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Income Tax Planning Strategies From the Recent ACTEC Meetings

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Presentation Materials

- The slides summarize some of the income tax planning techniques presented by Stacy Eastland at the ACTEC Summer Stand-Alone Program in Vancouver, British Columbia, June 26, 2019, and further summarized with the charts contained herein by Gregory V. Gadarian at the ACTEC fall meetings in Philadelphia, PA.

Planning Strategies

- Low Basis Assets Inside a Grantor Trust
- Power of Appointment for an Older Beneficiary in a Grantor Trust
- Basis Step Up Transactions Involving S Corporations
- Beneficiary Deemed Owned Trusts

Obtaining a Basis Step-Up for Low Basis Assets in a Grantor Trust

- General Facts
 - Grantor sold low basis assets to a grantor trust. No gain under Rev. Rul. 85-13.
 - Goal – Grantor swaps high basis assets for low basis assets, and receives a basis step up in basis on the low basis assets at death.
 - Problem – Grantor does not have any high basis assets or cash.
 - Solution – Third Party Loan Transaction

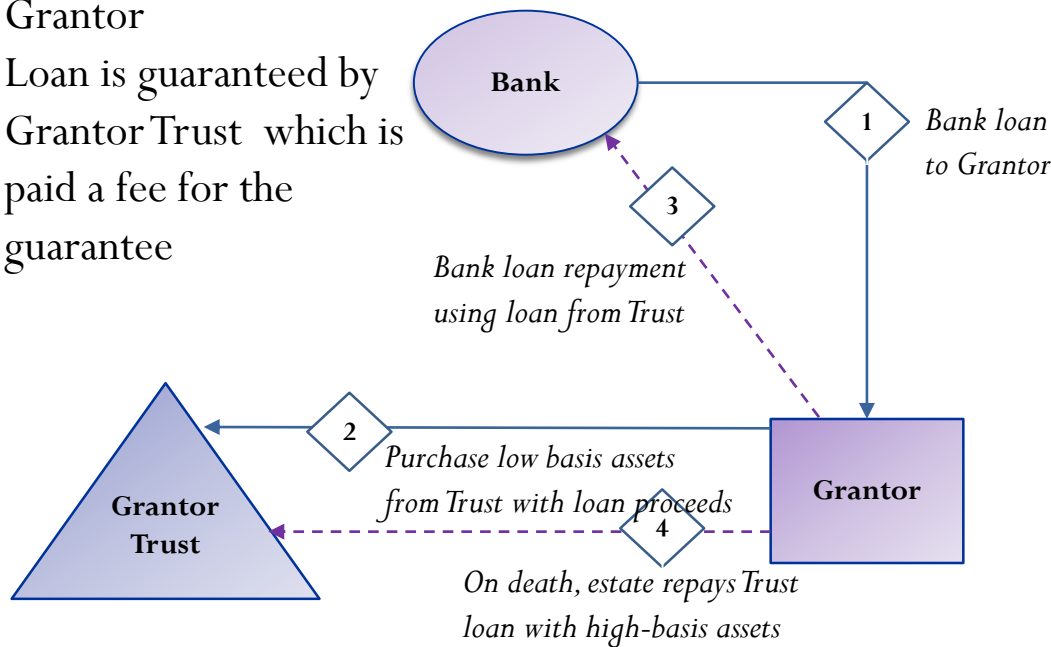
Obtaining a Basis Step-Up for Low Basis Assets in a Grantor Trust

- If the Grantor does not have any high basis assets or cash, the Grantor can borrow funds from a third-party lender.
- The Grantor then uses that borrowed cash to purchase the low basis assets from the Grantor Trust.
- At a later time, in an independent transaction, the Grantor can borrow cash from the Trust (which converts to a non-grantor trust) or through a partnership in which the Grantor Trust is the limited partner with a long-term, recourse note and use that cash to repay the third-party loan. If the loan from the Trust has adequate interest and adequate security, and if it is made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor, then § 675(3) will not cause the trust to be treated as a grantor trust.

Bank Loan Transaction

Bank

- Bank loans funds to Grantor
- Loan is guaranteed by Grantor Trust which is paid a fee for the guarantee



Grantor Trust

- ☐ Trust owns low-basis assets which it sells to Grantor for cash--No gain to Trust under Rev Rul 85-13
- Trust ends up with cash
- ☐ Later the Trust may make a loan to the Grantor which is used to repay the bank loan
- ☐ The Trust's loan receivable is satisfied with high basis assets from Grantor's estate on Grantor's death

Grantor & Grantor's Estate

- ☐ Grantor borrows funds from bank
- Grantor purchases assets from "grantor trust"- No gain to Trust under Rev Rul 85-13
- ☐ Grantor refinances loan by borrowing cash from the Grantor Trust Assets receive new basis on Grantor's death equal to FMV
- ☐ Grantor's estate liquidates loan from the Trust with the estate's high basis assets.

Low Basis Assets in a Grantor Trust and General Power of Appointment

- The Grantor [and possibly his spouse] sell assets to a Grantor Trust recognizing no gain under Rev Rul. 85-13. The assets have a low income-tax basis. The Grantor receives a promissory note for a portion of the sales price
- The trust beneficiary has a general power of appointment—the ability to appoint the assets to the creditors of his or her estate. See §2041(b)(1)
- The goal is for the low basis assets to receive a basis step-up on the beneficiary's death.
 - ❖ § 1014(e) only applies to property acquired by gift if the donee dies within 1 year of the date of the gift
- The trust remains a Grantor Trust as to the original grantor under Treas. Reg. § 1.671-2(e)(5).

Sale of Low Basis Assets to a “Grantor Trust” whose Beneficiary Holds a General Power of Appointment

Grantor Trust

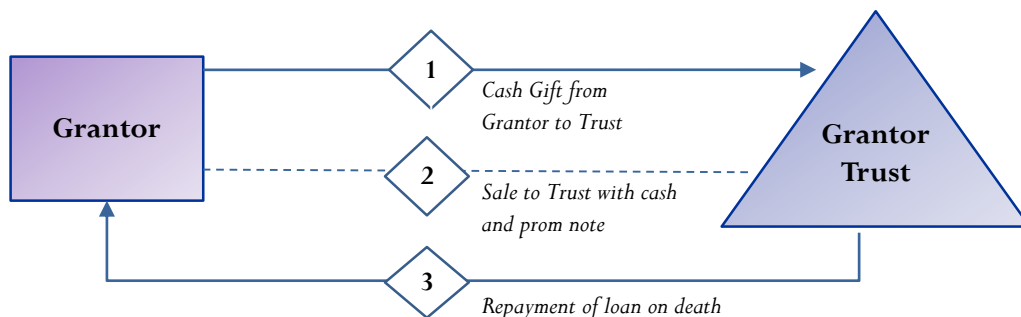
- ☐ Grantor creates a Grantor Trust naming an older relative as the current trust beneficiary.
- ☐ Trust Agreement grants the beneficiary a general power of appointment
- ☐ If power of appointment is not exercised the remainder is held in trust for the Grantor
- ☐ On beneficiary's death assets in trust receive a step-up in basis to fair market value
- ☐ Trust continues as a Grantor Trust after older beneficiary's death

Steps of Transaction

- 1) *Grantor gifts cash to Grantor Trust for benefit of older relative*
- 2) *Grantor Trust buys low basis assets from Grantor for cash and a promissory note*
- 3) *On older beneficiary's death, the Trust liquidates the loan from the Trust's high basis assets*

Grantor

- ☐ Grantor makes cash gift of seed money to a Grantor Trust
- ☐ Grantor sells assets to Grantor Trust- No gain to Grantor under Rev Rul 85-13
- ☐ Trust can sell low basis assets and repay its loan to Grantor or transfer high basis assets to Grantor after older beneficiary's death in repayment of the loan



Creating Basis in S Corporation Non-Depreciable Assets following the Death of Sole Shareholder

Sole
Shareholder

- S Corp Non-Depreciable Assets*
FMV \$1,000,000
Basis \$100,000
- Liquidation of S Corp
Following sole Shareholder's Death

- On shareholder's death, the stock passes to her estate, whose basis in the stock is \$1 million under § 1014(a).**
- In a succeeding taxable year, the S corporation liquidates, and its assets are distributed to the estate
- The liquidation of the S corporation will give rise to capital gain to the S corporation under to § 311 in the year of liquidation. The estate includes in its gross income all of the S corporation's income (i.e., the entire \$900,000 of gain since the estate is the only shareholder) under § 1366(a)(1(A)).
- The estate's basis in his S corporation stock is increased from \$1,000,000 (the value under § 1014(a)) to \$1,900,000 pursuant to the increase in basis under § 1367(a)(1(A)).***
- On liquidation of the S corporation the estate will recognize a \$900,000 loss under § 336 and § 1001 (\$1.9 million basis in the stock less the value of the assets (\$1,000,000) distributed to the estate. The \$900,000 loss offsets the \$900,000 gain under § 311.
- The estate's basis in the assets will be \$1,000,000 under § 334.
- This effectively gives the estate a full basis step-up in the S corporation's underlying assets even though the deceased shareholder only owned stock (and not the underlying assets) at the time of death.

*This technique only works if the assets are not subject to § 1239. § 1239 treats the gain on the sale of depreciable property between related parties as ordinary income. Thus if § 1239 applies, then there will be a mismatch of ordinary income and capital loss on liquidation.

**§ 1367 (b)(4)(B) provides that the basis determined under § 1014 of any stock in an S corporation shall be reduced by the portion of the value of the stock which is attributable to items constituting income in respect of the decedent.

***The adjusted basis of stock held in a liquidating corporation is adjusted for current-year passthrough items prior to determination of gain or loss from the receipt of the liquidating distributions (see Regs. Sec. 1.1367-1(d)(1)).

Creating Basis in S Corporation Depreciable Assets following the Death of Sole Shareholder

Sole
Shareholder

- S Corp Depreciable Assets*
FMV \$1,000,000
Basis \$100,000
- Liquidation of S Corp
Following sole Shareholder's Death

- On shareholder's death, the stock passes to her estate, whose basis in the stock is \$1 million under § 1014(a).**
- In a succeeding taxable year, the S corporation sells the building and liquidates, distributing the cash to the estate. The liquidation must occur in the same year as the sale.
- The sale of the building by the S corporation will give rise to capital gain in the year of receipt. The estate includes in gross income all of the corporation's income (i.e., the entire \$900,000 of gain since the estate is the only shareholder) under Section 1366(a)(1(A)).
- The estate's basis in his S corporation stock is increased from \$1,000,000 (the value under § 1014(a)) to \$1,900,000 pursuant to the increase in basis under § 1367(a)(1(A)).***
- On liquidation of the S corporation the estate will recognize a \$900,000 loss under § 336 and § 1001 (\$1.9 million basis in the stock less the amount of cash (\$1,000,000) distributed to the estate. The \$900,000 loss offsets the \$900,000 gain under § 311.
- This effectively gives the estate a full basis step-up in the S corporation's underlying assets even though the deceased shareholder only owned stock (and not the underlying assets) at the time of death.

*If the building is held in a partnership, then § 1239 should not be applicable and the result would be the same as slide 7. However, Rev Rul 72-172 treated a sale of a partnership interest as a sale of the partnership assets and applied § 1239 thus treating the gain as ordinary income.

**§ 1367 (b)(4)(B) provides that the basis determined under § 1014 of any stock in an S corporation shall be reduced by the portion of the value of the stock which is attributable to items constituting income in respect of the decedent.

***The adjusted basis of stock held in a liquidating corporation is adjusted for current-year passthrough items prior to determination of gain or loss from the receipt of the liquidating distributions (see Regs. Sec. 1.1367-1(d)(1)).

BENEFICIARY DEEMED OWNED TRUST

- If the Beneficiary is granted the right to withdraw taxable income the Beneficiary is treated as the "owner" of the Trust taxable income, including capital gains, under § 678 regardless of whether he withdraws the income or allows it to remain in the Trust.
- PLR 2016-33021 involved a non-grantor trust (#1) funding a second trust (#2) (a BDOT), with the second trust granting the first trust the power to withdraw the taxable income (*but not the power to withdraw corpus beyond that*) with the power lapsing on the last day of the calendar year. IRS ruled the first trust must report the taxable income, including capital gains, withdrawable under § 678 regardless of whether the first trust withdraws it.
- To the extent the Beneficiary does not withdraw taxable income of the Trust up to the lapse protection (the so-called "5 and 5" protection of § 2514(e)(2) and § 2041(b)(2)), that amount remains in the Trust in a manner that will not be subject to gift taxes and estate taxes. However, to the extent that a current or hanging power exists at death or a prior power lapsed in excess of the lapse protection, that portion of the Trust will be subject to inclusion in the Beneficiary's gross estate. The beneficiary may withdraw the excess amount of net taxable income (payable out of income, corpus or proceeds of the corpus of the trust) that exceeds 5% of the value of the corpus of the trust.
- **The Beneficiary can sell assets to the Non-Grantor Trust recognizing no gain under Rev. Rul. 85-13. PROVIDES AN ESTATE PLANNING FREEZE TECHNIQUE FOR BENEFICIARY.**
- Under Treas. Reg. §1.671-2 portion rules, trust corpus and income are allocated and divided as either a fractional share, per asset or based on accounting income/principal, depending on the language of the document that creates the partial status.
- Trust Protector may also exercise power to grant Beneficiary the right to withdraw corpus in order to increase cost basis in assets at Beneficiary's death.

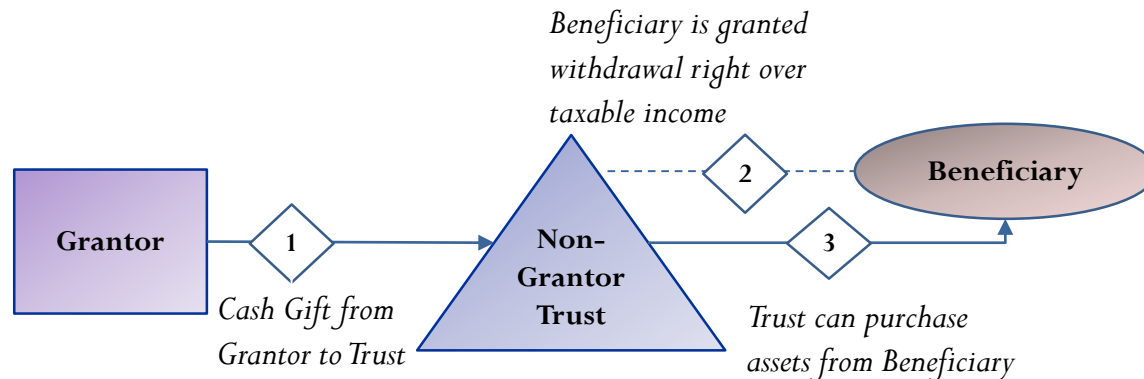
“Beneficiary Deemed Owned Trust”

Non-Grantor Trust

- ❑ Grantor creates a Non-Grantor Trust for the Beneficiary.
- ❑ Trust Protector can grant the Beneficiary a power to withdraw corpus or income exercisable solely by the Beneficiary. If power not exercised corpus or income are held in trust for Beneficiary

Steps of Transaction

- 1) Grantor creates a Non-Grantor Trust and gifts cash to Non-Grantor Trust
- 2) Trust grants Beneficiary right to withdraw trust taxable income
- 3) Non-Grantor Trust can buy assets from Beneficiary for cash and a promissory note



Beneficiary

- ❑ Grantor makes cash gift to a Non-Grantor Trust
- ❑ The Beneficiary is treated as the “owner” of the Trust taxable income, including capital gains, under § 678
- ❑ The Beneficiary can also sell assets to the Trust- No gain to the Beneficiary under Rev Rul 85-13

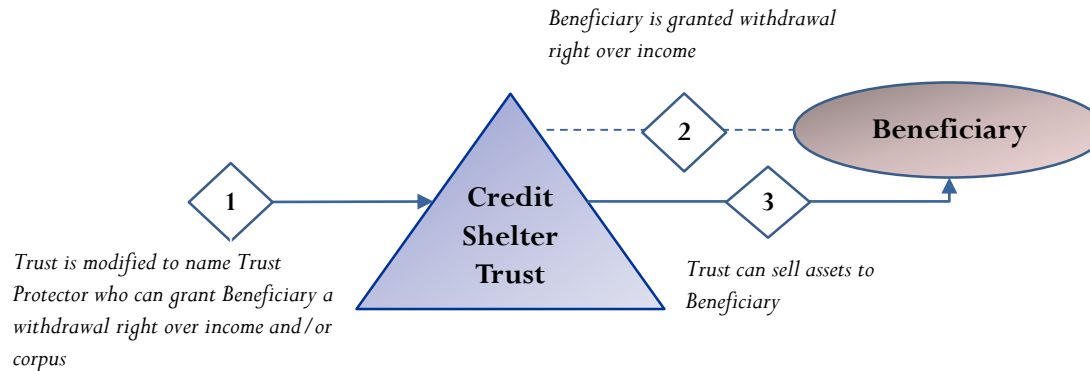
Converting a Credit Shelter Trust to a “Beneficiary Deemed Owned Trust”

Non-Grantor Trust

- ❑ A Credit Shelter Trust (a Non-Grantor Trust) was previously created for the Beneficiary.
- ❑ A Trust Protector is appointed and has the power to grant the Beneficiary a power to withdraw corpus or income exercisable solely by the Beneficiary. If the power is not exercised, corpus or income are held in trust for Beneficiary.

Steps of Transaction

- 1) *Existing Credit Shelter (Non-Grantor Trust). Trust Agreement is modified to appoint a Trust Protector who can grant the Beneficiary a right to withdraw trust taxable income, or corpus*
- 2) *Beneficiary granted power to withdraw corpus or taxable income*
- 3) *Credit Shelter Trust can sell low basis assets to Beneficiary for cash or high basis assets*



Beneficiary

- ❑ The Beneficiary is treated as the “owner” of the Trust income, including capital gains, under § 678
- ❑ The Beneficiary can purchase assets from the Trust- No gain to Beneficiary or Trust under Rev Rul 85-13

- If the beneficiary is granted the right to withdraw taxable income the beneficiary is treated as the “owner” of the Trust taxable income, including capital gains under § 678 regardless of whether he or she withdraws the income or allows it to remain in the Trust
- PLR 2016-33021 involved a non-grantor trust (#1) funding a second trust (#2) (a BDOT), with the second trust granting the first trust the power to withdraw the taxable income (*but not the power to withdraw corpus beyond that*) with the power lapsing on the last day of the calendar year. IRS ruled the first trust must report the taxable income, including capital gains, withdrawable under § 678 regardless of whether the first trust withdraws it.
- To the extent the Beneficiary does not withdraw net taxable income of the Trust up to the lapse protection (the so-called “5 and 5” protection of § 2514(e)(2) and § 2041(b)(2)), that amount remains in the Trust in a manner that will not be subject to gift taxes and estate taxes. However, to the extent that a current or hanging power exists at death or a prior power lapsed in excess of the lapse protection, that portion of the Trust will be subject to inclusion in the Beneficiary’s gross estate. The beneficiary may withdraw the excess amount of net taxable income (payable out of income, corpus or proceeds of the corpus of the trust) that exceeds 5% of the value of the corpus of the trust.
- The Beneficiary can sell assets to the Non-Grantor Trust or purchase assets with neither the Trust nor the Beneficiary recognizing gain under Rev Rul. 85-13.
- Under Treas. Reg. §1.671-2 portion rules, trust corpus and income are allocated and divided as either a fractional share, per asset or based on accounting income/principal, depending on the language of the document that creates the partial status.



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Diagram prepared by Gadarian & Cagy, PLLC

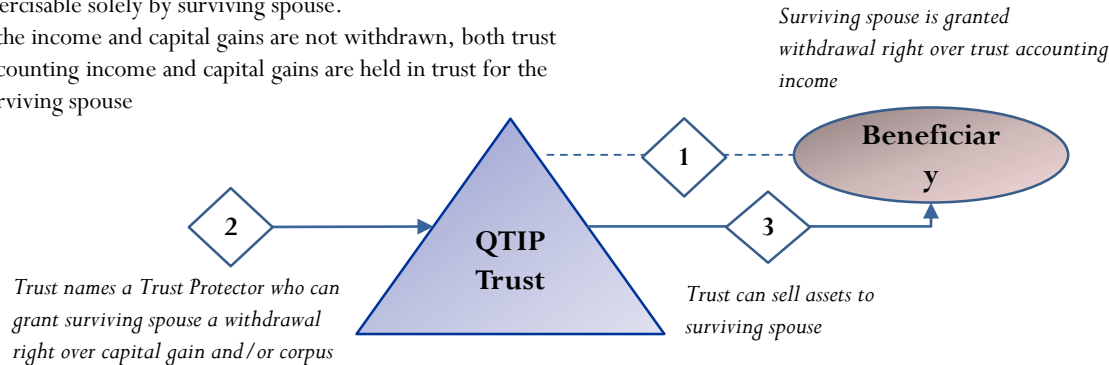
Creating QTIP Trust as a “Beneficiary Deemed Owned Trust”

Non-Grantor Trust

- ❑ A QTIP Trust (a Non-Grantor Trust) is created for surviving spouse (either as an inter vivos trust or as a testamentary trust).
- ❑ Surviving spouse has the right to withdraw trust accounting income.
- ❑ A Trust Protector is appointed and has the power to grant the surviving spouse a power to withdraw capital gain exercisable solely by surviving spouse.
- ❑ If the income and capital gains are not withdrawn, both trust accounting income and capital gains are held in trust for the surviving spouse

Steps of Transaction

- 1) *QTIP Trust grants surviving spouse right to withdraw trust accounting income*
- 2) *Trust Protector can grant surviving spouse power to withdraw corpus or capital gains*
- 3) *QTIP Trust can sell assets to surviving spouse without gain recognition*



Beneficiary

- ❑ The surviving spouse is treated as the “owner” of the Trust income, including capital gains, under § 678
- ❑ The surviving spouse can purchase assets from the Trust—No gain to surviving spouse or Trust under Rev Rul 85-13

- A marital trust must give the surviving spouse the right to all the trust’s accounting income for life. A spouse’s right to withdraw accounting income satisfies the regulations applicable to marital trusts, including QTIP trusts. Treas. Reg. §§ 20.2056 (b)-5(f)(8) & 20.2056(b)-7(d)(2).
- If the beneficiary is granted the right to withdraw taxable income the beneficiary is treated as the “owner” of the Trust taxable income, including capital gains, under § 678 regardless of whether he or she withdraws the income or allows it to remain in the Trust
- PLR 2016-33021 involved a non-grantor trust (#1) funding a second trust (#2) (a BDOT), with the second trust granting the first trust the power to withdraw the taxable income (*but not the power to withdraw corpus beyond that*) with the power lapsing on the last day of the calendar year. IRS ruled the first trust must report the taxable income, including capital gains, withdrawable under § 678 regardless of whether the first trust withdraws it.
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- The surviving spouse can sell assets to the QTIP Trust or purchase assets with neither the QTIP Trust nor the Beneficiary recognizing gain under Rev Rul. 85-13.
- Under Treas. Reg. §1.671-2 portion rules, trust corpus and income are allocated and divided as either a fractional share, per asset or based on accounting income/principal, depending on the language of the document that creates the partial status.

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