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Gift Planning in the Wake of Fiscal Cliff Developments

BY JOHN H. SCHAPIRO
Special to the Legal

Not since enactment of the first federal gift tax in 1924 had there been such a strong incentive as there was in 2012 to give property to one's heirs during one's lifetime, and to do it right away. Part of the so-called "fiscal cliff" was the prospect that the lifetime exemption for passing property tax-free to one's children and grandchildren would go from $5.12 million per person in 2012 to $1 million per person in 2013. The automatic expiration built into the Bush-era tax reductions would have returned the lifetime exemption to that amount, and President Obama's position was that the exemption applicable to decedents' estates could be larger, but that $1 million should be reinstated as the limit on tax-free gifts during a lifetime.

By kickoff time at the Rose Bowl, however, the fiscal cliff looked more like a speed bump. Except for a hike in the federal gift and estate tax rate, to 40 percent, most favorable aspects of 2012 law remained unchanged. The New Year's Day tax bill included none of a list of gift tax loophole plugs previously proposed by the Treasury Department.

What's more, the lifetime gift tax exemption had risen, from $5.12 million per person to $5.25 million, thanks to an inflation adjustment. Even people who maxed out their $5.12 million lifetime exemptions the day before now had some ongoing gifting ability. Those who had not gone to the limit, or who had somehow missed the party, still had the ability to make tax-free lifetime gifts on a scale not seen for almost a century until the past few years. The trick now is to get the biggest bang out of every buck of exemption remaining.

JOHN H. SCHAPIRO, *a partner in Kleinbard Bell & Brecker's business and finance department, is the practice leader of the firm's taxation group and a member of the trusts and estates group. He has counseled middle-market businesses, their executives and their families for more than 25 years. He combines extensive experience as a transactional business attorney with expertise in federal and state income taxes, and estate and inheritance taxes.*

The way to do that is to use leverage systematically. That includes leverage in the traditional sense: using as much debt as possible in a transaction financing structure, so that whatever equity is present has a lower value but greater potential return. But it also means leveraging gifts that count toward the $5.25 million lifetime limit with gift-like elements that do not count toward the limit.

Of course, leverage generally creates additional risk. But three elements of the gift-tax legal structure as it has developed radically reduce the risk from leverage. Not coincidentally, two of these have been targeted for legislative change by the IRS and Treasury Department. Taxpayers' ability to use them could expire as soon as the next significant tax bill is passed.

First, loans between family members receive very favorable tax treatment in the current climate. In theory, family lenders are supposed to charge a market rate of interest, but the Internal Revenue Code requires taxpayers and the IRS to measure "market" interest by reference to Treasury bonds, not actual interest rates that would apply in an arm's-length transaction between private parties. The "applicable federal rate" under Code §§1274 and 7872 for obligations due within three years is currently 0.21 percent, and 1.01 percent for those due in three to nine years. (It goes all the way up to 2.52 percent for longer-term instruments.) The rate used to value annuities for gift-tax purposes under §7520 is 1.2 percent.

Family members and family-owned companies can make loans to one another on a basis that would be impossible for a bank. Federal tax law authorities will respect the form of such loans, as long as the parties give the loans the basic structure of actual debt. No Federal Reserve regulations apply to intrafamily loans; no one worries about the Basel Accords, capital reserves or stress tests.

Second, appraisers regularly apply discounts of 30 percent or higher to the value of underlying assets when they are valuing an illiquid, non-controlling interest in a business or investment fund. Valuation discounts go a long way toward assuring that a leveraged gift will be successful. Success for a leveraged gift means that the rate of return on the underlying productive assets must exceed the interest rate on the debt. Valuation discounts make it far more likely that will happen.

If the underlying asset is in fact sold, and all equity owners participate, the initial valuation discount will increase the yield of any equity owners who acquired their interest at the discount. A 25 percent interest in a business valued at $1 million may be appraised for gift-tax purposes at $175,000, and if it is subject to an additional $150,000 of debt, it may represent a gift of only $25,000. If the business is later sold for its current value, without appreciation, the net value of the gifted interest will be $100,000, a 300 percent return. If the business is sold for $1.5 million, the return will be about 900 percent.

Even if the property declines in value between the appraisal and a sale, the valuation discount provides a cushion. The million-dollar business could be sold for $750,000, and the 25 percent leveraged gift would still be worth $12,500 more than its gift-tax value. And if the underlying asset is not sold, but it performs more or less as was expected when the valuation was made, the valuation discount will significantly increase the return on equity.

The third element that enhances the effect of leverage and reduces risk is the survival in the code of the so-called "intentionally defective grantor trust." These trusts are a classic tax loophole, one the Treasury Department has sought to close, but only by Congress enacting legislation.

Intentionally defective grantor trusts are trusts that, for federal income-tax purposes, do not even exist. The "grantor" — generally, but not always, the person who contributed assets to the trust — is treated as the owner (and taxpayer) of all the trust property for income-tax purposes, even if he or she has no interest in its economics. At the same time, for gift and estate tax purposes, the trust is recognized, and a transfer to the trust constitutes a completed transaction that removes any assets transferred to the trust from the transferor's estate. A properly drafted grantor trust allows the trust beneficiaries to earn whatever return the trust assets generate without paying taxes on that return, notwithstanding that the asset was valued on a taxable basis.

What's also important is that the trust's grantor pays federal taxes on the trust income, but under a long-standing administrative ruling those payments are not treated as gifts for purposes of the gift tax, even if they free up the trust cash flow for distribution to beneficiaries. Over time, paying those taxes significantly expands the grantor's gifting capacity.

Intentionally defective grantor trusts can be used in a number of ways: as the recipient of leveraged gifts, or even as the purchaser of assets from the grantor, often with seller financing (at the favorable federal rate). The grantor does not recognize taxable income from such a sale, because the transaction is disregarded for federal income-tax purposes. (The same is not true for Pennsylvania personal income taxes, however.) Such purchase transactions are powerful estate planning tools, but require adequate equity in the grantor trust and regular cash payments of debt service.

A specialized form of grantor trust is the "grantor retained annuity trust," or GRAT. A GRAT resembles the sale to a grantor trust, but without the need for cash payments of debt service or an equity contribution from the trust. The grantor contributes assets to the trust in return for an annuity obligation that represents a portion (up to 100 percent) of the value of the assets contributed, and for gift-tax purposes is only charged with the difference between the value of the assets and the imputed value of the annuity. If the trust does not have sufficient cash to make the annuity payment, it can pay the annuity in kind, returning a portion of the assets contributed at their then-current value. Properly structured, GRATs are one of the safest techniques of estate planning, because they have specific statutory and regulatory authority. Unfortunately, if the grantor dies before the GRAT annuity period ends, the GRAT property is included in the grantor's taxable estate, and the estate-planning tax benefits of the transaction are lost completely. For that reason, people often choose very short-term GRATs, two or three years, with large annuities, usually exceeding the available cash flow. If the return on investment exceeds the federal 1.2 percent annuity rate, the actual value transferred in a GRAT will exceed the amount reported as a gift for gift-tax purposes. If the investment loses money, the grantor will simply get the assets back ... and will likely try again with a new GRAT. If the GRAT has a $0 gift value at the outset, the grantor will not even use any gift-tax exemption if the investments are not successful.

(One of the Treasury's loophole-closing proposals has been to require GRATs to have a term of at least 10 years and to ban $0 gift value GRATs. So if a GRAT seems attractive, it is worth exploring now, before Congress' next opportunity to pass tax legislation.)

For the moment, at least, wealthy families that can afford to give more to the next generation than they have already given have many ways to transfer wealth, without subjecting themselves to current gift tax.

Actual estate-planning transactions are complicated, however. Each type of technique discussed here (and those not discussed here) has technical requirements and limitations that competent counsel must address. The law could change at any time, including as part of the "tax reform" bargain both Democrats and Republicans claim to favor. It is also vitally important to recognize that all of these transactions involve actual transfers of wealth and should be undertaken only by people who are absolutely certain they will not need access to the assets transferred to support their own lifestyles and health. •