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Lifetime Gifting in Estate Planning: Leveraging QTIP Trusts, QPRTs, SLATs

WEDNESDAY, MARCH 11, 2015

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Lifetime Gifting in Estate Planning: Leveraging QTIP Trusts, QPRTs, SLATs

I. Gift planning goals in a high exemption environment

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The Current State of Estate and Gift Tax Exemptions in 2015

- The Federal Estate Tax Exemption for 2015 has risen to 5.43 million or 10.86 million for a married couple, assuming they have made no prior lifetime gifts.
- Exemption maybe used at death or during life through gifting.
- Any amounts gifted in excess of the lifetime exemptions will be taxed at 40%.

Annual Gift Tax Exemption in 2015

- In addition to the lifetime gift tax exemption, there is annual gift tax exclusion amount.
- For 2015 it will be $14,000, the same as 2014. Up from $13,000 in the year 2013.
  - The $14,000 may be given to anyone and a married couple can each give $14,000 to each person.

Other Gifts

- In addition to the annual exclusion and the lifetime exemption, an individual can make unlimited gifts for medical, dental and tuition expenses for as many relatives and friends as they like.
- The one caveat that most clients ignore is that these amounts must be paid directly to the provider.

529 Plans

- Consider using annual exclusions to fund 529 plans.
- A “Super Fun” 529 Plan by making five years’ worth of gifts in one year. Beware of limitations.
- If a donor dies during the five year period, the unamortized gifts will be pulled back into the donor’s estate, but any appreciation will not.
- If maximum annual exclusions are made, the donor may not make other gifts to the same donee during the five year period.
- 529 Plan rules vary by state. States have limitations on the total size of plan, so you must be aware of not only the federal rules, but also the state rules pertaining to 529 Plans.

Annual Exclusion Gifting to Trust

- Annual exclusions may be gifted to Trust with Crummy powers.
- May provide more control than gifting to custodial accounts.

Large Gifts to Trusts

- Since only less than .15% of individuals will be subject to estate tax, these individuals will have substantial wealth and should consider large gifts potentially utilizing there entire lifetime exemption to a gifting trust.
- Preferably gifts to a Dynasty Gifting Trust where the donor can allocate his or her GST exemption to the gift, thereby making the trust estate tax exempt for generations.

Taxable Gifts

- Very wealthy clients may wish to make taxable gifts and pay the 40% gift tax.
- Especially gifts of rapidly appreciating assets.
- Even though estate tax and gift tax are both 40%, the way the tax is calculated is different. Estate tax is a “gross tax,” while gift tax is a “net tax.”
- If a donor dies within three years, the gift tax paid will be pulled back into the donor’s estate and the tax will be as if the donor transferred the asset at death. However, the appreciation will not be included.

Beware of Kiddie Tax

- When making gifts to minors, especially in custodial accounts, be aware of the “Kiddie Tax” issues.

Beware of Gift Tax Requirements

- Gift Splitting. When one spouse makes a gift in excess of $14,000, a gift tax return must be filed in order to split the gift between the two spouses and utilize both annual exclusions.
- Gifts in excess of annual exclusion must be filed on a properly filed gift tax return.
- If gifts to a Trust are intended to be GST exempt, do not rely on automatic allocation of GST exemption. Specifically allocate GST exemption to the Trust.
- Be aware of special rules regarding gift tax return filing requirements for 529 Plans.

State Estate Tax

- Even though a very small percentage of individuals may be subject to Federal Estate Tax, individuals with smaller estates still may consider gifting if they live in one of the 19 states or the District of Columbia that currently have some form of estate tax.

Estate Tax

- Remember that gifts are not removed from the basis for calculating estate tax, and that an estate tax preparer must be careful to make sure that they investigate all potential lifetime gifts in order to avoid issues on audit and unexpected additional tax.

Increases in Lifetime Gift Tax Exclusion

- Even though a client has fully used the lifetime exclusion in a prior year, the client still will receive the benefit of any increase in the lifetime exclusion and can make additional gifts of this amount.

Benefits of Lifetime Giving

- Net Tax v. Gross Tax.
- Removal of appreciation and income from assets gifted.
- Gifts can be discounted.
- Gifts to Trust can be "supercharged" by making the trust defective, thereby having the donor pay the income tax, effectively making a gift of the income tax paid, while not affecting any exemption, exclusions or ultimate estate tax.
- The donor can witness a beneficiary enjoying the gift.

Disadvantages of Lifetime Gifting

- In the new gift and income tax environment, the biggest disadvantage to lifetime gifting maybe the loss of the step-up in basis at death.
- This is more of a concern in the current environment where estate tax rates have decreased and income tax rates have increased.
- A careful analysis of the assets proposed to be transferred and potential appreciation must be done.
- Substantial appreciation must occur in order to offset the loss of the step-up in basis. The donor's age and health maybe be a factor in this analysis.

Depreciation of Gifted Assets

- Another major disadvantage of lifetime gifting is the fact that the gifted assets could depreciate significantly, thereby wasting lifetime exclusion and/or GST Exemption on assets that decrease in value.

Finally

- One of the major disadvantages of lifetime gifting that we as tax planners often fail to consider, is a change in the donor's circumstances.
- In the last decade or so with the ups and down of the stock market and the real estate market, there have been clients with substantial wealth, whose circumstances have changed drastically, and looking back, the lifetime gifts would not have been made.

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Lifetime Gifting in Estate Planning: Leveraging QTIP Trusts, QPRTs, SLATs

II. Gift planning trusts

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Inter Vivos QTIP

- Technique to use poorer spouse's estate tax exemption but allow the wealthier spouse to retain control of the remainder interest

- Wealthier spouse transfers assets to an inter vivos QTIP fbo the poorer spouse

- Also allows grantor to use the poorer spouse's unused GST exemption
  - If skip persons are remaindermen of the QTIP trust, distributions passing to remaindermen at poorer spouse's death will be deemed to have been made by the poorer spouse so the poorer spouse's GST exemption can be used

Inter Vivos QTIP – Statutory Requirements

- Spouse is a U.S. citizen
- Spouse has a qualifying income interest for life in the trust principal payable annually
- Spouse not required to have any rights over principal
  - Grantor can give trustees discretion to distribute principal to spouse
  - Typically, spouse is given a special testamentary power of appointment
- Funds transferred to trust qualify for the gift tax marital deduction under Section 2523(a)
- Trust is included in the spouse's gross estate under Section 2044
- Election must be made to qualify trust as a QTIP trust by filing a gift tax return in the year the transfer to the trust is made
- Election, once made, is irrevocable

Inter Vivos QTIP – Tax Ramifications

- Grantor may reserve for himself/herself a lifetime interest in the trust in the event the poorer spouse predeceases the grantor, as long as the lifetime interest does not grant the grantor the power to alter, amend, revoke or terminate the trust. Reg. 25.2523(f)-1(d).
  - Grantor could retain secondary life estate, right to invade principal subject to an ascertainable standard and a special power of appointment
  - Risk: may be treated as self-settled trust reachable by creditors, meaning assets are includible in Grantor's gross estate as a constructive general power of appointment

- Filing deadline for making the QTIP election is fixed by statute
  - Limits IRS' discretion to grant extension of time to make election

- Under Section 672(e)(1)(A), inter vivos QTIP trust is a grantor trust
  - Grantor is treated as holding any power or interest granted to his/her spouse

- In the event of divorce, Section 682(a) provides that the income of the trust is thereafter includible in the beneficiary spouse's income

- The grantor may serve as trustee. Section 2523(f)(5) should not cause inclusion in the grantor's gross estate
  - May be included if the trust allows the grantor to make discretionary distributions of principal to the spouse.

Inter Vivos QTIP – Tax Ramifications

- Provides for planning opportunities if funded with assets which may be discounted for lack of marketability or lack of control.

- At death of poorer spouse, assets held individually are valued separately from assets held in QTIP trust for his/her benefit. Estate of Mellinger v. Commissioner, 112 T.C. 26 (1999)
  - For example, if poorer spouse's gross estate contains real property, part of which is held in the QTIP trust and part of which is held individually, both portions are deemed to be held independently and are thus eligible for separate valuation discounts.

Inter Vivos QTIP – Divorce

- Individual may create a new QTIP trust for each spouse that he/she marries

- Inter vivos QTIP is not terminated by divorce
  - Former spouse will retain his/her income interest for the remainder of his/her life, even if he/she remarries
  - Trust may be drafted so that a trustee's discretionary right to invade principal for the benefit of the spouse is contingent upon being married to the grantor

Ways to Give the Home Away – QPRT

- Defined – personal residence is transferred to an irrevocable trust, donor retains right to use the residence for a term of years after which the ownership passes to selected remainder beneficiaries (kids or a trust for the benefit of the kids)

- The older the grantor, the longer the term and the higher the 7520 rate, the smaller the gift.

- Reg. 25.2702-5(c) requires the governing instrument of a QPRT to contain several provisions.

- Rev. Proc. 2003-42, 2003-23 I.R.B. 993 contains a sample QPRT

Ways to Give the Home Away – QPRT

- Assets that may be held in a QPRT:
  - Residence:
    - QPRT may hold only one residence to be used as a personal residence by the term holder. It must be either (1) the principal residence of the term holder, (2) "one other residence" of the term holder (which meets the requirements of 280A(d)(1) without regard to 280A(d)(2) – meaning that it be used by the term holder for personal purposes for the number of days which exceeds the greater of (a) at least 14 days per year or (b) 10% of the number of days during the year it is rented out), or (3) an undivided interest in either.
      - QPRTs holding fractional interests in the same residence are treated as one QPRT
    - The residence may include adjacent land not in excess of that reasonably appropriate for residential purposes.
    - Residence subject to a mortgage are a problem because principal payments on the loan constitute additional gifts to the QPRT.
      - If the grantors must retain a mortgage, convert to an interest only loan.

Ways to Give the Home Away – QPRT

- Assets that may be held in a QPRT:
  - Cash
    - Amount used to pay expenses, mortgage payments or improvements already incurred or reasonably expected to be incurred within the following 6 months or to be used to purchase a personal residence within the follow 3 months (provided the trustee has already entered into a contract to purchase the residence).
      - Trustee must distribute any cash held which is in excess of the permitted amounts at least quarterly to the term holder.
      - Within 30 days of the termination of the term interest, the trustee must distribute to the term holder any cash held for the payment of expenses that is not used to pay trust expenses due and payable on the date of termination.
    - Trustee may retain any sales proceeds from the residence for up to two years from the date of sale for the purchase of another personal residence of the term holder.
    - Trustee may hold (1) one or more insurance policies on the residence and (2) retain any casualty insurance proceeds and proceeds from an involuntary conversion of the residence received by the trustee in a separate account for up to two years for the repair, improvement or replacement of the residence.

Ways to Give the Home Away – QPRT

- Operation of the QPRT
  - The grantor pays all of the expenses during the term of the QPRT that are normally allocated to a life tenant i.e. ordinary repairs, maintenance fees, real estate taxes, insurance. The remainder beneficiary of the QPRT bears the costs of improvements and major repairs.
  - A QPRT is a grantor trust for income tax purposes
    - No EIN is required
    - The grantor continues to take income tax deductions for property taxes
    - The grantor continues to be eligible for the exclusion of gain on the sale of the principal residence
  - Improvements during the term of the QPRT constitute additional gifts

Ways to Give the Home Away – QPRT

- Termination of the QPRT
  - At the end of the term, the home passes to the name beneficiaries or a trust for their benefit.
  - The grantor may then lease back the home or even buy back the home
    - Lease must be fair market rent

Ways to Give the Home Away – QPRT

- Tax issues
  - The value of the gift is determined by using the applicable Federal rate (7520 rate) and the IRS valuation tables
  - The value of the gift to the remainder beneficiaries (children) is the value of the property less the parent’s retained use of the property and the value of the possible reversion of the property to the parent if he dies during the QPRT term.
  - The higher the interest rate, the smaller the gift
  - The longer the term, the smaller the gift
  - All appreciation of the property avoids gift or estate taxation
  - The remaindermen (children) take a carryover basis in the property.
  - A gift tax return must be filed on the creation of the QPRT disclosing the gift
    - An appraisal of the property is required
      - If a fractional interest discount is taken, written document of the discount is required

Ways to Give the Home Away – QPRT

- Tax issues
  - A QPRT is a grantor trust for income tax purposes
    - No EIN is required
    - The grantor continues to take income tax deductions for property taxes
    - The grantor continues to be eligible for the exclusion of gain on the sale of the principal residence
  - Improvements during the term of the QPRT constitute additional gifts
  - Gifts to the QPRT do not qualify for the gift tax annual exclusion
  - Transferring a personal residence subject to a mortgage, although permissible, creates additional gifts when payments are made on the principal of the mortgage
  - The generation skipping transfer tax exemption cannot be allocated to the QPRT until the term ends due to the estate tax inclusion period (ETIP).

Ways to Give the Home Away – QPRT

- Prohibited sales and transfers:
  - QPRT instrument must prohibit selling or transferring the residence to the grantor, the grantor’s spouse, a trust treated as owned in whole or in part by the grantor or the grantor’s spouse under the grantor trust rules or an entity “controlled” (as defined in Reg. 25.2701-2(b)(5)(ii) and (iii)) by the grantor or the grantor’s spouse.
    - Reason: to prevent the grantor from repurchasing the residence in a non-taxable transaction that avoids capital gain tax (e.g. purchasing it from a grantor trust) and holding it until death to get a step-up in basis
    - If the residence is transferred to another grantor trust upon or after the expiration of the retained term, such other trust must contain the same prohibitions on transfers.

Ways to Give the Home Away – QPRT

- Ceasing to be a QPRT:
  - Ceases to be a QPRT if the residence not used or held for use as a personal residence of the term holder
    - Deemed to be used as the term holder's personal residence as long as it is available at all times during the term for his or her use, without regard to his or her actual ability to use it and so long as no one other than a spouse or dependent resides there.
  - If residence is sold and the proceeds are used within 2 years to acquire a new personal residence, or if the residence is damaged or destroyed and the insurance proceeds are used with 2 years to repair or replace the residence, the trust will continue to qualify as a QPRT
  - Won't fail to be a "personal residence" merely because a <u>portion</u> of the residence is used for another purpose (e.g. rental or use in a trade or business) as long as such use is <u>secondary</u> to the use as a residence of the term holder. PLR 9816003.
  - If it ceases to be a QPRT, it must terminate and trust must either distribute the trust property to the term holder within 30 days or convert it to a qualified annuity trust for the remainder of the term. Same for any sale or insurance proceeds that remain unspent within two years of the sale or damage.

Ways to Give the Home Away – QPRT

- Continued use after the expiration of the QPRT term:
  - If home passes to a trust of which the grantor's spouse is a beneficiary, the spouse may continue to live in the home rent-free and the grantor may reside with him or her rent-free.
    - PLR 9735035 – home passed to trust giving spouse the right to use and possess the home during her lifetime and IRS held that grantor could continue to live with his spouse after the expiration of the QPRT term and the value of the home would not be includible in his estate under 2036 if the grantor predeceased his spouse.
    - However, following the spouse's death, or if the spouse is not a beneficiary of the trust, the grantor must pay rent to the trust to be able to continue to reside in the home.

- The grantor could retain an option at the time the QPRT is created to lease the home for fair market rent after the QPRT term or alternatively the QPRT document could give the grantor the right to lease the home after the QPRT term.

Ways to Give the Home Away – QPRT

- Disadvantages to a QPRT
  - Requires a taxable gift
  - Does not allow grantor to use GST exemption
    - Untested technique: have existing stand-alone GST exempt trust purchase the remainder interest from the remainder beneficiaries
  - Residence is included in the grantor’s gross estate for federal estate tax purposes if the grantor dies before the QPRT period ends
  - Grantor must pay rent to remainder beneficiaries to continue to live in the residence

Ways to Give the Home Away – Multiple QPRTs

- Transfer interests in a single residence to more than one QPRT
  - Reason: to reduce the mortality risk

- Example: D transfers 50% of a residence to a 10 year QPRT and 50% to a 15 year QPRT
  - If grantor dies in year 11, the first QPRT will have successfully transferred 50% of the residence held in the 10 year QPRT out of the grantor's estate even though the 50% of the residence held in the 15 year QPRT was included in the grantor's estate

  - After the 10 year term has expired, D must pay FMV rent for the 50% that is now out of his estate to avoid inclusion under 2036 even though he still has a right to use 50% of the residence that is held in the 15 year QPRT

  - Authority: PLR 9714025

Ways to Give the Home Away – Multiple QPRTs

- Another alternative: spouses could each transfer part of their residence to separate QPRTs

- Example: H and W transfer 50% of a residence to their own separate 10 year QPRT

  - If H dies in year 9 but W survives the 10 year term, the W's 50% interest in the residence will have been successfully transferred out of the estate even though the H's 50% interest was included in his estate.

  - Assume further that when H's QPRT fails because he dies before the end of the QPRT term, his 50% interest in the residence passes outright to W under his will. If W survives her QPRT term and continues to live in the residence, she will have to pay FMV rent to avoid estate tax inclusion under 2036 even though she co-owns the residence.

  - Authority: 9626041

Spousal Limited Access Trust

- Created to use grantor’s gift tax exemption but allow spouse to be a beneficiary
- Create irrevocable trust
- Fund with amount up to the grantor’s remaining gift tax exemption
- Name spouse (and, if desired, others) as a beneficiary

Spousal Limited Access Trust

- Donor's spouse and children can be permissible beneficiaries

- Spouse can be given 5 x 5 power

- Spouse could have inter vivos or testamentary power of appointment in favor of family members (including the donor spouse) other then herself, her estate, her creditors or creditors of her estate
  - Could be exercised in favor of donor (assuming no pre-arrangement)
  - Review state law –exercise of SPOA in trust fbo donor spouse may be deemed to be a self-settled trust which may be available to donor's creditors under state law.
    - To the extent trust fbo donor spouse is available to his/her creditors, it is includible in donor's estate for estate tax purposes

- Spouse can be a discretionary beneficiary of trust e.g. SLAT
  - Discretionary distributions can be made to non-donor spouse which will give donor spouse indirect benefit of distribution
  - Trust should prohibit trustee from making any distributions to satisfy a support obligation of the grantor
  - If both spouses do trusts, avoid the reciprocal trust doctrine – trust must be materially different
  - If spouse-beneficiary predeceases donor, donor loses ability to benefit indirecftly from the trust

Spousal Limited Access Trust - Benefits

- Uses grantor’s $5,430,000 exemption
- Trust assets not subject to Federal estate tax
- Can allocate grantor’s generation skipping tax exemption to the trust
- Non-grantor spouse is a discretionary beneficiary meaning the grantor spouse benefits indirectly
- Results in grantor trust status for life (because the grantor’s spouse is a beneficiary), even if spouses later divorce
  - Solution: give a special trustee the right to distribute assets outright to the non-grantor spouse in the event of a divorce
  - This will eliminate the indirect benefits of the trust to the grantor spouse
  - This will waste the grantor’s exemption that was used to create the trust

Spousal Limited Access Trust - Benefits

- Each spouse could set up a trust benefiting the other
- Must avoid the reciprocal trust doctrine i.e. the trusts must be materially different
  - Trust should be created at different times, with different assets and with materially different terms, different distribution standards, different trustees, etc.
    - For ways to avoid reciprocal trust doctrine, see Levy v. Comm. T.C.M. 1983-453 (wife had broad lifetime SPOA over her trust while husband did not have such a power over his trust). See also PLR 200426008 and PLR 9643013
  - Consequence of violating reciprocal trust doctrine: estate tax inclusion
    - Drafting tip: use a contingent marital trust where any assets subject to estate tax inclusion go to marital trust so estate taxes will be deferred

Spousal Limited Access Trust - Disadvantage

- Non-donor spouse may die
  - Donor spouse loses indirect access to assets
  - Solution: spouse could exercise a testamentary special power of appointment in favor of the donor spouse (assuming there is no pre-arrangement)
- Spouses may divorce
  - Donor spouse loses indirect access to assets
- Restatement of Trusts (Third) redefines "discretionary trusts" so that a beneficiary appears to have an enforceable right to a distribution
  - Causes a potential estate tax inclusion issue in states that adopt the Restatement (Third).
- Can't split gift. Reg. 25.2513-(1)(b)(4)
  - Limited to maximum $5,430,000 gift

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III. Income Tax Efficiency

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Pre-ATRA Planning

- Prior to the passage of (and for a period after) the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the federal estate tax exemption was relatively low, and transfer tax rates were relatively high.
- During this time, it was generally more efficient to have clients make lifetime gifts to avoid estate taxes than to retain an asset and have that asset receive a stepped-up basis.

Pre-ATRA Planning

- In light of these circumstances, practitioners generally created estate plans based primarily on estate tax planning, and only secondarily considered income tax planning.

Pre-ATRA Planning

- Gradually leading up to and following the passage of the American Taxpayer Relief Act of 2012 (ATRA), which implemented "permanent" higher federal estate tax exemption amounts and lower applicable federal estate tax rates (together with higher capital gains tax rates and net investment income tax), income tax planning has taken a much larger role in estate planning.

The "Tax Efficiency Gap"

- This distance between estate tax rates and capital gains tax rate has become known as the "tax efficiency gap."
- The tax efficiency gap is an indicator of whether it is more efficient to retain assets until death or make lifetime gifts, taking the overall tax implications of each.

Grantor Trusts

- Grantor trusts have been and continue to be popular tools to (among other things) receive gifts and reduce grantors' taxable estates, using techniques that "freeze" the values of assets transferred to the trust, "squeeze"/discount the value of such assets, and/or "burn", or continue to diminish, the value of the grantor's taxable estate.

Current Tax Structure/Efficiency

- The current federal tax structure (accentuated by state income and transfer taxes) and tax efficiency gap shows that, in fact, a completed gift to a grantor trust, without the use of a post-gift asset exchange, may be less efficient than the grantor retaining the asset until his or her death.

More on the "Tax Efficiency Gap"

- Basis, generally
  - When a grantor makes a gift to a trust, the trust receives the grantor's basis in that asset and the asset is removed from the grantor's taxable estate.
  - However, all pre- and post-gift appreciation is subject to income tax (often at capital gains rates) when sold by the donee.
  - Because gifts to grantor trusts often consist of assets expected to appreciate, the potential income tax liability tends to be high.

More on the "Tax Efficiency Gap"

- The tax efficiency gap, then and now:
  - In 2000, the tax efficiency gap (federal only) was <u>20%</u>, with an exemption amount of $675,000.
    - Federal estate tax rate: 55%
    - Federal capital gains tax rate: 35%
    - Practically, this large tax efficiency gap–combined with the low exemption amount–meant that, even without a post-gift asset exchange, it was more efficient to make lifetime gifts to trusts than to retain assets until death and have them receive a stepped-up basis.

More on the "Tax Efficiency Gap"

- The tax efficiency gap, then and now:
  - In 2015, the tax efficiency gap (federal only) is <u>16.2%</u>, with an exemption amount of $5,430,000.
    - Federal estate tax rate: 40%
    - Federal capital gains tax rate (assuming a 20% capital gains rate plus 3.8% net investment income tax): 23.8%
    - Practically, this small tax efficiency gap–combined with a high exemption amount–means that unless post-gift asset exchanges are made, it is now inefficient to make lifetime gifts to trusts.

More on the "Tax Efficiency Gap"

- The tax efficiency gap summary:
  - The larger the gap, the more efficient it is to make lifetime gifts to remove assets from the grantor's estate, generally.
  - The smaller the gap, the more efficient it is to retain assets until death to receive a step up in basis, generally.

Post-Gift Asset Exchanges

- Instead of advising clients to either make a gift to a grantor trust (locking in the value to avoid estate inclusion of future appreciation) or retain an asset (receiving a step up basis at the client's death), clients can choose a third alternative—the post-gift asset exchange–and get both.
- Making post-gift asset exchanges is *almost always* more efficient than not.

Post-Gift Asset Exchanges - Logistics

- Grantor makes a lifetime gift, often an asset expected to appreciate, to a grantor trust.
- As close to the grantor's death as possible, he or she exchanges assets with the trust, giving the trust high-basis assets in exchange for low-basis assets.
- This is accomplished by having the grantor purchase assets from the trust, or more preferably, by exchanging them for his or her own assets, if permitted by the terms of the trust.

Example – Federal Income Tax Only

- In 2015, client, a resident of a state with no state income or estate tax, owns stock with basis of $2 million, FMV of $10 million. Projected value of stock in 2033 is $25 million. Projected estate tax exemption amount in 2033 is $8.95 million.
  - If client <u>retains</u> the stock until death, client will pay no gift tax, but client's estate will have a $6.42 million estate tax bill ($25m*40% - $8.95m*40%).
  - Stock will receive stepped up basis on client's death.
  - Total tax: <u>$6.42 million</u>.

Example – Federal Income Tax Only

- In 2015, client, a resident of a state with no state income or estate tax, owns stock with basis of $2 million, FMV of $10 million. Projected value of stock in 2033 is $25 million. Projected estate tax exemption amount in 2033 is $8.95 million.
  - If client <u>gifts</u> stock to grantor trust in 2015, client will pay $1.83 million in gift tax ($10m*.4 - $5.43m*.4).
  - Trust's basis in asset will be approximately $3.5 million (transferred basis plus gift tax on net appreciation).
  - Taxes on gains on pre-death appreciation will be approximately $5.1 million.
  - Total taxes paid ($1.83 million + $5.1 million): +/-<u>$6.93 million</u>.

Example – Federal Income Tax Only

- In 2015, client, a resident of a state with no state income or estate tax, owns stock with basis of $2 million, FMV of $10 million. Projected value of stock in 2033 is $25 million. Projected estate tax exemption amount in 2033 is $8.95 million.
  - If client <u>gifts</u> stock to grantor trust in 2015, client will pay $1.83 million in gift tax ($10m*.4 - $5.43m*.4).
  - If client subsequently <u>exchanged asset</u> for cash in 2033, the year of client's death, the asset would be included in client's estate (as the cash would have), but will receive a step up in basis to $25 million, its FMV. Accordingly, the <u>total tax paid will be $1.83 million</u>, with no capital gains tax.

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State Income and Transfer Taxes

- As expected, federal income and transfer taxes are only part of the tax efficiency gap. State (and even local) taxes will also have an effect.
  - States that have high state income tax rates and low estate tax rates (or no state estate tax) often have small tax efficiency gaps. In these states, without the use of post-gift exchanges, lifetime gifts will tend to be even less efficient than in states without state income and estate taxes.
    - CA: Tax efficiency gap of 2.9% (40% federal estate tax; no state estate tax; 37.1% federal and state income tax rate in 2014).

State Income and Transfer Taxes

- States that have moderate state income tax rates but high state estate tax rates may have larger tax efficiency gaps than those without a state estate tax. However, tax efficiency gaps in those states are still generally smaller than states without state estate or income tax.
  - NY (New York City resident): Tax efficiency gap of 13.1% (49.6% federal and state estate tax; 36.5% federal, state, and local income tax rate in 2014).

Collectibles

- For trusts which have received or will receive assets subject to taxation at rates higher than capital gains, asset exchanges become even more important, as tax efficiency gaps shrink.
  - Artwork, precious metals, fine wines, glassware, antiques and other commonly collected items have an effective tax rate of 31.8%, as opposed to the effective tax rate of 23.8% on capital gains.

Post-Gift Asset Exchanges - Techniques

- Cash Purchase
  - If grantor has the assets, a cash purchase is an easy way to exchange assets. Because the trust is a grantor trust, no gain or loss should be recognized, the trust will receive cash (with a basis equal to its FMV), and the grantor will receive the low basis asset. The low basis asset will be included in the grantor's taxable estate and receive a step up in basis at that time.

Post-Gift Asset Exchanges - Techniques

- Third Party Financing
  - If grantor does not have the assets available to make a cash purchase of the low-basis assets, he or she can try to obtain third party financing for the purchase, and receive the same benefits as a cash purchase.

Post-Gift Asset Exchanges - Techniques

- Promissory Note from Grantor
  - If the grantor doesn't have the cash to make a cash purchase and can't obtain third party financing, he or she can purchase the low-basis assets from the trust in exchange for a promissory note to the trust.
  - <u>Warning</u>: Some commentators believe that this method may have adverse repercussions, as the IRS could argue that because the trust ceases to be a grantor trust upon the grantor's death, the trust will be deemed to sell its assets to the donor in exchange for the note at that time, and be required to recognize the gain from the sale of the gifted assets. This would defeat the purpose.

Post-Gift Asset Exchanges - Techniques

- Exchange
  - If the trust gives the grantor the power to substitute its assets (see IRC 675(4)(C)), the grantor can simply exchange the trust's low basis assets for his or her own assets with a higher basis.
  - This power is often included in trusts, as it is one way to make them defective to the grantor.

Post-Gift Asset Exchanges - Techniques

- Decanting
  - If the purchase options are not feasible and trust does not contain a substitution power, it may be possible to decant the trust to another trust which gives the grantor a substitution power.
  - This will depend on the applicable state law of the trust.

Post-Gift Asset Exchanges–Additional Steps

- Valuation of Exchanged Assets
  - It's not enough to simply exchange the assets–the value of the assets exchanged must be appraised.
  - If discounts were utilized when assets were contributed, they should also be used when assets are exchanged.

Post-Gift Asset Exchanges–Additional Steps

- Reporting
  - Since no gift is being made, it is not necessary to report the exchange to the IRS.
  - To start the running of the 3-year limitations period for the IRS to challenge the exchange, however, it may make sense to file Form 709.
  - Practically, why not file this? You've presumably already obtained the appraisal for the assets.

Post-Gift Asset Exchanges–Additional Steps

- Reporting, continued
  - If the IRS determines that the value of assets provided to the trust in the exchange exceed the value of the assets received by the grantor, the grantor could be treated as having made a gift to the trust.
  - If the IRS determines that the value of assets provided to the trust in the exchange were less than the value of the assets received by the grantor, the donor could be treated as having retained an interest in the trust, and have all of its assets included in his or her estate.

Potential Drawbacks

- Post-gift asset exchanges work best when utilized as close as possible to the grantor's death, which is generally impossible to determine.
- Some clients may not have the financial ability to purchase or exchange the asset, or may not want to risk using a promissory note.
- Client may not want to go through the process of the asset changing hands again (especially if the asset is subject to buy/sell agreements or its transfer otherwise requires consents from others).

When are Post-Gift Asset Exchanges not Efficient?

- When the current FMV of a gifted asset is less than its basis, which if exchanged, would be included in the grantor's estate and receive a step-down in basis.
- If the asset gifted to the trust has been sold by the trust. While this isn't necessarily inefficient, since the gain/loss would have already been recognized, it may not make sense to exchange assets at that point (unless a new appreciating asset has been acquired).

Conclusion

- With the small tax efficiency gap created by the current tax laws, it's important to not simply plan for income tax or estate tax, but to use lifetime gifts, grantor trusts, and asset exchanges to maximize the use of client's exemption amounts and minimize income tax liability.