



How to Navigate Through the Recent Tax Law Changes and Embrace the Future

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Today's Topics



- Overview – The 2010 Act
- The Transfer Tax Landscape
- The 2010 Law – Then and Now
- The 2011 and 2012 Law
- The 2013 Law – Who Knows?
- Use It Before We Lose It Again – Planning Opportunities
 - Intra-Family Loan
 - Grantor Retained Annuity Trusts (GRATS)
 - Installment Sale to Grantor Trust
 - GST Tax Planning Opportunities

Income Tax Provisions in the 2010 Tax Relief Act



- Retention of 2010 tax brackets, with a top bracket of 35%
- Long term capital gains and qualified dividends taxed at a maximum rate of 15%
- Repeal of itemized deductions and personal exemption extended
- Alternative Minimum Tax patch
- Charitable contribution incentive and IRAs
- Payroll Tax Holiday
- Energy Efficient Improvement Credit
- Child Tax Credit
- Other Individual Deductions and Extenders
 - State and local sales tax deduction
 - Higher education tuition deduction
 - Teacher's classroom expense deduction
- Bonus Depreciation and Other business Credits and Extenders

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Overview – The Transfer Tax Landscape



	2010	2011 / 2012	2013
Estate Tax Exemption	\$5,000,000 (or unlimited if elect out)	\$5,000,000 (2012: Indexed for post 2010 inflation) + portability	?
Maximum Estate Tax Rate	35% (or no estate tax if elect out)	35%	?
Carryover Basis or Step Up	Step up if pay tax / Option to elect carryover basis and pay no estate tax	Basis Step Up	?
Gift Tax Exemption	\$1,000,000	\$5,000,000 (2012: Indexed for post 2010 inflation) + portability	?
Maximum Gift Tax Rate	35%	35%	?
GST Tax Exemption	\$5,000,000	\$5,000,000 (2012: Indexed for post 2010 inflation)	?
GST Tax Rate	0%	35%	?

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Overview



- On December 17, 2010, the President signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "2010 Tax Relief Act") into law.
- The 2010 Tax Relief Act greatly changes the rules regarding our transfer tax system—but only through 2012.
- The law is temporary—if Congress does nothing (and we have seen that happen), in 2013, the 2010 Act sunsets and the transfer tax system will revert to pre-Bush era law.

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Overview - The Transfer Law in 2011 and 2012



- The federal estate, gift and generation-skipping transfer (GST) tax exemptions are unified
- The exemption amount is \$5,000,000 (\$10 Million for a married couple)
- The exemption amount is indexed for post 2010 inflation in 2012
- The maximum tax rate for all three transfer taxes is 35%
- There is portability of the exemption between spouses for estate and gift tax purposes (but not for GST Tax purposes)

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Overview - The 2010 Law Before Enactment of the Tax Relief Act



Before Enactment of the 2010 Act:

- There was no Federal Estate Tax
- There was a carryover basis regime
- There was no Generation-Skipping Transfer Tax (GST Tax)
- The gift tax rate was 35% and there was a \$1,000,000 exemption

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Overview - The Estate Tax Law in 2010



- There are two different tax paths for decedents who died in 2010 – the estate tax regime or the carryover basis regime
- The repeal of the estate tax is retroactively rescinded to January 1, 2010
- The default provision is the automatic application of the estate tax
- The exemption amount is \$5,000,000 and the maximum tax rate is 35%
- There is a basis step-up – unless the estate elects out of the estate tax regime
- If an election out is made, the modified carryover basis rules apply
- The Act does not say how the election out is made—the law instructs the IRS to determine the time and manner of the election
- Once made, the election out is revocable only with the IRS' consent
- Note: In 2010, there is no portability between spouses

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The Estate Tax Law in 2010—Which Path to Take?



- Projecting the effect of the modified carryover basis rules will be difficult
- One has to consider a number of factors including
 - The net appreciation in each asset
 - The character of the gain on the sale of the asset
 - The applicable tax rate
 - Whether and when the asset is to be sold

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The Estate Tax Law in 2010—Which Path to Take?



- Whether or not the election is made can also determine who receives the estate:
 - Many Wills and Trusts include formula clauses based on estate tax concepts
 - For example: I leave the amount that can pass free of the federal estate tax to my children and the balance of my estate to my spouse in trust
 - In the above example, if an election is made to opt out of the estate tax regime, the entire estate could pass free of federal estate tax to the children and the spouse would then be disinherited

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Overview – The Gift Tax in 2010



- The gift tax was not repealed in 2010
- The 2010 Act did not make any changes to the 2010 gift tax
- The exemption for 2010 remains at \$1,000,000 – unlike the estate and generation-skipping tax exemptions which were both increased to \$5,000,000 for 2010
- The maximum rate is 35%
- The gift tax is reunified with the estate tax in 2011 when the gift tax exemption is increased to \$5,000,000
- The 2010 Act did not extend the time to file 2010 gift tax returns – the return was due by April 18, 2011 (unless an extension was filed)

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Overview – The Generation-Skipping Transfer Tax Law in 2010



- Like the estate tax, the GST Tax was repealed in 2010
- The 2010 Tax Act reinstates the GST Tax in 2010, with a \$5,000,000 exemption
- But the tax rate is 0% for 2010 only

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Overview – Filing Extensions



- For 2010 decedents who died before the date of enactment, the following deadlines are extended nine months after the date of enactment to September 19, 2011 (Note September 17 is a Saturday):
 - Filing Form 706
 - Paying the estate tax
 - Filing a return reporting a GST Transfer
 - Making disclaimers
 - Caution: Since a qualified disclaimer has to satisfy state law, unless state disclaimer laws are modified the Act's extended deadline to make a qualified disclaimer is somewhat problematic

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Form 8939 – Allocation of Increase in Basis for Property Acquired from a Decedent



- Form 8939, the basis reporting and allocation return for 2010 Decedents, was originally due with the Decedent's final Form 1040, i.e., on April 18, 2011
- On March 31, 2011, IRS announced that it was extending the due date of Form 8939 (IR- 2011-33)
- IRS said that it plans on issuing further guidance that will provide a deadline for filing the form as well as for electing not to have the estate tax regime apply

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The 2010 Tax Relief Act – Unanswered Questions



- Is there any danger of a “clawback” in the event that the \$5,000,000 exemption is not extended past 2012?
 - Say a taxpayer uses all of the \$5,000,000 gift tax exemption and then in 2013 the gift and estate tax exemption reverts to \$1,000,000. Will the \$4,000,000 gift exceeding the then available \$1,000,000 exemption generate a gift upon later lifetime transfers or an estate tax at death?
 - Most practitioners doubt this will occur but the outcome will not be certain until there is definitive guidance
 - Even if there is recapture, the growth earned on the transferred property will not be recaptured
- Will portability be made permanent?
- Will the ability to create perpetual dynasty trusts be lost?
- If a Trust was subject to an ETIP on January 1, 2010, did the ETIP terminate on January 1, 2010 because there was no federal estate tax on that date so the trust property could not have been included in the taxpayer's estate on that date even if the taxpayer was alive on that date?
- If the Estate of a 2010 Decedent elects out of the estate tax regime, how will GST Exemption be allocated?

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2010 – The Carryover Basis Regime



- If the Estate elects out of the estate tax regime, the carryover basis regime applies and there is no step up to date of death values (except for the limited basis modification rules that apply)
 - Note: Inheritor's basis is limited to the lower of decedent's basis and fair market value at date of death

Basis modification rules

- Executor (or if no executor persons in possession of property) has limited ability to increase basis of property received from a decedent (but not above fair market value)
- \$1.3 Million upwards basis adjustment for property passing to anyone (including a surviving spouse) plus certain unused losses (i.e., capital loss carryovers, net operating loss carryovers and built in loss property)

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2010 – The Carryover Basis Regime



Basis Modification Rules (cont'd)

- There is also a \$3 Million special spousal adjustment for property passing to surviving spouse
 - Must pass to spouse in qualified form – either outright or in a Q-TIP Trust
 - Property held in general power of appointment trust does not qualify for basis step up

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Carryover Basis Rules



- Property must be acquired from the decedent so Section 2044 property included in survivor's estate does not qualify for step-up
- Certain types of property such as IRD items and certain entities do not qualify for step-up
- Death bed gifts (except to spouse) cannot be used to get upward basis adjustment
 - Rule = gifts received by an individual within 3 years of death cannot qualify for the adjustment
- Special Spousal Death Bed Rule
 - No time restrictions
 - Transfers can be made on death bed to get upward basis adjustment

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Carryover Basis Regime - Disadvantages



- Those who inherit negative basis property are saddled with a liability rather than an asset
- Recordkeeping nightmare

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Carryover Basis Tax Returns



- Filing requirement: Estates with assets over \$1.3 Million have to file Form 8939 to report basis and allocate the basis adjustments
- Return has to report property's basis and fair market value
- So, appraisals would still be required
- Due date: Under the old law, the return would have been due on April 18, 2011
- On March 31, 2011, in IR-2011-33, IRS announced that Form 8939 would not be due on April 18 and further announced that the due date will be issued at a later date

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Portability – Much Ado About Nothing?



- For 2011 and 2012, the 2010 Act provides that the surviving spouse's basic available exemption amount is increased by the Deceased Spouse's Unused Exclusion Amount (DSUEA)
 - Note: The Act calls the \$5,000,000 exemption (as indexed for inflation) the "basic exclusion amount" and defines the sum of the basic exclusion amount and the DSUEA as the "applicable exclusion amount"
- Use of the DSUEA allows a surviving spouse to take advantage of the unused exemption amount of a deceased spouse thereby increasing the amount of the survivor's exemption
- Unlike the basic exemption amount, the DSUEA is not indexed for inflation
- Unlike assets placed in a by-pass trust by the first spouse to die, use of the DSUEA does not shield future appreciation from tax
- However, assets covered by the survivor's DSUEA will get a step-up in basis at the survivor's death (unlike assets in a by-pass trust which do not get a basis step-up at the survivor's death)
- Under the current law, portability sunsets in 2013
 - Note: The Administration's fiscal year 2012 Revenue Proposals would make the portability of the unused exemption amount between spouses permanent.

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Portability – Much Ado About Nothing?



- There are many complexities, conditions and rules concerning portability leading to confusion about the application of the rules, especially in remarriage situations which will have to be addressed by technical corrections
- Some of the rules pertaining to the DSUEA in remarriage situations are:
 - The surviving spouse must entirely use up his/her own exemption before the DSUEA is applied
 - The DSUEA is available only from the last deceased spouse – you cannot enter into serial marriages after you are widowed to keep collecting unused exemptions
 - The survivor keeps the DSUEA from his/her last deceased spouse even if the survivor marries a new spouse. But if the new spouse dies before the survivor, the survivor loses the DSUEA of his/her first spouse and takes the DSUEA of the new spouse

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Portability – Much Ado About Nothing?



- Apparently, the rules have even been misinterpreted in the Joint Committee Report:
 - The Report gives this example: A widower inherited a \$2,000,000 DSUEA from his predeceased wife and had not used any of his own \$5,000,000 exemption, so he has a total applicable exclusion amount of \$7,000,000. He makes gifts of \$3,000,000, remarries and dies without a taxable estate. What is the DSUEA received by his second wife? The Report says that the second wife would receive a DSUEA of \$4,000,000 (\$7,000,000 less \$3,000,000), meaning that the deceased husband's lifetime gifts first used the DSUEA received from his first wife before using his own exemption thus leaving \$4,000,000 of his \$5,000,000 exemption available for his second wife. As pointed out by a number of commentators, the Report's conclusion is inconsistent with the provisions of the Code. Under the Code, the DSUEA is the decedent's own basic exclusion amount (\$5,000,000 reduced by his/her used exemption amount). So in the Report's example, the DSUEA is \$2,000,000 (not \$4,000,000 as indicated in the Report). The \$2,000,000 represent the decedent's \$5,000,000 exemption less the \$3,000,000 of taxable gifts that he made.

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Portability – Much Ado About Nothing?



- Right now the utility of portability is limited – both spouses have to die within a two year term because of the sunset of the Act in 2013
- So, a surviving spouse only gets the benefit of portability from a deceased spouse who dies after 2010 and the survivor must die before 2013
- A DSUEA election must be made on the Form 706 of the first spouse to die in order for the survivor to benefit from the DSEAU
 - Query: Does this mean that a Form 706 will have to be filed for every estate, even those under the exemption amount, in order to make the election?
- Once made, the election is irrevocable

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Portability – Much Ado About Nothing?



- Portability was supposedly instituted by Congress to make planning for married couples easier and obviate the need for Wills and other planning documents
- Certainly the availability of portability will lead many couples to conclude that there is no need to have a comprehensive estate plan – “I love you Wills” will probably be used more frequently
- But is it wise to leave all assets to the survivor outright or should a by-pass trust be used?

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Portability – Much Ado About Nothing?



- Portability probably should not be relied on:
 - First, portability may only be available for 2011 and 2012 – and to take advantage of the DSUEA both spouses have to die within the 2011 and 2012 time frame
 - A spouse's GST Tax exemption is not portable so trusts should be used to take advantage of the GST exemption

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Portability – Much Ado About Nothing?



- There are also many non tax reasons to use trusts:
 - Asset Protection
 - Creditor Protection
 - Divorce Protection

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The Continued Tax Odyssey – Planning Issues



- The increase in the transfer tax exemption amounts in 2011 and 2012 means that planning documents that use formula clauses will have to be reviewed to avoid unintended consequences
- Moreover, there is no guarantee that the \$5,000,000 exemption will be available after 2012 so planning documents will have to be drafted with sufficient flexibility to take all possible scenarios into account
- For 2010 decedents, the effect of having the estate tax apply or electing carryover basis can effect the disposition under the Will
- Note: Most states have adopted legislation construing formula clauses in the Wills of 2010 decedents
 - Most of these construction statutes apply in the event there is no federal estate tax when the decedent dies
 - The construction statutes generally define the amount that can pass free of federal estate tax as equal to the federal exemption amount as it existed on December 31, 2009 - \$3,500,000
 - Query – how do the construction statutes work if the Estate opts out of the estate tax regime?

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2013 – It's Back to Future Uncertainty



- Under the terms of the 2010 Act, all of the changes made to the transfer tax system expire in 2013
- What happens in 2013?
- Who knows, but if Congress does nothing, we will be back to the pre-Bush law – a \$1,000,000 exemption for the estate tax and gift tax and a \$1,000,000 exemption indexed for inflation for the GST Tax
- The maximum rate will revert to 55% (with a 5% surcharge on large estates)

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Take Advantage of the Two Year Window of Opportunity



- Past history tells us that we cannot be sure of what Congress will do in 2013 – but we do know the rules for 2011 and 2012
- So now is the time to take advantage of what we know we have
- We have discussed what the 2010 Act did
- This is what it did not do:
- Zeroed-out and short term GRATs are still viable – the Act did not adopt the proposed restrictions on their use
 - Note: Short term GRATs are more advantageous than long-term GRATs because there is less of a mortality risk and they are less susceptible to market volatility
- The Act did not eliminate the use of valuation discounts for family entities
- So we can still, for now, plan with zeroed-out and short term GRATs and use valuation discount
- Note: The Administration has again proposed eliminating the use of short term GRATs and restricting the use of valuation discounts

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Take Advantage of the Two Year Window of Opportunity



- So, planners should encourage their clients to take advantage of the two year window before any changes to the law are enacted – it has never been a better time to make gifts
 - The exemption amounts have never been higher
 - The transfer tax rates have never been lower
 - Some asset values remain low
 - The AFR is still relatively low – so now is the time to take advantage of low interest rates

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The Administration's Fiscal Year 2012 Revenue Proposals



- The recently released Revenue Proposals resurrect the restrictive proposals that were not passed as part of the 2010 Tax Relief Act and include new proposed restrictions as well. The proposals include:
 - Restrictions on GRATS
 - They would have to have a minimum term of 10 years
 - The remainder interest would have to have a value greater than zero
 - Any decreases in the annuity during the GRAT term would be prohibited
 - The restrictions would apply to GRATS created after the date of enactment
 - Restrictions on the use of valuation discounts
 - The Proposals create another category of "disregarded restrictions" that would be ignored in valuing an interest in a family controlled entity transferred to a family member if, after the transfer, the restriction will lapse or may be removed by the transferor or his family
 - The Proposal would apply to transfers of property after the date of enactment subject to restrictions created after October 8, 1990

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The Administration's Fiscal Year 2012 Revenue Proposals



- The recently released Revenue Proposals also:
 - Eliminates the use of dynasty trusts in perpetuity
 - On the 90th anniversary of the creation of the trust, the GST exemption allocated to the trust would generally terminate
 - The proposal was made due to the repeal or limitation of the application of the rule against perpetuity statutes by many states, resulting in trusts that can last for perpetuity
 - The proposal would apply to trusts created after the date of enactment and to the portion of a pre-existing trust attributable to additions to the trust after that date (subject to grandfathering rules)

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The Administration's Fiscal Year 2012 Revenue Proposals



- What does the Administration Proposals say about the future tax exemption amounts and tax rates after 2012?
- The General Explanations of the Proposals assume the estate and gift tax provisions as in effect for 2009 are permanently extended
- Under the rules in effect in 2009:
 - The estate tax exemption would be \$3.5 Million
 - The gift tax exemption would be \$1 Million
 - The estate and gift tax maximum rate would be 45%
- The General Explanations note that "... since Congress recently enacted more generous estate tax provisions through 2012, there is considerable expectation that future legislation will provide more generous treatment than pre 2001 law."

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Gifts Can Reduce State Transfer Tax Liability



- Residents of decoupled states that do not impose a gift tax (like New York) can take advantage of gifting to reduce state estate tax liability
- If the state does not impose a gift tax, lifetime gifts do not trigger any transfer tax and the gifted property is removed from the calculation of the resident's state estate tax
- This is because decoupled states (in most cases) base their estate tax on the amount under the old federal credit for state death taxes as it existed in 2001
- The calculation of the state death tax credit is based on the value of the taxable estate (the gross estate less deductions) less \$60,000
- The amount of adjusted taxable gifts made by the decedent during his/her lifetime are not included in the base amount when calculating the state death credit

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Take Advantage of Low Interest Rates



- Opportune time to make gifts at reduced transfer tax cost
- Leverage difference between IRS assumed rate of return (hurdle rate) and rate of return actually realized
- You are betting that you can beat the IRS hurdle rate
- In low interest rate environment, it is easier to beat hurdle rate
- Potential to remove future appreciation from gross estate

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IRS Assumed Rates



- IRS sets minimum interest rates for family loans under Code Section 1274
- IRS requires use of the Code Section 7520 rate to measure the value of certain gifts
- IRS assumes that the investment will grow at a certain rate
- We will call the rates the AFR (assumed federal rate or hurdle rate)
- AFR's change monthly
- For certain techniques, deflated interest rates lower the value of the taxable gift

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Historical Review of Required Interest Rates Intra-Family Loans – Section 1274 Rate



	05/01	12/10	05/11
Short-Term Intra-Family Loans (AFR)	4.25%	32%	56%
Mid-Term Intra-Family Loans (AFR)	4.77%	1.53%	2.44%

Note: The IRS' assumed rate of interest applicable to a promissory note depends on the term of the note. A short-term rate applies to terms of 3 years or less; a mid-term rate applies to terms of more than 3 years but no greater than 9 years. The long-term rate applies to terms in excess of 9 years.

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Historical Review of Section 7520 Rate



	05/01	12/10	01/11	05/11
AFR (Sec. 7520 Rate)	5.8%	1.8%	2.4%	3.0%

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Advantages of Low Interest Rates



- Easier to produce an actual return that exceeds AFR
- To extent actual rates exceed AFR, appreciation passes tax free to remainder beneficiaries

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Low Interest Rate Environment Strategies



- Examples of strategies that work best in low interest rate environments:
 - Intra-Family Loan
 - GRATS
 - Sale to Grantor Trust
 - Charitable Lead Trusts

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Technique Using Low Code Section 1274 Rate



Intra-Family Loans: Loans to Children

- An intra-family loan allows shifting of wealth to younger family members when the growth rate exceeds the Section 1274 rate
- Parent charges minimum interest rate based on AFR and term of Note
- Interest is includable as income on parent's return
- Parent can use annual exclusion/unified credit to forgive portion or all of interest
- Note: Consider making loan to a grantor trust so interest is not includable in parent's taxable income

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Advantages of Intra-Family Loans When Interest Rates are Low



Intra-Family Loans: Loans to Children

- Easier for return on child's investment to eventually beat interest on Note
- If child's investment return exceeds stated interest rate in Note, spread is a tax-free gift
- Lower interest rates mean more easily manageable loan payments
- Risk – if the child's investment is not successful, he/she may not be able to repay loan

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Illustration: Intra-Family Loan



IRS AFR: May 2011		
Up to 3 years	.56%	
9 years	2.44%	
<u>Loan to children</u>		
Assume average rate of return:	5.00%	
Term of loan:	3 years	9 years
Amount of loan:	\$1,000,000	
Term	3 years	9 years
Amount of loan	\$1,000,000	\$1,000,000
Average rate of return	5.00%	5.00%
Annual return	50,000	50,000
Loan interest	(5,600)	(24,400)
Annual Benefit	44,400	25,600
Term of years	3	9
Net over term of loan	133,200	230,400

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GRATS



- Grantor transfers assets to a Trust
- Grantor retains fixed annuity for fixed term
- At the end of term, remaining assets pass to remaining beneficiaries (children or trusts for their benefit) tax free

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Gift Taxation of GRAT



- Transfer is subject to gift tax upon formation
- Value of taxable gift = value of gifted property less present value of annuity
- So value of gift = present value of remainder interest
- Determine present value of annuity actuarially using IRS Tables (AFR)
- Use AFR for month of the gift

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Good News: Can Structure GRAT So There is No Taxable Gift



- Can “zero out” GRAT (Walton case)
- This means that the gift of the remainder interest is valued at zero
- This also means that no gift tax is payable and no gift tax exemption has to be used
- Trust Agreement has to provide that annuity is paid for entire trust term
- So, if Grantor dies during GRAT term, annuity has to be paid to his/her estate
- Select combination of annuity/term that results in present value of annuity equaling amount contributed to GRAT

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Why Use “Zeroed-Out” GRAT if Nothing Remains at End of Term for Children



- Remember IRS assumes rate of return
- Rate of return can potentially exceed IRS' assumed rate
- Achieve higher rate of return by gifting assets that Donor believes will appreciate in value

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More Good News: Valuation Discounts



- Valuation discounts may also be available to increase amount passing to children
- Annual annuity paid to Grantor is based on discounted value

How Does a GRAT Work?



A	
	Undiscounted Value:
1. Trust Value:	\$1 Million
2. Trust Term:	3 Years
3. AFR May 2011	3.0%
4. Payout Rate:	35.35317%
5. Annual Annuity:	\$353,532
6. Appreciation Rate:	5%
7. Value of Gift:	\$0

B	
	Discounted Value:
	\$700,000
	3 Years
	3.0%
	35.35317%
	\$247,472
	5%
	\$0

Year	Beginning Value	Appreciation	Payout to Grantor	Ending Value
1	\$1,000,000	\$50,000	\$353,532	\$696,468
2	\$696,468	\$34,823	\$353,532	\$377,759
3	\$377,759	\$18,888	\$353,532	<u>\$43,115</u>

Year	Beginning Value	Appreciation	Payout to Grantor	Ending Value
1	\$1,000,000	\$50,000	\$247,472	\$802,528
2	\$802,528	\$40,126	\$247,472	\$595,182
3	\$595,182	\$29,759	\$247,472	<u>\$377,469</u>

GRATS: Are There Risks?



- Rate of return does not exceed AFR
- If Grantor dies during term all or part of Trust assets are included in gross estate
- Risks are not really significant
- If use zeroed-out GRAT, no gift tax cost – only cost = professional fees. Would be no worse off than if had not established GRAT

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Installment Sale to IDGT



- Simple theory behind intra-family loan can be elevated by using installment sale to intentionally defective grantor trust (IDGT)
 - Note: There is nothing wrong or “defective” about the trust – it is simply a trust that is intentionally designed as a grantor trust for income tax purposes but is not deemed to be a grantor trust for estate tax purposes
 - Note: Caution must be taken so that Grantor does not retain so much control over the trust so as to cause estate inclusion
- Strategy usually combines sale and gift - Planners recommend that Grantor gift at least 10% of the value of the transferred assets to support the IDGT's purchase of the assets

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How is the Purchase Price Paid?



- Balance of assets that are not gifted is sold to IDGT in exchange for a promissory note
- Note must bear interest at Section 1274 rate
- Note often provides for interest only payments for a term of years with a balloon payment at end
- Trust appreciation that exceeds IRS hurdle rate passes to remainder beneficiaries free of transfer tax

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Income Taxation of Sale to IDGT



- Grantor does not recognize any gain upon the sale
- Rev. Rul. 85-13 says that Grantor does not recognize gain or loss when he/she sells assets to a grantor trust
 - Grantor is deemed to have made a sale to himself
 - There is no income tax consequence as a result of a transaction with oneself
 - So interest on the Note is not included in gross income since the Grantor and the IDGT are deemed to be the same taxpayer – you are merely taking funds from one pocket and putting it into another pocket

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Taxation of Gift



- Initial gift to IDGT is a taxable gift
- So, the Grantor's gift tax exemption will be applied to eliminate or reduce the gift tax on the gift
 - If the Grantor has used all his gift tax exemption, he will have to pay a tax
- If assets transferred to the IDGT do not appreciate in value, gift will have been wasted

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Is There a Gift on Sale Portion of the Transaction?



- Sale portion should not result in a taxable gift if value of the promissory note is equal to the fair market value of the property
- Note must bear required IRS assumed interest rate

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Comparison of GRAT and Installment Sale to IDGT



- Sale to IDGT has to beat Section 1274 rate; GRAT has to beat 7520 rate
- Code Section 1274 rate is generally lower than 7520 rate
- So since sale to IDGT generally has a lower rate of return to beat, general consensus is that IDGTs produce greater economic benefit than GRATs
- But difference in two rates is generally not significant
- So conventional thinking is that using an IDGT only produces a modestly better economic effect than the GRAT
- Still, some analyses conclude that use of IDGTs provides the opportunity for significantly better returns than a GRAT

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Why Could Sale to IDGT Outperform GRAT?



- IDGT has ability to outperform GRAT since payments back to the Grantor are deferred farther into the future
- IDGT can make interest only payments back to the Grantor
- GRAT fund available to earn income and appreciate in value is depleted more quickly due to required annuity payment

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Factors to Consider When Choosing a GRAT or Sale to IDGT



Inherent Risks

- Using a GRAT may be safer and less complicated
- The GRAT is endorsed by statute
- No statutory authority exists recognizing the installment sale to an IDGT

Estate Inclusion

- Outstanding note balance is includable in the Grantor's estate
- Assets held in the IDGT upon the Grantor's death could arguably be included in the estate if the note is still outstanding at death
- IRS could claim that the Grantor retained an interest under Code Section 2036
- Before issuance of Final Regulations (T.D. 9414) regarding inclusion of GRAT assets in the estate of a Grantor who does not survive the GRAT term, risk of trust assets being fully included in the estate was considerable lower with an IDGT
- With the issuance of the Final Regulations, GRATs now potentially provide less risk of full inclusion in the estate (unless the GRAT is zeroed-out which would require full estate inclusion)

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Factors to Consider When Choosing a GRAT or Sale to IDGT



Income Tax Treatment upon Grantor's Death

- If the Grantor dies while the promissory note is outstanding, consequences are uncertain
- One theory is that capital gains taxes could be due on the sale portion of the transaction

Code Sections 2701 and 2702

- May be issues regarding application of Code Sections 2701 and/or 2702 to installment sale to IDGT
- Sections apply if the Grantor is deemed to have kept an "applicable retained interest" after the transfer is made
- Results of such a determination would be horrendous – the entire value of the transferred asset (without reduction for the value of the promissory note) would be treated as a gift

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Factors to Consider When Choosing a GRAT or Sale to IDGT



- Code Sections 2701 and 2702 provide that debt is not an applicable retained interest. In the Karmazin case, IRS maintained that Sections 2701 and 2702 may apply to installment sales and that the promissory note received in the sale did not constitute debt
- Case was ultimately settled on other grounds
- Case shows IRS' thinking on issue
- It is imperative that the Note be structured and administered as a bona fide debt to avoid application of Sections 2701 and 2702

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Factors to Consider When Choosing a GRAT or Sale to IDGT



GST Issues

- If the Grantor's goal is to ultimately benefit grandchildren, the installment sale to the IDGT is more efficient than a GRAT
- This is because of the so-called E-TIP (estate tax inclusion period) rules of Section 2642(f)
- That Code Section provides that the GST tax exemption cannot be effectively allocated to a trust during the period in which the trust property would be includable in the Grantor's estate were he/she to die (the E-TIP period)
- In a GRAT, the trust property (or a portion thereof as determined under the Final Regulations) is includable in the Grantor's estate if he/she dies during the GRAT term
- This means that GST exemption cannot be effectively allocated to the GRAT until the end of the GRAT term (using the values at the end of the GRAT term)
- So, a GRAT is not a good tool for multigenerational planning since it does not allow for leveraging of the GST tax exemption
- On the other hand, the Grantor's GST exemption can be applied to an IDGT

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Factors to Consider When Choosing a GRAT or Sale to IDGT



IRS Revaluation

- If the Grantor has no tolerance for incurring a gift tax liability if IRS were to increase the gift tax value of the transferred asset on audit, a GRAT should be used rather than the sale to the IDGT
- In the installment sale scenario, there is a risk of a taxable gift if IRS determines that the purchase price was less than the property's fair market value at the time of transfer
- The difference between the IRS' adjusted value and the purchase price is a gift
- If IRS were to increase the value of the property transferred to the GRAT, there would not be any increase to the value of the taxable gift since the annuity payable to the Grantor is measured by the value of the property transferred to the GRAT as finally fixed for federal gift tax purposes
- So, revaluation increases the amount of the annuity – it does not increase the taxable gift

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GST Tax Planning Opportunities



In 2011 and 2012 dynasty trusts should be considered:

- The exemption amount is \$5,000,000
- The rate is 35%
- Along with the \$5,000,000 gift tax exemption, there is a favorable environment to create dynasty trusts without causing a gift tax or GST Tax liability
- Remember that married couples to split gifts can transfer up to \$10,000,000 free of tax
- And remember that the Administration has proposed to eliminate the use of trusts lasting in perpetuity

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CRITICAL THINKING AT THE CRITICAL TIME™

Contact Information



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Thank You for Your Time