Gifting Strategies: Leveraging Your Client's Gift Tax Exemption Now and Planning for 2026 (and Beyond)

WEDNESDAY, NOVEMBER 6, 2019, 1:00-2:50 pm Eastern

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November 6, 2019

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KIRKLAND & ELLIS LLP

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II. "Clawback" Regulations
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Tax Reform Overview

Overview of Tax Reform – Tax Laws

- December 17, 2010: President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act (TRUIRJCA) into law, which was supposed to be in effect for two years. This raised the estate tax exemption to $5 million, adjusted for inflation.
- January 2, 2013: President Obama signed the American Taxpayer Relief Act (ATRA) into law, which made certain TRUIRJCA provisions permanent, locking in the $5 million exemption *plus* inflation adjustments.
- December 22, 2017: President Trump signed the Tax Cuts and Jobs Act (TCJA) into law. Effective January 2018, the TCJA essentially doubled the estate and gift tax exemption.
- The federal estate and gift tax exemption is indexed for inflation. The two taxes share the same exemption, and are adjusted periodically to keep pace with the economy.

Overview of Tax Reform – Tax Laws

- Annual gift tax exclusion ($15,000 for single person/$30,000 for married couples) remained in place under the TCJA.
- The step-up in basis rule remained unchanged by the TCJA, meaning a beneficiary's tax basis in inherited property that has appreciated will be "stepped-up" to the fair market value as of the decedent's date of death. A beneficiary is able to wipe out the capital gains tax on any pre-death appreciation in the value of the property under this rule. However, basis can also be stepped down if assets have declined in value.
- TCJA doesn't specifically mention generation-skipping transfer (GST) tax, but the GST tax exemption amount is tied to the basic exclusion amount.

Overview of Tax Reform – History of the Gift Tax Exemption

Year	Gift Tax Exemption	Top Gift Tax Rate
2000	$675,000	55%
2001	$675,000	55%
2002	$1 million	50%
2003	$1 million	49%
2004	$1 million	48%
2005	$1 million	47%

Overview of Tax Reform – History of the Gift Tax Exemption

Year	Gift Tax Exemption	Top Gift Tax Rate
2006	$1 million	46%
2007	$1 million	45%
2008	$1 million	45%
2009	$1 million	45%
2010	$1 million	35%
2011	$5 million	35%

Overview of Tax Reform – History of the Gift Tax Exemption

Year	Gift Tax Exemption	Top Gift Tax Rate
2012	$5.12 million	35%
2013	$5.25 million	40%
2014	$5.34 million	40%
2015	$5.43 million	40%
2016	$5.45 million	40%
2017	$5.49 million	40%

Overview of Tax Reform – Current Gift Tax Exemption

Year	Gift Tax Exemption	Top Gift Tax Rate
2018	$11.18 million	40%
2019	$11.4 million	40%

- The TCJA is set to expire at the end of 2025.
- The exemption will then plummet back to $5 million (plus inflation since 2012) in 2026 unless Congress acts to keep the TCJA's estate and gift tax provisions in place going forward.

Overview of Tax Reform – Current Gift Tax Exemption

- The Treasury Department and the IRS issued proposed regulations which implement changes made by the 2017 Tax Cuts and Jobs Act (TCJA).
- As a result, individuals planning to make large gifts between 2018 and 2025 can do so without concern that they will lose the tax benefit of the higher exclusion level once it decreases after 2025.

“Clawback” Regulations

“Clawback” Regulations - Treasury Reg. § 20.2010-1

- Regulations proposed in 2018 (but not yet finalized) stipulate that individuals who make large gifts in 2018 through 2025 and benefit from the historically generous unified federal estate and gift tax exemptions for those years will not be penalized if the exemptions revert to the pre-TCJA amounts after 2025.
- Under the proposal, a decedent’s federal estate tax exemption would be the greater of:
  1. The TCJA exemption amount that was used to shelter earlier gifts, or
  2. The exemption amount that’s allowed in the post-TCJA year of death.

“Clawback” Regulations - Treasury Reg. § 20.2010-1

- Proposed Reg. §20.2010-1(c)(2) provides the following example:

  Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $10 million in basic exclusion amount allowable on the dates of the gifts. A dies after 2025 and the basic exclusion amount on A’s date of death is $5 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A’s post-1976 gifts (based on the $9 million basic exclusion amount used to determine those credits) exceeds the credit based on the $5 million basic exclusion amount applicable on the decedent’s date of death, under paragraph (c)(1) of this section, the credit to be applied for purposes of computing the estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on the post-1976 gifts made by A.

Benefits and Trade-Offs of Lifetime Gifting

Benefits of Lifetime Gifting – Tax-Free Transfers

- To the extent gifts qualify for the annual exclusion or the tuition and medical exclusions, wealth can be transferred to heirs free of transfer taxes.
- The amount of a gift sheltered by the applicable credit avoids estate tax only if the credit subsequently decreases. A tax-free gift or bequest transfers the same amount to heirs (excluding future income and appreciation).

Benefits of Lifetime Gifting – No Tax on Post-Gift Appreciation

- Any income from and appreciation of the gifted property after the transfer is transferred to the donee free of gift and estate taxes.
- This is potentially the most significant benefit of making gifts.
- Clients should be encouraged to make gifts of their most rapidly appreciating or income-generating assets to take full advantage of this benefit.
- **Example:** Bob owns $100,000 worth of stock. He transfers the stock to his daughter and, as a result of the annual exclusion and the applicable credit amount, pays no gift tax. Bob dies 15 years later when the value of that stock has increased to $1 million. All appreciation subsequent to the date of the gift (from $100,000 to $1 million) has avoided transfer tax. Had Bob retained the stock until his death, all $1 million of value would have been included in his estate. Further, his daughter can enjoy the benefit of the stock now, rather than having to wait until Bob's death.

Trade-offs of Lifetime Gifting – Loss of Property Transferred

- The primary disadvantage of making current gifts is that the donor loses complete access to and use of the property.
- This could prove painful if the donor's financial position were to change, and the donor found that he or she needed the assets to support himself or herself.
- **Best Practice: If client might need it, don’t give it away.**

Trade-offs of Lifetime Gifting – Loss of Basis Step-Up

- Property included in a person’s gross estate and transferred at death receives a step-up or step-down in basis to the fair market value at the date of the decedent's death.
- However, property transferred during life by gift does not receive a step-up in basis (although it does receive a step-down if its fair market value is less than the donor's basis); instead, the basis in the hands of the donee is the same as it was in the hands in the donor, but *increased* by any gift tax paid that is attributable to the asset's pre-gift appreciation.
- As a result, the donee of appreciated property by gift would recognize capital gains upon his or her sale of such property, whereas the recipient of property by testamentary bequest would only recognize capital gains on appreciation that accrues after the decedent's death.

Benefits of Lifetime Gifting – Actual Payment of Gift Tax

- The gift tax is calculated on a tax-exclusive basis (*i.e.*, gift tax is assessed only on the value of the property transferred to the donee and not on the amount of the gift tax paid).
- On the other hand, the estate tax is tax-inclusive (*i.e.*, estate tax is assessed on the value of the entire taxable estate, including that portion ultimately used to pay the estate tax). Thus, estate tax actually includes a "tax on the tax."
- Thus, paying gift tax is "cheaper" than estate tax.

Tax-Exclusive Nature of Gift Tax

- **Example:** Mom has exhausted her federal gift tax exemption by making prior gifts.

  Mom makes a $1,000,000 gift to her child. At a 40% federal gift tax rate, the tax will be $400,000. As the donor, Mom pays the gift tax which results in Mom's child receiving the full $1,000,000 and an additional $400,000 being removed from Mom's estate. Thus, it costs $1,400,000 for Mom to give her child $1,000,000.

  If Mom waits until her death to give the child $1,000,000, it would take a $1,666,667 bequest for Mom to leave her child $1,000,000 (40% of $1,666,667 = $666,667 in taxes, leaving $1,000,000 for child).

  The result: it will cost $266,667 more to give child $1,000,000 at her death than during Mom's lifetime ($666,667 - $400,000 = $266,667).

  The gift tax has an effective 28.5% rate vs 40% estate tax rate.

Trade-offs of Taxable Gifts – Loss of Use of Any Gift Tax Paid

- To the extent that gift tax is paid, the individual is actually prepaying the transfer tax (since it could be deferred until his or her death) and loses the use of the money from the time of the gift tax payment until the time his or her estate would have been required to pay an estate tax.
- Moreover, if the gift or estate tax rates were reduced or the transfer taxes repealed, the benefits obtained by making a gift would have been reduced or lost.

Trade-offs of Taxable Gifts – Three-Year Rule

- Gift taxes paid on gifts made within three years of the donor’s death are included in his or her gross estate.
- If this occurs, the difference in the way the gift and estate taxes are calculated (“exclusive” versus “inclusive”) is negated.
- The gift tax paid plus the estate tax on the gift tax included in the estate will equal what the estate tax would have been if the property had been subjected to estate tax in the first place.
- However, if the property increased in value between the date of the gift and the donor’s death, such increase will escape transfer taxation.

SCIN to Offset Section 2035

- If a donor plans to make a taxable gift for which he will be paying gift tax, the donor may also want to consider simultaneously making a loan to the donee in the amount of the gift tax in the form of a three-year self-canceling installment note (SCIN).
- A SCIN is a form of promissory note that is canceled upon the seller’s/obligee’s death, with no further debt obligation on the part of the purchaser/obligor. Because of this self-canceling feature, the purchaser must pay a “risk premium” in order to avoid a taxable gift by the seller to the purchaser.
- The risk premium may be in the form of either a higher price for the assets or a higher interest rate on the note (which would otherwise be at the AFR). It is determined by using the term/life annuity factor from Table 2000CM in order to take into account the likelihood of the seller's dying before the SCIN term ends.

SCIN Strategy

- If the seller dies within 3 years after the gift (which is the same as the term of the note), the gift tax is included in the estate, but the SCIN (of an equal amount) is canceled, negating the impact of section 2035.
- However, if the seller survives the entire term of the note, the purchaser will have paid a higher interest rate than if a traditional promissory note had been used. This higher “hurdle” rate can significantly reduce the benefits of the sale transaction.

Lifetime Trust for Spouse – Structure

- Client creates an irrevocable trust created for the benefit of their spouse as well as additional family members, most commonly children and/or grandchildren.
- The grantor, or “donor spouse,” uses their gift tax exemption to make a gift to the trust, and the “beneficiary spouse” is named as a current beneficiary.
- While the donor spouse gives up his or her right to the property transferred into the trust, the beneficiary spouse maintains access to that same property.
- The terms of the trust can be structured as appropriate for each family.

Lifetime Trust for Spouse – Benefits

- Reduces/avoids estate tax
- Grantor trust
- Can reduce/avoid capital gains on death tax (via “swap” power)
- Asset protection
- Can be used as a traditional ILIT

Practical Gifting Considerations

- Donor's health or financial circumstances may deteriorate, and she may have a greater need for assets than she expected.
- Beneficiaries may mismanage or sell transferred property.
- Transferred assets may be subject to creditors of beneficiaries if the gift is not in trust.

Gift Tax Exclusions, Deductions, and Credits

Annual Exclusion

- **Gift Tax Annual Exclusion:** In 2019, an individual may make gifts of up to $15,000 each calendar year to an unlimited number of persons free of gift tax. To qualify for the annual gift tax exclusion, the donees need not be related to the donor in any way. If the annual exclusion is not used in any year, it is lost.
- Annual exclusion gifts may be made to siblings, nieces, nephews, parents and spouses of children. Client may create a “pot trust” to receive annual exclusions for several people, but distributions don’t have to be equal.

Annual Exclusion

- Section 2462(c) Trust: Outright annual exclusion gifts to “skip persons” (*e.g*., grandchildren) are not subject to GST tax. However, if annual exclusion gifts are made to a trust of which a skip person is the sole beneficiary, the trust must qualify under Section 2642(c) to avoid GST tax:
  - The skip person must be the sole beneficiary.
  - The trust must be included in the beneficiary's gross estate if the trust is still in existence at his or her death (e.g, via a GPA).
- Annual exclusion gifts to a trust for the benefit of children and grandchildren (non-skip and skip persons) will not trigger GST at the time of the gift, but distributions to the grandchildren will be subject to GST *unless* GST exemption was allocated.

Non-Taxable Gifts

- **Payment of Tuition and Medical Expenses:** IRC § 2503(e) excludes from the gift tax any amount paid on behalf of an individual as tuition at an educational organization (any level), or as payment for medical care of such individual. In each case, the payment must be made *directly* to the service provider (*e.g.*, the school, the doctor, the pharmacy or the hospital) and may not be reimbursements to the donee for his or her expenses. *D*oes *not* include room and board, books and supplies, or any other expenses even though they may be related to the donee's education.

Non-Taxable Gifts

- **Transfers to Political Organizations:** Transfers to political organizations are not subject to gift tax. "Political organizations" is defined in IRC § 527(e) and generally includes organizations organized and operated primarily for the purpose of accepting contributions and/or making expenditures in order to influence the selection, nomination, election, or appointment of an individual to federal, state, or local office. Generally, this includes political parties and political action committees

Gift Tax Deductions

- The marital deduction and the charitable deduction are fundamental estate planning tools.
- **Marital Deduction:** Unlimited transfers may be made between spouses without gift tax. These tax-free transfers can be (1) outright, (2) by the creation of joint tenancies, or (3) by the creation of certain qualifying interests in trusts.
  - The qualified domestic trust (QDOT) must be used if the surviving spouse is not a U.S. citizen.
  - The election for a lifetime QTIP gift is to be made by the due date of a timely filed gift return reporting the gift (including extensions), or if the donor died that same year (after the gift), by the due date of the estate tax return (including extensions).

Gift Tax Deductions

- **Charitable Deduction:** IRC § 2522 provides an unlimited deduction from taxable gifts for outright transfers solely for charitable purposes. A deduction also is available for the value of the charitable interest in certain transfers that have both charitable and non-charitable components ("split interest" transfers). Generally, the charitable interests in these transfers must be in the form of an annuity or unitrust amount.

Gift-Splitting

Gift-Splitting – Generally

- An individual's spouse may elect to be treated, solely for gift tax and GST tax purposes, as the donor of one-half the value of the gifts the individual makes from his or her separate funds.
- Thus, use of gift tax exemptions and exclusions (or gift tax liability) can be split between spouses, even though only one spouse actually transfers assets.
- The election to split gifts is made on the spouses' gift tax returns.

Gift-Splitting – Requirements

- Three basic requirements must be met to elect to split a gift:
  1. The parties electing to split the gift must be *married to each other* at the time the gift is made, and if they later divorce, the gift may not be split if either of them marries another person during the same calendar year;
  2. The parties must both be *U.S. citizens* or *residents;* and
  3. The non-transferring spouse must *consent* to split the gift on the transferring spouse's gift tax return.
- An election to split a gift to a trust for spouse and children is effective only with respect to the interest transferred to the children, and only inasmuch as that interest is ascertainable at the time of the gift (and hence severable from the interest transferred to the spouse). Reg. 25.2513-1(b)(4).

Gift-Splitting –Tax Effects

- For gift tax purposes, the non-donor, consenting spouse of a split gift is treated as having made one-half of the value of that portion of the gift that is capable of being split.
- For GST tax purposes, the non-donor spouse of a split gift is treated as the transferor of one-half of the transferred property.
- For estate tax purposes, the non-donor spouse of a split gift will *not* be treated as the transferor of the property. So, the non-donor spouse could be a beneficiary or trustee of the trust.
- For income tax purposes (e.g., grantor trusts), the non-donor spouse of a split gift will *not* be treated as the transferor of the property; only the spouse *actually* transferring the property is the transferor.

Net and Net-Net Gifts

Net Gifts

- A gift can be made on the condition that the donee pay the resulting gift tax, if any. Such transactions are referred to as “net gifts” (*i.e.*, a gift net of the gift tax).
- This can reducing risk to the donor: If the gift value is increased by the IRS resulting in gift tax, it would be the donee’s liability.
- Further, the gift tax payable by the donee would be less than if it was the donor’s liability. For example, if the gift was increased by $1 million, $400,000 of tax would be payable by the donor. But if it is the donee’s responsibility, the gift tax is assessed only on the “net” amount retained by the donee.
  - Gift tax on a net gift = (tentative tax) / (1 + rate of tax)
  - In this case: $400,000 / 1+.40 = $285,714 -- $114,285 less than the donor would pay.
  - In other words: The donee received an extra $1 million, pays $285,714 of tax, netting him $714,285 (the “net gift”). 40% tax on $714,285 = the $285,714 gift tax paid.

Net, Net Gifts

- The net, net gift is a variation on a net gift.
- The net, net gift goes one step further by requiring the donee to pay not only the gift tax associated with the gift, but also any additional estate tax caused by IRC § 2035(b). See McCord v Comm'r, 461 F.3d 614 (5th Cir. 2006).
- Section 2035(b) includes in a decedent's estate all gift taxes paid on gifts made within three years of death. Because the donee is taking on an additional liability (albeit a contingent one), the assumed liability further reduces the amount of the taxable gift.
  - However, the probability of the donor dying within 3 years may be low, so the reduction of the gift may be minimal and not worth the potential liability to the donee.

Structuring GRATs to Maximize Benefits

GRAT Basics

- A “grantor retained annuity trust” (GRAT) is a trust in which the grantor retains the right to receive fixed annuity payments, payable at least annually, for a term of years (an annuity interest).
- At the end of the term, any remaining trust principal is distributed to the remainder beneficiaries (such as the grantor’s descendants or a trust for their benefit).
- If the grantor survives the term, the remaining trust property is excluded from his or her estate for federal estate tax purposes. If the grantor fails to survive the term, most or all of the trust property will be included in his or her gross estate under IRC § 2036.
  - The amount included is the annuity / 7520 rate at death.
  - If a GRAT was funded with $1 million and has $110,000 annual payments for 10 years, the amount included in the estate if the grantor dies would be $2.75 million if the 7520 rate is 4%. Unless there was extraordinary growth, the entire trust is included.

Maximizing Benefits of a GRAT – Source of Benefits

- The Section 7520 rate is assumed rate of return on the GRAT's assets (i.e., the discount rate) for purposes of valuing the annuity interest.
- A GRAT will transfer property free of gift tax to the remaindermen if and only if the property in the GRAT produces income and appreciation at a rate greater than the Section 7520 rate.

Structuring GRAT – Term and Annuity Amount

- Short-Term and Long-Term
- Separate GRATs for separate assets
- Zeroed-Out GRATs
- Re-GRATs (Rolling GRATS)
  - Flat
  - Increasing
  - Decreasing

Maximizing Benefits of a GRAT – Zeroed-Out GRATs

- An economically zeroed-out GRAT (or “zeroed-out” GRAT) is a fixed-term (not the shorter of a term or the grantor’s life) GRAT in which the annuity is set so that the present value of the annuity payments (using the Section 7520 rate as the discount rate), is exactly equal to the value of the assets transferred to the GRAT, and thus the remainder (and gift) is zero.
  - The zeroed out annuity is derived by dividing the amount transferred to the GRAT by the annuity term factor in Table B of the *Actuarial Tables, Book Aleph*, Publication 1457.
- If the GRAT’s rate of return equals the Section 7520 rate, then, by definition, the last annuity payment to the grantor will consume the last assets remaining in the GRAT, leaving nothing for the remaindermen. If the property in the GRAT appreciates at a rate greater than the Section 7520 rate, some property will be left to pass to the remaindermen at the end of the GRAT term.

Re-GRATS (or Rolling GRATs)

- The Re-GRAT technique is simply a series of short-term (2-year) GRATs. Each successive GRAT is funded with the annuity payments received from the existing GRATs. The annuity payments are continuously redirected to new GRATs, and potentially out of the grantor's taxable estate, significantly increasing the benefit of the GRAT technique.
- Benefits:
  1. Reduced mortality risk: less likely to die during any 2-year GRAT
  2. Less investment risk: can start fresh every 2 years
- Interest rate risk

Separate GRATS

- If several stocks are transferred to a GRAT, it will be successful only if the weighted-average return of the portfolio is greater than the 7520 rate. A GRAT holding a "star" investment that produces double-digit returns could nonetheless be unsuccessful because lesser performing assets reduce the overall portfolio return.
- When multiple GRATs are used (e.g., one per stock), a benefit can be achieved even if the weighted-average return of all the GRATs' investments is less than the 7520 rate. If the return on the asset in any GRAT is greater than the Section 7520 rate, that GRAT will be successful. The remaindermen will benefit from the GRATs holding winning investments, without reduction from those that do not.

Separate GRATS: Example

- Assume a two-year GRAT is funded with $10 million comprising 10 different stocks of equal values ($1 million each), and stock #1 produces a return of 1%, stock #2 produces a return of 2%, and so on.
  - The weighted-average return of the portfolio would be 5.5%. If the 7520 rate is 5.4%, only $15,533 will pass to the remaindermen.
- If those same stocks, however, are transferred into 10 separate 2-year GRATs, the GRATs will transfer a total of over $208,034 to the remaindermen—more than 13 times the amount from a single GRAT holding multiple stocks.
  - The five GRATs earning a return greater than 5.4% produced a net benefit, undiminished by the GRATs with lower returns. The difference is even more pronounced when some of the investments are "home runs."

Gifting Upstream

Gifting "Upstream" to Parents

- With the heightened exemption amounts, upstream gifting is a consideration for wealthy clients with a parent who is not expected to make use of that parent's entire heightened exemption amount.
- **Example:** Daughter transfers low-basis assets to Father or to a trust for Father's benefit that is subject to estate tax. At Father's death, Father's estate will not actually owe any Federal estate tax as long as he has enough exemption remaining. However, because the gifted assets are includible in Father's estate, the income tax basis should be stepped up to the fair market value as of the date of his death.

Gifting "Upstream" to Parents

- Why would Daughter use her exemption amount to gift assets upstream to Father, rather than downstream to her children?
  - The family expects to receive a step-up in tax basis at Father's death, which is likely to occur sooner than Daughter's death.
  - If the assets are highly appreciated, the tax benefit of the upstream gift can be dramatic, particularly if the family had wanted to sell the assets but felt constrained by the built-in capital gain.
- One could make annual exclusion gifts to parents, and not use up any exemption.

Gifting "Upstream" to Parents

- **Caution:** Gifted assets will not receive basis step-up if Father dies within one year of the gift and the assets revert back to Daughter at that time. However, many practitioners believe that step-up will be allowed if the assets pass to a trust for Daughter, rather than outright, or if the assets pass to a third party, such as Daughter's children

Gifts to Lifetime QTIP Trusts

Marital Deduction

- The marital deduction enables an individual to make transfers to his or her spouse without incurring any transfer tax.
- From a tax standpoint, the value of the marital deduction should be viewed in the context of estate tax deferral and basis step-up.
- If an individual dies and makes maximum use of the marital deduction, he or she can eliminate all federal estate tax at the time of his or her death, with the property eventually being subject to estate tax at the surviving spouse's death.

Qualifying for Marital Deduction

- The general requirements that must be met in order to qualify for the marital deduction are (1) the decedent must leave a surviving spouse and (2) the property must pass to or in trust for the benefit of the surviving spouse.
- Terminable Interest Rule: Certain “terminable interests” passing to a spouse, otherwise meeting the general requirements of the marital deduction, will not qualify for the deduction unless structured in ways provided in IRC § 2056(b) and 2523(f).
  - GPA marital trusts
  - QTIP marital trusts

QTIP Marital Trusts - Generally

- An exception to the Terminable Interest Rule is the Qualified Terminable Interest Property (QTIP) Marital Trust. IRC § 2056(b)(7) and 2523(f)
- At the surviving spouse's death, the property in trust passes as the *donor spouse* has directed in the QTIP trust.
- A QTIP trust is the best way for an individual to take advantage of the marital deduction while retaining control of the ultimate disposition of the property.
- A QTIP trust can be created during one's life for his or her spouse.

Lifetime QTIP Marital Trust - Requirements

1. The trust must be irrevocable.
2. Must be created for the benefit of a spouse who is a U.S. citizen – there is no such thing as a "Lifetime QDOT."
3. The spouse must be entitled to receive all of the net income from the trust at least annually.
4. The spouse must have the right to demand that non-income producing property be converted into income-producing property.
5. No person can appoint property to anyone other than the spouse.
6. A federal gift tax return (Form 709) must be timely filed. The QTIP election is not made for a trust, but is made for property passing or transferred to the trust.

Benefits of Lifetime QTIP Marital Trusts

- Creditor protection
- Control
- Puts assets in the other spouse's estate to use his or her estate tax and GST exemptions at death
  - The GST exemption is not portable if not used.
- The QTIP trust can pour into a credit shelter trust (CST) for the donor spouse (if the donor survives). This trust can be a grantor trust to the donor, allowing the trust to grow outside the donor's estate free of income tax.
  - The donor spouse is not treated as the transferor to the CST for estate tax or GST purposes because the assets were part of the donee-spouse's estate.

Planning with Grantor Trusts

Grantor Trusts and Non-Grantor Trusts

- Under the federal income tax system, the manner in which the income from property held in trust is taxed depends on whether the trust is a “grantor trust” or a “non-grantor trust.”

Benefits of Grantor Trust Status

- Tax-Free Rate of Return. In Revenue Ruling 2004-64, the IRS confirmed that the grantor's payment of the income tax isn't a taxable gift because it is the grantor's liability.
  - Tax-free compounding by the trust and payment of taxes on a growing corpus will greatly increase the trust size while reducing the taxable estate.
- Transactions between the grantor and the trust are disregarded for income tax purposes. Revenue Ruling 85-13.

Growth of Non-Grantor Trust Status

Assuming 10% growth rate and 20% tax on annual growth

Year		Start of Year		Growth		Tax Paid		End of Year
1	$	1,000,000	$	100,000	$	(20,000)	$	1,080,000
2	$	1,080,000	$	108,000	$	(21,600)	$	1,166,400
3	$	1,166,400	$	116,640	$	(23,328)	$	1,259,712
4	$	1,259,712	$	125,971	$	(25,194)	$	1,360,489
5	$	1,360,489	$	136,049	$	(27,210)	$	1,469,328
6	$	1,469,328	$	146,933	$	(29,387)	$	1,586,874
7	$	1,586,874	$	158,687	$	(31,737)	$	1,713,824
8	$	1,713,824	$	171,382	$	(34,276)	$	1,850,930
9	$	1,850,930	$	185,093	$	(37,019)	$	1,999,005
10	$	1,999,005	$	199,900	$	(39,980)	$	2,158,925
11	$	2,158,925	$	215,892	$	(43,178)	$	2,331,639
12	$	2,331,639	$	233,164	$	(46,633)	$	2,518,170
13	$	2,518,170	$	251,817	$	(50,363)	$	2,719,624
14	$	2,719,624	$	271,962	$	(54,392)	$	2,937,194
15	$	2,937,194	$	293,719	$	(58,744)	$	3,172,169
16	$	3,172,169	$	317,217	$	(63,443)	$	3,425,943
17	$	3,425,943	$	342,594	$	(68,519)	$	3,700,018
18	$	3,700,018	$	370,002	$	(74,000)	$	3,996,019
19	$	3,996,019	$	399,602	$	(79,920)	$	4,315,701
20	$	4,315,701	$	431,570	$	(86,314)	$	4,660,957
					$	(915,239)		

Growth of Grantor Trust

Assuming 10% growth rate and 20% tax on annual growth

Year	Start of Year	Growth	Tax Paid	End of Year
1	$ 1,000,000	$ 100,000	$ -	$ 1,100,000
2	$ 1,100,000	$ 110,000	$ -	$ 1,210,000
3	$ 1,210,000	$ 121,000	$ -	$ 1,331,000
4	$ 1,331,000	$ 133,100	$ -	$ 1,464,100
5	$ 1,464,100	$ 146,410	$ -	$ 1,610,510
6	$ 1,610,510	$ 161,051	$ -	$ 1,771,561
7	$ 1,771,561	$ 177,156	$ -	$ 1,948,717
8	$ 1,948,717	$ 194,872	$ -	$ 2,143,589
9	$ 2,143,589	$ 214,359	$ -	$ 2,357,948
10	$ 2,357,948	$ 235,795	$ -	$ 2,593,742
11	$ 2,593,742	$ 259,374	$ -	$ 2,853,117
12	$ 2,853,117	$ 285,312	$ -	$ 3,138,428
13	$ 3,138,428	$ 313,843	$ -	$ 3,452,271
14	$ 3,452,271	$ 345,227	$ -	$ 3,797,498
15	$ 3,797,498	$ 379,750	$ -	$ 4,177,248
16	$ 4,177,248	$ 417,725	$ -	$ 4,594,973
17	$ 4,594,973	$ 459,497	$ -	$ 5,054,470
18	$ 5,054,470	$ 505,447	$ -	$ 5,559.917
19	$ 5,559,917	$ 555,992	$ -	$ 6,115,909
20	$ 6,115,909	$ 611,591	$ -	$ 6,727,500

Non-Grantor Trust vs. Grantor Trust

ROR	With Non-Grantor Trust	With Grantor Trust
10%	$4.66m	$6.72m
15%	$17m	$33m

Most Often Used Powers to Create Grantor Trusts

- Beneficial enjoyment controlled by nonadverse party and majority of trustees related or subordinate (or with the power to add beneficiaries). IRC § 674.
- Power to make loans to the grantor without adequate security. IRC § 675(2).
- Power of substitution (or “swap” power). IRC § 675(4).
- Power to use income to pay premiums on insurance on the life of the grantor or the grantor’s spouse. IRC § 677(a)(3).
- Beneficial interest held by the grantor’s spouse.

Grantor Trusts – "Swap" Power

- The most common way for a grantor to achieve grantor trust status is to retain the power to substitute assets in a non-fiduciary capacity (a swap power). Can be held by persons besides the grantor.
- Achieves grantor trust status without affecting beneficiaries' economic interests.
- Permits the grantor to reacquire appreciated assets from the trust, including them in the grantor's estate, where, on the grantor's death, they'll receive a basis step-up, eliminating any capital gains tax heirs may later incur on the appreciation during the grantor's lifetime.
- Similarly, the grantor may wish to swap assets that have declined in value *into* the trust, so as to preserve the loss on the grantor's death.
- Rev. Rul. 2008-22: Will not cause inclusion under 2036 or 2038.

Sales to Grantor Trusts

- The “sale to grantor trust” is a strategy in which a grantor trust essentially borrows funds from the grantor which it invests in a manner that (hopefully) produces a rate of return that is greater than the interest rate on the note evidencing the debt.
- The grantor lend money or sells assets (*e.g.*, stock, partnership interests) to the grantor trust in exchange for a promissory note issued by the trust. So long as the promissory note bears interest at the appropriate applicable federal rate (“AFR”), the value of the note for gift tax purposes will be its face amount, and no gift will occur upon the sale to the trust for a note.

Sales to Grantor Trusts

- The IRS held in Revenue Ruling 85-13, as well as several private letter rulings, that because the property of a grantor trust is treated as owned by the grantor for income tax purposes, transactions between a grantor trust and its grantor have no income tax consequences (disregarded).
  - Thus, no gain is recognized upon the grantor's sale of assets to or from the grantor trust.
  - Further, because the sale is made to a grantor trust as to the grantor, the loan evidenced by the note is treated as being between the grantor and himself for income tax purposes. As a result, the grantor does not recognize interest income on account of the note.
- The trust can satisfy its obligation on the note with appreciated property without income tax consequences.

Sales to Grantor Trusts – Benefits & Risks

Benefits	Risks
No gain recognition	Debt-to-equity ratio
Tax-free transfers	Annual cash flow requirements
Cash flow	Death before note discharged
Non-appreciating asset	Investment performance risk

Questions & Answers

Biographies

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