First Western Trust Bank

GET ’EM BEFORE THEY’RE GONE

Estate Planning Techniques that Could Be Eliminated or Restricted by the End of the Year

By Melissa Montgomery-Fitzsimmons

Change is on the horizon for estate tax planning. With the repeal of the federal estate tax set for 2010 and its reinstatement scheduled just one year later and at a much higher rate, the outlook for estate planning includes substantial changes every year for the next three years. As the end of the year approaches, it becomes more and more likely that Congress will pass a one-year “patch” that keeps the 45% maximum rate and the $3.5 million exemption in place. Nonetheless, legislators are still diligently working on estate tax reform.

It is no secret that federal expenditures are unprecedented, federal tax revenues are insufficient, and the current administration’s policies advocate tax law changes aimed at generating substantial tax revenues from the wealthy. Given Washington’s mood towards maximizing tax revenues, the strategies used to transfer wealth to future generations are at a very real risk.

Nothing can entirely insulate an estate plan from the future actions of Congress or its representatives, but the current uncertainty actually creates planning opportunities. Although you will want an experienced estate and tax advisor to counsel you regarding specific wealth transfer strategies, there are four specialized techniques that should be explored before they are eliminated or restricted in the future. These estate planning tools can be very advantageous when used appropriately.

The Grantor Retained Annuity Trust

A Grantor Retained Annuity Trust, or GRAT, is a trust intended to transfer an asset with a high likelihood of appreciation to beneficiaries with little or minimal gift or estate tax. These so-called “hot assets” can be any kind of marketable security, as well as more speculative private equity investments, including stock in closely held private companies or real estate.

Mechanically, the grantor creates the GRAT and gifts the assets to it. The grantor then receives back a portion of the property through annuity payments over a fixed number of years (the amount the grantor receives back over the course of the fixed term is typically equal to the grantor’s contribution plus an interest rate, which is determined monthly and announced by the IRS, called the 7520 Rate or the “Hurdle Rate”).

The payments may be made either through cash distribution or other property. At the end of the term, any trust property that has not been returned to the grantor—including appreciation—is passed down to the heirs essentially tax free. The size of the benefit depends on how much the actual appreciation

in value of the GRAT property exceeds the IRS interest rate.

However, there is an important caveat—the grantor must survive the entire GRAT term for the intended benefit to be achieved. If the grantor does not survive, the GRAT property—including appreciation—is subject to taxation in the grantor's estate. Not surprisingly, a very popular estate planning technique is to execute a series of short-term trusts instead of one long-term trust (i.e., five two-year trusts instead of one 10-year trust). This strategy is called "rolling GRATs." Its primary advantage over a longer 10-year GRAT is that if the grantor dies in year nine of the rolling GRAT strategy (i.e., he survives four of the five 2-year GRATs), the grantor's estate receives 80% of the benefit; whereas if the grantor dies in year nine of the 10-year GRAT, the grantor's estate would receive 0% of the benefit.

Legislators have proposed a minimum term, most likely 10 years, in order to limit the rolling terms. The effect of this limitation will be that fewer people will implement GRATs, and there will be a greater likelihood of grantors not surviving the entire length of the term of the longer GRATs. Accordingly, there will be fewer significant assets transferred out of the grantor's estate and more estate taxes due at the grantor's level.

The Qualified Personal Residence Trust (QPRT)

QPRTs are special trusts used to transfer the personal residence of a grantor to family members, usually children or grandchildren, at some time in the future at a reduced transfer tax. The ideal type of property for this strategy is a "legacy property," in other words, a property that has sentimental value to the family or one that the family would like to maintain for future generations. This can be a primary residence or a vacation home. A QPRT is similar to a GRAT in that the grantor puts an asset—a personal residence, in this case—into a trust for a certain period, and at the end of the term, the residence transfers to the beneficiaries estate tax free, income tax free, and usually gift tax free (there may be a small gift tax associated, but it is usually not very significant).

When the term of the QPRT expires, the property held by the trust is then owned by the beneficiaries, either outright or in a trust for their benefit. The grantors will no longer own the house, therefore making QPRTs an effective way to reduce estate taxes usually imposed on a personal residence. But while the grantors may no longer own the house, they may wish to continue to reside in it. If the grantors choose to stay in the house, they will pay rent to the new owners—typically, their children. While this rent obligation may sound off-putting at first, in reality, paying rent is a great way to get more assets out of the grantor's estate, thereby further reducing the size of the estate tax bill, and transferring more assets down to subsequent generations without running afoul of the gift tax laws.

In theory, a QPRT will afford the greatest transfer tax savings when the grantor is young and the trust term is long. Therein lies the dilemma: similar to a GRAT, if the grantor dies before the trust has terminated, the residence will be included in the grantor's taxable estate. Therefore, the purpose of the QPRT will be defeated.

One must weigh the lower gift tax cost that results from a relatively long trust term against the greater risk that the residence will be included in the grantor's gross estate if he or she dies before expiration of the trust term. The risk has to be weighed against the expenses of the trust, the loss of stepped-up basis, and the loss of alternative strategies.

QPRTs have been on the chopping block several times in the recent past, and came close to being eliminated during the Clinton administration. Undoubtedly, the current administration would prefer to receive the 45% estate tax that is otherwise eliminated from these assets.

The Minority Interest Discount

Parents often transfer partial ownership of their assets via limited partnership interests to children, other family members, or trusts for their benefit. Since limited partners exercise no control over partnership assets and the marketability of their interests is curtailed, the value of a limited partnership interest is discounted for gift tax purposes. Said another way, the minority interest discount refers to a limited partnership interest that has been gifted for less than the fair market value of the underlying assets.

While almost any type of property can be placed in a family limited partnership, the assets assigned most frequently are those with appreciation potential, such as marketable securities, real estate, family businesses, and interests in non-family businesses.

There is, and always has been, a fair amount of argument among the estate planning community, the tax planning community, and the legislative community as to whether these discounts are valid. Though there are solid arguments on the appropriateness of valuation discounts, not least the limited marketability, there are groups in Congress that would like to eliminate the minority interest discounts altogether. In fact, legislation has already been proposed that would eliminate the use of certain valuation discounts.

If certain valuation discounts are not eliminated altogether this year, it is likely that people will be more conservative in the discounts they take, resulting in higher taxes via higher estate and gift tax values.

The Intentionally Defective Grantor Trust

Despite its peculiar name, the Intentionally Defective Grantor Trust, or IDGT, is not really defective at all. It involves making a partial gift to a trust, which then purchases the rest of the asset in installments. IDGTs are often smarter than GRATs because IDGTs move an asset out of an estate immediately.

IDGTs are set up as an irrevocable trust, where the grantor sells assets to a trust, receives installment payments from the trust, and shifts transferred assets, including income and appreciation, to the trust beneficiaries. The trusts are "intentionally defective" because the grantor—not the trust—pays the taxes on any income that is generated by the assets held by the trust. The effect is to increase the amount of the gift. Similar to GRATs, if IDGT assets appreciate at a rate greater than the Applicable Federal Rate (AFR) at the inception of the IDGT, the excess appreciation passes transfer tax free to the IDGT beneficiaries.

IDGTs are permitted by the IRS, provided that the trust is funded so that it can meet its installment payments. Economic times with a low AFR and depressed asset values make IDGTs attractive wealth transfer strategies that may significantly reduce the transferor's gift and estate taxes.

IDGTs are advantageous for beneficiaries who are able to purchase an asset on a very favorable basis from the grantor. They are also advantageous for the grantor who gets an income stream for a period of years, and ultimately, they are advantageous for the estate when the asset is passed down estate tax free.

IDGTs are under intense scrutiny right now in the IRS, rather than Congress. In this stressed revenue environment, the IRS has been auditing them diligently. Therefore, it is very important to structure IDGTs carefully in order to withstand a thorough examination.

Legislation has already been proposed to eliminate or significantly limit certain tax planning techniques in the near future, so it is time to find out what solutions are best for your situation. Assuming Congress does not pass a one-year extension, taxpayers should act by December 31, in order to ensure they are able to take advantage of these estate planning tools.

Melissa Montgomery-Fitzsimmons coordinates First Western Trust Bank's proprietary wealth planning program, known as 'WealthView 360™,' creating the technical training for all of our wealth planners and fostering the Bank's relationship with professional advisors in the estate planning, tax and philanthropic communities. Melissa has been developing wealth management strategies for clients for more than a decade. Prior to joining First Western, Montgomery-Fitzsimmons was Vice President, Wealth Advisor, for JP Morgan in Denver. Also, she was an associate attorney with the law firm of Buchanan & Stouffer, where she focused on wealth transfer and tax strategies for multi-generational clients. She graduated magna cum laude with a BA in International Business and earned a J.D. degree from the University of Colorado. She has been awarded the Certified Financial Planner designation from College of Financial Planning.