SOPHISTICATED (AND LESS SOPHISTICATED!) PLANNING TECHNIQUES

PLI – 50th Annual Estate Planning Institute
September 16, 2019 – New York City

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I. Overview. The term **"**sophisticated planning techniques" generally refers to techniques that are designed to help "freeze" an estate's value, while passing potential appreciation gift-tax efficiently to heirs. These techniques typically include GRATs (grantor retained annuity trusts), Sales to Defective Grantor Trusts, CLATs (charitable lead annuity trusts) and QPRTs (qualified personal residence trusts). Gifts or sales of interests in LLCs (limited liability companies) and FLPs (family limited partnerships) are often part of the mix, and "defined value clauses" are sometimes used to limit potential gift tax exposure when hard-to-value property is transferred. Yet because of what's informally known as "The Tax Cuts and Jobs Act" (P.L. 115-97), enacted on December 22, 2017, the former exclusion amount of $5 million, indexed for inflation, is now $10 million, indexed for inflation, from 2018 through 2025. Thus, even fewer individuals will be concerned about protecting transfers from gift and estate taxes and generation-skipping transfer tax (GST), focusing instead on minimizing income taxes.

Nevertheless, sophisticated planning techniques are still relevant – not only for those whose wealth exceeds the inflation-indexed $10 million exclusion amount ($11.4 million in 2019, or $22.8 million for married couples), but for those who live or own property in a "decoupled" state such as New York, Connecticut or Massachusetts, where the *state* estate tax is based on a smaller state exclusion amount.

Less sophisticated planning techniques should not be overlooked, however. These may involve simple but effective ways to make good use of the current $15,000 annual exclusion, or something as basic as directly paying someone's tuition or medical expenses, or making a loan to a family member.

Before getting into these different techniques, some background may be helpful.

II. Background on current transfer taxes.

A. **The Tax Cuts and Jobs Act (TCJA) – 2017.** As noted above, from 2018 through 2025, the Tax Cuts and Jobs Act has temporarily increased the $5 million exclusion amount, indexed for inflation, to $10 million, indexed for inflation; barring Congressional action, in 2026, the exclusion will revert to $5 million, indexed for inflation. In 2019, the inflation-indexed number is $11.4 million; it is based on the permanent new inflation measure mandated by TCJA – namely the "chained"

Consumer Price Index for All Urban Consumers (C-CPI-U), which will produce smaller increases than the former CPI for All Urban Consumers (CPI-U).

B. 2010 Act. As part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16), 2010 dawned with (i) no estate tax or GST, (ii) a gift tax with a $5 million exclusion and 35% rate, and (iii) a "modified" carryover basis regime, whereby heirs inherited a decedent's built-in capital gains, subject to certain exemptions. At the end of 2010, taxpayers were facing a return to what could be called confiscatory transfer taxes, with $1 million exclusions and a top rate of 55%, as well as the loss of the 2001 income tax cuts, along with those under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Pub. L. No. 108-27). The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act") (Pub. L. 111-312), enacted on December 17, 2010, postponed this reckoning for two years, by continuing the tax cuts through 2012, and doing the following for transfer taxes:

1. **For 2010:** the estate tax and GST were reinstated, retroactive to January 1, 2010. The estate tax exclusion and GST exemption were both increased to $5 million, the top estate tax rate was reduced to 35% (from 45% in 2009), and the GST rate – *for 2010 only* – was reduced to **0%**; executors of 2010 decedents could opt out of the estate tax in favor of the modified carryover basis regime mentioned above.

2. **For 2011 and 2012:** the gift tax exclusion (formerly $1 million) was increased to match the estate tax exclusion and GST exemption, which remained at $5 million (indexed for inflation as of 2012), while the 35% gift tax rate was adopted for estate tax and GST purposes; "portability" (see below) allowed the deceased spouse's unused exclusion to carry over to the surviving spouse.

C. ATRA, briefly. By the end of 2012, it was "déjà vu all over again": the 2001 and 2003 tax cuts were about to expire, as well the 2010 Act's transfer tax provisions. The American Taxpayer Relief Act of 2012 (ATRA) (Pub. L. 112-240), enacted on January 2, 2013, made the 2001 and 2003 tax cuts permanent for most taxpayers, while raising taxes on the top 1% to 2% of taxpayers. ATRA increased the top transfer tax rate from 35% to 40%, and made permanent the $5 million gift and estate tax exclusion and GST exemption (indexed for inflation), as well as portability.

1. **The applicable exclusion amount.** The "applicable exclusion amount" (AEA) consists of the "basic exclusion amount" (BEA), $5 million indexed for inflation as of 2012 – and $10 million, indexed for inflation, from 2018 through 2025 – plus, in the case of surviving spouses, the "deceased spousal unused exclusion amount" (DSUE). IRC Sec. 2010(c). (For individuals who have no DSUE, their basic exclusion amount is the same as their applicable exclusion amount.) The applicable exclusion amount protects taxable transfers from gift and estate tax, and the GST exemption, which equals the *basic* exclusion amount, protects transfers to people such as grandchildren (either outright or in trust) from GST.

The inflation-indexed BEA is as follows:

	Single	Married Couple
2012	$5.12 million	$10.24 million
2013	$5.25 million	$10.50 million
2014	$5.34 million	$10.68 million
2015	$5.43 million	$10.86 million
2016	$5.45 million	$10.90 million
2017	$5.49 million	$10.98 million
2018	$11.18 million	$22.36 million
2019	**$11.40 million**	**$22.80 million**

2. **"Portability."** "Portability" refers to how the DSUE (see above) carries over to the surviving spouse, provided that the deceased spouse's executor files an estate tax return (a return is required even if the deceased spouse's gross estate plus "adjusted taxable gifts" is under the filing threshold ($11.18 million in 2018 and $11.4 million in 2019)). By merely filing an estate tax return, the executor is deemed to elect portability; to opt out of that election, the executor must check a box (or just not file a return if one is not otherwise required). The surviving spouse can use the DSUE for gift or estate tax purposes (and it is deemed used before her own exclusion). Note that there can only be *one* unused spousal exclusion – namely, that of the "last" predeceased spouse. In addition, the IRS will have an unlimited amount of time to examine the predeceased spouse's return with respect to the portable exclusion; put differently, even if it is too late to assess gift or estate tax against the predeceased spouse's estate, the IRS can still challenge the size of the DSUE. Finally, note that neither the GST exemption nor any *state* estate tax exclusion is portable (except, apparently, for Hawaii and Maryland).

   Is it worth it? Married couples with collective assets under the current $11.4 million estate tax filing threshold may wonder whether it is worth incurring the expense of having someone prepare a "pure portability" estate tax return so that the predeceased spouse's DSUE carries over to the surviving spouse – potentially providing that spouse with a $22.8 million exclusion (in 2019). Perhaps the simplest answer is that portability is like insurance: it may never be needed, but if it is, it's good to have it.

III. Sophisticated techniques – a selected overview.

A. **GRATs (grantor retained annuity trusts).** A GRAT is a creature of statute, and is found in IRC Sec. 2702; it involves a transfer in trust to a member of the donor's family wherein the donor retains a "qualified [annuity] interest." Although a GRAT will not reduce the donor's existing wealth, it is a tax-efficient way to pass potential appreciation to the donor's heirs. The donor typically funds the GRAT with an asset that either is likely to appreciate significantly or is a "cash cow." The trust pays the donor an annuity, usually for two or three years. After that period is over, whatever is left in the trust passes, either outright or in further trust, to the remaindermen (typically the donor's children).

When the donor funds the trust, the donor is deemed to make a gift equal to the fair market value of the property transferred to the trust minus the present value of the donor's retained annuity interest, which can be structured to equal up to 100% of the trust's value, so that there is little or no gift (a "zeroed-out" GRAT). If the trust property outperforms the 7520 rate used to value the annuity (see below), that appreciation will pass gift-tax free to the remaindermen. Also, if the IRS successfully challenges the value of the property transferred to the GRAT, the gift will not increase because the annuity automatically adjusts to take into account any valuation increase.

Example: Dad hopes to take his company public within the next year or so. Based on the latest venture capital financing, the stock is currently valued at about $10 per share. Dad creates a GRAT in June 2019, when the 7520 rate is 2.8%. He funds it with 500,000 shares of stock, so that the GRAT is worth $5 million. For three years, he'll receive a 35.21746% annuity, valued at $1,760,873, which can be satisfied with the stock. At the end of three years, whatever is left in the GRAT will pass outright to his adult children. Because the present value of Dad's annuity equals the fair market value of the stock on the date it is transferred to the GRAT, the present value of the current gift to his children is zero.

In Year 1 of the GRAT, Dad receives 176,087 shares to satisfy the annuity. During Year 2 of the GRAT, the stock goes public and is now worth $15 per share. Dad receives 117,392 shares to satisfy the annuity. By Year 3, the stock is now worth $20 per share, and Dad receives 88,044 shares to satisfy the annuity. At the termination of the GRAT, the trust still has 118,477 shares, which are worth $2,369,540, and pass to Dad's children, gift-tax free. The shares Dad has received in payment of the annuity (a total of 381,553) are now worth $7,630,460.

Possible downsides. If Dad dies during the GRAT term, then the amount necessary to produce his retained annuity will be includible in his estate; this typically will be most, if not all, of the trust property. (See Treas. Reg. § 20.2036-1(c)(2).) (If the GRAT still has the closely held business at Dad's death, however, this includibility can mean that his estate is eligible for IRC Sec. 6166 and an extension of time to pay estate tax; such treatment is not available if Dad instead sold his business to a defective grantor trust – see below – and dies owning the note, rather than the business itself.) Also, if the property transferred to the GRAT doesn't beat the 7520 rate used to value Dad's interest, Dad will receive everything back, and there will be nothing left for his kids. In that instance, he will be out his set-up costs (and perhaps annual appraisal costs if the GRAT holds a hard-to-value asset), but will not have wasted any of his $11.4 million applicable exclusion amount, assuming he zeroed-out the GRAT. Finally, because of the generation-skipping transfer tax **"ETIP"** rules, which preclude Dad from allocating his GST exemption to the trust until *after* his annuity interest is over, the GRAT is not a desirable vehicle for transferring property to grandchildren and more remote descendants (see IRC Sec. 2642(f)).

Escalating GRAT. The GRAT's annuity also can be structured to increase by 20% every year (see Treas. Reg. § 25.2502-3(b)(1)(ii)); this can allow more appreciation to accrue for remaindermen, since the annuity payments are effectively "back-loaded."

Note about the 7520 Rate. Named after the section of the Internal Revenue Code where it is set forth, the 7520 rate is published monthly and represents what the IRS assumes is a reasonable rate of return. It equals 120% of the applicable federal mid-term rate, rounded to the nearest 0.20% (20 basis points, or 2/10th of 1%; the mid-term rate is based on the average market yield of outstanding marketable Treasury obligations with maturities that are over three years but not over nine years). The 7520 rate is used to value annuities as well as income, reversionary and remainder interests; it factors into the gift tax computations for GRATs, CLATs (charitable lead annuity trusts), QPRTs (qualified personal residence trusts) and CRATs (charitable remainder annuity trusts); it has little or no bearing on the value of unitrusts, where the payout fluctuates, based on the trust's annual valuation (as with a charitable remainder unitrust or charitable lead unitrust). The 7520 rate has been in effect since May 1, 1989. To the extent the transferred property outperforms the 7520 rate used to value, say, the present value of the GRAT's annuity interest, property will be left for the GRAT remaindermen.

B. Sales to Defective Grantor Trusts. This technique is similar to a GRAT in that it will not reduce a donor's existing wealth, but is a tax-efficient way to pass potential appreciation to the donor's heirs. Although not sanctioned by statute, Sales offer certain advantages over GRATs, including generally using a lower interest rate than GRATs. Nevertheless, whereas the GRAT can be "zeroed-out" so that there is little or no use of the donor's applicable exclusion amount, the typical Sale requires a gift with a value of at least 10% of the property the donor intends to sell to the trust, with the donor taking back an interest-only balloon note to memorialize the sale (because the transaction involves a grantor trust, the donor isn't taxable on any gain on the sale or interest from the note).

Assuming the note is for nine years or less, its interest rate will be *lower* than the 7520 rate used to calculate the present value of the annuity interest in a GRAT. Thus, because the Sale has a lower "performance hurdle" than the GRAT, more potential appreciation can accrue for the trust's beneficiaries; in addition, unlike the GRAT, the trust can benefit multiple generations, rather than just children. And if the donor dies while the note is outstanding, only the balance due on the note is includible in her estate – not the entire value of the trust, as is typically the case with the GRAT; note, however, that the income tax consequences of the donor's death are uncertain (it is possible that gain on the installment payments might become taxable). Finally, if the IRS successfully increases the valuation of the asset sold, the donor may be treated as engaging in a "bargain sale," meaning that she didn't charge enough for the property, and made an additional gift to the extent the property was undervalued (this is not an issue with a GRAT, since the annuity payment is expressed as a formula that automatically adjusts to account for any valuation increase, thereby negating any additional gift tax exposure).

Example. Mom creates a trust for her children and grandchildren, which she funds with $500,000, and to which she allocates GST exemption. The trust is structured as an "intentionally defective grantor trust" (IDGT) – i.e., although Mom is responsible for paying the trust's income taxes, it won't be taxable in her estate when she dies. Mom has a privately held company that she intends to take public within the next year or so; based on the latest venture capital financing, the company's stock is worth $10 per share. In June 2019, Mom sells 500,000 shares of the stock (worth $5,000,000) to the trust in exchange for a promissory note that requires annual payments of interest, and a balloon payment of principal in 5 years. The note's interest rate is 2.38%, the June 2019 annual mid-term AFR (applicable federal rate) under IRC Secs. 7872(f)(2) and 1274(d). Because this is an IDGT, no gain or loss is realized on the sale, Mom does not pay income tax on the annual interest payments of $119,000 she receives, and the trust cannot deduct the interest paid. In June 2024, the stock is now worth $20 per share, and the trustee distributes 250,000 shares to Mom satisfy the $5,000,000 note (Mom has also received a total of $595,000 in interest payments that were paid from corporate distributions made to the trust). The trust still has 250,000 shares, worth $5,000,000.

Sale vs. GRAT. With the Sale, Mom's children and grandchildren receive $5 million, contrasted with the $2.3+ million that Dad's children receive from the GRAT. In other words, with the Sale, more appreciation passes to the trust beneficiaries, gift-tax free. This comes at a "cost," however: an up-front gift of $500,000 – something that matters less in 2019 because of Mom's $11.4 million applicable exclusion amount. Note that the more impressive Sale result is possible because Mom *only* receives interest (rather than interest and principal) during the term of the note, and the performance hurdle – namely, the note's 2.38% interest rate versus the GRAT's 2.8% 7520 rate – is lower. Also, if Mom dies while the note is outstanding, only the balance of the note (and not any appreciation on the stock) is includible, and potentially taxable, in her estate.

Possible downsides. If the property Mom sells to the trust doesn't outperform the note's interest rate, there won't be any appreciation for the trust beneficiaries, and the trust probably won't be able to pay off the note. Mom also will have wasted her significant up-front gift. And, as mentioned above, if Mom dies while the note is still outstanding, the possible income tax consequences are uncertain. Finally, if the IRS successfully challenges the valuation of the property sold to the trust, Mom may be treated as making a gift to the extent the property was "undervalued." Again, however, the $11.4 million applicable exclusion amount lessens this potential valuation concern. See the chart in the appendix comparing and contrasting GRATs and Sales. See also "Defined value clauses" at III.G. below.

"Swapping" assets. Typically, GRATs and IDGTs have a "swap power" – namely, a power under IRC Sec. 675(4)(C), "exercisable in a nonfiduciary capacity," for a person to “reacquire the trust corpus by substituting other property of an equivalent value.” Not only does such a power make a trust a grantor trust, it also allows the grantor to reacquire low-basis trust property and substitute other property of an equivalent value for it. In other words, the grantor could swap cash or high-basis property for the trust’s low-basis property, thereby helping to mitigate potential capital gains tax on the trust’s appreciated property.

C. QPRTs (qualified personal residence trusts). QPRTs offer a discounted way to give a personal residence to, say, children. With a QPRT, Mom, for example, transfers her vacation home to a trust and retains the right to use it for a term of years, and gets the property back if she dies during the trust term. If she’s still alive at the end of the trust term, the property passes, say, to her daughter. With interest rates still low, Mom’s retained interests are not worth as much as they would be if rates were higher; the corresponding gift to her daughter (her future right to receive the property) is therefore greater. Nevertheless, the $10 million inflation-indexed exclusion amount ($11.4 million in 2019) helps mitigate any gift tax “friction” from the transaction. Note, however, that this large exclusion amount may make a straight gift more appealing, as it also avoids the mortality risk inherent in a QPRT.

Example. Mom is 60, and wants to give her $2.5 million Martha’s Vineyard vacation home to her daughter. She sets up a QPRT in June 2019, when the 7520 rate is 2.8%. The trust will last for 10 years. If Mom survives the term, the property passes to her daughter; if Mom doesn’t survive the term, the property goes to her estate (and will receive a basis adjustment). When Mom creates the trust, her retained interests in the house are worth 35.218%, or $880,450; the corresponding gift to her daughter is 64.782%, or $1,619,550. Mom has more than enough of her $11.4 million exclusion amount to shelter this gift (she’s basically only out of pocket the cost of creating the trust and appraising the house). Mom survives the 10-year term, and her daughter owns the property, which is now worth about $3.7 million (about a 4% growth rate). The QPRT has “frozen” the value of Mom’s house – another way of saying that appreciation passes to her daughter gift-tax free.

Possible downsides. If Mom wishes to keep using the home after the QPRT is over, she must pay Daughter fair market rent. (If the home continues to be held in a grantor trust, however, the rent Mom pays will not be taxable to that trust and is effectively a tax-free gift to the trust; in addition, if Dad is still alive and is a beneficiary of this trust, no rent needs to be paid.) Also, Daughter takes Mom’s “adjusted basis” in the house; thus, if Daughter sells the house, she’ll pay the same capital gains tax that Mom would have paid; this tax could be substantial and may outweigh the QPRT’s transfer tax benefits.

Practical considerations. “Successful” QPRTs – as where Mom survives the fixed term and the residence passes to Daughter – can evoke a “good news, bad news” response. That is, it’s good news that the QPRT worked…but it can also be bad news: as mentioned above, if Mom wants to continue using the property, she must pay fair market rent, and Daughter takes Mom’s adjusted basis (and any built-in capital gains). Putting those issues aside, what if the residence passes not just to

Daughter, but to Mom's other two children as well? Suppose that Daughter 1 is fond of the place, but is very pre-occupied with family and professional responsibilities, and rarely uses it. Daughter 2 dislikes the home, never uses it, and resents contributing to its upkeep. And Son, who's always short of cash and perennially unemployed, has made the home his own. Not a happy situation.

How do multiple owners iron out such potential difficulties? There are no easy answers. Generous Mom might make an additional gift to an account that the co-owners can use to meet the home's operating expenses – but that requires discipline on the part of the co-owners not to deplete the account for other purposes. The co-owners could also draft an "operating agreement," whereby they set forth usage and payment rules; this requires the "honor system" and cooperation. The co-owners could also create a limited liability company (LLC) to which they transfer their ownership interests, and again set forth rules by which they agree to abide. This requires a financial and emotional investment that the co-owners might be unwilling to make. And so forth. In the author's opinion, sibling co-ownership of vacation homes generally doesn't work. Often, the wealthier sibling buys out the other siblings because the family differences are insurmountable – and if a buy-out isn't financially feasible, the place gets sold and the co-owners get cash.

D. CLTs (charitable lead trusts). CLTs are a gift and estate tax strategy that provide an "up-front" income interest to charity, with the remainder typically passing to the donor's children and grandchildren. These trusts may make sense if the donor is charitably inclined, and believes her children and grandchildren are inheriting "enough," but is willing to give them more if it won't cost a lot of additional gift or estate tax. With a charitable lead annuity trust (CLAT), the payout is a percentage of the trust's *initial* value; with a charitable lead unitrust (CLUT), the payout is a percentage of the trust's *annual* value (CLTs have no minimum payout). Because the annuity interest "freezes" the up-front charitable interest, CLATs, like GRATs, can be zeroed-out. The lower the 7520 rate, the higher the present value of charity's annuity interest, and the lower the gift of the remainder interest.

To illustrate, suppose Mom puts $2 million into a 20-year CLAT. To zero out the remainder gift to her heirs, the annual annuity need only be 6.598% ($131,960) when the 7520 rate is 2.8%, but must be 10.799% ($215,980) when the 7520 rate is 8.8%. As with the GRAT, to the extent the CLAT outperforms the 7520 rate used to value the annuity interest, that appreciation will pass gift-tax free to Mom's heirs. By contrast, a unitrust interest is generally unaffected by interest rates, as the up-front charitable beneficiary and remaindermen share equally in the trust's appreciation (and depreciation); CLUTs cannot be zeroed-out and can have a significant gift component.

Income taxation of a CLT. A charitable lead trust (CLT) can be structured as a grantor trust, whereby the grantor is taxable on the trust's income, but receives an immediate "upfront" charitable income tax deduction for the present value of charity's interest (note that if the trust ceases to be a grantor trust before the charitable interest is over, the grantor (or the grantor's estate) "recaptures" the unused deduction as additional income). Typically, however, CLTs are separate taxpayers, whereby they (and not the grantor) are entitled to an income tax deduction for any income paid to charity. To minimize potential income taxes, CLTs often provide that the charitable payout is "tiered," and is treated as coming first from ordinary income items, and then from capital gains. Final Treasury Regulations issued on April 16, 2012 (T.D. 9582) have confirmed Treasury's position that such a provision will not be respected for income tax purposes unless it has "economic effect independent of income tax consequences." Treas. Reg. § 1.642(c)-3(b)(2). This means that the payout will be treated as coming, pro rata, from the trust's different items of income. Note that non-grantor CLTs are potentially subject to the 3.8% tax on "net investment income" that commenced in 2013 (see IRC Sec. 1411).

Special GST rule. Donors interested in benefiting grandchildren or more remote descendants ("skip persons") typically use a charitable lead *unitrust* (CLUT) rather than a CLAT, because they can fully protect a CLUT from generation-skipping transfer tax (GST) by allocating enough GST exemption to the trust to cover the present value of the remainder interest at the trust's inception. Donors cannot achieve the same GST certainty with a CLAT. When they allocate GST exemption to the CLAT at its inception, they won't know how much of the trust is protected from GST until the trust terminates, since that is when the trust's corpus is matched to the donor's "adjusted GST exemption" (i.e., the amount of GST exemption allocated to the trust, compounded by the same 7520 rate used to determine the present value of charity's interest; see IRC Sec. 2642(e)).

Example. Grandma creates a 20-year zeroed-out CLAT with $10 million in June 2010, when the 7520 rate is 2.8%. The annual annuity is 6.598%, or $659,800. Grandma allocates $4 million of GST exemption to the trust. 20 years later, charity's interest terminates, and the trust's remainder passes to grandchildren. Grandma's adjusted GST exemption (the $4 million allocated to the trust, compounded at 2.8%), is nearly $6.95 million. ***Assuming a 5% growth rate,*** the trust is left with a little over $4.7 million, which passes to Grandchildren free and clear. Because this amount is less than Grandma's $6.95 million adjusted GST exemption, Grandma wasted some of her GST exemption by allocating too much to the trust. ***Assuming a 7% growth rate,*** the trust is left with nearly $11.65 million, or more than Grandma's $6.95 million adjusted GST exemption. Because Grandma didn't allocate enough exemption to the trust, about 40% of it, or $4.66 million, is now subject to GST ($6.95 million/$11.65 million = .60; 1 minus .60 = .40). After a GST "haircut" of about $1.865 million (a 40% top estate tax rate), Grandchildren net about $9.785 million.

Although a handsome amount of property still passes gift-tax free to grandchildren in the above example, the GST uncertainty of CLATs generally deters most donors. Not unlike the ETIP rule mentioned above, which precludes donors from using GRATs to benefit skip persons, this CLAT rule recognizes that an annuity, which freezes the upfront interest, can allow "too much" potential appreciation to pass to grandchildren and more remote descendants.

E. **SLATs (spousal lifetime access trusts).** SLATs offer a way for Mom or Dad to make a significant gift into a trust and still maintain indirect access to it – as long as the other is a beneficiary and still alive.

Example. Mom wants to make a significant lifetime gift into a generation-skipping trust that will ultimately benefit her children, grandchildren and more remote descendants. She would still like the comfort of knowing that she could have indirect access to the trust property if the need arises, however. She therefore makes Dad a discretionary income and principal beneficiary of the trust. Because of Dad's interest in the trust, it will be grantor as to Mom, so that she is responsible for paying the trust's income taxes – meaning that Mom will be making additional tax-free gifts to the trust and its beneficiaries. Dad dies several years later, and Mom no longer has indirect access to the trust property. The trust continues as a "defective" grantor trust as to Mom, however, because of her ability to "swap" trust assets under IRC Sec. 675(4)(C). (See "Swapping assets" under III.B. above.)

F. **Insurance trusts.** An insurance trust is used to remove life insurance from the insured's estate for estate tax purposes. In the case of a single life policy, the trust is typically for the insured's spouse and children; in the case of a second-to-die policy (as in, the policy does not pay out until both spouses have died), the trust is typically for the couple's children. The life insurance premiums are often funded through use of annual exclusion gifts into the trust, with the trustee providing "Crummey" notices to the beneficiaries, informing them that they have a limited period of time to withdraw the gift (see IV.A below).

G. **"Defined value clauses."** A defined value clause is designed to mitigate adverse gift tax consequences when the donor gives away hard-to-value property. With such a clause, the gift's value typically equals a fixed dollar amount (as in, the donor gives away LLC units equal to $1 million, "as such value is finally determined for federal gift tax purposes"); if the IRS successfully argues on audit that the property was undervalued and the donor therefore gave away too much, the clause reallocates the donor's "excess" gift to another beneficiary, such as charity (see *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011)). *Wandry v. Commissioner*, T.C. Memo. 2012-88, a significant taxpayer victory, took this reallocation a step further: here, the "excess" gift was reallocated to the donors, not charity. Although the IRS appealed the case, it withdrew its petition in October of 2012, and on November 13, 2012, issued an Action-on-Decision stating that it "non-acquiesced" in the Tax Court's holding, and "generally, will not follow [*Wandry*] in disposing of cases involving other taxpayers." Despite this AOD, many taxpayers now use the *Wandry* approach.

H. **FLPs and LLCs.** Entities such as family limited partnerships (FLPs) and limited liability companies (LLCs) are often employed in the family-gifting context, and may be one of the assets sold in, say, the Sale to the Defective Grantor Trust described above (see III.B). These entities pass their income through to partners and members, and are not separately subject to income tax. They generally garner valuation discounts because of restrictions on the rights and powers of the limited partners (in the case of the FLP) and of the members (in the case of the LLC). For example, limited partners cannot freely transfer their respective interests, control distributions, participate in the partnership's management, or easily withdraw from the partnership.

FLPs and LLCs invite scrutiny from the IRS, and are generally looked upon more favorably if they have "legitimate non-tax purposes," and are funded with some kind of working business, rather than just marketable securities or cash. These entities are more likely to withstand an audit challenge when a taxpayer truly respects the entity rather than uses it more as a "piggy bank" by retaining economic benefits (see, e.g., *Strangi II*, 417 F.3d 468 (5th Cir. 2005) – taxpayer lost; and *Kimbell* (317 F.3d 257 (5th Cir. 2004) – taxpayer won on appeal). When donors make gifts of these entity interests, an appraisal to determine the value of the donated interest is essential, and must be part of the gift tax return so as to provide the IRS with "adequate disclosure" of the gift, and thereby start the statute of limitations running on the gift (and the reported valuation).

Proposed regulations on valuation discounts. On August 2, 2016, the IRS released proposed regulations chiefly relating to IRC Sec. 2704 and valuation discounts on transfers to family members of interests in family-controlled entities, such as partnerships and LLCs (REG-163113-02). Although designed to eliminate perceived valuation abuses in this area, the rules aimed broadly, and seemed to catch not just entities funded with cash and marketable securities (presumably the intended target), but operating businesses as well. As a result, numerous family business owners and groups, advisors and Republican members of Congress declared the regs irreparably flawed, and urged their withdrawal. On April 21, 2017, President Trump issued an Executive Order that required Treasury Secretary Mnuchin to examine all "significant" regulations that were issued in 2016. These proposed regs fell under that umbrella, and were officially withdrawn on October 20, 2017, the date the withdrawal notice was published in the Federal Register. Thus, valuation discounts still appear to work.

I. CRTs (charitable remainder trusts). CRTs are set forth at IRC Sec. 664(d)(1) and (d)(2). With a CRT, an individual gets the "up-front" income interest for a period of years (not more than 20) or life, and charity gets the remainder interest. Testamentary CRTs generate an estate tax deduction for the present value of charity's remainder interest; *inter vivos* CRTs, or those established during the donor's lifetime, generate a corresponding gift tax deduction for the present value of charity's remainder interest, along with an income tax deduction for the charitable remainder interest. Donors typically create lifetime CRTs when they wish to diversify low-basis assets, defer the capital gains tax and provide themselves with an income stream. The trust's payout is taxable to the up-front beneficiary, but will benefit from favorable capital gains rates if the trust is invested for growth or has significant capital gain from the sale of the low-basis assets used to fund it (the income is "tiered" under IRC Sec. 664(b), with the most expensive type of income deemed to come out first – call it a "WIFO" system: worst in, first out). Because of the ***3.8% tax on "net investment income" (NII) that commenced in 2013***, distributions of post-

2012 income are treated as NII in the hands of the beneficiary, and therefore are potentially subject to this tax. See Treas. Reg. § 1.1411-3(d).

With a ***CRAT (charitable remainder annuity trust)***, the payout must equal at least 5% (but no more than 50%) of the trust's *initial* value, and there can't be greater than a 5% probability that the trust's principal will be exhausted before the up-front interest ends (see Rev. Rul. 77-374) – an issue that the current low-interest rate environment exacerbates.

With a ***CRUT (charitable remainder unitrust)***, the payout must equal at least 5% (but no more than 50%) of the trust's *annual* value. The ***"FLIP-CRUT"*** is a variation on the CRUT, and can effectively serve as an additional retirement vehicle: the trust initially pays the lesser of its income or at least 5% of its annual value – a net income with make-up charitable remainder unitrust (NIMCRUT) structure – and turns into a regular CRUT on the happening of a specified non-discretionary event (such as the birth of a child) or on a specified date (such as anticipated retirement). See Treas. Reg. § 1.664-3(c).

Note regarding interest rates. Because interest rates are low, it is difficult to satisfy a CRAT's 5% probability test when a life interest (as opposed to a term of years) is used for the trust term. For example, using the June 2019 7520 rate of 2.8%, the grantor must be at least 69 years old to create a 5% CRAT with quarterly payouts for the rest of his life: although the charity's interest of 41.858% easily satisfies the 10% charitable remainder requirement, the trust's 3.87% "probability" number is relatively close to the 5% probability test (with a 68 year-old, a 5% lifetime quarterly payout would flunk). By contrast, if the 7520 rate were 7.4%, the 5% probability test would not be a problem, and the charitable remainder interest for a 68 year-old would be 57.360%. (Interest rates have little or no impact on unitrusts, since the income and remainder interests share equally in appreciation and depreciation.)

Possible downsides of CRATs. Assuming the grantor is able to create a lifetime CRAT in this low interest-rate environment, she has the same issue as with any fixed interest: she'll never be able to get "more" from the trust. In addition, an annuity is not considered a hedge against inflation, unlike a unitrust interest; plus, if the investment performance is disappointing, the trust principal may be exhausted long before the grantor's death, even though, from an actuarial perspective, the trust worked when she created it.

Note regarding any lifetime interest. Whether the grantor creates a lifetime CRAT or a CRUT, if she dies "too soon" and doesn't survive her actuarial life expectancy, the early termination of the trust is a windfall for charity.

IV. Less sophisticated techniques – they still can be powerful!

"Technique" is probably the wrong word to describe the humble annual exclusion gift under IRC Sec. 2503(b) or the exclusion under IRC Sec. 2503(e) for direct payments of tuition or medical expenses; nor is the term really accurate to describe intra-family loans. Yet gifts under these provisions can be substantial over time and extremely meaningful for the lucky recipient, just as a loan to a family member in a low interest-rate environment such as ours can be far more favorable for that family member than a commercial loan. Here, then, is a selected review of these gifts and intra-family loans.

A. **Annual exclusion gifts – IRC Sec. 2503(b).** Annual exclusion gifts do not erode the donor's $11.4 million applicable exclusion amount, and are currently $15,000 per donee per year (or $30,000 if the donor's spouse agrees to split the gift). Such gifts are often the cornerstone of funding trusts, particularly life insurance trusts (see III.F. above); to ensure that a gift in trust is eligible for the annual exclusion and gives the beneficiary the requisite "present interest," the trust beneficiary typically receives a **"Crummey" notice** informing the beneficiary that she has, say, 30 days, to withdraw the gift. But suppose the donor is not funding a trust using annual exclusion gifts, and has something simpler in mind? Here are some possible uses of annual exclusion gifts:

   1. **529 plans.** If the donor's goal is to save for a child's college education, a 529 plan can be a very good use of annual exclusion gifts. Such accounts are tax-preferred in that the dollars grow tax-free, and if account withdrawals are used for "qualified higher education expenses," including tuition and room and board, the earnings are never taxed. (Note that the Tax Cuts and Jobs Act, mentioned above, now also permits withdrawals up to $10,000 per year for K - 12 tuition – something that may or may not be considered a "qualified withdrawal" by the state sponsoring that particular plan; New York, for example, has indicated that such a distribution may trigger adverse tax consequences.) 529 plans (named after IRC Sec. 529) also permit the donor to "front-load" the account with five years' worth of annual exclusion gifts ($75,000, or $150,000 if the donor's spouse agrees to split the gift), change the beneficiary, and reclaim the contributed dollars (subject to penalties) *without* the dollars being includible in the donor's estate.

   2. **Custodial accounts.** Prior to 529 plans, which were enacted in the late 1990's, custodial accounts under UGMA (Uniform Gifts to Minors Act) and UTMA (Uniform Transfers to Minors Act), were the vehicles of choice for setting money aside for a child's college education or making non-trust gifts of property to a minor. The catch with such accounts is that the property belongs to the minor and must be turned over to him upon reaching age 18 or 21 (depending on what the account says). Nevertheless, the custodian's use of the dollars for the child's benefit is not limited to educational expenses.

   3. **Roth IRA.** Suppose that the donor's young college graduate has managed to get a job, but is barely making ends meet. Nevertheless, that child still has at least $6,000 of earned income (the 2019 maximum Roth IRA contribution). In that case, Mom or Dad could use part of an annual exclusion gift to give Son or Daughter the means to open a Roth IRA, which is funded with after-tax dollars, and offers a host of future benefits, including shielding the account's earnings

from income tax when they are withdrawn. Enabling the child to create such an account is not only an investment in the child's future, but can be appealing for parents who don't want their children to view annual exclusion gifts as automatic entitlements to be immediately spent.

4. **Direct gift.** The simplest annual exclusion gift is, of course, a check to the donee with no strings attached. (This could also take the form of a check payable to the donee's landlord to help pay the rent.)

B. Direct payments for tuition and medical expenses – IRC Sec. 2503(e). Direct payments for an individual's tuition or medical expenses are "extras" that, in addition to annual exclusion gifts, do not erode the donor's $11.4 million applicable exclusion amount. (Under Treas. Reg. § 25.2503-6(b)(3), medical expenses also include health insurance premiums.) "Direct" means that the payment is made directly to the school, medical provider or insurance carrier, and not to the donee who, in turn, makes the payment. Tuition can even be for nursery school; the requisite "educational organization" simply has to qualify under IRC Sec. 170(b)(1)(A)(ii), meaning that the organization maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students. These direct payments can be life-altering for the donee.

C. Intra-family loans. If the donor does not feel flush enough to make gifts, or does not wish to permanently part with her money, the continuing low-interest rate environment makes intra-family loans a good deal for both the lender and the borrower: if the loan is on the smaller side, the lender won't have huge amounts of taxable interest income to report, and the borrower will doubtless pay a lower interest rate than he would with a commercial loan. Intra-family loans are often used to help a child or grandchild buy a house; they should carry interest, and be memorialized in writing to underscore the lender's seriousness about being repaid.

1. **Why is interest required?** Because the Supreme Court said so, in a 1984 case called *Dickman v. Commissioner* (465 U.S. 330). *Dickman* stood for the proposition that interest a lender could have charged on a loan (but didn't) was really a gift. Although the Court declined to say how to calculate that interest, Congress promptly drafted IRC Sec. 7872 to deal with "below-market loans" (these can also crop up between employers and employees, trusts and trust beneficiaries, partnerships and partners, etc.). The gist of these laws is that if lenders follow the rules and charge enough interest, they won't have a problem; if they don't follow the rules, they will: in the family "gift loan" context, for example, Mom will be treated as making gifts of the foregone interest, which will also be treated as income to her.

   So how much interest is enough, and where do lenders find the "safe harbor" loan rates? In general, these are the "applicable federal rates" (AFRs), which the IRS publishes every month.

2. **Term loans.** Term loans up to three years use the ***short-term AFR***; loans over three years but not over nine years use the ***mid-term AFR***; loans over nine years use the ***long-term AFR***. Those parameters are further refined with the annual, semi-annual, quarterly or monthly rate that corresponds to the payment schedule. For instance, if Mom gives Son a ten-year loan with quarterly payments, she would charge the quarterly long-term AFR in effect at the loan's inception (the June 2019 rate for this is 2.73%).

3. **Demand loans.** Demand loans – i.e., those on which the lender can demand payment at any time – are thornier. Revenue Ruling 86-17, 1986-1 C.B. 377, addresses how to calculate the interest for a demand loan if the principal amount remains outstanding for the entire year; that is, the amount is multiplied by the "blended annual rate," which the IRS publishes in June of each year. (The blended annual rate is derived from the January and July short-term rates (compounded semiannually)). If some of the principal is paid off during the year, the interest presumably would be calculated on a pro-rated basis, using the January and July short-term rates (compounded semiannually).

   The point is that the interest rate on a demand note is effectively adjusted every six months. As a practical matter, however, it makes sense to simplify matters, and lock in a current low interest rate by structuring the loan as a term note.

4. **Loan forgiveness.** What if Mom gives Son a loan that carries sufficient interest, but Son's payments to Mom are spotty or non-existent? Can Mom forgive some of the debt using her $15,000 annual exclusion ($30,000 if Dad agrees)? The answer is yes. The risk, however, is that if it appears Mom is not serious about being repaid, the loan may be construed as a gift, notwithstanding Mom's loan documentation. (The issue might come up if Mom's estate is audited.) In addition, note that if Mom forgives the debt under her will, this is treated like a taxable bequest; if she doesn't forgive the debt, her executor will be expected to enforce it.

5. **Refinancing an existing loan.** Suppose Mom's existing loan to Son carries a higher interest rate, and she'd like him to benefit from the lower rates. If she lets him refinance, are there any gift tax implications? After all, she's giving up a higher return in exchange for a lower one. Although there does not appear to be any authority on the subject, prudence suggests that Mom alter one of the loan's terms, so that she's getting something in return, such as, perhaps, a shorter payout, or more frequent payments.

6. **Accruing the interest.** Is it possible to simply accrue the interest and add it to the outstanding principal balance? While there appears to be nothing that precludes Mom from doing that, the risk with such an arrangement is again how it might look to an auditor: did Mom genuinely intend to be repaid, or is the loan a disguised gift?

7. **Other thoughts.** Intra-family transactions always get close scrutiny from the IRS. Thus, for the loan to be respected and not treated as a tacit gift, the *lender* needs to respect it. In other words, there should be a note. Its interest rate should satisfy the rules under IRC Sec. 7872 to avoid being characterized as a "below-market loan." There should at least be interest payments (some notes are structured as a "balloon" and only require current payments of interest, not principal). The lender should report those interest payments on her income tax return; and the borrower, assuming the funds have been used to purchase, say, a principal residence, may be able to deduct the interest payments on his income tax return as long as the loan is secured by the residence (note that the borrower should have a realistic ability to repay the loan). In short, the loan and its formalities need to be taken seriously – just like anything else in the planning arena.

V. **Tax reform.** The Tax Cuts and Jobs Act was mentioned above. Enacted on December 22, 2017, it has been called the most sweeping tax legislation since the Tax Reform Act of 1986. Businesses were the key beneficiaries of the Act, but individuals benefitted as well. Most of the individual provisions, however, are temporary and only run from 2018 through 2025, after which (barring Congressional action) these temporary provisions will revert to what they were prior to the Act. Although the Republican drafters of the Act had hoped to repeal the estate tax and GST, this proved too costly; thus, the $5 million inflation-indexed exclusion was increased to $10 million, indexed for inflation. Whether that exclusion will revert to $5 million in 2026 – or sooner, if Democrats gain control of Congress and the White House in 2020, 2022 or 2024 – remains to be seen. In the meantime, planning is necessary, and continues based on the law as we currently know it.

APPENDIX

GRATs and Sales – compared and contrasted

GRATs	Sales
Pros: • Little or no up-front gift • Can pass significant appreciation to grantor's heirs (typically, children) • Recognized by statute • If the property underperforms, grantor is simply out set-up costs • If IRS successful in increasing valuation, annuity automatically adjusts so there won't be an additional gift • Minimal upkeep **Cons:** • Shouldn't be used to benefit heirs such as grandchildren and great-grandchildren • If grantor dies during the trust term, the trust property will be includible in grantor's estate	**Pros:** • Generally uses a lower interest rate than GRATs: this lower performance benchmark lets more potential appreciation pass gift-tax free to grantor's heirs • If grantor dies before the note is paid off, only the note's balance is includible in grantor's estate, and not any appreciation • Can benefit multiple generations, not just children • Can use a balloon note to "backload" repayment of principal, thereby compounding potential appreciation **Cons:** • Requires an "up-front" gift to the trust – generally 10% of the value of the property grantor is selling to the trust • If the property underperforms, grantor may get up-front gift back, thereby "wasting" exclusion used for the gift • If valuation of property sold is successfully challenged, could trigger an additional gift • If grantor dies before the note is paid off, uncertainty about whether sale triggers capital gains tax; in addition, 6166 will not be available to extend the payment of estate tax if closely held business was the asset sold

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