

## An Active Estate Planning Approach

### The Most Valuable Partner to Investment Management for Taxable Estates

Wealth and Estate Planning Strategists  
Family Office Resources

Estate planning is the memorialization of a person's wishes around the management and disposition of his/her assets in the event of incapacity and death. For individuals with significant wealth, a successful plan will also minimize the impact of transfer taxes. The planning process can be uncomfortable because it requires confronting one's own mortality; therefore, some people may revisit a plan only upon the occurrence of a significant life event or change in circumstances. The adoption of an active estate planning approach--a marriage of the planning structure to the ongoing investment management of the underlying assets--can greatly enhance not only the likelihood of success but also the impact and benefits of the plan.

#### **What is an Active Estate Planning Strategy? How Can it Provide Value?**

A comprehensive estate plan for an affluent individual may include various legal entities and the documents to govern them. Advanced planning strategies implemented during an individual's lifetime can reduce income and transfer taxes while also enhancing growth outside of the estate for the benefit of family or others. The impact of a particular strategy depends on the characteristics of the assets deployed, their performance over time, the type of vehicle created to hold them, and the interest rate environment from the time of implementation onward.

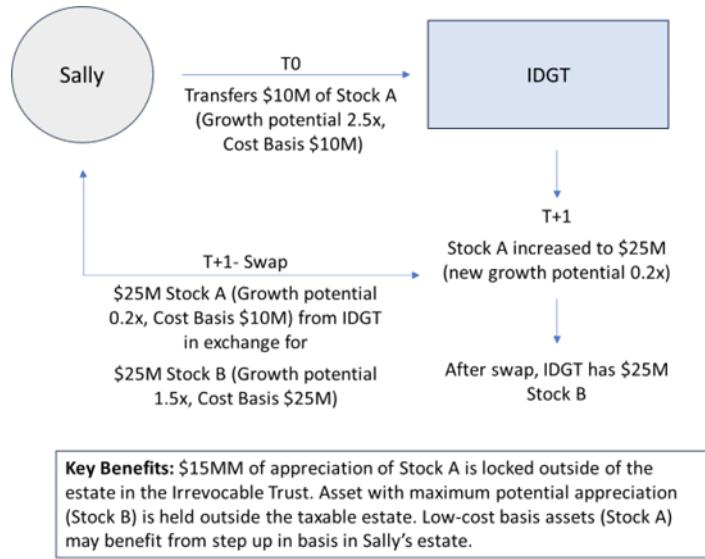
- (i) Other key concepts that are important to understand the benefit of some of the most popular estate planning strategies are: Intentionally Defective Grantor Trust ("IDGT"). An IDGT is a trust whose assets have been removed from the grantor's estate for federal gift and estate tax purposes but continue—for federal income tax purposes—to be considered the property of the grantor. That is, although assets held in a properly structured IDGT should not be subject to federal estate tax upon the grantor's death, the grantor will be personally responsible for reporting all items of income, gain, and loss that occur in the trust each year on his/her own individual federal income tax return and be personally responsible for payment of income taxes. Because the IDGT is the grantor's alter ego for income tax purposes, he/she and the trustee of the IDGT can engage freely in sales or exchanges of assets without recognizing any gain or loss.

- (ii) Adjustment of income tax basis at death. The income tax basis of most assets that are included in a person's estate upon his/her death is adjusted to fair market value as of the decedent's date of death. A "step-up in basis" for appreciated assets allows for the beneficiary of a particular asset to sell without recognizing any gain that may have accrued over the decedent's holding period. It is important to note that because assets that are held in an IDGT are not includable in the grantor's estate, they will not benefit from a step-up in basis. It may be possible, however, for a grantor to engage in strategic sales/exchanges of assets with his/her IDGT to reduce beneficiaries' potential future income tax exposure.
- (i) Grantor Retained Annuity Trust ("GRAT"). A GRAT is an estate planning vehicle used to remove the growth of an asset that is expected to appreciate significantly over a short period of time from the grantor's estate. Generally, the grantor contributes an asset to the GRAT and retains the right to an annuity for a period of time (the "GRAT term" is generally 2-5 years) and designates beneficiaries to receive any assets remaining at the end of the GRAT term. The value of the gift to beneficiaries for gift tax purposes is calculated at the time of contribution to equal the present value of the remainder at the expiration of the GRAT term after all required annuity payments are made to the grantor. Frequently, the transaction is structured so that no (or very little) federal gift and estate tax exemption is used. Since a grantor need not use exemption to fund a GRAT, there is little risk of "wasting" it in the event the GRAT fails on account of poor performance. It is important to note that, while a GRAT is a grantor trust for income tax purposes for income tax purposes during the GRAT term, it is not an IDGT because the assets continue to be includable in the grantor's estate until the expiration of the GRAT term. However, once the GRAT term expires, the remaining assets may continue in a trust structured as an IDGT; however, it is typically not transfer-tax efficient to allocate any of the grantor's generation-skipping transfer ("GST") tax exemption to such trust.

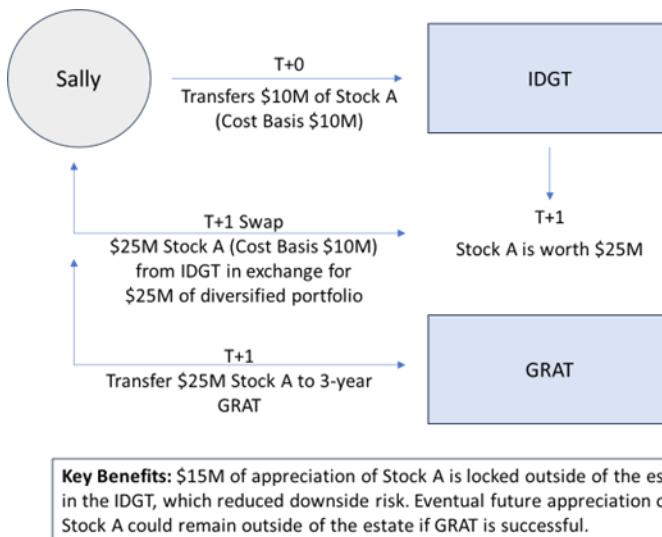
An active estate planning strategy requires close collaboration among the client, his/her tax and estate planning professionals, and investment advisors and involves a continual analysis of asset performance, market conditions, and interest rate trends. This can ensure that the right assets are allocated to the right strategy at the right time, optimizing returns and reducing estate tax exposure. The use of savvy planning can result in an estate tax savings equal to 40% of the value of the gifted assets at the time of death and a wash out of the 20% federal capital gains tax (plus the 3.8% net investment income tax) on any appreciation. This article will describe some of the ways in which an active estate planning strategy can provide value.

#### **Example 1: Swap for Assets With Greater Growth Potential**

Sally contributes marketable securities (shares in Company A) she believes possess significant upside potential to an IDGT, removing their value and future appreciation from her taxable estate. As the shares' upward trend plateaus, Sally and her financial advisor identify another position in her portfolio they expect will appreciate (shares in Company B) more than the Shares of Company A in the future. Sally exchanges her own Company B shares for the IDGT's Company A shares having an equal fair market value. This strategic "swap" can "lock in" the appreciation experienced in the IDGT and provide an opportunity for further growth. Additionally, if Sally dies holding Stock A in her individual name, the shares, if appreciated at the time of her death, will benefit from a step-up in income tax basis to fair market value, allowing her beneficiaries to liquidate the position without realizing any capital gains accrued during her life on the sale.

**Illustration****Example 2: Swap of Assets to Lock in Appreciation Outside of Estate**

Suppose again that Sally contributes Company A shares to her IDGT and the stock rallies as expected. Believing that the shares could retreat from their high, Sally engages in a strategic swap of her own cash for the IDGT's Company A shares, removing downside risk and locking in the appreciation outside her estate until a more attractive investment opportunity can be identified. In addition to the above, if after the swap Sally expects that Company A shares could continue increasing in value and she would like to shelter the potential future upside from estate tax exposure, she could contribute the Company A shares to a GRAT.

**Illustration**

### Example 3: Leveraging the Strategy

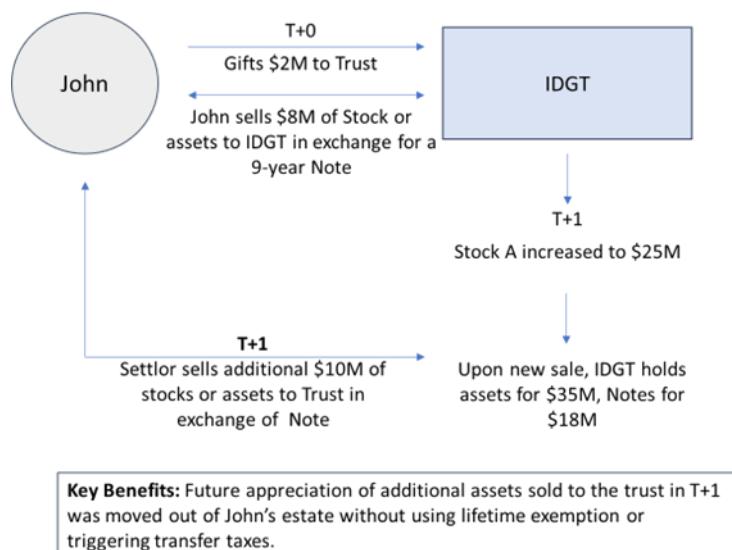
Many estate-freeze techniques are accomplished through a sale of appreciating assets to an IDGT in exchange for a promissory note. This arrangement allows any growth in excess of interest payments due on the note to occur outside the grantor's estate. If the transaction is to be respected by the Internal Revenue Service, the IDGT should hold other assets of sufficient value to establish its creditworthiness. Generally, this can be accomplished with a "seed" gift from the grantor, which would consume a corresponding amount of his/her lifetime federal gift and estate tax exemption. The grantor can also insulate the gift from future transfer taxes by allocating his/her GST exemption to the gift.

An active estate planning strategy can add value if the IDGT's debt/equity ratio, prevailing interest rates, and market conditions are monitored regularly, allowing the grantor to engage in additional sales when the time is right without the need to use additional gift and estate tax or GST exemption.

Assume John will pursue an estate-freeze to remove the potential growth of Company A shares having a current fair market value of \$10 million. He makes an initial gift to an IDGT of \$2 million worth of his \$10 million Company A position, using a corresponding amount of his federal gift and estate tax and GST exemptions. John then sells his remaining \$8 million position in exchange for a 9-year note. 2 years later, the shares have appreciated to \$15 million and the outstanding balance on the note is \$8 million, plus accrued interest. Now the IDGT may have sufficient equity to purchase additional shares from John.

Assume further that interest rates have fallen since John's initial sale to the IDGT. It may be possible for the parties to refinance the debt obligation to take advantage of the lower rates in exchange for an early payment of a portion of the principal due, or other consideration.

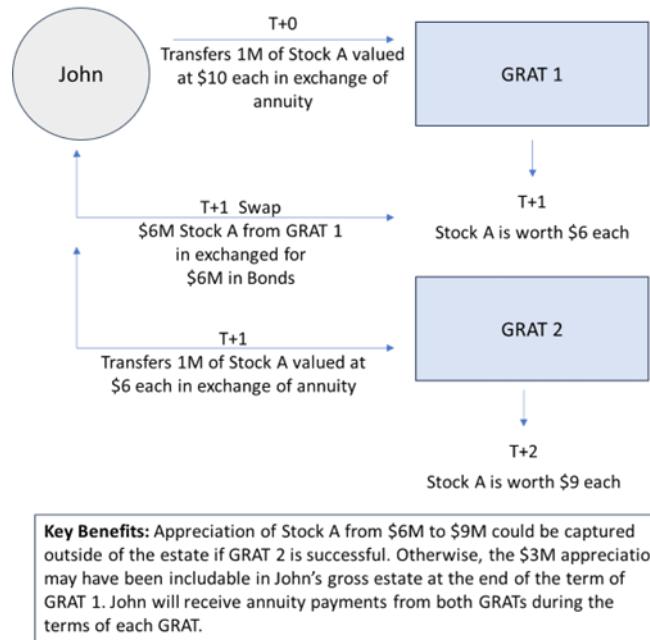
### Illustration



### Example 4: Timely Resetting Failing GRATs

An active estate planning strategy can provide benefits in cases where GRAT assets experience significant volatility during the GRAT term. For example, assume John creates a 5-year GRAT and transfers 1 million shares of Company A having a value of \$10/share. During the GRAT term, the share price dips to \$6/share. If John leaves the Company A shares in the GRAT, any rebound from \$6 to \$10/share would remain within John's taxable estate. There are no adverse tax consequences if the GRAT must return all assets to John (i.e., if the GRAT "fails"). If John remains optimistic that Company A shares will recover their value, he can swap other less volatile assets for the GRAT's Company A shares and fund a new GRAT with the Company A Shares to capture any upside outside his estate.

### Illustration



### Conclusion

There is a common misconception that, once executed, an estate plan need only be revisited when there are significant changes within the family or the law and that, once implemented, strategies can live on their own independent of the investment management strategy and without consideration of the ongoing investment management process. However, as detailed above, families with significant wealth, may be more likely to achieve their particular goals through proactively monitoring the performance of the assets deployed in estate planning strategies as well as other factors that may impact success.

### **Important Disclosure**

Morgan Stanley Smith Barney LLC does not accept appointments, nor will it act as a trustee, but it will provide access to trust services through an appropriate third-party corporate trustee.

This material has been prepared for informational purposes only and is subject to change at any time without further notice. Information contained herein is based on data from multiple sources and Morgan Stanley Smith Barney LLC ("Morgan Stanley") makes no representation as to the accuracy or completeness of data from sources outside of Morgan Stanley Smith Barney LLC. It does not provide individually tailored investment advice. Be aware that the particular legal, accounting and tax restrictions, margin requirements, commissions, and transaction costs applicable to any given client may affect the consequences described, and these analyses will not be appropriate to discuss with every client. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

Many estate techniques share the common risk of the loss of control of the assets once the gift of the assets is complete. The strategies set forth herein are shown for educational purposes only, are not tailored to any specific client, and do not constitute a recommendation to employ any strategy identified. To that end, the examples do not capture all possible outcomes but are based on a limited set of assumptions. If the assumptions upon which they are based are not realized, the efficacy of the strategy may be materially different from that which is reflected in the illustration. Accordingly, clients must consult their tax advisor when considering the utility and appropriateness of any strategies identified herein.

Tax laws are complex and subject to change. This information is based on current federal tax laws in effect at the time this was written. Morgan Stanley Smith Barney LLC, its affiliates, Financial Advisors or Private Wealth Advisors do not provide tax or legal advice. Clients should consult their tax advisor for matters involving taxation and tax planning and their attorney for matters involving trust and estate planning and other legal matters.

The term "Family Office Resources" is being used as a term of art and not to imply that Morgan Stanley and/or its employees are acting as a family office pursuant to Investment Advisers Act of 1940.

---

© 2025 Morgan Stanley Private Wealth Management, a division of Morgan Stanley Smith Barney LLC., Member SIPC.