Estate and Gift Tax Updates and Opportunities in the Current Economy

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Recent changes and proposed legislation in U.S. estate and gift tax law will affect many existing estate plans. The current downturned economy also presents unique opportunities for minimizing transfer tax liability through various gifting techniques, some of which may soon be curtailed by legislative action. Please note this article was written with an effective date of July 1, 2009, so any legislative predictions may have been settled by the time of publication.

Estate and Gift Tax Law Changes and Proposals

For 2009, the “applicable exclusion amount” (the maximum amount of net assets an individual’s estate may contain before becoming subject to estate tax) has increased from $2 million in 2008 to $3.5 million. Although under existing law the estate tax is scheduled for repeal in 2010 and a subsequent reinstatement in 2011, most practitioners anticipate that Congress will enact legislation prior to the repeal and set a permanent applicable exclusion amount of only $3 million (the maximum amount of “taxable gifts” individuals may make during their lifetimes before becoming subject to gift tax) will remain at $1 million. These exclusions are interrelated because to the extent one utilizes his or her lifetime gift tax exclusion, the applicable exclusion amount will be reduced by a corresponding amount. For example, if an individual died in 2009 having made $500,000 of taxable gifts during life, his estate would be shielded by an applicable exclusion amount of only $3 million ($3.5 million less $500,000).

A taxable gift occurs when, during any calendar year, an individual transfers to any one person property with value in excess of the “annual exclusion amount.” The annual exclusion amount for 2009 is $13,000, increased upward for inflation from $12,000 in 2008. The annual exclusion amount allows individuals to gift to any other person up to $13,000 per year without exhausting any of their $1-million lifetime gift tax exclusion. For example, if a couple wanted to assist a child and the child’s spouse with a down payment on a house, the couple may give $26,000 to the child and an additional $26,000 to the child’s spouse, for a total tax-free transfer of $52,000. Please note certain gifts are excluded from the annual exclusion amount calculation, such as gifts between spouses and direct payments of the tuition or medical expenses of another. If during any calendar year one individual gifts to another person an amount exceeding $13,000, a taxable gift results and requires the filing of a gift tax return; however, gift tax will not be owed until an individual has exhausted the $1-million lifetime gift tax exclusion.

Effect of Legislative Changes

With the increased applicable exclusion amount, utilizing basic trust techniques and proper retitling of assets allows married couples with a combined net worth of $7 million to avoid federal estate tax liability. Single individuals owning net assets valued at $3.5 million at death similarly will not owe any federal estate tax. Both of the aforementioned are assuming no taxable gifts were made during life.

Persons with Nontaxable Estates

For persons whose financial positions will not subject them to federal estate taxation, the increased applicable exclusion amount still could have significant impacts on their existing estate plans. The applicable exclusion amount has increased progressively from $675,000 in 2001 to the present level of $3.5 million. These increases may have the undesirable effect of apportioning unnecessarily large amounts of estate assets to credit shelter trusts where distributions to surviving spouses are limited to those necessary for the spouse’s health, education, maintenance, and support (the HEMS standard). Many existing wills and revocable trusts utilize common drafting techniques where upon the death of the first spouse, estate assets equal in value to the applicable exclusion amount are placed into a credit shelter trust governed by the HEMS standard and the balance of the estate is distributed unrestricted to the surviving spouse (either in trust or outright). The HEMS standard language is necessary to
prevent the principal of a credit shelter trust from being included in a surviving spouse’s estate as would result if the surviving spouse had unfettered access to the funds. Due to the increased applicable exclusion amount and the recent market declines, many individuals may no longer have reason to fully fund credit shelter trusts and would prefer to direct a greater portion of their estates to surviving spouses. In most instances, simple amendments to revocable trusts will rectify such problems.

**Persons with Taxable Estates**

For persons owning substantial assets, all indications are that the estate tax is here to stay, although with an increased applicable exclusion amount. For affluent couples, where each spouse owns assets well in excess of $3.5 million, a portability provision would not eliminate the benefits of credit shelter trust planning. Under current law, a decedent may pass an unlimited amount of assets to a surviving U.S. spouse without incurring federal estate tax liability. However, where both spouses are wealthy, the surviving spouse may have no need for an additional $3.5 million and the future interest and appreciation subsequently earned thereon. For these individuals, significant estate tax savings would result by fully funding the credit shelter trust with $3.5 million of estate assets that possess the greatest potential for future appreciation and naming children as the remainder beneficiaries. For example, assume each spouse owns assets worth $10 million when the first spouse passes and the surviving spouse lives an additional 10 years. Assuming an annual return of 8 percent on the credit shelter trust assets, approximately $7.5 million ‘would pass tax free to the children at the surviving spouse’s death, as opposed to around $4 million’ if such assets were included in the surviving spouse’s estate and subject to taxation. For security purposes, surviving spouses still could enjoy the credit shelter trust property during life subject to a HEMS standard without risking estate inclusion. For security purposes, surviving spouses still could enjoy the credit shelter trust property during life subject to a HEMS standard without risking estate inclusion. For security purposes, surviving spouses still could enjoy the credit shelter trust property during life subject to a HEMS standard without risking estate inclusion.

For those individuals with taxable estates who place importance on minimizing transfer tax liability and maximizing the amount of wealth that passes to younger generations, then the present market conditions are ideal for reducing taxable estates through various gifting techniques.

**Estate Planning Opportunities in the Current Recession**

The current market conditions, with low interest rates and diminished asset values, provide tremendous estate planning opportunities when leveraged with traditional gifting techniques such as grantor retained annuity trusts, defective grantor trusts, and family limited partnerships. With taxable estates, a goal of gifting should be to transfer quickly appreciating assets sooner rather than later so subsequent appreciation escapes inclusion in the transferor’s estate.

Gifting techniques that capitalize on diminished asset values involve gifting assets that may justifiably be appraised at low values in the present market but will likely appreciate quickly once the economy recovers. Gifting methods that utilize low interest rates revolve around gifting assets that will outperform the applicable federal rate (AFR) and structuring the gifts in manners that incur only minimal transfer tax consequences. The AFR is an Internal Revenue Service (IRS)-prescribed rate of interest published on a monthly basis representing the minimum rate of interest to charge another on a loan to avoid gift tax implications. For June 2009, the mid-term AFR was 2.24 percent. Many of the techniques discussed below take advantage of diminished asset values and low interest rates.

**Family Loans**

Family members may loan money to each other without gift tax consequences if the note bears interest equal to the AFR. The AFR rate varies depending on the term of the note. For instance, a nine-year note made in June 2009 must charge a minimum rate of 2.24 percent interest for the loan’s duration. These intra-family loans allow older, wealthier family members to provide younger generations with an opportunity to earn greater returns in the market, in their business affairs, or to pay off higher-rate indebtedness. Reducing these loans to formally written notes is extremely important for term verification if ever challenged by the IRS.
GRATs

Grantor retained annuity trusts (GRATs) are popular techniques for individuals to use with either marketable securities or family business interests with potential for appreciation or significant cash flow. Often, under depressed market conditions, such assets have values far below their potential for future appreciation and earnings. A GRAT is established where an individual (grantor) transfers assets to a trust in exchange for the right to receive fixed annuity payments from the trust at specified future dates. The trust is established for a term of at least two years and children or grandchildren typically are designated as remainder beneficiaries. At the end of the GRAT’s term, all assets remaining in the trust pass to the remaindermen.

GRATs may be structured where no gift tax consequences arise by setting the fixed annuity payment at the appropriate amount (a zeroed-out GRAT). For a zeroed-out GRAT to be successful, the contributed assets must appreciate and/or produce income during the GRAT’s term at a rate exceeding 120 percent of the AFR (known as the hurdle rate). Upon the GRAT’s termination, such excess appreciation and earnings will pass to the remainder beneficiaries free of any transfer taxes. The downside to an unsuccessful GRAT is negligible as the contributed assets simply return to the grantor and the remainder beneficiaries receive nothing at the GRAT’s termination.

A common technique for increasing a GRAT’s success and trapping appreciation outside of the grantor’s estate is the implementation of a series of two-year rolling GRATs where any property that returns to the grantor is immediately recontributed to another GRAT. Another practice utilized in conjunction with rolling GRATs is GRAT immunization, where at the end of a GRAT’s first year, the grantor substitutes bonds or other stable assets in exchange for the GRAT’s assets and then funds a new GRAT with the old GRAT’s assets. This is possible because GRATs typically are structured so the grantor retains the power to reacquire the GRAT’s assets by substituting property of equal value. GRAT immunization effectively limits the GRAT’s term to one year and by doing so increases the probability for greater amounts of wealth transfer regardless of whether the GRAT had a successful or unsuccessful first year.

In the event a GRAT’s first year is unsuccessful (the asset failed to appreciate), the likelihood of the GRAT producing a second-year return that will offset the first year’s poor performance and make the GRAT an overall success is minimal. Therefore, it is advantageous to immunize the GRAT by having the grantor substitute bonds for the GRAT property and restructure such property to a second GRAT. Having the asset held in a new GRAT greatly increases chances for a successful transfer of wealth because the obstacle of overcoming the first year’s poor performance has been eliminated.

Immunizing a successful GRAT, where the asset appreciated significantly in the first year, is also beneficial because it stabilizes the GRAT’s return and lessens the risk of a poor second-year performance diminishing the GRAT’s overall success. Considerable appreciation during the first year allows the grantor to substitute a greater amount of stable assets for the GRAT’s existing asset, thereby preserving the first year’s appreciation and securing a successful transfer of wealth to the remaindermen. Further, because the asset from the old GRAT will immediately be recontributed to a new GRAT, any second-year appreciation on such asset in excess of the hurdle rate would still likely avoid transfer taxes, especially if another immunization is undertaken. Although GRAT immunization requires the grantor to hold liquid assets, the technique provides tremendous estate planning opportunities by effectively allowing the grantor to freeze the GRAT’s appreciation on an annual rather than on a bi-annual basis.

Sales to Intentionally Defective Grantor Trusts

Sales to intentionally defective grantor trusts (IDGTs) often are used by the owners of closely held businesses, real estate, or other income-producing property to transfer business interests to younger generations. An IDGT is a trust that allows the grantor to continue paying income taxes attributable to the trust assets, but by virtue of releasing a certain degree of control the trust principal is not includable in the grantor’s estate at death. A grantor typically sells assets to the trustee for a note bearing interest at the AFR with annual interest payments and a lump-sum principal payment at the note’s expiration. Sales to grantor trusts are treated as transactions with oneself for income tax purposes and therefore no tax liability arises from either the sale of the asset or receipt of interest on the note. At termination of the trust, the principal passes to the remainder beneficiaries without transfer tax consequences.

Ideally, the IDGT’s asset will produce income in excess of the AFR, thus enabling payment of the interest without affecting trust principal. Further, it is intended that the IDGT’s asset will appreciate significantly over the term of the note whereby the end lump-sum payment will only represent a small portion of the asset value. By paying income taxes attributable to the trust asset, the grantor can effectively make additional gifts to the remainder beneficiaries in the form of tax payments for which the trust would otherwise be liable. As a bonus, such income tax payments are not counted toward either the annual exclusion amount or the lifetime gift tax exclusion.

For those persons with existing IDGTs, there is growing consensus among practitioners (but not binding authority), that new notes at the lower
AFR may be substituted for older notes bearing higher rates of interest without any negative tax consequences.

Family Limited Partnerships

Family limited partnerships have been used frequently to reduce transfer tax liability. Typically parents will form a partnership, transfer assets to the entity, and then make gifts to their children of nonvoting, nontransferable limited partnership interests. Because the gifted partnership interests have no voting rights, are nontransferable, and constitute a noncontrolling limited partnership interest, the gains are valued at substantially less than the proportionate value of the partnership’s underlying assets. Discounts of more than 60 percent of the underlying gifted property have been upheld as accurate valuations. These discounts can be used concurrently with the gifting techniques discussed above and together they allow for transferring vast amounts of wealth with minimal tax consequences, especially under the current market conditions.

Ideally, the assets contributed to the partnership are interests in closely held businesses, real estate, or assets other than marketable securities. When readily tradable securities are the partnership’s primary assets, the transactions are more prone to IRS attack on the grounds that no business purpose, other than estate tax avoidance, exists.

Importance of Appraisals

When implementing any of the above techniques, where valuation may later be questioned, receiving an appraisal is highly advisable for discouraging and persevering against IRS challenges. In this economy appraisers may justifiably assess the value of assets at far below what their worth may reasonably be expected to return to after the recession subsides. When one makes a taxable gift requiring the filing of a gift tax return, attaching a professional appraisal to the return is common and prudent practice, and sometimes is required.

Possibility of Legislative Change (aka Loophole Closings)

Speculation exists that Congress may seek to curtail the attractiveness of some of these gifting methods in the near future; although at this juncture exactly how is a subject of debate. One proposal circulating on Capitol Hill has targeted family limited partnerships by eliminating some minority discounts. The Obama administration has advocated for requiring that GRATs have a minimum term of 10 years in order to decrease their effectiveness.16 Only time will tell what the ultimate terms of the ensuing legislation will contain. However, most practitioners believe that the applicable exclusion amount will be set at a minimum of $3.5 million for years into the future. Therefore, if reducing one’s estate tax liability may be accomplished by employing some of the above techniques, then now, with the depressed markets, low interest rates, and the possibility of curtailing legislative action, is the time to consider implementing such a plan.

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Endnotes

1 Under the 2001 Economic Growth and Tax Relief Reconciliation Act sunset provision, if legislative action is not taken, then in 2011 the applicable exclusion amount will return to $1 million with a top estate tax rate of 55 percent.

2 The exception for gifts of direct payments of medical and tuition payments provides tremendous opportunities for wealthy grandparents to pay such expenses for their grandchildren and avoid gift, estate, and generation-skipping transfer taxes.

3 The future value calculation of $3.5 million earning an 8-percent return compounded annually = $3,500,000 x (1 + .08)^10 = $7,556,237. This calculation does not account for any reductions resulting from possible trust distributions and/or income or capital gains tax liability attributable to the credit shelter trust.

4 $7,500,000 x 45% estate tax rate = $3,375,000 of estate tax liability.

5 $7,500,000 – $3,375,000 = $4,125,000.


7 A long-term note, one with duration of longer than nine years, must charge a minimum of 3.84 percent.

8 For an in-depth discussion regarding GRAT immunization, see David L. Weinreb and Gregory D. Singer, 2008, An Analysis of GRAT ‘Immunization,’ American College of Trust and Estate Counsel (ACTEC) Journal 34, no. 3 (winter): 200.

9 Id.

10 Id.

11 Id.

12 Id.

13 Id.

14 Id.

15 If desired, language may be added to the trust to terminate or reinstate the grantor’s obligation to pay income taxes attributable to the trust assets.