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INSIGHT: New Tax Law, Same Old Tricks: The '1014 Trust'

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The Tax Cuts and Jobs Act was enacted on Dec. 22, 2017, and has temporarily doubled each individual's federal lifetime transfer tax exemption to $11.18 million (or $22.36 million for married couples) beginning in 2018. This amount is adjusted for inflation each year and is expected to be $11.4 million in 2019. Most Americans' estates (even those we consider rich) fall well below this new federal exemption leaving much of it unused. However, this disparity (between the exemption and the value of the estate) opens the door to a multi-generational planning technique known as a ''1014 Trust'' or a ''Step-Up In Basis Trust.'' A 1014 Trust allows younger generations to eliminate capital gains at the death of a grandparent (or parent) by including the appreciated assets in the grandparent's (or parent's) estate without incurring any estate tax through the utilization of the grandparent's (or parent's) unused exemption.

The premise of the technique is designed around tax code Section 1014. When an individual dies, his assets receive a step-up in basis to their fair market value (FMV). This eliminates any built-in capital gains, currently taxed at 23.8 percent plus any state and local taxes. This is the highest federal capital gains rate, with the Medicare surtax. For example, for residents of New York City, the combined federal and state capital gains tax rate could be as high as 36.496 percent. The 1014 Trust is designed to be included as an asset of the grandparent's estate in order to receive the step-up, effectively eliminating any capital gain exposure.

The structure of a 1014 Trust is very specific but can be designed for maximum flexibility and permits some alterations based on the client's wishes. The following is the typical 1014 Trust structure. The grantor of a 1014 Trust is a child or grandchild who funds the trust with low-basis assets. The trustees can be the grantor's spouse along with an independent person (i.e., a non-beneficiary) such as a sibling of the grantor. The current beneficiaries are the grantor's grandparent (or parent, depending on the parent's age), the grantor's spouse and the grantor's descendants. The trust will terminate upon the grandparent's (or parent's) death. The remaindermen will be persons other than the grantor, such as the grantor's spouse and descendants.

The grantor's grandparent is given a power to appoint the assets of the trust to the creditors of the grandparent's estate. The grantor's grandparent can also be given a power of appointment to the creditors of the grandparent and/or the grandparent's estate. This is a general power of appointment, which causes the assets of the trust to be includable in the grandparent's estate for estate tax purposes. Therefore, at the grandparent's death, the assets of the trust will receive a step-up in basis to their FMV. Because of the grandparent's unused exemption, the increase in value to grandparent's estate from the inclusion of the trust assets will not result in an estate tax. Though it is expected that the grandparent would not exercise this general power, it is specifically limited to the creditors of the estate to limit the grandparent's ability to change the ultimate disposition of the trust assets determined by the grantor. If the power allowed an appointment to the grandparent's estate, the grandparent would be able to redirect the distribution of the assets through the grandparent's estate plan rather than the terms of the trust.

Alternatively, the general power could be exercisable only with the consent of a non-adverse party. The appointment power would remain a general power as long as such person did not have a substantial interest in the trust, making such person non-adverse. The grantor's grandparent could also be given a special power of appointment to appoint the trust assets to a group of persons that includes the grantor. The reason this is so im-

portant is if the grantor wants to regain control of the assets after the step-up in basis, there needs to be a method to get the assets back to him. However, this power should be used cautiously. If it is exercised simultaneously or in close proximity to the creation of the trust, it is arguable that a step-transaction occurred. In that event, the multiple steps of the transaction would be collapsed, which would mean the grantor gave the assets to himself, and the assets would not be entitled to the step-up in basis. The other methods to get the assets back are through the grantor's spouse or children (discussed further below).

One might wonder why the grantor would not just be the remainderman of the trust. Wouldn't this avoid the need for the special power and any risk possibly associated with it? However, if the grantor is the remainderman, then the grantor would have a reversionary interest in the trust. If the reversion is greater than 5 percent (which it would likely be based on the grandparent's age), the gift to the trust will not be considered complete and therefore the assets would not be entitled to a step-up in basis, negating the entire technique. On a positive note, the exclusion of the grantor as a remainderman also avoids the requirement of the one-year holding period to receive the step-up under Section 1014(e). Under Section 1014(e), if the grantor gives an asset away but it is returned to the grantor at the death of the recipient within one year, the step-up does not apply. So, think of it as a blessing in disguise for the unwitting.

The trust termination can be based on various triggering events depending on the client's wishes. The simplest technique would be for the trust to terminate at the death of the grandparent. This obviously guarantees the step-up in basis. However, depending on the size of the grandparent's estate, this could also result in estate tax exposure. Because the increase in the exemption sunsets at the end of 2025 and reverts back to $5 million (indexed for inflation), one should either limit the size of the trust or cause the trust to terminate before 2026. Either approach would avoid any adverse estate tax issues, but the latter might not achieve the basis step-up.

In addition to the grantor's grandparent, the grantor's spouse and descendants can be current beneficiaries. This may provide the grantor with access to the trust property through his spouse during the trust term. Distributions could be made to the spouse who then could make gifts of those distributions to the grantor. Because the grantor's spouse is entitled to an unlimited marital deduction, the transfers to the grantor are gift tax free. Additionally, the grantor can use the trust funds for his children in place of the grantor using his remaining personal funds for their benefit (e.g., school, extra-curricular activities, vacations, etc.). This method essentially has the same effect as removing the assets dollar for dollar from the trust back into the hands of the grantor.

If the special power of appointment is exercised in favor of the grantor, then upon the termination of the trust, the assets could pass either outright or in further trust for the benefit of the grantor. Obviously, the former is the simpler approach but wastes the grantor's transfer tax exemption. This assumes the grantor has a taxable estate. If the grantor's estate is below the federal exemption and inclusion of the assets of the 1014 Trust would not cause the grantor's estate to exceed the federal exemption, there is no actual squandering of the grantor's federal exemption. If the assets passed to a further trust, they would be exempt from estate tax not only on the grantor's death but also on future generations' deaths because of the grandparent's generation-skipping transfer exemption. Additionally, a further trust could provide the grantor with creditor protection over assets that otherwise would be subject to creditor claims.

The remaindermen of the trust are the spouse and descendants of the grantor. This serves as a backstop if the grandparent does not exercise the limited power appointment in favor of the grantor. The net result would be almost the same as giving a gift to a spousal lifetime access trust (SLAT). The grantor would have used the same amount of his exemption to fund a SLAT as he did for the 1014 Trust. The grantor would have removed the same assets from his taxable estate to grow estate tax free. The grantor would have continued to have access to the funds through his spouse. But, the assets of a 1014 Trust (compared to a SLAT) would have no trapped-in capital gains through the grandparent's date of death.

With the historically high federal exemption, the 1014 Trust could be attractive for clients who want to shelter themselves from some capital gains tax exposure. Similar to a GRAT where the results are either positive or neutral, the 1014 Trust has little downside. Because each 1014 Trust can be tailored to the specific needs of the client, clients big and small can similarly benefit from this technique.

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