



## FEATURE: ESTATE PLANNING & TAXATION

By **Jay D. Waxenberg** & **Nathan R. Brown**

# The Narrowing “Tax Efficiency Gap”: Part II

Post-gift asset exchange techniques

In Part I of this article,<sup>1</sup> we discussed the increased significance of the income tax consequences of estate planning in light of the American Taxpayer Relief Act of 2012<sup>2</sup> and the 3.8 percent tax on net investment income<sup>3</sup> and highlighted the effect that a narrowing tax efficiency gap<sup>4</sup> and a “permanent” \$5 million estate tax exemption, indexed for inflation (\$5.344 million for 2014), have had on the tax efficiency of lifetime gifts. We now turn to the various post-gift asset exchange techniques that can be used to maximize the tax efficiency of lifetime gifts by taking advantage of a step-up in basis in the gifted assets on the death of the donor.

### Post-Gift Asset Exchanges

To mitigate the effects of a narrowing tax efficiency gap and a \$5 million estate tax exemption, individuals making lifetime gifts should consider engaging in post-gift asset exchanges by exchanging previously gifted low basis assets for cash or high basis assets at a point in time close to the donor's death (which, admittedly, is often difficult to predict).

When the donor makes the initial gift (to a grantor trust, for example), the trust takes a carryover basis in the gifted assets equal to the donor's basis in the gifted assets immediately prior to the transfer.<sup>5</sup> As a result, although the donor has effectively removed any post-gift appreciation from his estate, if the trust subsequently

sells the gifted asset, the trust will have to pay capital gains tax on all of the appreciation, even that occurring prior to the gift. A post-gift asset exchange is an effective method to mitigate or even eliminate the capital gains tax attributable to appreciation occurring prior to the donor's death. **Through the use of this technique, the trust will receive assets with a basis equal to fair market value (FMV) (or as close thereto as possible), and the donor will receive the low basis asset previously gifted to the trust.** These low basis assets will be included in the donor's gross estate, thereby receiving a step-up in basis on the donor's death.<sup>6</sup>

For estate planners to effectively assist their clients in maximizing the tax efficiency of lifetime gifts, they must have a working knowledge of the various techniques that can be used to accomplish a post-gift asset exchange. Here's an overview.

### Cash Purchase

**The simplest way for a donor to make a post-gift asset exchange is for the donor to use cash to purchase the previously gifted assets from the trust.** As long as the trust was structured as a grantor trust with respect to the donor, no gain or loss should be recognized on the sale.<sup>7</sup> After the purchase, the trust will hold cash, which has a basis equal to face value and, therefore, no gain potential. The donor will hold the previously gifted low basis assets, which will be included in the donor's gross estate and receive a step-up in basis on the donor's death. Ideally, the donor will have sufficient cash on hand to purchase the assets.

### Third Party Financing

Often, a cash purchase won't be possible. If a donor can't use one of the asset exchange techniques discussed below, the donor will have to find an alternative way to

**Jay D. Waxenberg**, far left, is a partner in the New York office, and **Nathan R.**



**Brown** is an associate in the Boca Raton, Fla. office, both at Proskauer Rose LLP



obtain the necessary funds to purchase the low basis assets. The **safest alternative is to borrow the necessary funds from a third-party lender**. It isn't necessary that the loan be repaid prior to the donor's death; rather, the loan could be repaid after the donor's death and would be an expense deductible on the donor's estate tax return.<sup>8</sup>

## Promissory Note

If the donor is unable to secure a loan from a third-party lender, or if the donor would rather not borrow money from a third-party lender, **the donor could purchase the gifted assets from the trust in exchange for a promissory note**. However, there are several risks involved with using a promissory note in this manner tied to the uncertainty regarding the income tax treatment of a grantor trust on the grantor's death.<sup>9</sup> At such time, the trust ceases to be a grantor trust with respect to the donor. The Internal Revenue Service may argue that a deemed sale between the donor and the trust occurs, pursuant to which the trust will be deemed to sell all of its assets to the donor in exchange for the promissory note.<sup>10</sup> If the deemed sale is treated as a recognition event for income tax purposes, the trust would be required to recognize any gain resulting from the sale of the gifted assets.<sup>11</sup> Additionally, it's not clear what the trust's basis in the promissory note would be. If the trust were deemed to have a carryover basis in the promissory note (that is, a basis equal to that of the assets exchanged for the promissory note in the post-gift asset exchange), the trust would recognize gain on repayment of the note. This treatment would eliminate the tax benefits of the post-gift asset exchange. In light of the uncertainty surrounding these issues, **the donor should use a promissory note only as a last resort**.

## Exercise a Substitution Power

Alternatively, the donor may be able to execute a post-gift asset exchange if the trust contains a "substitution power." This is a provision commonly employed by estate planners to invoke grantor trust status that permits the grantor of the trust to reacquire the trust corpus by substituting other property of an equivalent

value.<sup>12</sup> If the trust to which the donor makes a gift is a grantor trust with respect to the donor, and it contains a substitution power, the donor can transfer high basis assets to the trust in exchange for the trust's low basis assets. This method will result in the low basis assets being included in the donor's gross estate, thereby receiving a step-up in basis on the donor's death. Because the trust is a grantor trust with respect to the

If the distributing trust doesn't contain a substitution power, the trustees may, depending on state law, be able to decant to another trust having different terms and conditions.

donor, no gain would be recognized on the substitution. **Ideally, the substituted assets will have a basis equal to or at least close to FMV to minimize any income tax that would be due on the sale of the substituted assets by the trust**. However, as long as the substituted assets have a basis in excess of the originally gifted assets held by the trust, the substitution will increase the tax efficiency of the lifetime gift.

## Decant Gifted Assets to a New Trust

If the trust to which the donor made the lifetime gift (the distributing trust) doesn't contain a substitution power, the trustees of the distributing trust may, depending on the particular state law governing the distributing trust, be able to decant the assets of distributing trust to another trust (the receiving trust) having different terms and conditions from the distributing trust, including a substitution power. **After the gifted assets have been**



## FEATURE: ESTATE PLANNING & TAXATION

decanted into the receiving trust, the donor can exercise the substitution power, exchanging the donor's high basis assets for the receiving trust's low basis ones. Currently, 19 states have decanting statutes, with some granting the trustees fairly liberal decanting power and others, such as Florida's, permitting decanting only when the trustees have unfettered discretion to make distributions of principal to the beneficiaries. Accordingly, if a client finds himself in a situation in which he's made gifts of highly appreciated assets to a trust that doesn't contain a substitution power, he should consider decanting to enable a substitution.

As noted above, a post-gift asset exchange is more

Prepare all of the documents necessary to effectuate the post-gift asset exchange ahead of time so that they can be implemented on short notice.

effective the closer in time that it occurs to the donor's death. Unfortunately, it's often difficult, if not impossible, to predict when an individual is going to die—making it a challenge to maximize the effect of a post-gift asset exchange. To plan around sudden and unexpected illnesses and events, it's wise for estate planners to prepare all of the documents necessary to effectuate the post-gift asset exchange ahead of time so that they can be implemented on short notice.

### Unnecessary Exchanges

Despite the tax savings that a post-gift asset exchange can provide, there may be situations in which a post-gift asset exchange is unnecessary, or even counterproductive. For example, if the FMV of an originally gifted asset has decreased below the asset's basis, the loss inherent in the asset would be eliminated by a post-gift asset exchange. In the absence of a post-gift asset exchange, the donee would recognize a deductible capital loss when the gifted asset is sold.<sup>13</sup> Conversely, if the

donor engages in a post-gift asset exchange, the gifted asset would be included in the donor's gross estate and would receive a step-down in basis to the asset's FMV, thereby eliminating the loss.<sup>14</sup>

Additionally, if the initial gift is made to a grantor trust, a post-gift asset exchange may be unnecessary if the grantor trust sells the gifted asset to a third party prior to the donor's death. In this scenario, the donor will report all of the gain recognized by the trust on the sale of the asset, and the donor will be required to pay the tax on such gain, further reducing the donor's estate. After the sale, the trust would hold cash or other FMV basis assets received as consideration for the originally gifted assets. Assuming that the donor dies shortly after the sale or that the assets received by the trust in the sale don't appreciate in value between the date of the sale and the date of the donor's death, a post-gift asset exchange would be unnecessary. However, if the assets do appreciate in value during such period, a significant tax savings may still be achieved through the use of a post-gift asset exchange.

### Valuation and Reporting


Irrespective of which post-gift asset exchange technique is used, it's imperative that the donor obtain appraisals for the assets held by the trust and the assets being exchanged to ensure that the FMV of such assets are the same. In this regard, if the initially gifted assets were valued on a discounted basis going into the trust, they should be valued on a discounted basis coming out of the trust. Furthermore, to ensure consistency in valuation of the assets, it's advisable to use the same appraiser for the post-gift asset exchange as was used for the initial gift.

Another consideration with a post-gift asset exchange is whether the donor should report the transaction on a Form 709. Because the post-gift asset exchange is a sale or exchange and not a gift, it isn't required to be reported on the donor's Form 709. However, it may be advisable for the donor to disclose the transaction to start the running of the 3-year statute of limitations.<sup>15</sup> If the post-gift asset exchange isn't disclosed, the IRS is free, at any time, to challenge the valuation of the assets involved in it.<sup>16</sup> If the IRS were to determine that the FMV of the assets transferred by the donor exceeded the FMV of those received from the trust, the donor may be treated as having made an additional gift to the



trust. Conversely, if the IRS were to determine that the FMV of the assets transferred by the donor was less than the FMV of those received from the trust, the IRS may argue that the donor retained a beneficial interest in the trust that would cause the entire value of the assets of the trust to be included in the donor's gross estate.<sup>17</sup> To mitigate the valuation risks associated with a post-gift asset exchange, **estate planners should consider structuring the exchange on a formula basis to prevent the transfer of any unintended excess value.**<sup>18</sup>

## Weighing the Tax Benefits

Now, more than ever before, estate planners and their clients carefully need to weigh the estate tax benefits of making lifetime gifts against the future income tax burdens associated with such gifts. In today's tax environment, with a small tax efficiency gap and a large indexed estate tax exemption, lifetime gifts are no longer the surefire winners they once were. If a client isn't expected to be in a position to make a post-gift asset exchange, a lifetime gift is likely to be far less tax efficient than dying with the asset. Even if a client is expected to be in a position to make a post-gift asset exchange, it's often difficult, if not impossible, to predict the date of the donor's death. The donor can have every intention in the world to make a post-gift asset exchange, but if the donor dies unexpectedly without having executed the exchange, no tax benefit will have been obtained by making the lifetime gift. 

## Endnotes

1. See Jay D. Waxenberg and Nathan R. Brown, "The Narrowing Tax Efficiency Gap," *Trusts & Estates* (July 2014) at p. 22.
2. 2012 HR 8. The American Taxpayer Relief Act "permanently" increased the: (1) estate and gift tax exemption to \$5 million (indexed for inflation, annually), (2) estate and gift tax rate to 40 percent, and (3) capital gains rate to 20 percent.
3. Internal Revenue Code Section 1411(a). With respect to individuals, the net investment income tax (NIIT) is equal to 3.8 percent of the lesser of: (1) an individual's net investment income for the year, and (2) the excess of the individual's modified adjusted gross income (AGI) for such year in excess of \$200,000 (\$250,000 if married and filing jointly). With respect to a trust, the NIIT is equal to 3.8 percent of the lesser of: (1) the trust's undistributed net investment income for the year, and (2) the excess of the trust's or estate's AGI for the year over \$12,150 (the dollar amount at which the highest tax bracket in Section 1 of the IRC begins).
4. As discussed in Part I of this article, *supra* note 1, the "tax efficiency gap" refers

to the difference between the estate tax rate and the capital gains tax rate.

5. See IRC Section 1015.
6. See IRC Section 1014, which provides, generally, that the basis of property in the hands of a person acquiring the property from a decedent is the fair market value of the property on the date of the decedent's death.
7. See Revenue Ruling 85-13.
8. See IRC Section 2053(a).
9. See Jonathan G. Blattmachr, Mitchell M. Gans and Hugh H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status By Reason of The Grantor's Death," 97 *J. Tax'n* 149 (2002). This article provides an excellent analysis of the income tax consequences on the death of a grantor of a grantor trust when, prior to death, the grantor sold assets to the trust in exchange for a promissory note, the principal balance of which remains outstanding on the date of the grantor's death. The authors conclude that: (1) death isn't a recognition event for income tax purposes, and no gain should be recognized on the grantor's death, (2) the transaction doesn't produce income in respect of a decedent under IRC Section 691, and (3) the trust should receive a stepped-up basis in the assets previously sold to the trust by the grantor in exchange for the promissory note. The situation addressed by the present article, although similar to that discussed in the above cited article, isn't the same. Here, it's the trust that's selling assets to the grantor in exchange for a promissory note (rather than the grantor selling assets to the trust); therefore, the analysis, while providing helpful insight, isn't directly applicable.
10. In Chief Counsel Advice 2009-23024 (Dec. 31, 2008), the Chief Counsel addressed a transaction in which a non-grantor trust was converted to a grantor trust. In its analysis, however, the Chief Counsel noted that the conversion of a grantor trust to a non-grantor trust during the grantor's lifetime would be a deemed transfer of property from the grantor to the trust requiring income tax recognition, whereas, the conversion of a grantor trust to a non-grantor trust as a result of the grantor's death is, generally, not treated as an income tax event.
11. The gain required to be recognized by the trust would be equal to the face amount of the promissory note (the amount realized by the trust in the deemed sale) less the trust's basis in the gifted assets.
12. See IRC Section 675(4)(C).
13. See IRC Sections 165(f), 1211(b) and 1212(b).
14. See IRC Section 1014(a).
15. See IRC Section 6501(a).
16. The donor will be required to report any transfer or sale of an interest in a partnership, limited liability company or corporation to a trust created by the donor on Line 13e of Part 4 of the donor's Form 706.
17. See IRC Section 2036.
18. See *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006); *Estate of Christiansen v. Comm'r*, 586 F.3d 1061 (8th Cir. 2009); *Estate of Petter v. Comm'r*, T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011); *Hendrix v. Comm'r*, T.C. Memo. 2011-133; *Wandry v. Comm'r*, T.C. Memo. 2012-88, nonacq., AOD 2012-004, 2012-46 IRB.