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2018 Year-End Estate Planning: Part 3

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In this four-part overview of 2018 estate planning developments, the **first article** focused on income and transfer tax exemption and rate changes. The **second article** highlighted important estate tax cases and planning considerations for 2018 and 2019. The overview continues below with a discussion of transfer techniques.

Transfer Techniques

Many techniques that have been utilized in prior years continue to be advantageous planning techniques under the Tax Cuts and Jobs Act. Due to potential sunset of many applicable provisions of the act, consideration should be given to planning that minimizes the risk of paying current gift taxes, but still allows taking advantage of the increased exemption amounts to shift assets and appreciation from the taxable estate. Additionally, consideration should be given to selling hard-to-value assets due to the increased exemption available to "shelter" any valuation adjustment of these assets upon audit. Lifetime gifting and sales transactions remain very important in providing asset protection benefits for trust beneficiaries, shifting income to beneficiaries in lower tax brackets and providing funds for children or others whose inheritance may be delayed by the longer life expectancy of one's ancestors.

Grantor Retained Annuity Trusts

Grantor retained annuity trusts, or GRATs, remain one of our most valuable planning tools, particularly in this time of continuing low interest rates. Due to rising interest rates and the fact that prior administrations' presidential budget proposals frequently called for adverse changes in how GRATs may be structured, GRATs should be created as soon as possible. Under current law, GRATs may be structured without making a taxable gift. Therefore, even if one has used all of his or her applicable exclusion amount, GRATs may be used without incurring any gift tax. Because GRATs may be created without a gift upon funding, they are an increasingly attractive technique for clients who want to continue planning to pass assets to their descendants without payment of gift tax in the uncertain tax environment.

A GRAT provides the grantor with a fixed annual amount (the annuity) from the trust for a term of years (which may be as short as two years). The annuity the grantor retains may be equal to 100 percent of the amount the grantor used to fund the GRAT, plus the IRS-assumed rate of return applicable to GRATs (which for transfers made in November 2018 is 3.6 percent). As long as the GRAT assets outperform the applicable rate, at the end of the annuity term the grantor will be able to achieve a transfer tax-free gift of the spread between the actual growth of the assets and the IRS assumed rate of return.

Although the grantor will retain the full value of the GRAT assets, if the grantor survives the annuity term, the value of the GRAT assets in excess of the grantor's retained annuity amount will then pass to whomever the grantor has named, either outright or in further trust, with no gift or estate tax.

Sales to Intentionally Defective Grantor Trusts

Sales to intentionally defective grantor trusts, or IDGTs, have become an increasingly popular planning strategy due to the increased exemption amounts under the TCJA.

In utilizing a sale to an IDGT, a taxpayer would sell assets likely to appreciate in value to the IDGT in exchange for a commercially reasonable down payment and a promissory note from the trust for the balance. From an income tax perspective, no taxable gain would be recognized on the sale of the property to the IDGT because it is a grantor trust, which makes this essentially a sale to one's self. For the same reason, the interest payments on the note would not be taxable to the seller or deductible by the trust.

If the value of the assets grows at a greater pace than the prevailing applicable federal rate (which for sales in November is as low as 2.7 percent for a short-term sale), as with a GRAT, the appreciation beyond the federal rate will pass free of gift and estate tax. While interest rates are projected to rise, they are still relatively low; this makes sales to IDGTs most opportune to structure now.

The current environment creates a window of opportunity for sales to grantor trusts. The increased federal exemption amounts may provide a cushion against any asset valuation risk attendant to such sales. Additionally, the increased exemption amounts permit the sale of a substantially larger amount of assets to grantor trusts. Typically, grantor trusts should be funded with at least 10 percent of the value of the assets that will be sold to the trust. With the higher exemption amounts, those who have not used any of their exemptions could contribute up to $11.18 million (or $22.36 million if splitting assets with a spouse) to a grantor trust. This would permit the sale of up to $100.62 million (or $201.24 million) of assets to the trust in exchange for a promissory note with interest at the appropriate applicable federal rate.

Consider a Swap or Buy-Back of Appreciated Low-Basis Assets From Grantor Trusts

If a grantor trust has been funded with low-basis assets, the grantor should consider swapping or buying-back those low-basis assets in exchange for high-basis assets or cash. If the grantor sold or gave (through a GRAT or other grantor trust) an asset with a low basis, when that asset is sold, the gain will trigger capital gains tax. However, if the grantor swaps or purchases the asset back from the grantor trust for fair market value, no gain or loss is recognized. The trust would then hold cash or other assets equal to the value of the asset that was repurchased. Alternatively, many grantor trust instruments give the grantor the power to substitute the trust's assets with other assets, which would allow the low-basis assets to be removed from the trust in exchange for assets of equal value that have a higher basis. Then on the grantor's death, the purchased or reacquired asset will be included in the grantor's taxable estate and will receive a step-up in basis equal to fair market value, eliminating the income tax cost to the beneficiaries. Those whose estates may not be subject to estate taxes due to the current high exemption amounts may utilize swaps or buy-backs to "undo" prior planning strategies that are no longer needed in today's environment.

Consider the Use of Life Insurance

Life insurance presents significant opportunities to defer and/or avoid income taxes, as well as provide assets to pay estate tax or replace assets used to pay estate tax. Generally

speaking, appreciation and/or income earned on a life insurance policy accumulates free of income taxes until the policy owner makes a withdrawal or surrenders or sells the policy. Thus, properly structured life insurance may be used as an effective tax-deferred retirement planning vehicle. Proceeds distributed upon the death of the insured are completely free of income taxes. Taxpayers should consider paying off any outstanding loans against existing policies in order to maximize the proceeds available tax-free at death, although potential gift tax consequences must be examined. Note that the decision to pay off such loans requires a comparison of the alternative investments that may be available with the assets that would be used to repay the loans and the interest rate on the loans.

Use Intra-Family Loans and Consider Re-Financing Existing Intra-Family Loans

Because interest rates remain low (and the exemption amounts are so high), many techniques involving the use of intra-family loans should be considered, including:

- The purchase of life insurance on the life of one family member by an irrevocable life insurance trust, with premium payments funded by loans from other family;
- The creation of trusts by older generation members for the benefit of younger family members, to which the older generation members loan funds. The spread between the investment return earned by the trust and the interest owed will create a transfer tax-free;
- Forgiving loans previously made to family The amount that is forgiven in excess of the annual gift tax exclusion amount will be a gift and thus will use a portion of your applicable gift tax and/or GST tax exclusion amount. This may be a beneficial strategy considering the increased exemption amounts.

Installment Sale to Third-Party Settled GST Tax-Exempt Trust

Unique planning opportunities and transfer tax benefits may be available if a relative or friend of the taxpayer has an interest in creating and funding a trust for the benefit of the taxpayer and/or the taxpayer's family. For example, a third-party grantor (e.g., a relative or friend of the taxpayer) could contribute cash to a trust for the benefit of the taxpayer, allocate GST tax exemption to that gift and then that trust could purchase assets from the taxpayer in exchange for such cash and a secured promissory note in the remaining principal amount of assets purchased. While this sale could result in payment of capital gain tax to the taxpayer (ideally at an earlier, lower value), this planning could present the following potential benefits:

- There should be no transfer tax concerns for the third-party grantor if the grantor's other assets, even when added to the value of the foregoing gift, would not be sufficient to cause the estate tax to apply at the grantor's death (this depends on what the estate tax exemption amount is at the grantor's subsequent death);
- The taxpayer could receive a step-up in basis as of the date of the initial sale;
- The taxpayer could be a beneficiary, hold a limited power of appointment over, and control who serves as trustee of the trust;
- The appreciation in the value of the asset being sold from the date of the initial sale above the interest rate on the promissory note (e.g., 04 percent is the midterm AFR in November) would accrue transfer tax free for the benefit of the taxpayer and/or

the taxpayer's family; and

- The trust could be structured in such a way as to provide protection from the taxpayer's creditors and remove the trust assets from the taxpayer's and his/her family members' taxable estates.

In order to achieve the foregoing benefits, it is important that only the third-party grantor makes any gratuitous transfers to the trust and that the third-party grantor not be reimbursed for any such transfers.

Purposely Triggering Application of Section 2701

A taxpayer may desire to utilize the increased gift and estate tax exemption prior to the scheduled sunset and may also desire to shift appreciation on this amount to a trust for the benefit of the taxpayer's children that is removed from the estate tax system. This desire may be met with hesitation to part with $11.18 million of assets. The taxpayer may also be concerned about losing cash flow from the transferred assets and not having the option of taking the property back if needed in the future.

Finally, the taxpayer may also have concerns that assets available for transfer have a low-income tax basis, which will carry over if a traditional gift is made. A planning alternative exists which can potentially address each of these concerns. The strategy is to create and fund a preferred partnership, which is structured to purposely violate Section 2701 of the code.

Assume the taxpayer gifts $1.1 million to an irrevocable trust for the benefit of the taxpayer's children (the family trust). Taxpayer and family trust create a preferred partnership, or PP. Taxpayer transfers to the PP $9.9 million of low-basis assets in exchange for a preferred interest entitling the taxpayer to a 5 percent noncumulative preferred return and the right to put the preferred interest to the PP for an amount equal to its associated capital account. The family trust contributes $1.1 million to the PP in exchange for a common interest entitling the family trust to all cash flow above the 5 percent payment made to the preferred interest and all appreciation on the PP's assets.

Structuring the preferred interest in this manner violates Section 2701 of the code. The result is a deemed gift of $9.9 million, which combined with the taxpayer's gift of $1.1 million to the family trust means the taxpayer has consumed $11 million of gift and estate tax exemption. Also, when the taxpayer dies, the preferred interest will be included in the taxpayer's estate under Section 2033 of the code, resulting in an income tax basis step-up of the preferred interest. The estate tax calculation will include a reduction in the taxpayer's tentative taxable estate of $9.9 million, to account for the prior taxable gift and avoid double taxation.

This structure has addressed each of the taxpayer's concerns. The taxpayer has consumed the increased exemption amount but has done so in a manner that preserves an income tax basis step up. The taxpayer has also retained a 5 percent return on the preferred interest and the right to put the interest back to the PP and take back the value of the taxpayer's capital account. Finally, cash flow above the 5 percent preferred return and appreciation on the PP's assets have been shifted to the family trust free of transfer taxes.

Consider Charitable Planning

As noted above, the TCJA increases the adjusted gross income percentage limit for cash contributions to public charities from 50 percent to 60 percent. Because of the increased percentage limitation, consideration should be given to accelerating charitable giving to possibly obtain a current income tax deduction and potentially reduce one's taxable estate

(of both the contributed asset, as well as future appreciation).

A planning tool that is very effective in a low-interest-rate environment is a charitable lead annuity trust, or CLAT, which combines philanthropy with tax planning. A CLAT is an irrevocable trust that pays one or more named charities a specified annuity payment for a fixed term. At the end of the charitable term, any remaining assets in the CLAT pass to the remainder, noncharitable beneficiaries. As with a GRAT, to the extent the assets outperform the IRS assumed rate of return (3.6 percent for November), those assets can pass transfer tax free to the chosen beneficiaries. Alternatively, a strategy that works better in a high-interest-rate environment is a charitable remainder annuity trust, or CRAT. A CRAT is an irrevocable trust that pays an annual payment to an individual (typically the grantor) during the term of the trust, with the remainder passing to one or more named charities. The grantor may receive an income tax deduction for the value of the interest passing to charity. Because the value of the grantor's retained interest is lower when interest rates are high, the value of the interest passing to charity (and, therefore, the income tax deduction) is higher. A CRAT may continue to become an attractive option, if interest rates continue to rise.

The qualified charitable distribution rules were made permanent by the Tax Hikes (PATH) Act of 2015 on Dec. 18, 2015. The PATH Act permanently extended the ability to make IRA charitable rollover gifts, which allow an individual who is 70.5 years old or older to make a charitable rollover of up to $100,000 to a public charity without having to treat the distribution as taxable income. Other types of charitable organizations, such as supporting organizations, donor advised funds or private foundations, are not eligible to receive the charitable rollover. Therefore, if one needs to take a required minimum distribution for 2018, he or she may arrange for the distribution of up to $100,000 to be directly contributed to a favorite public charity and receive the income tax benefits of these rules. Due to new limitations on itemized deductions (i.e., the cap on the state and local tax deduction), some taxpayers may no longer itemize deductions on their personal income tax returns. Without itemizing deductions, these taxpayers could not receive the income tax benefit of a charitable deduction for charitable contributions.

The qualified charitable distribution rules allow taxpayers who are claiming a standard deduction to still obtain a financial benefit from charitable donations.

Attention to Rising Interest Rates

Certain planning techniques are more attractive in a higher interest rate environment. With interest rates rising, taxpayers should consider strategies that can take advantage of these higher rates. As noted above, a CRAT is an effective charitable planning strategy when interest rates are high, as it increases the value of the charitable portion of the trust and thereby increases the income tax deduction. As another example, QPRTs are also attractive when interest rates are higher. A QPRT is an irrevocable trust designed to pass a primary residence or vacation home to chosen beneficiaries, while the grantor retains the right to occupy the residence for a period of time. The creation of the QPRT "freezes" the value of the residence for the purposes of gift and estate tax. When interest rates are higher, the present value of the gift made by the grantor is lower.

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