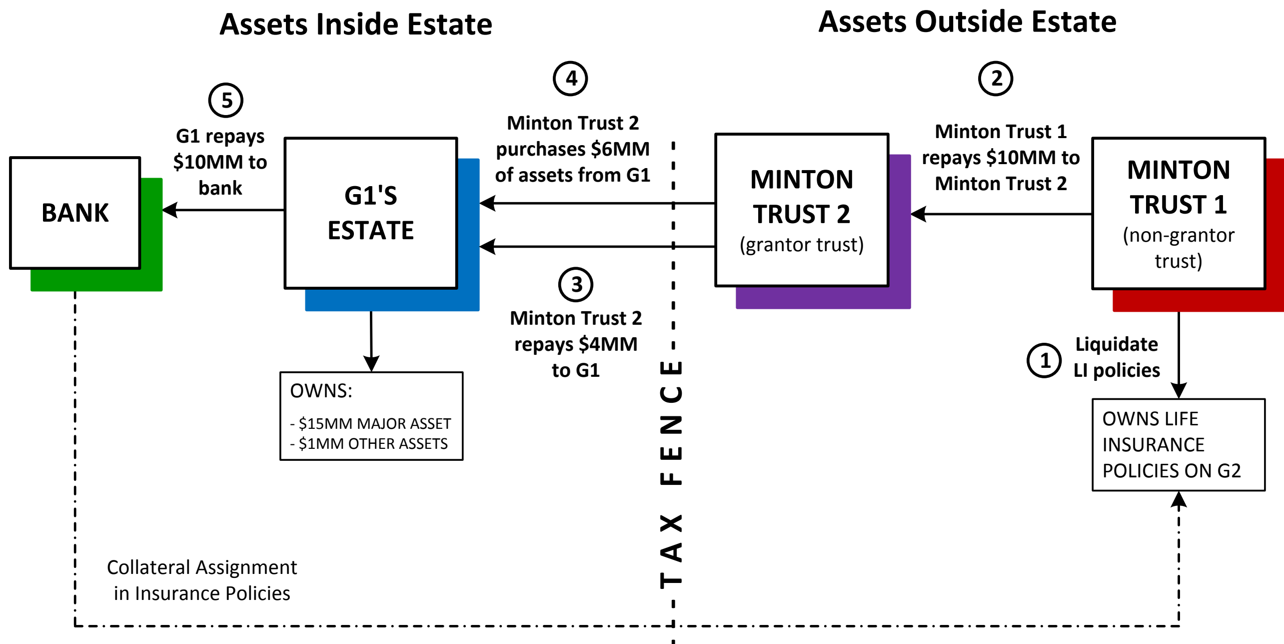
- At the death of G1, their taxable estate will be zero, and they will have no federal estate tax liability.

| | Value |
|---|---|
| Major asset | $15,000,000 |
| Note receivable (no discount) | $4,000,000 |
| Other assets | $1,000,000 |
| Total assets | $20,000,000 |
| Less debt (owed to bank) | ($10,000,000) |
| Net worth of estate | $10,000,000 |
| Less combined federal tax exemption | ($10,900,000) |
| Taxable estate | $0 |

- G2 will receive a step-up in basis in the major asset to $15 million.
- If G2 sells the major asset, no income tax will be due following the sale.
  *[$15,000,000 fair market value less $15,000,000 basis = $0 capital gain]*
- Summary following second stage of G1/G2 Basis Planning:
  - Estate tax: $0
  - If Note 1 not yet repaid, income tax owed by estate when Note 1 repaid: $0
  - Income tax owed by heirs on subsequent sale of major asset: $0
  - Total taxes: $0

### ***Unwinding the Planning, If Desired***

- Following the death of G1, G2 can unwind the planning if the life insurance on G2 is no longer needed.
- (1) Minton Trust 1 would cash in the life insurance policies on the lives of G2 in exchange for the cash value of the policies. Income tax would be due to the extent that Minton Trust 1 received back more than it paid in (as ordinary income).
- (2) Minton Trust 1 would pay Minton Trust 2 $10 million to pay off Note 1 owed to it. No income tax would be due because Minton Trust 2 has a $10 million carry-over basis in Note 1 (since G1 had a $10 million basis in Note 1 when it sold Note 1 to Minton Trust 2, a grantor trust).
- (3) Minton Trust 2 would pay $4 million to G1's estate to pay off Note 2 owed to it. No income tax would be due because G1's estate has a $4 million basis in Note 2 (since Note 2 was in G1's estate and received a basis equal to its $4 million fair market value when G1 died).
- (4) Minton Trust 2 could buy $6 million of assets from G1's estate (a $6 million portion of the major asset). No income tax would be due because G1's estate has a $15 million basis in the major asset (full step-up).
- (5) G1's estate would use the $4 million and the $6 million to repay the $10 million owed to the bank.



Note that if the planning is unwound while G1 is living, capital gains tax would not be due when Minton Trust 2 purchases $6 million of assets from G1 because Minton Trust 2 is a grantor trust, but Minton Trust 2 would not receive a step-up in basis on the $6 million of assets it purchased. Therefore, capital gains tax would be due later when Minton Trust 2 sells the $6 million asset. Accordingly, it is more tax efficient to wait until after G1 dies to cash in the policies and pay back the bank.