Eliminating Capital Gains and Maximizing Basis

With an Upstream Power of Appointment Trust

For many clients the 2017 Tax Cuts and Jobs Act moved income tax planning to the forefront over traditional estate tax planning. Clearly wealthy clients should not miss the opportunity to utilize the current $11.4 million estate tax exemption to transfer wealth for multiple generations through dynasty trusts. However, for clients not presently concerned about estate taxes, minimizing income taxes and eliminating capital gains is now a priority. But what if you could have both? The use of Upstream tax planning through a Power of Appointment Trust could be the perfect solution.

Traditional "downstream" estate planning involves a wealthy donor utilizing their estate and generation-skipping transfer tax (GST) exemptions to fund trusts for their spouses and descendants.

Clients whose net worth is less than $20 million may be unwilling to transfer their wealth just yet. However, those same clients whose investment portfolios reaped the benefits of a decade long bull market are keen to reduce or even eliminate their capital gain taxes.

Upstream Power of Appointment Trust.
Unlike the traditional planning model, in the Upstream Power of Appointment Trust the client includes their elderly and much less wealthy parent(s) as an additional trust beneficiary. The key to this tool is that the Upstream Power of Appointment Trust gives the elderly parent a power to appoint the trust assets to the parent's estate or to the creditors of the estate. This power of appointment causes the trust assets to be included in the parent's taxable estate (even though they never owned the assets) and the cost basis of the assets in the Trust is increased upon the parent's death to the fair market value – thus eliminating any appreciation on those assets since the Grantor acquired them. The trust is typically funded with low basis, highly appreciated assets which, when aggregated with the value of the parent's personal estate, do not exceed the applicable estate tax exemption amount (currently $11.4 million). Assuming that the client's parent / trust beneficiary survives for at least 12 months from the date the trust is funded, this strategy provides the family with several income and transfer tax benefits.

Tax Benefits.

Income Tax Benefit
Upon the parent's death, the trust assets subject to the general power of appointment are included in the parent's estate even if the power of appointment is not exercised. This estate inclusion eliminates the unrealized capital gains on the investment portfolio due to Internal Revenue Code §1014. That section requires that the basis of assets included in the estate at death is adjusted to

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equal the fair market value of the assets at that time. For example, a client with an investment portfolio of $6.0 million with a basis of only $1.0 million will pay approximately $1,727,500 in income taxes[1]. Instead, if those assets are transferred to an Upstream Power of Appointment Trust the parent's death wipes out the income tax bill. The family could then diversify the portfolio with minimal capital gains taxes.

Estate Tax Neutral

The parent's unused estate tax exemption shelters the trust assets from estate taxes. Assuming that the $6.0 million portfolio combined with the value of the parent's other assets is below the estate tax exclusion amount, there are no federal estate taxes due[2]. As an added bonus, the deceased parent's GST tax exemption (also $11.4 million in 2019) can be applied to the trust assets when the parent dies so that multiple generations can have continued access to the investment portfolio without paying any GST tax when distributions are made.

Who is a good candidate for this strategy?

First, you should have sufficient assets so you can transfer an appreciated investment portfolio or real estate to the trust without needing access to those assets in the near future. Second, the client's parent should be healthy enough to survive at least 12 months from the date that the trust is funded and should have sufficient resources that they do not anticipate needing Medicaid or other government benefits for their care. The parent should have no creditors who could foreseeably remain unpaid at the time of the parent's death. Finally, there should be agreement regarding the intended flow of the trust assets, with the general power of appointment carefully tailored to ensure that the transferred assets are not diverted from their intended use. If this strategy appeals to you, we can help you design and implement the appropriate trust for your situation.

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[1] $1,190,000 in federal taxes based on a 20% capital gain rate and 3.8% net investment income tax and $537,500 in New Jersey state income taxes based on a 10.75% rate on income in excess of $5.0 million.

[2] Assumes parent resides in a state with no state level estate tax or where the state level estate tax exemption is large enough to avoid the imposition of a state estate tax.

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