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Gifting With Strings Attached

By Gary K. Hager, CFP

Abstract: *Clients can be emotionally unprepared to give up control of their own money, despite the financial benefits of reducing their estates through traditional wealth transfer and gifting strategies. Grantor retained annuity trusts (GRATs) can give your clients a sense of control. Making a spousal lifetime access trust (SLAT) beneficiary of a GRAT can give your clients the best of both worlds – removing an asset from the estate while keeping the controls in a spouse's name. A super trust, drawing on these techniques with the addition of a limited liability company, is a sophisticated solution for the ultra high-net-worth family's estate.*

Do a Google search for the definition of gifting and the first response is, "Anything given' anything voluntarily transferred by one person to another without compensation; a present; an offering."

Traditional gifting occurs when parents decide it make sense to strip assets from their estate and give them either to their children or grandchildren. The purpose of gifting could be to defund the estate expressly for estate tax reduction or to act on the desire to support the children's lifestyle as well. Whatever the reasons for gifting, the typical approach is to irrevocably assign the asset to a child or grandchild with no strings attached.

It is no surprise that most people do not understand the beneficial results of implementing a comprehensive, lifetime, wealth transfer protocol. A recent study by PNC Bank[1] reported that 37% of individuals with assets in excess of $10 million do not even possess a valid will. How then, could we reasonably expect them to have an understanding of the various methods and subsequent benefits of gifting?

The estate and gift tax code has gone through various machinations over the years and today the government, through the IRS, still maintains limits on what one can transfer tax free to the next generation. For this article we will refer to the two main gifting options as the "cold and hot water spigots."

The cold water spigot represents the $11,000 annual exclusion gift.[2] This cold water spigot can run continuously during a person's life. So if a husband and wife have three children they could gift $11,000 per parent per child or $66,000 a year for 10 years. With more children or grandchildren this amount could increase. Imagine gifting $66,000 a year for 10 years. That would remove $660,000 from the taxable estate, plus any growth the asset(s) experienced, saving up to $330,000 in estate taxes in the process. That sounds pretty good, but it gets better.

The hot water spigot represents the available lifetime exemption.[3] This spigot can only fill a $1 million bucket. This one-time, lifetime amount may be used in its entirety, regardless of timing, by gifting some of it or all of it in one or multiple years. Once the $1 million is gifted, unlike the perpetual nature of the annual exclusion, the bucket cannot be refilled. And while the unified exemption or "death amount" is scheduled to grow annually until repeal in 2010,[4] the $1 million amount is capped.

If parents were to gift the $1 million out of their estate while alive, they are, in essence, gifting away the $ 1 million, plus all of the possible future growth expected for the assets. Take a husband and wife who combined have a $2 million lifetime exemption. They choose to gift this amount either in trust or directly to their children. Assume that the $2 million asset appreciates at 7.2% over 20 years following the initial transfer. (The "Rule of 72" approximates how long an asset takes to double. Divide 72 into the expected growth rate, i.e., 72/7.2 = 10 years to double.) So in this example, over 20 years the fit would quadruple. The value now in the beneficiary's hands would be worth $8 million. Simply by giving away the credit amount today, this example shows that after 20 years, $6 million in growth has been removed from the taxable estate. At an assumed 50% estate tax bracket, that would equate to a savings of approximately $3 million.

By combining the annual exclusion cold water spigot with the lifetime exemption hot water spigot and the time to grow, a family can remove a large amount of assets from the taxable estate, thereby making a sizable dent in the ultimate tax burden the next generation will face.

Fear of Losing Control of Assets

Many clients, when presented with the planning recommendation of gifting assets out of their estate, may feel frightened or believe that such a gifting strategy puts them in a precarious position. The balance sheet often indicates the *capability* to gift, but that is never the sole determinant. The emotional element always plays a big role. Typical responses might be, "What if I need the money?" or "What if I live too long, and I gave away off of my assets?" The "what ifs" are endless.

It may seem evident to most financial professionals that a 76-year-old widow with $10 million in bonds producing a 4% net return and whose annual living expenses are $65,000 a year would probably agree that there is substantial room for gifting. This mother of four and grandmother of seven could maximize her gifting potential gifting her $1 million exemption along with annual gifts of $110,000 for as along as she lives. It is apparent that there are significant excess assets available with which to make lifetime gifts without affecting her lifestyle. But in this particular case, this person was unable to make any gifts. Why? She was too nervous. What if the worst happened? After all, that's what happened to her parents in 1929 when they ended up penniless despite a significant business and large amount of investment. So while this individual was economically qualified, she was psychologically unable to take advantage of one of the most powerful estate planning transfer strategies.

While your clients are alive, the economics of gifting allows the gifted assets to be placed out of harm's way, away from estate taxes. Over time this process of systematically stripping assets from the estate will provide a much higher percentage of assets being distributed to the next generation.

However, this benefit may still be unpalatable to a husband and wife when you suggest they irrevocably gift assets. Regardless of all the cash flow models, taking action with their assets just doesn't sit well with them. So they wind up doing nothing and letting the government take a disproportionate amount of assets through an egregious tax system.

Keeping Strings Attached to the Assets

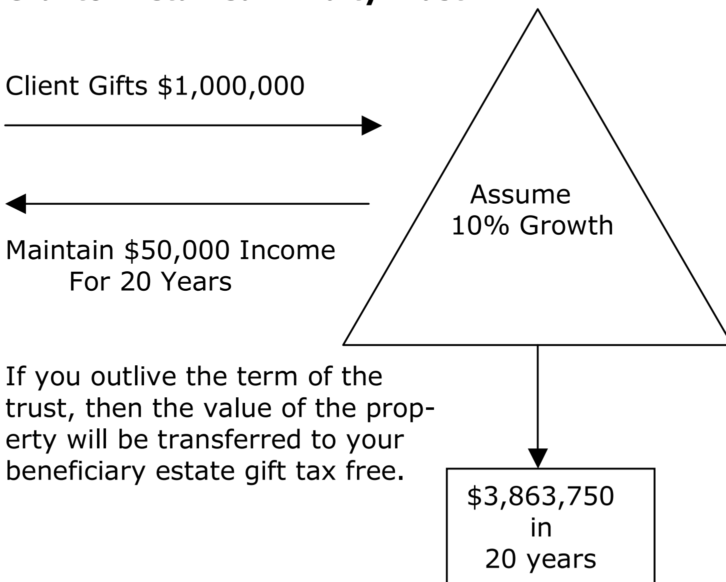
What if the husband and wife could combine estate planning efficiency with personal fiscal responsibility? What if you help your clients take advantage of all that is available in the tax code, and do it with confidence about their own financial well-being? What if you could offer your clients cake and allow them to eat it too?

There are multiple estate planning strategies that allow an individual or couple to maintain different forms of interest in the asset they "give" away.

Let's start with a relatively simple strategy – a grantor retained annuity trust (GRAT). A GRAT is set up by an individual, called the grantor. The grantor retains an annuity or specified payment for a period of years. The principal of the trust at the end of the chosen term of years will transfer to a designated beneficiary (Figure 1).

FIGURE 1

Grantor Retained Annuity Trust



A GRAT may be an effective means for a wealthy client who wants or needs to retain all or most of the income from a high-yielding and rapidly appreciating property to transfer the property to a child or other person with minimal gift or estate tax.

A GRAT is created by transferring one or more high-yield assets into an irrevocable trust and retaining the right to an annuity interest for a fixed term of years or for the shorter of fixed term or life. When the retention period ends, assets in the trust (including all appreciation) go to the named "remainder" beneficiary(ies). In some cases other interests, such as the right to have assets revert back to the transferor's estate in the event of the transferor's premature death, may be included.

GRATs provide a fixed annuity payment, usually expressed as a fixed percentage of the original value of the assets transferred in trust. For example, if $1,000,000 is placed in trust and the initial annuity payout rate is 6%, the trust would pay $60,000 each year, regardless of the value of the trust assets in subsequent years. If income earned on the trust assets is insufficient to cover the annuity amount, the payments will be made from principal. Therefore, the client-transferor is assured steady and consistent payments, at least until the principal is exhausted.

All income and appreciation in excess of that required to pay the annuity accumulates for the benefit of the remainder beneificiary(ies). Consequently, it may be possible to transfer assets to the beneficiary(ies) when the trust terminates with values that far exceed their original values when transferred into the trust and, more importantly, that far exceed the gift tax value of the transferred assets.

The gift tax value of the transferred assets is determined at the time the trust is created and funded using the "subtraction method." This value is determined by subtracting the value of the annuity interest (and, in some cases, other retained interests such as the right to have the assets revert back to the transferor's estate if he or she does not live the entire term of the trust) from the fair market value (FMV) of the assets transferred in trust. How the annuity interest and any other retained interests are valued depends on who the remainder beneficiary(ies) is(are) and who retains the annuity and other interests relative to the transferor. There is a more restrictive and less appealing set of valuation rules when family members are beneficiaries and certain family members retain interests in the property both before and after the trust is created than when unrelated parties are involved.

If family members are involved, the fit tax valuation rules of IRC Sec.2702 may apply. Under these rules certain types of retained interests, such as the right to have trust assets revert to the transferor's estate in the event of the transferor's premature death, may be valued at zero when computing the gift tax value of the transfer. As a general rule, every retained interest but a "qualified interest" is assigned a value of zero for gift tax valuation purposes. In the case of a GRAT, a qualified interest is the right to receive "fixed amounts" payable annually, more frequently (a fixed annuity), or a qualified remainder interest – that is, any noncontingent remainder interest if all other interests in the trust consist of qualified retained interests (qualified annuities).

The right to receive a "fixed amount" means the annuity must be a specified fixed dollar amount or a fixed percentage of the initial value of the trust payable each year rather than merely the income produced by the assets in the trust. Although fixed payments throughout the term of the trust are the norm, final regulations define the term "fixed amount" more liberally. They would permit the annuity payments to increase or decrease in a systematic manner each year without adverse gift tax consequences. However, the annuity amount may not increase by more than 20% over the prior year.

According to Treas. Reg. Sec. 25.2702-3(e), Example 5, the retained annuity payable from a GRAT for a term of years must be valued for the shorter of the term or the grantor's life even though the annuity is payable to the grantor's estate if the grantor should die during the term of the trust. This has the effect of lowering the value of the retained interest and increasing the value of the taxable gift. The U.S. Tax Court has held this regulation to be invalid in *Walton v. Commissioner*,[5] but appeals are still possible. A simplified example is:

$1,000,000 asset
10-year trust term
5% payout
$50,000 payments for 10 years = $500,000

The grantor retained $500,000 through the $50,000 annuity paid for 10 years. In theory there is a $500,000 gift. However, the measured or actual gift is marginally greater to account for an interest rate applied by the IRS – the applicable federal rate (AFR).

It is important to note that a GRAT requires a 5% minimum annuity stream with no maximum. Just note that the smaller the retained interest, the larger the gift and vice versa. So from a design standpoint, you establish

the timeline and the amount of cash flow that makes the most sense for the client given age restrictions and income requirements.

Planning for "Hot" Assets

Adding real sizzle to this strategy is the option of creating what is referred to as a zero or Walton GRAT. This is a form of GRAT where no gift is realized by the grantor. In the face of one having a hot asset, a high-income-amount sort-duration trust is often used. The idea is to take mortality risk out of play be keeping the duration short, so in turn the annuity amount would be large.
For example:
    Asset value: $1,000,000
    Expected growth: Double in three years to $2 million
If a client held this asset in his or her name it could create an additional $500,000 in estate tax (at 50%) after the three years.

Now let's assume the client didn't need the growth on this asset but did want to maintain the principal in his or her name. You can design the GRAT to pay an income stream over three years approximately equal to the principal deposited. This can be done without any gift or estate tax. In principle, by giving away $1 million and taking back $1 million in payments (plus the interest rate differential, AFR), your client has made no gift. Once again, any appreciation over and above the principal deposited would be excluded from one's estate. From a gift perspective, any of the asset growth is ignored.

For example, a client who expected significant growth in the value of his or her company transfers 25% to a short-duration, high-payout GRAT. Example: The value for the stock transferred is $30 million. The stock appreciated to $150 million over three years. The client pulled out the original $30 million, and the remaining $120 million was removed from the estate without any gift tax.

However, what if the timing was wrong? What if the asset did not appreciate over the three years, but the client still expected dramatic growth? A new trust could be created and the client could try again. The only cost to move the future asset growth out of the estate is the actual legal preparation cost.

In addition, it is important to prepare the client for the income tax issues inherent in this strategy. While it makes sense to move assets out of an estate in a favorable way, many clients find it unpalatable to be personally responsible for the income taxes generated by their GRAT. For example, in a recent case a client moved approximately 35% of his company in a series of GRATs at very favorable values. When the company was sold, the combination of both federal, ordinary, and capital gains taxes, and multiple state income taxes, all paid by the client/grantor, resulted in 54% of the next sale proceeds remaining in the GRAT and 46% in the hands of the client.
For example, on a $100 million sale:
    Expectation:
    $65 million client taxes at 35% = $22.75 million
    Net = $42.25 million
    $35 million GRAT taxed at 35% = $12.25 million
    Net = $22.75 million
    In reality:
    $65 million client taxes = $35 million
    Net = $30 million (taxes paid on whole transaction)
    $35 million GRAT taxes = 0
    Net = $35 million

Here is an explanation that most clients can understand. Assume the trust realizes a $100 million gain, and the combination of taxes equals 35% or $35 million. When the client pays this tax, he or she is making a tax-free contribution to the trust of $35 million, saving approximately $17.5 million in gift taxes (assuming a 50% gift tax). If the trust paid the tax, the trust would be worth $22.75 million instead of $35 million. As beneficial as this is to the trust, it is important for the client to understand and be prepared to shoulder the entire income tax.

Keeping Principal within Reach with a Spousal Lifetime Access Trust

What if your client wants to keep the income/principal within his or her reach?

What if the client wanted his or her spouse to primary rights ahead of the children?

One strategy is to make the spouse the beneficiary of the GRAT. By making the spouse the beneficiary, the purpose of removing assets from both estates is defeated. To solve this problem, a trust could be used as the ultimate beneficiary of the GRAT. This is called a spousal lifetime access trust (SLAT). The use of a SLAT in conjunction with a GRAT can give your client the best of both worlds: removal of an asset from the estate while keeping the asset available to one's spouse.

Proper design requires that upon the spouse's demise, the children would follow as beneficiaries of the SLAT. In this manner the client can insulate the asset from estate taxes at the time of his or his spouse's demise. In addition they will protect these assets from other "predators" such as the maladies associated with divorce, death and remarriage, liabilities, or claims of creditors. This is a powerful method as to how one might give away an asset (from an estate tax perspective) and still maintain significant access.

Let's take a step back and look at the structure of a SLAT and then see how the GRAT can be combined with the SLAT.

In simple terms, the SLAT is an irrevocable trust set up by a husband for his spouse. Typically, the spouse will be the primary beneficiary with any children or grandchildren in second and tertiary positions. A husband may gift his annual exclusion cold water spigot ($11,000) multiplied by the number of beneficiaries. In addition, he may gift the full hot water amount as well ($1 million).

These funds may be given in cash or in almost any other form of investable asset, and with the permission of the trust can invest and reinvest in many alternative vehicles. The trust will normally have very flexible dispositive provisions, but it can also have more restrictive language regarding income and principal access.

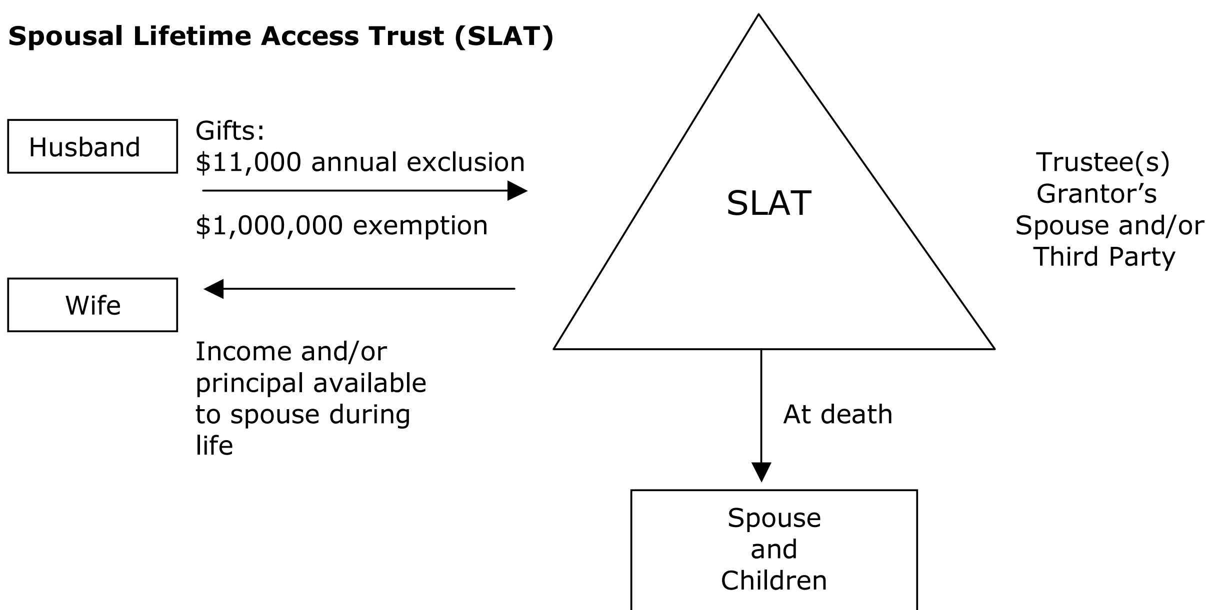
By "inserting" the spouse *ahead* of the children, estate effectiveness of the annual exclusion and the lifetime exemption will be maintained while placing the3 assets only a short distance away. By having the wife as the beneficiary, she may, if she wishes, receive income and principal distributions. When the wife passes away, the children step into her place and may receive the same or entirely different withdrawal rights. In addition, the assets themselves should not be subject to any estate inclusion; hence any estate tax.

This trust will also protect assets from all adversaries arising from divorce, death and remarriage, liability, creditors, bankruptcy, etc. this trust can also be made generational – that is, it may protect assets from estate tax and creditors for multiple generations.

If your client wishes to get really serious, two trusts can be created. One is created by the husband for the wife and children/grandchildren and another trust is created by the wife for the husband and children/grandchildren. When each parent sets up "reciprocal" trusts, the parents can double the amount of assets set outside of the estate (Figure 2). The only negative to this strategy is the first death drop off.

FIGURE 2

Spousal Lifetime Access Trust (SLAT)



Since the wife is beneficiary to the husband's trust and vice versa, when one spouse dies, one trust will no longer be available to the remaining spouse. While both are alive their ability to share remains. But when one spouse (mother) dies, the children step into her position, become the current beneficiaries, and might not share assets with the father.

The key to creating twin trusts is to make certain that when one spouse dies the loss of access to one fo the two trust does not place a financial burden on the survivor. In addition, it makes sense that both parents have the desire to see their children receive some of the total estate versus waiting for both of the parents to die before they inherit. As long as the dual SLATs are affordable they are a great method in ensuring that the children enjoy inherited assets while one parent is still alive. The SLAT can also give the surviving parent the chance to see how the children respond to an inheritance and may provide insights into how the surviving spouse might adjust his or her own will or plans based on how the children handle their newfound wealth.

The Super Trust

All of these techniques can be drawn together into the very powerful planning combination known as the super trust, so named because it can almost leap tall buildings in a single bound and is virtually invulnerable to attack.

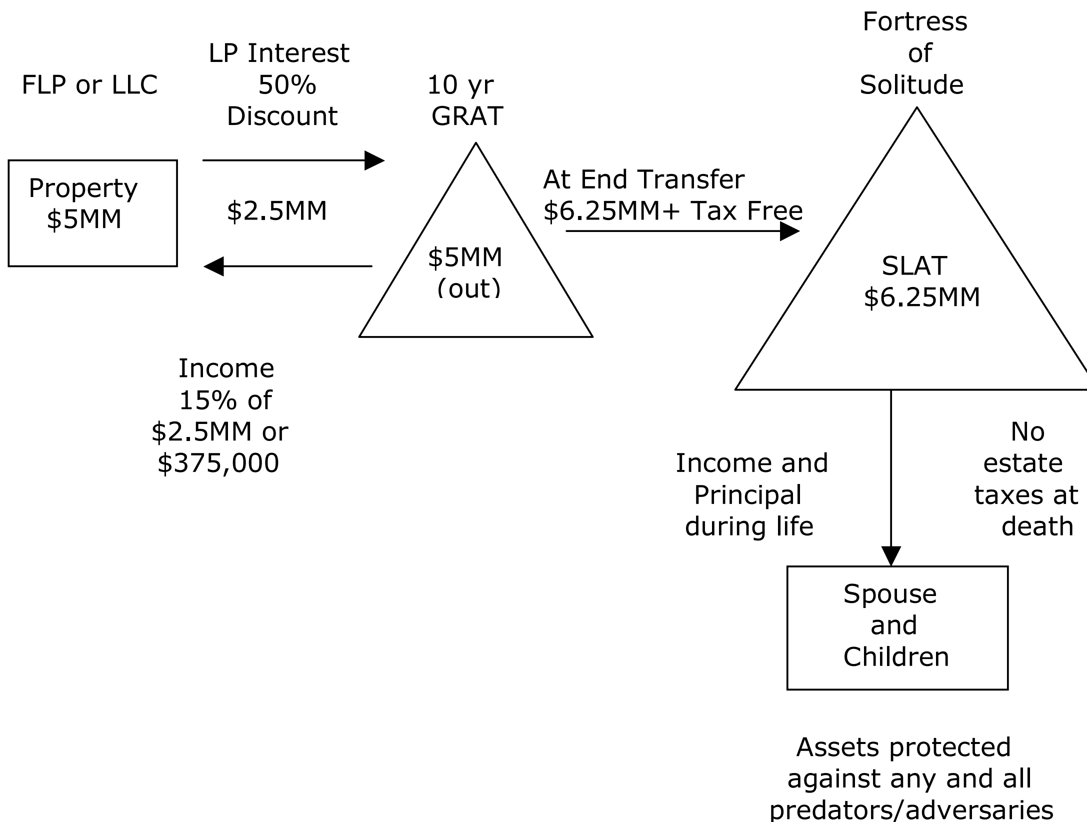
Example: Assume two parents and three children with a $5 million piece of income-producing real estate and current cash flow of $500,000 a year or a 10% cap rate.

- Step one: Create a limited liability corporation (LLC) or a family limited partnership (FLP). Either entity can be used to house assets such as investments, business or real estate.
- Step two: Transfer the property into the LLC. This is a nontaxable transfer.
- Step three: Create a GRAT. This GRAT will be designed to pay income for a period of 10 years. The income amount specified will be 15%.
- Step four: Create the "fortress of solitude" – the SLAT. The spousal trust is created by the husband for the spouse and children/grandchildren.

Three entities are now in position to form the super trust (Figure 3).

FIGURE 3

Super Trust



Before preparations are made for the super trust, the property must be appraised, not just for its FMV but more importantly, to provide an assessment of the asset valuation discount that could be claimed as the super trust strategy is pursued. Marketability, liquidity, and minority ownership discounts are very important components to this transaction.

Next, the parents will gift approximately 98% of the LLC interest to the GRAT. The actual amount of this gift is based on the marketability and liquidity discounts taken. In order to properly discount the FMV of an asset, a reputable appraisal company must be retained. This analysis could discount the asset by as much as 50%. For ease of calculations we will assume a 50% discount for this scenario.

Let's review:

Discounted Gift - $2.5 million
Income = $500,000
Income as a percentage of discounted gift = 20%

By designing the GRAT to pay out 15% over a period of 10 years, a zero tax GRAT has been created, even though the actual income as a percentage of the discounted gift is 20%. Remember, when the principal is pulled out by the growth is left, the family is entitled to transfer a significant amount of assets free of all estate taxes. The discount applied makes a huge difference.

Let's look at the numbers:

15% income on $2.5 million = $375,000
Actual cash flow from asset = $500,000
Excess cash flow = $125,000

By retaining the $125,000 cash flow in the GRAT the trust will actually grow by $1.25 million over the 10 years, again just by reinvesting the excess cash flow. So without using any annual exclusion or lifetime exempt amounts, the family is transferring $125,000 of additional dollars per year, free of any gift or estate tax.

At the end of the trust term (10 years) the beneficiary of the GRAT, the spousal trust, will receive the asset. Therefore, without any principal growth accounted for, which could add substantially to the end value, the original $5 million transferred plus the $1.25 million of excess income will result in pulling $6.25 million out of the estate. Not bad for a strategy that actually keeps asset access in the hands of the parents.

Thus, at GRAT termination, $6.25 million will transfer to the spousal trust, be outside of the estate, protected against creditors, and will ultimately pass to the next generation free of estate tax. If a couple really wants to experience the best of both worlds – giving while maintaining access – the super trust approach might just fit the bill.

Please consult a competent tax attorney and or financial planner to determine if this strategy is right for your client's specific objectives and financial constraints.

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(1) "PNC Advisors Survey Finds That Wealth Brings Complication, Added Responsibilities," press release, Jan 10, 2005, PRN Newswire.
(2) IRC Secs. 2001, 2511.
(3) IRS Publication 553 (1/2005), Highlights of 2004 Tax Changes.
(4) IRS Publication 559 (2004), Survivors, Executors, and Administrators.
(5) *Walton v. Commissioner*, 1125 T.C. 589 (2000), holding that Sec. 25.2702-3)e), A transfers property to an irrevocable trust, retaining the right to receive a unitrust amount for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. The example concludes that A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust amount for 10 years or until A's death. However, the unitrust amount payable to A's estate if A dies within the term of the trust is not a qualified interest.