

# 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 an individual's instructions for the management and disposition of their assets in the event of incapacity and death. For individuals with exposure to the transfer taxes, a successful plan will also minimize the impact of such 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 the likelihood of success and the impact of the plan.

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

A comprehensive estate plan designed with transfer tax minimization in mind may include various legal entities and governing documents. Advanced planning strategies implemented during an individual's lifetime can reduce income and transfer taxes while also enhancing growth outside of the taxable estate. The impact of a particular strategy depends on the characteristics of the assets deployed, performance over time, the type of vehicle created to hold the assets, and the interest rate environment from the time of implementation onward.

Active estate planning typically involves understanding the key concepts and structures below:

- Intentionally Defective Grantor Trust ("IDGT"). Assets in an IDGT are excluded from the grantor's estate for federal estate tax purposes, but continue to be considered the grantor's for federal income tax purposes (i.e., the grantor will continue to be responsible for payment of any income tax liability generated by the trust and will report the trust's income, gain, and loss on the grantor's individual income tax return). Because the IDGT is not recognized for income tax purposes, the grantor and the trustee of the IDGT can engage freely in sales or exchanges of assets without recognizing any gain or loss.
- Adjustment of income tax basis at death. The cost basis of assets included in a person's taxable estate is adjusted to fair market value as of the 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. Since assets that are held in an IDGT are not includable in the grantor's estate, basis remains unchanged as of the grantor's death. It may be possible, however, for a grantor to engage in strategic sales/exchanges of assets with their IDGT to reduce beneficiaries' potential future income tax exposure.
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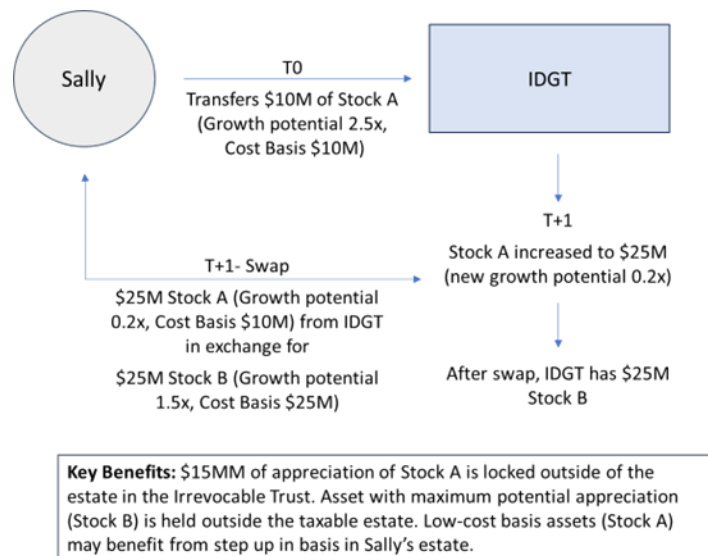
- Grantor Retained Annuity Trust (“GRAT”). A GRAT is an estate planning vehicle used to remove the growth of an asset that is expected to appreciate significantly over a short period of time from the grantor’s estate. Generally, the grantor contributes an asset to the GRAT and retains the right to an annuity for a period of time (the “GRAT term” is typically 2-4 years) and designates beneficiaries to receive any assets remaining at the end of the GRAT term. The value of the gift to beneficiaries is 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. While a GRAT is a grantor trust for income tax purposes during the GRAT term, 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 individual, their 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 the elimination 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.

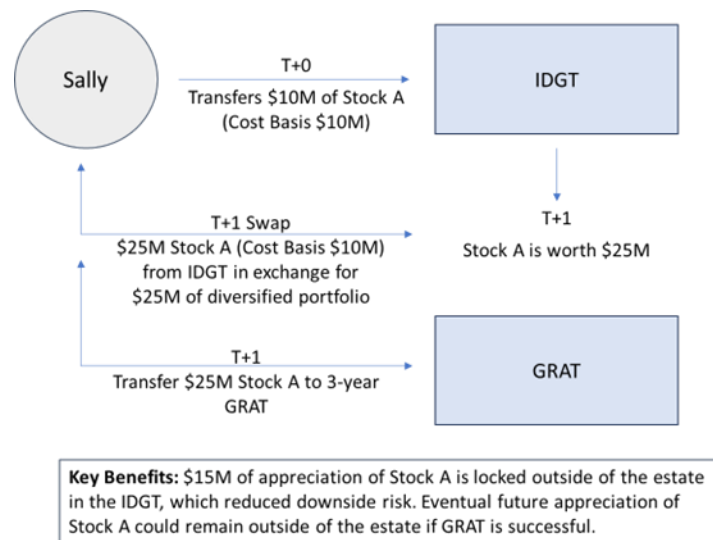
### Illustration



## 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



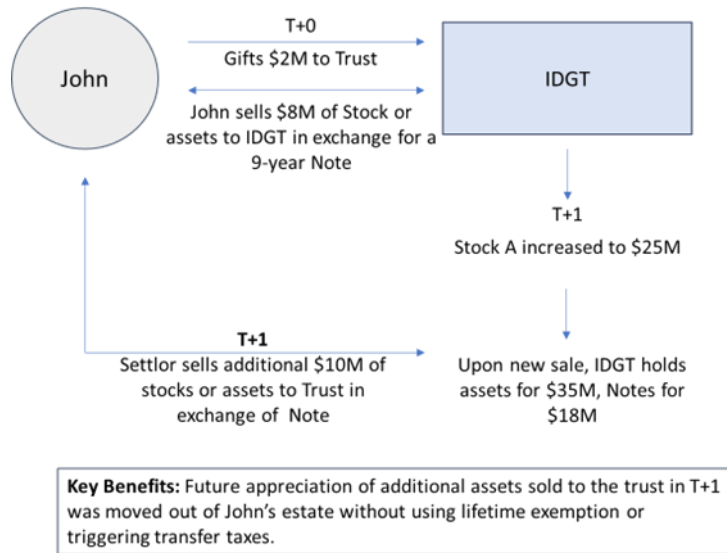
## Example 3: Leveraging the Strategy

Many estate-freeze techniques are accomplished by selling 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 their lifetime federal gift and estate tax exemption. The grantor can also insulate the gift from future transfer taxes by allocating their 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.

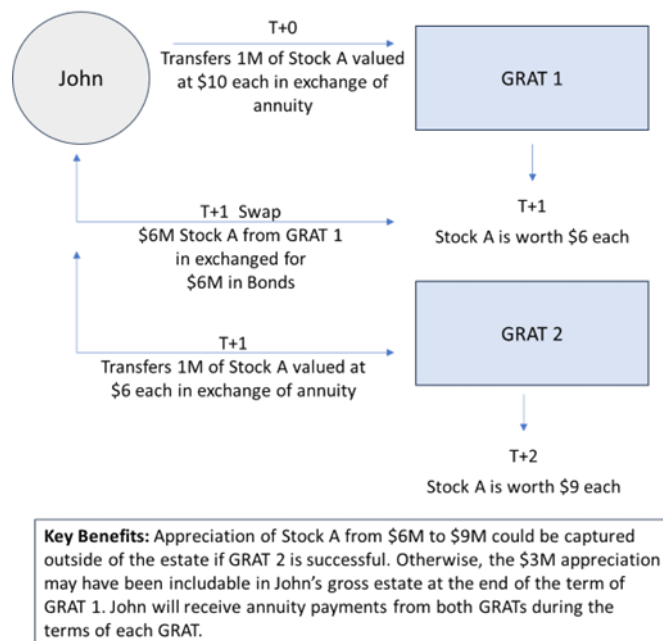
## Illustration



## 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 are independent of the investment management strategy. 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.

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CRC 5305709 03/2026