TCJA Supercharges 'Upstream' Estate Tax Planning Techniques

by Jonathan Curry

Individuals with considerable wealth are undoubtedly pleased by the newly doubled estate and gift tax exemption, but practitioners say the opportunity for wealth tax savings is just getting started.

Now that high-income individuals are operating under greatly increased thresholds for estate and gift tax exemption — courtesy of the Tax Cuts and Jobs Act (P.L. 115-97) — elderly relatives and friends can offer clients a way to obtain a basis step-up on highly appreciated assets, or even to gain access to additional generation-skipping transfer tax exemptions.

To do this requires "upstream" planning, in which a client shifts assets meant for a child or grandchild to a parent whose estate can afford to absorb the value of the assets without triggering the tax. When the parent dies, the intended recipient can inherit those assets, only now with a step-up in basis. In the case of gifting indirectly to grandchildren, this method enables the grandchild to inherit the assets without the client using up the GSTT exemption.

While upstream planning theoretically could have worked before the TCJA, the law's doubling of the individual gift and estate tax exemption amount to $10 million makes it much more viable, according to Turney P. Berry of Wyatt Tarrant and Combs LLP. And that $10 million exemption is expected to be north of $11.2 million when inflation adjustments are factored in.

"Now that you've got $11 million to work with, there are a lot of things that all of a sudden start to be worth the trouble," said Berry, who heads the firm's trust and estate planning service.

Jonathan Blattmachr of Pioneer Wealth Partners LLC referenced the "enormous opportunity" the TCJA affords to upstream planning during a February 27 American Bar Association Section of Taxation webinar. Every estate tax planner has clients who can benefit from this type of planning, he said.

You've Got the Power

One way upstream planning can be used to help clients with moderate wealth is to create a trust and assign the parent a general power of appointment (GPOA) over the trust.

Carlyn S. McCaffrey of McDermott Will & Emery described how this technique could apply when a client has more estate and gift tax exemption than they need right now, but who could use a step-up in basis on some highly appreciated assets.

"Let's say my mother is 99 and I haven't used up any of my [gift and estate tax] exemption yet, and I've got $10 million in highly appreciated securities that I would like to sell," said McCaffrey, who is co-leader of the firm's private client practice in New York. Under this scenario, McCaffrey said she would then create an irrevocable trust and move the $10 million in securities into the trust, which uses up her own exemption amount, and then give her mother a GPOA, thus shifting the assets into her mother's estate.

Using up her own exemption amount is "the cost of doing this," McCaffrey said, but because the value of the $10 million will continue to grow and the exemption level could expire in a few years, she still would have wanted to move these assets into a trust for her kids now.

"The bonus is, this is a trust I was going to create anyway . . . and now by giving my mother this general power, I'm going to get a basis step-up for all the assets I've put in the trust," she explained.

Plan B(asis)

Another technique involves transferring assets into a parent's estate via a grantor-retained annuity trust (GRAT). This "upstream GRAT" — an idea credited to Berry — reverses the direction of a normal GRAT to take advantage of a basis adjustment.

Under an ordinary GRAT setup, the client moves assets into a GRAT for a set number of years, and then receives all those assets back in annuity payments, along with interest on the assets equal to the interest rate set by section 7520 on those assets, which fluctuates month to month. When the GRAT period terminates, if the trust's assets increased in value beyond the section 7520 rate, the remainder is distributed to the trust's beneficiaries — usually the grantor's children — without triggering the federal gift tax.

By running the money through the estate of our parents, "we're going to get basis as we go," Berry said.

"It's a way of making a tax-free gift, because what you're giving away is the future growth," explained T. Randolph Harris of McLaughlin & Stern LLP.

Further, if the parent also has unused GSTT exemption — which functions as a separate exemption amount from the unified gift and estate tax, despite being equal in rates and exemption amounts — the parent can bequeath those assets to their grandchildren and apply their GSTT exemption to those remainder interests because they didn't create the GRAT, Berry said.

An upstream GRAT could be used by moderately wealthy clients who still have some estate and gift tax exemption left, but because only the trust's remainder interest is being transferred to the client's descendants, it's most useful for wealthier clients who don't want to make straightforward gifts to their kids because they've already used up their exemption, Berry said.

And, conceptually, there's no reason to limit this technique to a client's parents, according to Berry. "We think about it with parents, but you could do all of this with collateral relatives. I mean, in theory, you could wander down to the emergency room and say, 'Hey, anybody come in?'"

Risky Business

Although there's an inherent risk that clients could lose control of assets they hope to get back when they effectively transfer them to another party's estate, there are ways to hedge against this risk.

For one, Blattmachr said that the client doesn't always have to inform the person granted a GPOA. "The cases are legion that the assets are includable in your estate under section 2041 even if you didn't know about the general power," he said.

Second, the client can arrange the trust so that even if the person surreptitiously given a GPOA finds out about the trust and the assets, he needs to obtain the consent of an adverse party to exercise that general power — and that adverse party can be the client's lawyer or the client's best friend.

Upstream planning isn't right for every situation, Berry said. "Sometimes you look at the family situation and you say it's not safe," like a case when there's enmity between a parent and a client. "Maybe Mom is going to hire the best lawyer in the world to figure out how to divert these assets. I don't see how she can do that, but I'm not going to go there," he said.

Or perhaps a parent presents a risk that could lead to creditors claiming the assets. "If Mother, God bless her, is driving along half-blind and she runs a school bus off a road, we've got a bunch of injured plaintiffs," Berry mused. Even if you draw up a trust to protect against creditors' claims, a court might overrule that, like it did in the 1997 Mississippi court case of *Sligh v. First National Bank of Holmes County, Trustee*.

On the other hand, McCaffrey noted that if the parent is 99 years old, lives in a nursing home, is no longer driving, and has no known creditors, there's very little risk.

Eyes on 'The Man'

With upstream planning, there's a risk that if the parent dies within a year of acquiring the client's assets, it would trigger section 1014(e), which would disallow the basis adjustment.

But Harris observed that section 1014(e) only applies if a client makes a gift that they re-inherit within a year. If the assets that are transferred to a parent instead go to the client's children, either as directed by the trust or as specified in the parent's will, section 1014(e) does not apply. And that kind of action can be taken at any point before the parent's death: "If Dad's on his deathbed, you run in and say, 'Oh, don't let him die yet, I've got to do this capital gain savings trust,'" said Harris, who co-chairs the firm's trusts and estates department.

Another risk is that the IRS might frown on upstream planning arrangements in which the recipient of the assets has little relationship with the trust or the client. McCaffrey argued that while there's no theoretical reason why upstream planning techniques have to be limited to a parent, "it just looks very artificial and the government is more likely to say it's a sham for somebody that is not a close relative," she said.

There's also a risk that the IRS could argue that if the parent or other low-wealth family member acts in a predetermined way, the original donor — the client — should still be deemed the transferor for GSTT purposes, according to Ronald D. Aucutt of McGuireWoods LLP. "Certainly, the understanding or prearrangement theory is strengthened by the very manner in which these techniques are presented," said Aucutt, who is chair emeritus of the firm's private wealth services group.

That being said, Aucutt added that use of this type of planning has been sporadic so far, so it's unclear whether the IRS has tacitly accepted these arrangements or seriously made the "understanding or prearrangement" argument in these kinds of situations.

And while this kind of planning could start to prove costly to the government in terms of lost revenue, most practitioners don't see the IRS or Congress cracking down on it anytime soon.

McCaffrey said that the IRS is already busy with the mammoth task of implementing the TCJA, and it seems unlikely that there would be much of a push to "go back and tighten up the estate tax, because after all, they wanted to repeal it altogether."

"I think their hands are full right now," Harris agreed. He added, "I don't think they're likely to enact new regs or new laws to put the kibosh on it in their near future." ■