**Basis Planning in Light of the Tax Cuts and Jobs Act**

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# Introduction

## Increase in estate tax exemption.

The unified credit has increased from $5.49 million in 2017 to $12.92 million in 2023 for individuals and from $10.98 million to $25.84 million for couples.[[1]](#footnote-1) In 2026, exemption amounts will revert to pre-Jobs Act levels, adjusted for inflation.[[2]](#footnote-2) This represents a unique opportunity for estate planning. Only gifts made before January 1, 2026­­­—or estate returns for a decedent who has died before January 1, 2026—will be able to utilize this additional exemption.

Tax planning between now and 2026 must consider the possibility of the previous estate tax exemption returning (adjusted for inflation). Flexibility in the estate plan will be more important for some clients than in previous years. Many clients may be forced to consider how to plan if the exemption goes down, risking a loss of step-up in cost basis by engaging in traditional estate planning. Many clients who already have engaged in traditional estate planning (sales to IDGT’s, credit shelter trusts, etc.) are risking loss of step up in cost basis and no resulting estate tax savings. Also, with the large exemption, even many taxable estates may have only a minimal effective estate tax rate which may be below what the effective tax rate following a sale of the estate’s assets.

Many planners have discussed married couple clients falling into three basic net worth categories: (1) those below one exemption amount; (2) those between one and two exemption amounts; and (3) those above two exemption amounts. For those above two exemption amounts (currently approx. $25.84M), it is clear that estate tax based planning is necessary. Couples with an expected joint net worth below one exemption, it may not be a terribly difficult decision to delay estate tax planning until we have a clearer knowledge of where tax laws will head. For those couples between one and two exemption amounts, the issue becomes more difficult. If exemptions stay high, the clients may be risking a lost in step-up in cost basis by engaging in estate tax based planning. However, if exemptions return to previous levels, such estate tax based planning may be important. For these clients, building flexibility in the estate plan becomes very important to maximize the ability of obtaining estate tax planning benefits, without the loss of a step up in cost basis to the extent that planning is not necessary.

## Increase in capital gains rates.

In 2012, the American Tax Payer Relief Act increased the top capital gains rate from 15% to 20%. The 20% rate applies to taxpayers in the highest income tax bracket, now 37%.

## Net Investment Income Tax (NIIT).

There remains a 3.8% tax on certain net investment income which took effect on January 1, 2013.[[3]](#footnote-3) Estates and trusts are subject to the NIIT if they have undistributed Net Investment Income and also have adjusted gross income over the dollar amount at which the highest tax bracket for an estate or trust begins for such taxable year under section 1(e) (for tax year 2023, this threshold amount is $14,450).[[4]](#footnote-4)

Net Investment Income includes: interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities and businesses that are passive activities to the taxpayer (within the meaning of section 469).[[5]](#footnote-5)

## **Effect of Higher Rates (i.e. recapture)**.

A step up in basis applies to recapture items in addition to capital gain assets. This can result in significant tax savings. Losing the step up for those assets can be even more costly than for capital gains assets given the ordinary income tax nature of that gain recognition.

Further, ordinary income rates are expected to increase back to pre-Jobs Act level rates in 2026. Higher ordinary rates mean a higher burden on taxpayers who recapture deductions taken for prior depreciation. Clients using depreciation deductions must be wary of this expected increase in 2026 and may wish to utilize depreciation or may be willing to accept a lesser recapture tax in anticipation of this increase.

## **State Tax Rates**

State taxes for recapture will be paid where the beneficiary resides when the asset is sold, not where the decedent was domiciled. Therefore, planning that considers the effect of state income tax is complicated by the need to consider where beneficiaries may end up living and understanding the income tax consequences of those jurisdictions.

Consider states such as California, Minnesota, New York, and Oregon where the top marginal income tax rate is as high was 13.3% as of 2018.[[6]](#footnote-6) This levies a significant additional tax burden on assets, increasing the benefit of achieving a step up in basis. States such as Mississippi, Texas, Florida, and Pennsylvania have lower state income tax.[[7]](#footnote-7) Clients residing in these states when assets are sold will be subject to less additional state income tax.

## Accepting loss of step-up for getting assets outside a taxable estate not always good.

First, if there is no need to create a credit shelter trust for a spouse to avoid estate tax, then there is obviously no reason to lose step up in cost basis. Consider the following examples:

**Ex. 1:** The first-to-die holds assets worth $11M. (below the exemption) but with low basis of $1M. When sold, $2M of the $10M of gain is depreciation recapture. If he/she dies in Mississippi, consider the consequences after application of a 20% capital gains rate, the 3.8% NIIT, the 37% federal income tax rate, and 5% state income tax. The taxpayer pays $2.304M of capital gains/NIIT and state income tax and $840K of income tax on the recapture, for a total tax of $3.144M and a total “effective” tax rate of 31.14%.

**Ex. 2:** Consider the same facts as above, except $8M of the $10M of gain is depreciation recapture. If he/she dies in Mississippi, the taxpayer pays $576K of capital gains/NIIT and state income tax, and $3.36M of state and federal income tax, for a total tax of $3.936M and a total “effective” tax rate of 39.36%.

The second example illustrates the effect of large amounts of recapture, a tax that can be increased further in states, such as California, with even greater state income taxes. In either example, a step up in basis can help the taxpayer avoid significant tax bills.

**Ex. 3:** If someone dies with $15M, then he/she would have estate tax of $832,000 at the current 40% estate tax rate. That is an effective rate of just over 5.5% on all assets. If that $15M of assets has a cost basis of $5M, then there may be $2,880,000 of tax paid due to a loss of step up (20% cap gains, 3.8% NIIT, and 5% MS income tax). The result is an 19.2% effective rate.

Here, assuming the beneficiaries would sell assets, it would have been much better to have paid estate tax than to lose the step up. However, the point is to illustrate that accepting the trade-off we which many are in the habit of accepting does not always make sense.

Third, the analysis of how to balance these considerations has become much more complicated given the Tax Cut and Jobs Act has given a large current exemption that is expected to sunset. In other words, we might need to plan for that provision to no longer be in place when the client dies. Therefore, we need to build flexibility into planning in order to maximize the opportunity to use exemptions, while also being sure we do not make a bad trade-off.

# **Basis Planning for Assets Currently Held**

## Upstream GRATs and UpSPATs

An upstream method of basis planning involves assets transferred by a child to the taxpayer’s parent to utilize the parent’s applicable exclusion amount. Considering that many clients provide financial assistance to their parents, making gifts from a trust that is best designed to benefit the entire family is often a practical estate planning tool. The recent, large increase in the unified credit makes this estate planning tool much more valuable than before.

An Upstream Grantor Retained Annuity Trust is one option for a taxpayer wishing to take advantage of a parent’s additional exemption. The Upstream GRAT would provide for a remainder to vest in a parent after an annuity term ends.[[8]](#footnote-8) Upon the parent’s death, the value of the remainder would be included in the parent’s estate and pass according to the parent’s estate plan.

An Upstream Sale to a Power of Appointment Trust (“UpSPAT”) involves a child’s sale of assets to a grantor trust in exchange for a note. The parents of the child are given a testamentary general power of appointment over the trust assets, resulting in the assets being included in the parent’s estate at death and a new basis in the property. The trust then uses the assets to pay off the note, returning the assets to the child with a step-up in basis. The UpSPAT is useful when the child is not concerned that the assets will return to his or her estate. Therefore, holding a 2037 reversionary interest will not cause any problems for the trust as it will return to the child’s taxable estate anyway.

## Upstream Crummey Optimal Basis Increase Trust

Ed Morrow describes a similar scenario in which the owner of appreciated property may gift a modest sum to a grantor *Crummey* trust.[[9]](#footnote-9) Unlike an ordinary trust that names only a spouse and children, the property owner names his parents as well and gives all beneficiaries *Crummey* powers. The trust then purchases the taxpayer’s property at fair market value with a small down payment and interest at the applicable federal rate or higher.[[10]](#footnote-10) The trust then grants the taxpayer’s parents a testamentary power of appointment. Upon the death of a parent, the property is included in the parent’s estate and given a step up in basis as of the date of the parent’s death.[[11]](#footnote-11)

The power can be given to only the first beneficiary to die, to avoid any issues regarding inclusion due to a lapse of powers.[[12]](#footnote-12) The power could also be a general power or a limited power exercised in such a way as to trigger the Delaware Tax Trap.[[13]](#footnote-13) A general power might permit the parent to appoint to his or her creditors or to the child. The limited power may permit appointment to a trust with the exact same provisions as the original *Crummy* grantor trust but which allows the child or another party to trigger the Delaware Tax Trap. The client’s decision between these powers might be dependent on state creditor and asset protection trust law.[[14]](#footnote-14)

If the settlor of an irrevocable grantor trust dies in the mist of repayment of an installment note with the settlor, income tax on the note may be triggered at the settlor’s death. Therefore, the success of this trust relies upon the settlor surviving the parent.[[15]](#footnote-15) The death of the powerholder is problematic only if the value of the assets dropped significantly after the gift. This is because the powerholder’s death triggers step up basis on the assets. Therefore, the basis of the assets likely will not exceed the liabilities, barring a sudden drop in the value of the assets. The settler must be careful in deciding which assets to sell to the grantor trust.

## Accidentally Perfect Grantor Trust

The Accidentally Perfect Grantor Trust (APGT) is similar to the UpSPAT in many respects. It requires a child taxpayer to contribute “seed” money to an Intentionally Defective Grantor Trust (IDGT) set up for the benefit of the taxpayer’s parents or senior family members. The trust purchases assets with high appreciation potential from the taxpayer. The APGT uses less gift tax exemption than if the taxpayer had gifted the property to the senior family member in hopes that it would be bequeathed back to him. Depending on the structure of the trust, it may remain a grantor trust for the taxpayer even after the senior family member has died.[[16]](#footnote-16) Mickey Davis gives an example of an APGT involving a closely held business:

**Example:** Jenny owns the stock in a closely held business that she thinks is about to explode in value. Her mom Mary's net worth is perhaps $100,000. Jenny recapitalizes the company so that it has 1 voting share and 999 non-voting shares. She then sets up an IDGT for Mary's benefit, and sells the non-voting stock to the trust for its current appraised value of $1 million. She uses a combination of seed money and *a guarantee by Mary* to make sure that the sale is respected for income and gift tax purposes. The trust has language that grants Mary a general testamentary power to appoint the trust property to anyone she chooses. Mary signs a new Will that leaves the trust property to a dynasty trust for Jenny and her descendants, naming Jenny as the trustee. (Just in case, the IDGT contains the same type of dynasty trust to receive the property if Mary fails to exercise her power of appointment). When Mary dies four years later, the stock has appreciated to $2 million in value. Because the trust assets are included in Mary's estate, the stock gets a new cost basis of $2 million.[[17]](#footnote-17)

Jenny has use of the trust property and may pass the property to her children with no wealth transfer tax obligation. Mary’s estate would also likely have remaining GST tax exemption to shelter the trust assets from estate tax when Jenny dies. The trust in this example has many benefits that Davis points out in turn: (1) Jenny has the lifetime use of the trust property, (2) it cannot be attached by Jenny’s creditors, (3) the property can pass to whomever Jenny whishes, (4) principal from the trust can be utilized sparingly for Jenn y’s benefit or the benefit of her descendants, (5) if the trust is not a grantor trust as to Jenny, the income from the trust can be utilized sparingly, at Jenny’s discretion, among herself and her descendants. This has the added benefit of shifting the trust’s income to taxpayers with potentially lower income tax brackets.[[18]](#footnote-18)

Ordinarily, if the taxpayer gives assets to a senior family member, and that family member dies within one year, leaving the property to the donor, there is no step-up in basis.[[19]](#footnote-19) However, in the above example, the property does not pass directly to the donor, it passes to a dynasty trust, a beneficiary of which happens to be the donor. This might permit a new step-up in basis, although the IRS has stated otherwise.[[20]](#footnote-20)

The status of the successor trust could depend upon the senior family member’s decision to exercise its power of appointment. Referring again to the above example, if the successor dynasty trust arose due to the senior family member’s failure to exercise its power of appointment, the trust can likely be characterized as a grantor trust as to the junior taxpayer.[[21]](#footnote-21) On the other hand, if the senior family member exercises its power of appointment, the senior family member will be the grantor of the trust, although the junior taxpayer is the grantor of the original trust.

The successor trust must limit the junior taxpayer’s access to rights normally associated with a dynasty trust to prevent the trust from becoming includable in junior taxpayer’s estate. For example, limit that taxpayer’s rights to make distributions by an ascertainable standard and allow only limited powers of appointment.[[22]](#footnote-22)

## Upside of debt

Debt is a tool for maximizing the benefits of a step-up in basis while minimizing the estate tax.[[23]](#footnote-23) Consider a taxpayer who owns fully depreciated commercial real property worth $10 million and $0 adjusted basis. Without deductions, the taxpayer will include $10 million of property in his taxable estate, and the property will get a step-up in basis to $10 million.

Now consider if the taxpayer took out a loan for $9 million, pledging the property as collateral, and uses the $9 million in cash to buy an asset in an IDGT with $0 basis. Both the $10 million and $9 million property receive a step-up in basis. The gross estate would be $19 million, reduced by $9 million in debt, resulting in the same taxable estate of $10 million, but this time, there is an additional $9 million of stepped-up basis.

Consider a third scenario in which a loan is again taken out for $9 million. The taxpayer uses “zeroed-out” transfers until only $2m of cash remains in the estate. The gross estate is now worth $12 million, reduced by $9 million in debt, resulting in a $3 million taxable estate. But, the taxpayer still gets a $10 million step up in basis for his original property.

Paul Lee refers to two driving factors, both illustrated in this example, that reduce estate tax obligations while maximizing step-up in basis: (1) ensuring that debt is deductible, and (2) engaging in additional transactions in exchange for something that can benefit from a step-up in basis (the second scenario) or transactions that reduce estate tax exposure of debt proceeds (the third scenario).[[24]](#footnote-24)

## Planning with partnerships

Partnerships give taxpayers the unique ability to shift and change the basis of property through distributions without requiring death or a taxable event. A thorough knowledge of the tax law governing partnership basis and the inside and outside basis partners hold in their partnership is a valuable tax-saving tool for a tax planner. These rules are contained in subchapter K, and among the most important concepts are: (1) unitary basis rules, (2) non-liquidating current distribution of partnership property, (3) liquidating distributions of partnership property, (4) “mixing bowl” transactions, (5) partnership liabilities and basis, (6) section 754 election and inside basis adjustments, (7) partnership division, and (8) anti-abuse rules.[[25]](#footnote-25)

Unlike shares in a corporation, a partner has a unitary basis in his partnership interest, regardless of differing classes of partnership interests.

### Non-Liquidating Distributions

Cash distributions will only trigger gain if the distribution exceeds the outside basis of the partnership interest of any partners.[[26]](#footnote-26) Any gain recognized to the extent the cash distributed exceeds outside basis reduces the partner’s outside basis.[[27]](#footnote-27) The cash in excess of basis is considered capital gain from the sale of the partner’s interest.[[28]](#footnote-28)

Property distributions do not result in any gain or loss upon distribution unless the property is a marketable security or is a “hot asset” pursuant to section 751.[[29]](#footnote-29)

### Liquidating Distributions

Liquidating distributions are treated as current liquidations except loss may be recognized. The only way to recognize such a loss is if the distribution consists only of cash and section 751 “hot” assets. Also, the basis of property distributed to a partner may be increased.[[30]](#footnote-30)

### Section 754 Election

Upon the death of a partner or upon the sale or exchange of a partnership interest, the partnership may elect to adjust the partnership’s basis (internal basis) pursuant to section 754.[[31]](#footnote-31) Most commentators agree that it is advantageous for the partnership to elect to adjust its basis if the fair market value of the decedent’s interest in the partnership exceeds the decedent’s interest in the basis of the partnership’s assets.[[32]](#footnote-32) If the deceased partner’s interest is worth more than that partner’s share of the basis of the partnership’s assets, then the section 754 basis adjustment will result in a step-up in basis.[[33]](#footnote-33)

### Estate Planning Techniques

Partnership rules typically provide sufficient planning flexibility to shift and change the basis of property through distributions (liquidating and nonliquidating) and the use of elections (like the Section 754 election). One option is the partnership may distribute a high basis asset to a partner with zero outside basis. The partner’s outside basis would allow for a step up in basis on the death of the partner. With a 754 election, the “stripped” basis, the partnership’s inside basis in the asset immediately prior to distribution, would allow for an upward basis adjustment to other assets remaining inside the partnership.[[34]](#footnote-34)

Debt is also allocable among partners to create tax basis as to certain partners. By carefully managing each partner’s share of debt, the partnership can increase or decrease basis.[[35]](#footnote-35)

Furthermore, creative partnership divisions may be useful. Since basis adjustments pursuant to a 754 election are allocated among all assets of the partnership, there may be benefit to dividing loss property from gain property. This allows making the 754 election only with respect to the partnership holding gain assets. Also, this technique may minimize discounting for specific partnership assets where discounting is not desirable due to substantial appreciation.

# Estate Planning to Maximize Step-Up in Basis Potential

## Grant independent trustee the power to make fully discretionary distributions

If a surviving spouse has an estate valued below the exemption amount, there exists opportunities to acquire a step-up in basis for property left by the deceased spouse. One possibility is giving an independent trustee (or co-trustee, distribution trustee, or trust protector) the broad discretionary authority to distribute property to the surviving spouse, allowing distributions of low basis assets to the surviving spouse so that such assets a step-up in basis. So long as the trustee were not a remainderman beneficiary of the trust, no gift would rise as a result of exercising (or not exercising) the power.[[36]](#footnote-36)

Tax planners must assure there are successors named in case the first trustee (or other person holding such power) cannot perform his or her duties. Likewise, such person must be aware of the planning needs and continue to monitor the circumstances considering any applicable fiduciary duties. Documents need to be drafted to account for flexibility. For example, an interested trustee could be granted the right to appoint an independent co-trustee or a trust protector could have this power. This structure also requires considerable attentiveness and potential liability on the part of the independent trustee. After all, the trustee cannot reasonably be expected to anticipate the surviving spouse’s death. It could be quite costly and burdensome for the trustee to hire counsel, analyze the medical condition of the spouse, and determine an accurate net worth of the spouse on the eve of the spouse’s death. Further, a distribution of property to the surviving spouse subjects the property to the creditors of the surviving spouse, which may not outweigh the tax benefits.[[37]](#footnote-37)

While this discussion is important for surviving spouses under credit shelter trusts, it also is relevant to descendants who are beneficiaries of trusts as well. Consider, for example, a GST trust set up for a client’s children to hold for their lifetimes. They lose a step up on cost basis at death for assets in the trust. If they would not have taxable estates, then this would be lost for no reason.

## Give independent third party (or trust protector) power to grant a general power of appointment

Another technique for placing property into a surviving spouse’s estate involves giving an independent third party the ability to give the surviving spouse a general power of appointment (GPA). A GPA exercisable by the spouse would cause inclusion in the spouse’s estate of any property subject to the power. This approach involves appointing a third party or trust protector to have the power to give the surviving spouse a GPA. In the event that the surviving spouse’s death will result in an estate below the exclusion amount, the third party may grant the power of appointment, resulting in inclusion of property in the estate, and a step-up in basis.

However, this method has many of the shortcomings mentioned in the first technique. A third party must be willing to hold this power and able to exercise it correctly on the eve of the surviving spouse’s death. Further, there is a risk that the surviving spouse might actually exercise the power, diverting assets away from the intended beneficiaries. Finally, the GPA must be exercisable only in conjunction with an adverse party.[[38]](#footnote-38) However, such a power can be conditioned upon the consent of a non-adverse third party.[[39]](#footnote-39) This allows a client to have the comfort of knowing the holder of the power will not be exercisable without a trusted person’s consent.

As with allowing for broad discretionary distributions, this same technique could be used with respect to trusts created for other beneficiaries, such as descendants.

## Grant formula general powers of appointment

A third technique involves giving the surviving spouse a formula GPA equal to his or her unused estate tax exemption, particularly assets with the greatest appreciation. The GPA may be limited to certain assets with a low cost basis so that they will experience the most substantial step-up, subject to certain rules. Alternatively, the formula may be based on assets subjected to the highest rate of tax, or even on an asset-by-asset basis. The formula typically involves two components: an Ordering Rule and a Capping Rule.

The Ordering Rule typically allows for the GPA to apply to those assets that give the greatest amount of benefit. As stated above, the Ordering Rule may seek assets with the greatest amount of appreciation, assets subjected to the highest rate of tax, or asset-by-asset. Ideally, the Ordering Rule specifies that the GPA applies on an asset-by-asset basis to provide the greatest benefit.[[40]](#footnote-40) An example of the way a formula may work based on the amount of appreciation in assets is as follows:

The power shall apply to the asset with the largest percentage of difference between fair market value at the time of my spouse’s death and the cost basis immediately prior to my spouse’s death first, cascading in turn to each subsequent asset with the next largest percentage difference between fair market value and cost basis (e.g. an asset with basis of $10, fair market value of $100 would have a “percentage of difference” of 90/100, or 90%).[[41]](#footnote-41)

Another Ordering Rule may prioritize ordinary income items (such as recapture) over those with the most step up.

The Capping Rule prevents the GPA from adding appreciated trust assets that also cause an increase in estate tax obligation. There is no reason one cannot grant a GPA over less than 100% of trust assets.[[42]](#footnote-42) Consider the following example:

Should the exercise of the above general power of appointment otherwise result in federal or state estate or generation skipping transfer tax liability, the appointive assets subject to this general power of appointment shall be further limited to that fraction or percentage that would not cause any estate tax liability.[[43]](#footnote-43)

## Trigger the Delaware Tax Trap

This method can be used to accomplish the same results as previous methods but by using a limited power of appointment rather than a GPA. The technique involves what was previously thought of as a tax pitfall in the rules involving the exercise of limited powers of appointment.[[44]](#footnote-44) Estate tax inclusion will occur if the limited power is exercised

by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.[[45]](#footnote-45)

This “trap” causes property to be included in the power holder’s estate if the power is exercised in a manner that restarts the running of the Rule Against Perpetuities without regard to the date that the original power of appointment was created.[[46]](#footnote-46)

To restart the rule against perpetuities, the surviving spouse can simply grant a Presently Exercisable General Power (“PEG Power”) to a beneficiary. The surviving spouse would appoint trust assets into a separate trust which gives a beneficiary a Peg Power. Under common law, this appointment is considered to reset the clock on the running of the Rule Against Perpetuities.[[47]](#footnote-47) Essentially, the vesting of the property has been postponed “for a period ascertainable without regard to the date of the creation of the first power.”[[48]](#footnote-48) By triggering section 2041(a)(3), the appointed property becomes a part of the surviving spouse’s estate. Estate tax inclusion means there is a step-up in basis.

Fortunately, Treasury regulations have explicitly stated that the limited power may be exercised in favor of the person who would receive the property in default. “[A] power of appointment is considered as exercised for purposes of section 2041 even though the exercise is in favor of the taker in default of appointment.”[[49]](#footnote-49)

One drawback of using the Delaware Tax Trap is that if a beneficiary is holding an inter vivos GPA (required to trigger the Delaware Tax Trap), trust assets are exposed to the beneficiary’s creditors. Creating the PEG Power exposes any assets placed into the new trust to the new beneficiary’s creditors (the holder of the GPA).

# Planning for Assets Currently Held in Trusts

## Decant or modify (UTC Article 4) to a trust with terms which will allow basis step-up

The procedure to decant or modify under Article 4 of the Trust Code[[50]](#footnote-50) requires a petition or complaint to be filed in the proper court in the jurisdiction of the trust’s principal place of administration.[[51]](#footnote-51) Any trustee or beneficiary may bring such an action. The Trust Code does not require the trustee or settlor (if living) to be made a party.[[52]](#footnote-52) However, the trustee may be a necessary party under the jurisdiction’s rules of civil procedure. Venue is governed by Section 204 of the Trust Code, not the local rules of civil procedure. Section 204 requires a proceeding involving a trust to be brought in the county in which the trust’s principal place of administration is or will be located.

A non-charitable trust may be modified or terminated by: (1) modification or termination by consent of settlor and beneficiaries, (2) compelled modification or termination by consent of beneficiaries when such modification or termination is not inconsistent with a material purpose of the trust, or (3) modification under Section 411 without consent of all the beneficiaries. The last option requires that had all the beneficiaries consented, the trust could have been properly modified or terminated and that the interests of a beneficiary who does not consent will be adequately protected.[[53]](#footnote-53) The second and third options are available even when the settlor is not alive.

### Tax Consequences of Decanting

**Income Tax.** Decanting does not trigger income tax obligations in most circumstances. However, one example in which gain will be recognized is on the decanting of negative basis assets from a grantor trust to a non-grantor trust.[[54]](#footnote-54) The original trust will recognize gain equal to the amount of any liabilities held.

**Gift and Estate Tax.** Decanting statutes do not allow a trustee who is also a beneficiary to decant. This would result in a taxable gift for the trustee/beneficiary. A beneficiary’s consent to decanting may be deemed to be a taxable transfer for gift tax purposes.[[55]](#footnote-55) Springing the Delaware Tax Trap may also present gift tax consequences, particularly for the powerholder exercising the first power of appointment. Commentators have disagreed as to whether power held in a fiduciary capacity is a power of appointment. Legislative history indicates that the Delaware Tax Trap was not intended to apply to a fiduciary power of appointment.[[56]](#footnote-56) But consider

One solution is to include a clause in the decanting instrument or in the terms of the second trust that provides that postponement of vesting of beneficial interests in, or suspension of absolute ownership or power of alienation over, trust property cannot be extended through the trustee’s discretionary distribution power or the exercise of a special power of appointment for a period in excess of the governing permissible perpetuities period measured as of the date of creation of the original trust.[[57]](#footnote-57)

**GST Tax.** Safe harbor regulations provide that certain trusts may not lose their grandfather status, a status that exempts the trust from GST tax. The Discretionary Distribution Safe Harbor requires: (1) either (i) the terms of the trust authorize decanting, or (ii) on the date the trust became irrevocable, state law authorized decanting; (2) the trustee is able to exercise the power to decant without the consent or approval of any beneficiary or court; and (3) the second trust does not postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property beyond the federal perpetuities period.[[58]](#footnote-58)

The trustee must be wary of its fiduciary duties, including a Duty of Loyalty, when considering decanting to another trust.[[59]](#footnote-59) State law also plays a major factor in what can and cannot be done by decanting.

### Tax Consequences of Modification

**Income Tax.** No income tax concerns should arise from a trust modification.[[60]](#footnote-60)

**Gift and Estate Tax.** Gift and estate tax concerns may arise when a beneficiary consents to a modification that lessens the beneficiary’s interest in the trust or gives an interest away. Also, a gift may occur if a beneficiary receives less than the beneficiary’s pro rata share of a trust assets upon termination.

**GST Tax.** Again, a trust can be exempt from GST tax if it is a grandfathered trust or a zero inclusion ratio trust. Safe harbor provisions exist to protect the grandfathered status of a trust. The Trust Modification Safe Harbor (which can also apply to decanting) requires: (1) the modification or decanting does not shift a beneficial interest in the original trust to any beneficiary occupying a lower generation than the person(s) holding beneficial interests in the trust prior to modification or decanting and (2) the modification or decanting does not extend the time for vesting of any beneficial interest in the original trust beyond the period provided for under the terms of the trust.[[61]](#footnote-61)

## Exchange low basis trust assets with assets of equivalent value

A general power of administration includes “power to reacquire the trust corpus by substituting other property of an equivalent value.”[[62]](#footnote-62) If the trust provides for this particular power of administration, a surviving spouse could exchange high basis assets for low bassets assets of, for example, an Intentionally Defective Grantor Trust, prior to death and effectuate a step-up in basis for those assets.[[63]](#footnote-63)

## Steps to reduce valuation discounts

Assets that may have been divided as they are passed down to multiple generations may have been subject to valuation discounts in the past. The taxpayer should consider reducing those discounts if he wishes to maximize his step-up in basis.

One option is to allow a parent to sell the parent’s interest to a child for undiscounted fair market value at death. This, of course, would be a gift unless given for full and adequate consideration.[[64]](#footnote-64) Other options include dissolving entities such that assets received in liquidation would no longer be subjected to discounts, allowing any owner to put his or her interests to the entity for the pro rata share of underlying net asset value, etc. The goal of this type of planning is to minimize the application of discounts which would reduce the amount of basis increase at death.

The tax planner should consider amending FLP/FLLC agreements to minimize discounts. If such amendments are made, unless it is desirable (discussed below), it will be important to be sure that amendments which reduce discounts do not result in inclusion under 2036.

## Trigger 2036 (especially after *Estate of Powell*)

The value of the gross estate includes the value of any interest in property to the extent the taxpayer made a transfer of that property, under which he has retained a right to possession or enjoyment or the right to designate the person who shall possess or enjoy the property, and if either of those rights last for the taxpayer’s lifetime.[[65]](#footnote-65)

*Estate of Powell* highlights several methods by which inclusion in the estate may occur under § 2036 when an estate planner is careless.[[66]](#footnote-66) But, these methods can be utilized to cause intentional inclusion when a step up in basis is desired. Section 2036(a)(2) inclusion in the estate applies when the decadent merely owned a limited partnership interest.[[67]](#footnote-67) The court reasoned that holding the power, in conjunction with others, to dissolve a limited partnership was ruled to cause inclusion under section 2036(a)(2).[[68]](#footnote-68) The court drew no distinction between a 99% LP interest and a 1% LP interest. Tax planners may take advantage of this inclusion, for example, by giving an individual a 1% LP interest and the power to dissolve the LP in conjunction with others. This would cause inclusion in the individual’s estate upon his or death, giving the assets a step up in basis without being subject to discounts.

Other methods of inclusion under 2036 may be to highlight facts indicating a retained right to the use or possession of FLP assets, allowing the parent to reside in a residence purchased by the FLP rent-free, etc. Especially for FLP interests which already are held between the taxpayer and an irrevocable trust, for example, creating such inclusion essentially can serve to unwind FLP’s which are no longer useful (and may be detrimental due to a loss of step-up).

1. I.R.C. § 2010(c)(3)(C) (adjusted for inflation).

   and Increase in the Annual Gift Tax Exclusion [↑](#footnote-ref-1)
2. *Id.* [↑](#footnote-ref-2)
3. I.R.C. § 1411. [↑](#footnote-ref-3)
4. Questions and Answers on the Net Investment Income Tax, IRS (Nov. 27, 2017), https://www.irs.gov/newsroom/net-investment-income-tax-faqs; Revenue Procedure 2016-55 [↑](#footnote-ref-4)
5. IRS, supra note 4. [↑](#footnote-ref-5)
6. Morgan Scarboro, *State Individual Income Tax Rates and Brackets for 2018*, Tax Foundation Fiscal Fact No. 576 3 (Mar. 2018). [↑](#footnote-ref-6)
7. *Id.* [↑](#footnote-ref-7)
8. Paul S. Lee, *Venn Diagrams: The Intersection of Estate & Income Tax (Planning in the Atra-Math)* 48, (Sep. 1, 2014). [↑](#footnote-ref-8)
9. Ed Morrow, *The Upstream Crummey Optimal Basis Increase Trust*, *in* Estate Planning Review-The Journal 84-85 (2014). [↑](#footnote-ref-9)
10. *Id.* [↑](#footnote-ref-10)
11. I.R.C. § 2041. [↑](#footnote-ref-11)
12. Morrow, *supra* note 12, at 85. [↑](#footnote-ref-12)
13. *Id.* [↑](#footnote-ref-13)
14. *Id.* [↑](#footnote-ref-14)
15. *Id.* at 86. [↑](#footnote-ref-15)
16. Mickey R. Davis, *Planning for New Basis at Death* 22-23, American Bar Association, Fiduciary Income Tax Committee Meeting (Jan. 31 2015). [↑](#footnote-ref-16)
17. *Id.* at 23. [↑](#footnote-ref-17)
18. *Id.* [↑](#footnote-ref-18)
19. I.R.C. § 1014(e). [↑](#footnote-ref-19)
20. IRS, Prv. Ltr. Rul. 200101021 at 5 (Jan. 5 2001). However, the PLR is distinguishable in that it relies upon a situation where the GPOA includes assets which were deemed to have been gifted by the surviving spouse immediately at the death of the first to die. Therefore, if the trust is the same person as the surviving spouse for § 1014(e) purposes, then the one year rule is not satisfied. However, here, even if the trust is deemed to be the same person as the child-grantor, the plan should work merely by the parent surviving one year. [↑](#footnote-ref-20)
21. Davis, *supra* note 19, at 24 (citing Treas. Reg. § 1.671-2(e)(5)). [↑](#footnote-ref-21)
22. *Id.* [↑](#footnote-ref-22)
23. Paul Lee, Senior Regional Wealth Advisor, Northern Trust, Planning in the ATRA-Math 46 (Feb. 2016). [↑](#footnote-ref-23)
24. Lee, *supra* note 9, at 60. [↑](#footnote-ref-24)
25. *See* Lee, *supra* note 9, at 64. [↑](#footnote-ref-25)
26. I.R.C. § 731(a)(1). [↑](#footnote-ref-26)
27. I.R.C. 731(c). [↑](#footnote-ref-27)
28. I.R.C. § 731(a). [↑](#footnote-ref-28)
29. Lee, *supra* note 9, at 70 (citing § 731(a)-(c)). [↑](#footnote-ref-29)
30. *Id.* at 71. [↑](#footnote-ref-30)
31. I.R.C. § 754. [↑](#footnote-ref-31)
32. Davis, *supra* note 16, at 25. [↑](#footnote-ref-32)
33. See I.R.C. § 734 for the rules governing basis adjustment. [↑](#footnote-ref-33)
34. Lee, *supra* note 9, at 63. [↑](#footnote-ref-34)
35. *Id.* at 64. [↑](#footnote-ref-35)
36. Davis, *supra* note 16, at 13. [↑](#footnote-ref-36)
37. *See id.* [↑](#footnote-ref-37)
38. I.R.C. § 2041(b). [↑](#footnote-ref-38)
39. I.R.C. § 2041(b)(1)(C); Reg. § 20.2041-3(c)(2) [↑](#footnote-ref-39)
40. Davis, *supra* note 16, at 16. [↑](#footnote-ref-40)
41. Robert J. Kolasa, *Obtaining Stepped-Up Basis for Credit Shelter Trusts* 7, Lake County Bar Association, 2015 Trusts & Estates Annual Seminar (Nov. 13, 2015). [↑](#footnote-ref-41)
42. *See* Treas. Reg. § 20.2041-1(b)(3). [↑](#footnote-ref-42)
43. Kolasa, *supra* note 39. [↑](#footnote-ref-43)
44. Davis, *supra* note 16, at 18. [↑](#footnote-ref-44)
45. I.R.C. § 2041(a)(3). [↑](#footnote-ref-45)
46. Davis, *supra* note 16, at 18. [↑](#footnote-ref-46)
47. *Id.* at 19 (citing Restatement (Third) of Trusts § 56 cmt. b.). [↑](#footnote-ref-47)
48. I.R.C. § 2041(a)(3). [↑](#footnote-ref-48)
49. Treas. Reg. § 20.2041-1(d). [↑](#footnote-ref-49)
50. The Uniform Trust Code has been adopted in thirty-four states of January 1, 2020. Elizabeth K. Arias, *Fixing a Broken Trust: Judicial and Non-Judicial Modifications, Reformations, and Decanting, Can You Change an Irrevocable Trust?* 2, Forty-Ninth Annual Southern Federal Tax Institute (Oct. 2014). [↑](#footnote-ref-50)
51. *Id.* [↑](#footnote-ref-51)
52. *Id.* [↑](#footnote-ref-52)
53. Unif. Trust Code § 411. [↑](#footnote-ref-53)
54. Arias, *supra* note 52, at 17. [↑](#footnote-ref-54)
55. *Id.* [↑](#footnote-ref-55)
56. *Id.* at 18 (citing S. Rep. No. 82-382 (1951)). [↑](#footnote-ref-56)
57. *Id.* [↑](#footnote-ref-57)
58. *Id.* at 19. [↑](#footnote-ref-58)
59. Melissa J. Willms, *Decanting Trusts: Irrevocable, Not Unchangeable*, 6 Est. Plan. & Community Prop. L.J. 35, 40-41 (2013). [↑](#footnote-ref-59)
60. Arias, *supra* note 52 at 17. [↑](#footnote-ref-60)
61. *Id.* at 19. [↑](#footnote-ref-61)
62. I.R.C. § 675(4). [↑](#footnote-ref-62)
63. *See* Lee, *supra* note 7, at 13. [↑](#footnote-ref-63)
64. *Id.* at 40. [↑](#footnote-ref-64)
65. I.R.C. § 2036(a). [↑](#footnote-ref-65)
66. Estate of Powell v. Comm'r of Internal Revenue, 148 T.C. No. 18 (T.C. May 18, 2017) [↑](#footnote-ref-66)
67. *Id.* [↑](#footnote-ref-67)
68. Steve R. Akers, *Estate of Powell v. Commissioner, 148 T.C. No. 18 (May 18, 2017)* 2, Bessemer Trust (June 2017). [↑](#footnote-ref-68)