Upstream Gifting: Leveraging the Estate Tax Exemption to Reduce Income Tax

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Let's face it, not many New Jersey residents have an estate tax problem these days. The individual lifetime federal estate and gift tax exemption is currently $11.4 million ($22.8 million per married couple when considering portability), and the New Jersey estate tax is all but a fading memory. With such a high federal exemption, certain clients may have elderly relatives who will die with large exemptions going unused. When the exemption was increased to $5 million in 2011, practitioners began proposing a technique called "upstream gifting" to leverage unused exemptions in order for a client to achieve a step-up in basis on his or her own assets.

At its most basic level, upstream gifting is performed as follows: a client makes a gift to his grandmother of an appreciated asset, and she bequeaths it to him under her will. Under IRC § 1014, when the client inherits the asset from grandma, the asset's tax basis is stepped-up to its fair market value (FMV) as of the grandmother's date of death, thereby eliminating the built-in gain.

Unfortunately, this basic form of upstream gifting is highly risky, estate tax-inefficient and simply impractical. If grandma's estate plan is not properly executed, the asset may inadvertently wind up in the hands of her creditors or other beneficiaries of her estate. The original gift to grandma also consumes some of the client's own exemption only to have the asset brought back into his or her estate. Moreover, the client loses access to, and control over, the asset until grandma dies. For those reasons, using trusts to perform upstream gifting is a much better solution. Consider the following example:

Facts: John and Jane Smith are married residents of New Jersey. They have two children and several grandchildren. John owns a 25-percent interest of an LLC consisting of commercial property. The FMV of John's LLC interest is $6 million, and his tax basis is $1 million. John's mother, Mary, also a New Jersey resident, is in her early 90s and has an estate valued at $1 million.

Issue: John would like to sell his LLC interest within the next five years to buy a vacation home. However, the tax liability on the $5 million gain would be significant.

Plan: John establishes a discretionary Spousal Lifetime Access Trust (SLAT) for the benefit of Jane and their descendants, but also includes Mary as a beneficiary. John's brother, Robert, is named as the trustee. The SLAT provides that Robert, as a non-interested trustee, has the power to confer a General Power of Appointment (GPOA) unto a beneficiary. If the GPOA is not exercised, the trust assets continue to remain in the SLAT for the benefit of Jane and the Smiths' descendants, i.e. a dynasty trust. Finally, John gifts his LLC interest to the SLAT.

Result: Mary's health begins to fail within the year. Robert exercises his power and grants Mary a GPOA over the entire corpus of the SLAT. When she passes away shortly thereafter, the GPOA causes inclusion of the trust's assets in Mary's estate under IRC § 2041 but does not result in an estate tax because she is still under the federal exemption and New Jersey has no estate tax. As a result, the LLC interest in the SLAT now has a basis equal to its FMV of $6 million. The SLAT can sell the LLC interest and would only realize a gain to the extent the sale price exceeds $6 million.

The technique used in the above example achieves a much better result than the basic upstream gifting technique mentioned earlier. Although John used $6 million of his exemption (or less if a discount was applied to the gift), the asset is entirely removed from, and remains out of, the marital estate. Any growth occurs outside of the Smiths' estate and in the trust. Jane (and John as Jane's husband) also retains the beneficial enjoyment of the asset as a trust beneficiary, along with any income earned by the LLC prior to sale. Furthermore, the asset is protected from creditors and accidental disposition. Finally, and most importantly, the Smiths avoid paying income tax on the $5 million gain that would have previously resulted.

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