For Trusted Advisors
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Taxation - Income, Estate, and Gift

Upstream estate planning

By Marvin E. Blum, JD, CPA

Within the realm of estate planning, there is a tendency to craft estate plans with a "downstream" focus. Generally, an estate planner begins an initial planning meeting by asking basic threshold questions: "What assets do you own?" and "Who would you like to leave those assets to after your death?" These questions are certainly a necessary starting point. After all, the main goal of establishing an estate plan is to create a vehicle that carries clients' assets down to their children (or other heirs) in an effective and tax-efficient way. But as clients ponder who "downstream" should receive their assets, it is important for planners to encourage clients to look "upstream" as well because the financial status of a client's parent can have a great impact on the structure of the client's estate plan.

There are two significant planning opportunities that may be overlooked by a strictly downstream focus:

1. A client who will likely receive a substantial inheritance from his or her parents; and
2. A client whose parent's estate falls below the estate tax exemption level.

It is safe to say that many high net worth clients will fall into one of these two categories. Planners must therefore be equipped with upstream strategies that will ensure the client's estate plan takes full advantage of every available estate planning tool.

Planning for receiving an inheritance. Even the strongest of estate plans can be weakened if the client receives an unexpected inheritance. In some cases, the inheritance may not even be that substantial, but rather may be just enough to push the client over the estate tax exemption amount. In other instances, a high net worth client may have engaged in extensive planning only to have a mass influx of wealth at the death of a parent. Unfortunately, the client and the planner will be back to square one as far as protecting that wealth and moving it outside of the client's estate.

Fortunately, however, there is a simple planning mechanism to prepare for an inheritance: the standby trust. With a standby trust, the inherited assets do not pass directly to the heir but instead flow to a trust benefitting the heir. Essentially, the client asks his or her parents to sign an irrevocable trust, creating a trust that benefits the client (and client's children). The trust could be nominally funded with one dollar if the parent has no desire to immediately transfer assets to the new trust. The parents then revise their wills to leave the client's inheritance to the standby trust rather than outright to the client.

This strategy, in effect, places the inheritance on standby for the client who can receive distributions from the trust but will not have to worry about the inheritance being included in his or her estate for estate tax purposes. Moreover, in addition to an estate tax advantage, the standby trust also provides general protections inherent to a trust as the assets are safe from the reach of creditors, as well as from a spouse in a divorce proceeding.

Alternatively, for clients who prefer not to ask parents to create the trust, a client can create the standby trust for the benefit of the client's spouse. For example, if the wife is expecting an inheritance, the husband can create a trust for the wife's benefit and then ask the wife's parents to leave the inheritance to it. In this case, all the parents need to do is sign a simple codicil leaving their daughter's inheritance to the standby trust instead of outright to their daughter.

Low basis asset planning. In today's environment of high exemption amounts ($5,450,000 for an individual in 2016), income tax basis planning has become a more significant part of many clients' estate plans. A well-known aspect of this tax planning is the "basis adjustment" at death. Generally, Section 1014 of the Internal Revenue Code (IRC) provides that if a person receives property from a decedent, then the recipient of the property may use the property's fair market value as of the date of the decedent's death (or the fair market value as of six months after the date of the decedent's death if the alternate valuation date is used) as the recipient's basis in the property. In short, if someone dies with low basis assets inside their estate, the basis of those assets will be stepped up to fair market value as of the date of the owner's death. Accordingly, if a client moves assets outside of his estate for estate tax purposes, any low basis assets that are outside of the estate at the client's death will not receive a basis adjustment. For this reason, planners sometimes recommend leaving low basis assets inside a client's estate. There is, however, an upstream strategy that can provide a solution to the low basis asset issue.

Many clients have parents whose estates do not exceed the estate tax exemption amount. Planners should immediately recognize this scenario as a potential opportunity for upstream planning. Rather than creating a trust for the client's children or grandchildren, the client and planner instead look upstream, and the client creates a trust for the benefit of the client's parents. For this planning technique to be successful and conflict-free, planners should confirm that the client and the client's parents have a good relationship and that the client's parents understand and are on board with the planning strategy. Once the trust is established, the client can then fund the trust with the low basis assets. It is important to note that if the value of the parents' estate is near the estate tax exemption amount, the client should be careful not to push the parents into a taxable estate.

The crucial part of this plan is that the client must grant the parents a general power of appointment over the trust assets, which is what allows the trust assets to be included in the parents' estate upon their deaths. Under IRC §2041, if a person dies while holding a general power of appointment, then all of the property subject to that power will be included in the gross estate of the power holder for estate tax purposes, thereby ensuring that the assets receive a basis adjustment to fair market value. When the client's parents eventually pass away, the low basis assets in the trust will receive a stepped-up basis.

Depending on the desires of the client and the client's parents, the trust assets could pass to the client, the client's spouse, the client's children, or to a trust for the client and his or her family. Ideally, the structure will provide for those assets to pass to a trust so that the assets are not only stepped-up but are also protected from creditors, divorce, and estate tax when the client later dies.

When choosing how to structure the trust, planners must be mindful of the fact that the Internal Revenue Code places a significant limitation on this planning technique. Pursuant to IRC §1014(e), if the parent dies within one year of receiving the assets from a child and the assets pass back to the child or the child's spouse, then those assets will not receive a basis adjustment at the death of the parent. This potential limitation can be avoided if the assets pass to the client's children or to a trust which benefits the child or child's spouse (preferably with a trustee other than the child or child's spouse) rather than back to the child or the child's spouse outright.

Planners should discuss the limitation with clients prior to making any decisions on how to structure this upstream planning technique.

Failing to have upstream conversations with clients can mean missed planning opportunities. Unexpected inheritances and unaddressed low basis assets can cause problems in the most elaborate of estate plans.

When everything seems to be flowing downstream, it can be difficult to remember to take a look back upstream, but, as planners, these upstream planning techniques must always be in our toolbox.

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The Blum Firm, P.C., established by Marvin Blum over 35 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 Thomson Reuters. He was selected by his peers for inclusion in *The Best Lawyers of America – Trusts & Estates*. Mr. Blum twice had the honor of asking questions to Warren Buffett at Berkshire-Hathaway Annual Meetings, attracting international media attention. He is a highly sought-after speaker, has been quoted by *The Wall Street Journal* and *The New York Times* for his expertise on the estate tax and also serves on the Editorial Advisory Committee for *Trusts & Estates* magazine.

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 1975, 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.

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 underserved children. Mr. Blum is in his 37th year as Treasurer of the Fort Worth Symphony and serves as Treasurer of the Miss America Organization. Mr. Blum is currently serving as Treasurer of The Multicultural Alliance, formerly The National Conference of Christians and Jews, a service organization fighting bias, bigotry and racism. Mr. Blum serves as Treasurer for the Texas Cultural Trust Board of Directors to help raise public and legislative awareness of the importance of the arts in Texas, and has recently joined the Board of Directors for B Sharp Youth Music Program, Inc., a program that fosters positive development of young musicians through emphasis on academic achievement. Mr. Blum is also a member of the national Board of Directors of TIGER 21.

Taxation - Income, Estate, and Gift

Funding ILIT premium payments with GRATs.

By Robert S. Keebler, CPA/PFS, MST, AEP® (Distinguished)

Irrevocable life insurance trusts (ILITs) are commonly used to provide estate liquidity, to serve as wealth replacement vehicles, or to transfer cash to heirs, estate tax free. To avoid any current gift tax consequences, taxpayers typically fund ILITs using their annual exclusion amounts. For 2016, this amount is $14,000 per donee.

> Example 1: Jane has a large estate that consists largely of illiquid assets and she wants to provide tax-free life insurance proceeds to her estate or her heirs when she dies.
>
> Suppose that the premiums for a policy providing a sufficient death benefit are $140,000/year for five years. Jane has two children and six grandchildren. Counting the children's spouses, this makes 10 possible donees. If Jane gives each of them a present interest in the ILIT through Crummey powers, she can use her annual exclusions to make $140,000 of gifts to the ILIT each year without incurring any gift tax or even using up any of her unified credit.

For taxpayers who want to provide greater death benefits and/or have fewer potential donees, funding the ILIT without any gift tax consequences may be more difficult. They may have to stretch out the premium payments over a longer period of time, have the heirs pay part of the premiums, or use some of their unified credit amount.

ILIT as a GRAT Remainderman

Another possibility would be to fund the ILIT in whole or in part by making the ILIT the remainder beneficiary of a zeroed-out grantor retained annuity trust (GRAT). This strategy might be very effective for a relatively young donor who doesn't need to fund the premiums immediately.

A GRAT is a split-interest trust in which the grantor retains an annuity interest for a term of years. At the end of the annuity term, any assets remaining in the trust pass to the remainder beneficiaries with no further tax consequences.

The amount of the taxable gift is the value of the property transferred to the GRAT minus the value of the lead annuity interest that the grantor keeps. The value of this lead interest can be set equal to the full value of the property transferred, leaving a value of zero for the remainder interest and making the amount of the gift zero. If a zeroed out GRAT produces a return equal to (or less) than the growth rate assumed under the applicable IRS table (the IRC §7520 rate), there will be nothing left in the GRAT to pass to the remainder beneficiaries at the end of its stated term. The remainder interest will be valued at zero and it will turn out that zero is what it was worth.

> Example 2: Carl transfers $2,000,000 to a five-year GRAT in April 2016

Year	Beginning balance	+ Return (1.8%)	Payout	Ending balance
1	$2,000,000	$2,036,000	$ 421,857	$1,614,143
2	1,614,143	1,643,198	421,857	1,221,341
3	1,221,341	1,243,324	421,857	821,467
4	821,467	836,254	421,857	414,397
5	414,397	421,857	421,857	0

when the IRC §7520 rate is 1.8%. Carl sets the annual payments at $210,857, setting the value of the lead annuity interest equal to $2,000,000 and zeroing out the GRAT. Assume that the actual return on the GRAT assets equals the 1.80% §7520 rate. The chart on the previous page shows the value of the GRAT assets over its five-year term and the amount remaining for the remaindermen.

If the GRAT assets produce a return in excess of the §7520 rate, however, there will be a tax-free transfer to the remaindermen.

Example 3: Assume the same facts as in Example 2 except that the GRAT assets produce a 10.0% total return. (See chart below.)

In this case, $645,530 passes to the ILIT remaindermen at the end of the trust term. This amount could be used to pay for all or a portion of a life insurance policy on the life of the grantor with no transfer tax consequences.

The higher the total return produced by the GRAT the larger the tax-free transfer.

- 1.8%................................ $0
- 4.0% $148,372
- 6.0........................ $298,383
- 8.0% $463,767
- 10%...................... $645,530
- 12%......................$844,666

Taxable GRATs

Finally, a grantor could combine a GRAT with using part of the grantor's unified credit amount. Instead of zeroing out the GRAT, the taxpayer could leave a taxable gift that was covered by unified credit.

Example 4: Assume the same facts as in Example 3 above, except that instead of zeroing out the GRAT, Carl sets the annual payout at 10%. This results in a taxable gift of $1,051,820. The 10% growth of the trust and the 10% annual payout net each other so that $2,000,000 remains in the trust for the remaindermen at the end of the trust term.

The downside to creating a taxable GRAT is that if the GRAT assets perform poorly, unified credit could be wasted.

By contrast, if the GRAT is zeroed out and there is no taxable gift, there is no possibility of wasting any credit amount.

Year	Beginning balance	+ Return (10.0%)	Payout	Ending balance
1	$2,000,000	$2,200,000	$ 421,857	$1,778,143
2	1,778,143	1,955,957	421,857	1,534,100
3	1,534,100	1,687,510	421,857	1,265,653
4	1,265,653	1,392,219	421,857	970,351
5	970,351	1,067,387	421,857	645,530

Conclusion

Relatively young taxpayers who are unable to fund an ILIT using annual exclusion amounts, or would prefer to use their annual exclusion amounts for other transfers, should consider making the ILIT the remainder beneficiary of a GRAT.

Robert S. Keebler, CPA/PFS, MST, AEP® (Distinguished)

Bob Keebler is a partner with Keebler & Associates, LLP, and is a 2007 recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planners & Councils. He also is a member of the NAEPC Hall of Fame. He has been named by *CPA Magazine* as one of the Top 100 Most Influential Practitioners in the United States and one of the Top 40 Tax Advisors to Know During a Recession. His practice includes family wealth transfer and preservation planning, charitable giving, retirement distribution planning, and estate administration. Keebler frequently represents clients before the National Office of the Internal Revenue Service (IRS) in the private letter ruling process and in estate, gift and income tax examinations and appeals. He has recently been quoted in *The New York Times* in an article titled "The 1040 Blues," where he provided insight on capital gains tax. Keebler has been a speaker at national estate planning and tax seminars for over 20 years including the AICPA's Estate Planning, High Income, Advanced Financial Planning Conferences, ABA Conferences, NAEPC Conferences, The Notre Dame Estate Planning Conference, and the Heckerling Estate Planning Institute.