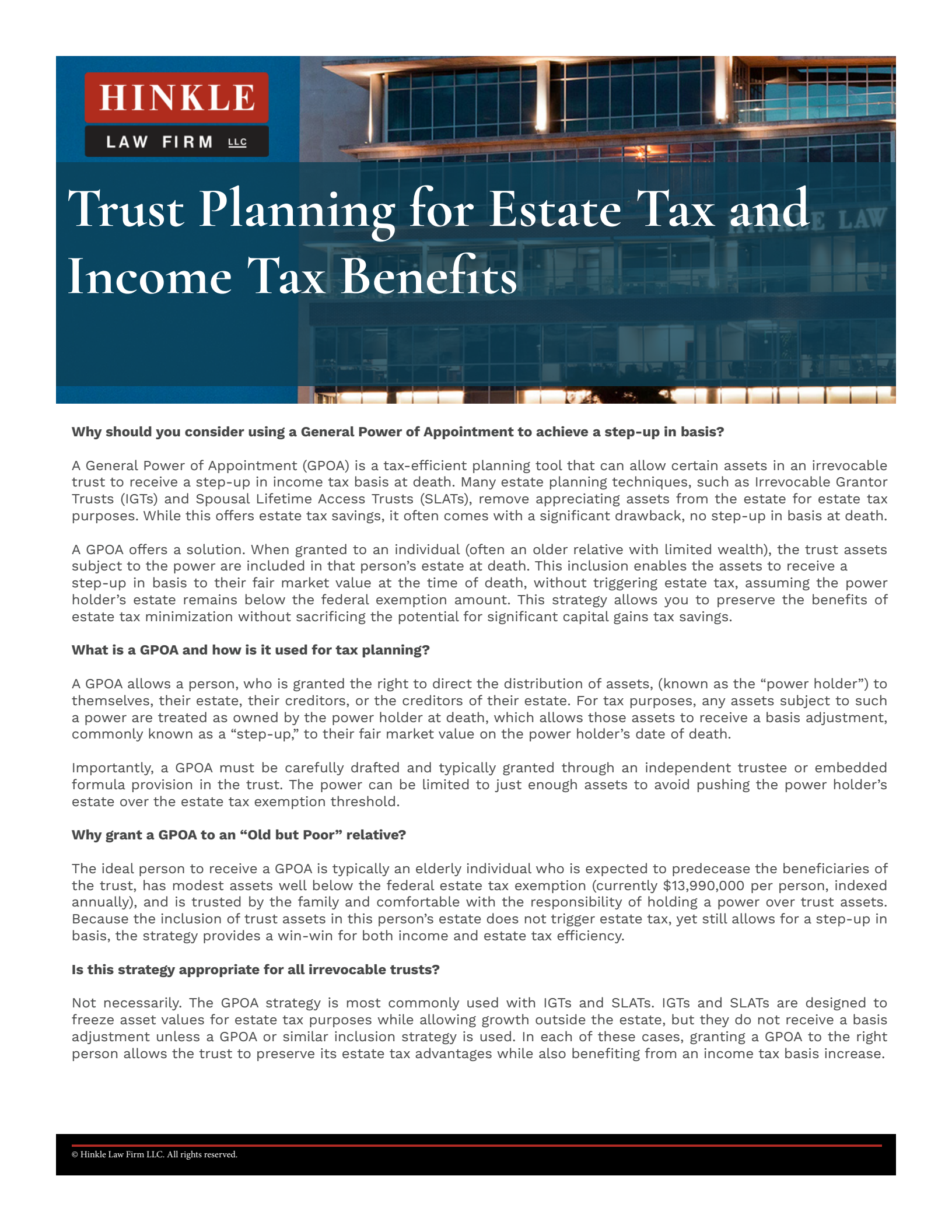


**HINKLE****LAW FIRM LLC**

Trust Planning for Estate Tax and Income Tax Benefits

Why should you consider using a General Power of Appointment to achieve a step-up in basis?

A General Power of Appointment (GPOA) is a tax-efficient planning tool that can allow certain assets in an irrevocable trust to receive a step-up in income tax basis at death. Many estate planning techniques, such as Irrevocable Grantor Trusts (IGTs) and Spousal Lifetime Access Trusts (SLATs), remove appreciating assets from the estate for estate tax purposes. While this offers estate tax savings, it often comes with a significant drawback, no step-up in basis at death.

A GPOA offers a solution. When granted to an individual (often an older relative with limited wealth), the trust assets subject to the power are included in that person's estate at death. This inclusion enables the assets to receive a step-up in basis to their fair market value at the time of death, without triggering estate tax, assuming the power holder's estate remains below the federal exemption amount. This strategy allows you to preserve the benefits of estate tax minimization without sacrificing the potential for significant capital gains tax savings.

What is a GPOA and how is it used for tax planning?

A GPOA allows a person, who is granted the right to direct the distribution of assets, (known as the "power holder") to themselves, their estate, their creditors, or the creditors of their estate. For tax purposes, any assets subject to such a power are treated as owned by the power holder at death, which allows those assets to receive a basis adjustment, commonly known as a "step-up," to their fair market value on the power holder's date of death.

Importantly, a GPOA must be carefully drafted and typically granted through an independent trustee or embedded formula provision in the trust. The power can be limited to just enough assets to avoid pushing the power holder's estate over the estate tax exemption threshold.

Why grant a GPOA to an "Old but Poor" relative?

The ideal person to receive a GPOA is typically an elderly individual who is expected to predecease the beneficiaries of the trust, has modest assets well below the federal estate tax exemption (currently \$13,990,000 per person, indexed annually), and is trusted by the family and comfortable with the responsibility of holding a power over trust assets. Because the inclusion of trust assets in this person's estate does not trigger estate tax, yet still allows for a step-up in basis, the strategy provides a win-win for both income and estate tax efficiency.

Is this strategy appropriate for all irrevocable trusts?

Not necessarily. The GPOA strategy is most commonly used with IGTs and SLATs. IGTs and SLATs are designed to freeze asset values for estate tax purposes while allowing growth outside the estate, but they do not receive a basis adjustment unless a GPOA or similar inclusion strategy is used. In each of these cases, granting a GPOA to the right person allows the trust to preserve its estate tax advantages while also benefiting from an income tax basis increase.

What basic steps are required?

To implement this strategy, certain requirements must be met:

1. The trust must include the GPOA in the original document, or allow an independent trustee to grant a GPOA.
2. The power holder must be carefully chosen for estate tax and family reasons.
3. A formula clause may be used to ensure only the portion of assets that won't trigger estate tax are included in the power holders' estate.
4. Advisors must review creditor and Medicaid risks that may arise from giving the power to certain individuals.
5. Legal counsel should carefully draft or amend the trust to include clear, enforceable GPOA language.

How does this strategy work in practice?

Example:

A grantor establishes an IGT and transfers \$10 million in highly appreciating assets to the trust. The trust is designed to exclude all future growth from estate taxes and protect the assets from risk of loss. The assets have an original cost basis of \$2 million. Because the IGT is structured to keep the assets outside the grantor's taxable estate, they avoid estate tax, but they also do not qualify for a step-up in basis at the grantor's death, potentially creating significant capital gains exposure for the beneficiaries of the trust.

To address this issue, the trust instrument includes a general power of appointment. The trust protector grants this power to the grantor's elderly father, who has an estate valued at less than \$500,000. Assuming the lifetime federal estate tax exemption is \$14 million, when the father passes away, \$10 million in trust assets are included in his "taxable" estate. It is important to note that while the "taxable" estate is just short of \$10 million, the assets in the trust do not transfer to the father's estate. Because the "taxable" estate remains below the federal estate tax exemption amount, no estate tax is owed.

The assets in the trust receive an increase in the income tax basis to \$10 million, wiping out \$8 million of unrealized long-term capital gains. This allows the beneficiaries of the IGT to later sell the assets with little or no capital gains tax, preserving significantly more wealth for the next generation while still achieving the original estate tax planning objectives.

What are the potential risks?

While the strategy can be highly effective, there are several important risks to consider. First, if the senior family member holding the general power of appointment dies within one year of the power being granted, Internal Revenue Code section 1014(e) may disallow the step-up in income tax basis. Additionally, the IRS may argue that the power is a "naked" power, one held by someone who does not have a meaningful beneficial interest in the trust, potentially undermining the effectiveness of the inclusion strategy. To address this concern, we would include the senior family member as a potential discretionary beneficiary under a provision of the trust document, providing them with a beneficial interest.

Another risk arises from state-specific laws. In states that have adopted the Uniform Power of Appointment Act, Section 502 provides that a general power of appointment may be subject to claims by the power holder's creditors. To mitigate this risk, the trust requires a non-adverse party, specifically an independent trustee, to consent to any exercise of the general power of appointment.

Additional concerns include the possibility that the power holder's estate might unexpectedly grow due to inheritance, lottery winnings, or other windfalls, minimizing the income tax savings. The power holder could also become incapacitated, complicating the administration of the GPOA. In each of these cases, careful drafting and ongoing guidance from qualified legal and tax professionals are essential to managing risk and preserving the intended tax benefits.

Conclusion

Irrevocable trusts are excellent tools for removing assets from an estate and reducing estate taxes. However, that benefit often comes at the cost of higher capital gains taxes down the road. By using a General Power of Appointment, you can create a planning opportunity that delivers the best of both worlds: estate tax exclusion for some family members and basis step-up for others. With careful planning, a GPOA can serve as a powerful tool to enhance your family's after-tax inheritance without increasing your estate tax exposure.

For additional information on legal issues related to CIPP, or if you would like to discuss any legal concerns you may have, please reach out Dan Peare or Scott Pohl at Hinkle Law Firm LLC.

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