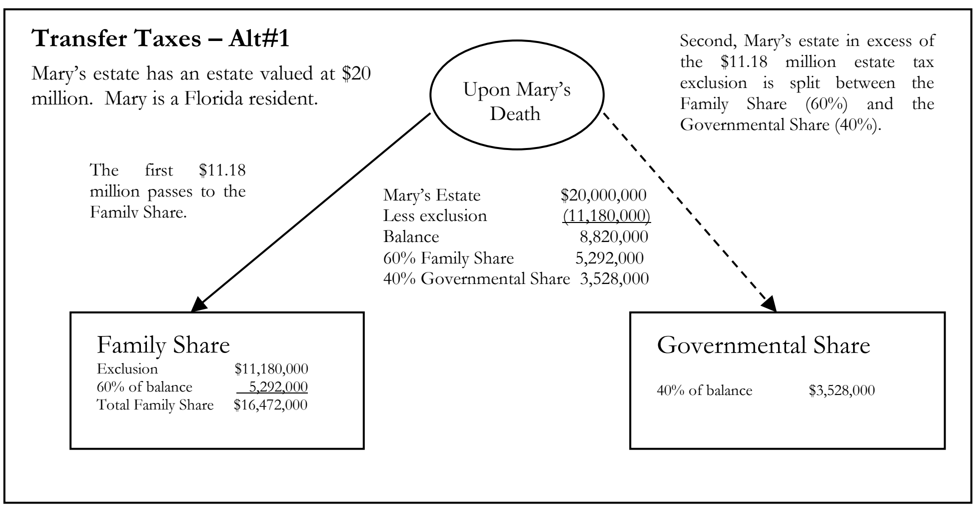
## *Governments Allow "Free Pass" Gifts – i.e., Unlimited Gift Tax Free Gifts to Children and Other Individuals!*

This Client Alert explains some methods by which unlimited transfers to family members may be made free from the gift and estate tax system. These unlimited "free pass" methods should be considered by parents having wealth in excess of the New Exclusion Levels for which they don't anticipate needing for their own standard of living. These "free pass" methods should also be considered by parents who are likely to survive the time of a possible roll back in the federal exclusions (i.e., survive 2026) and have wealth in excess of the Rollback Levels. Before explaining these "free pass" methods, a brief introduction is provided to the transfer tax system.

*Introduction to Transfer Taxes and the Social Capital Share (i.e., the governmental share)*

Many parents desire to transition their accumulated wealth to their family but they face a mandatory "sharing" with others – namely, the governmental share. Federal and state governments impose this sharing in the form of wealth transfer taxes (for federal purposes, this includes the gift, estate and generation-skipping transfer taxes). This sharing with the governments is required if the parents' wealth exceeds the statutory exclusion amounts.

The transfer tax system provides taxpayers with an exclusion amount from the various transfer taxes (each an "exclusion"). Starting this year, Congress doubled the federal gift and estate tax exclusions to $11.18 million for a single person and $22.36 million for a married couple (the "New Exclusion Levels").[1] This eliminates federal transfer taxes for roughly 99.9% of the U.S. population. However, under the new Tax Act, the exclusions are scheduled to roll back to the pre-2018 levels (e.g., approximately $5.6 million for a single person or $11.18 million for a married couple) in 2026 (or perhaps earlier if control of the government changes to the Democrats) (the "Rollback Levels"). Wealth in excess of the exclusions is subject to transfer taxes at a federal rate of 40%. Twelve states[2] and DC impose their own separate estate taxes at varying rates

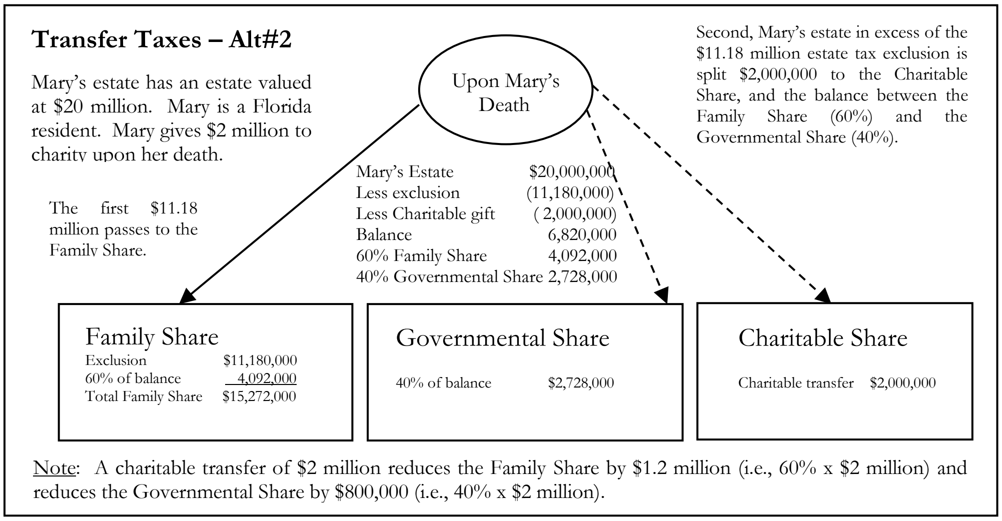


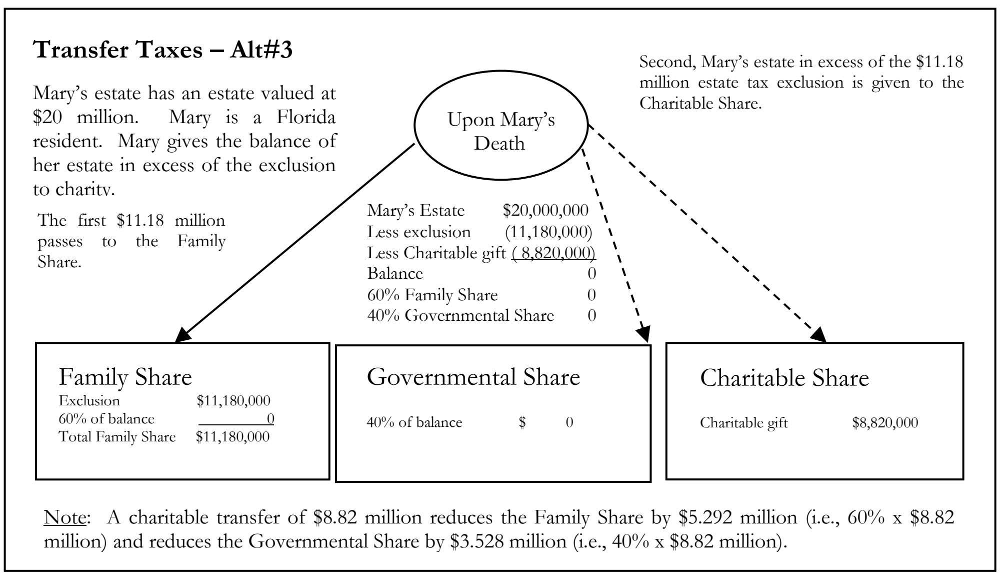

[1] The actual amount of the exemption has technically not been determined based on a change made in the calculation of the annual inflationary adjustments in recent tax legislation. It is anticipated that the amount for 2018 will ultimately be $11.18 million, so, for purposes of this alert, the amount is presumed to be $11.18 million.

[2] The following states impose a separate estate tax (exclusion amount stated in parenthesis): 1. Connecticut ($2.7 million); 2. Hawaii ($11.18 million); 3. Illinois ($4 million); 4. Maine ($11.18 million; 5 Maryland ($4 million); 6. Massachusetts ($1 million); 7. Minnesota ($2.4 million); 8. New York ($5.25 million); 9. Oregon ($1 million); 10. Rhode Island ($1,537,656); 11. Vermont ($2.75 million); and 12. Washington ($2.193 million). Also, the District of Columbia ($11.18 million) imposes

(e.g., up to 16%). Therefore, in these jurisdictions, wealth in excess of the exclusions is subject to an aggregate total transfer tax of approximately 50%.

Similar to being able to reduce income taxes by making charitable gifts, transfer taxes can be reduced (and sometimes eliminated) by making transfers to charity. Parents have the option to shift part or all of the governmental share to the charities of their choice by making transfers to charity. It is important to recognize, however, that charitable transfers not only can shift value away from the government but can also reduce the amount payable to the family. By using sophisticated charitable trusts in making the transfers to charity, it is possible to minimize the reduction of the family share.[3]




For parents with wealth beyond the exclusions mentioned above, using the $15,000 annual gift tax exclusion is the first priority.[4] This allows the parents to make annual gifts of $15,000 ($30,000

a separate estate tax. Connecticut is the only state to impose a separate gift tax. A few additional states impose a separate inheritance tax, including Iowa, Kentucky, Maryland, Nebraska and Pennsylvania. Maryland is the only state that imposes both an estate tax and an inheritance tax. The inheritance taxes are typically less than the separate estate taxes and/or only apply to the receipt of property by certain groups.

[3] Rather than leaving the contribution directly to the charity, firm member Richard Franklin and co-author, Jennifer Birchfield (formerly an associate with our predecessor firm, McArthur Franklin), in their article *The Intermediary CLAT Alternative to the Residuary Estate Family Foundation Gift*, Vol. 39, No. 3, ACTEC LAW JOURNAL, 355 (winter 2013 [actually published Jan. '15]) suggest using a charitable lead annuity trust. This trust will pay the amount passing to charity over a number of years, yet have the same federal estate tax benefit as a direct bequest to charity. This approach allows the family share to be less impacted by the charitable contribution because it creates the possibility of a reinfusion of wealth back to the family at no estate tax costs. If you would like a copy of our article, please email Sharon at smcdermott@fkl-law.com.

[4] In 2017, the annual gift tax exclusion amount was $14,000; the inflationary adjustments increased this to $15,000 for 2018.

for a married couple) to an unlimited number of individuals. Repeatedly making these gifts for many years can substantially increase the family share and thereby reduce the governmental share.[5] Stated alternatively, to not fully make annual exclusion gifts increases the governmental share of the family wealth. Annual exclusion gifts can be made outright or to trusts, and if made to trusts, we recommend using irrevocable "grantor" trusts for the reasons set forth in "free pass" #4 below.

We frequently recommend a host of "free pass" strategies to reduce the governmental share – strategies beyond charitable transfers and annual exclusion gifts.

*The "Free Pass" Methods of Transfer*

Congress allows parents to make certain *unlimited* gifts to children and other individuals without imposing any gift taxes! Everyone knows that *unlimited* gifts can be made to a spouse or charity without paying gift taxes,[6] but there are ways in which *unlimited* gifts can be made to children and grandchildren, nieces and nephews, or other individuals,[7] without paying gift taxes or using any of the parents' exclusions![8]

The following is a non-exclusive list of ways that parents can make these unlimited, gift tax free and exclusion free gifts:

1. <u>Tuition and Medical Payments</u>. The parents can pay tuition for an unlimited number of individuals in *unlimited* amounts.[9] Full and part-time tuition are both acceptable. Any level of schooling (*e.g.* primary, secondary, prep school, university) is acceptable. Prepayment of tuition for future years is allowed, so long as there is a specific beneficiary of the gift and the gift is nonrefundable. These payments <u>must</u> be made directly to the learning institution. The payments, however, encompass only tuition – payment for books, supplies, dormitory fees, room and board, or other similar expenses, do not fall within exception to the gift tax.

   Parents can also pay certain medical expenses in *unlimited* amounts for an unlimited number of individuals. They can pay for medical insurance premiums and medical services, including transportation for medical services, hospital and doctor's bills. As with the tuition payments, these payments <u>must</u> be made directly to the insurance company or medical provider. This gift tax exclusion, however, does not cover any amounts that are reimbursable by the beneficiary's health insurance provider (which makes sense). These payments can possibly also qualify for the federal and state income tax medical deduction if paid for a tax dependent.

2. <u>GRATs</u>. A GRAT or grantor retained annuity trust is used to transfer future appreciation in an asset to children or other individuals free of gift and estate taxes.[10] In general, the grantor transfers property to an irrevocable trust and receives back an annuity (often once a year for two years). The annuity paid back to the grantor is typically equal to near 100% of the value of the transferred property on the date of transfer,

[5] Using the annual gift tax exclusion, as well as the other "Free Pass" methods outlined in this Client Alert, can reduce the required sharing with the governments. We intentionally did not say that it would reduce the social capital passing to charity. This is because the family is always free to make transfers for charitable purposes. Using these tax savings methods may reduce the impetus for making charitable transfers <u>just</u> to save on the required sharing with the governments.

[6] Internal Revenue Code (IRC) § 2523 allows a gift tax deduction in unlimited amounts for gifts to a U.S. citizen spouse. IRC § 2522 allows a gift tax deduction in unlimited amounts for gifts to a charity. Unlimited gifts cannot be made to a non-U.S. citizen spouse without incurring gift taxes.

[7] These methods would be excellent ways to benefit a non-U.S. citizen spouse without incurring gift taxes.

[8] Making gifts that use the $15,000 annual gift tax exclusion amount, as well as making gifts that use the $11.18 million gift tax exclusion and that actually result in gift tax liability, also should be considered and implemented when appropriate. This Client Alert is solely focused on raising awareness of ways to make gifts to children and other individuals without using gift exclusion and without paying gift taxes.

[9] IRC § 2503(e). Click here for an easy to read article on the tuition and medical exclusions.

[10] Our Estate Tax Strategies memorandum entitled "Grantor Retained Annuity Trust" gives an overview of the technique.

plus interest at the applicable IRS rate.[11] The actual gift for gift tax purposes upon establishing the GRAT will be nominal, often $100 or less. All of the appreciation over the 2-year period in excess of the IRS interest rate, passes gift tax free to the trust remaindermen, who are typically the grantor's children or other individuals (or to a trust for their benefit).

An *unlimited* amount of wealth can be potentially passed gift tax free using this technique. For example, assume $1 million of widget company stock is transferred to a 2-year GRAT in February 2018, paying an annuity $521,050 to the grantor at the end of year one and end of year two. If the stock appreciates at a rate of 15% each of the two years, the remainder passing to the children or other individuals free of gift taxes is $202,000. If the stock appreciates by 50% each of the two years, the remainder passing free of gift taxes is $947,000. If instead, the trust is funded with $50 million of widget company stock, then at the same growth rates, the remainder passing free of gift taxes would be $10.1 million and $47.4 million, respectively. Is this really possible? Yes! The framework for GRATs set forth in the Tax Code, and the technique is fully described within the Treasury Regulations.

3. Sales to Irrevocable "Grantor" Trusts. In our Estate Tax Strategies memorandum Sales of Interests in Family or Private Companies to Irrevocable "Grantor" Trusts, we describe the technique of selling business interests (the "Sale") to irrevocable "grantor" trusts for the benefit of children or other individuals. The Sale freezes the value of the equity interest in the hands of the parent generation at today's value, while allowing most of the post-transfer appreciation to pass free of gift taxes. If (or, more hopefully, "when") the sold interest appreciates after the Sale, the appreciation will be removed from the transferor's estate for estate tax purposes. A secondary benefit of a Sale of a minority interest in a privately held company is that valuation discounts would generally be applicable in determining the sale price. The amount of the discount also escapes gift taxes.

   Like the GRAT, a potentially *unlimited* amount of wealth can be passed gift tax free using this technique. For example, suppose a 49% interest in widget company is sold for $1 million to an irrevocable "grantor" trust for the benefit of children or other individuals.[12] The irrevocable "grantor" trust pays for the equity interest by issuing a promissory note.[13] Suppose further that the $1 million price reflects a 30% aggregate valuation discount for being a minority interest in a privately held company (which means that the pre-discounted value is $1,428,571). After 5 years, suppose the company is sold and the irrevocable "grantor" trust receives sale proceeds of $2,857,142 (which represents a 50% appreciation in the undiscounted value of $1,428,571). The irrevocable "grantor" trust then pays off the $1 million promissory note, leaving the trust with $1,857,142 which it received free of any gift tax or the use of any exclusion.[14] The true power of this concept can be illustrated by increasing the value of the equity interest. Suppose that, instead of the discounted value of $1,000,000, the discounted value of the 49% equity interest is $50 million. Assuming the same sale with 50% appreciation after 5 years, the net amount remaining in the trust after paying off the promissory note would be approximately $93 million.

4. Irrevocable Grantor Trusts. Using an irrevocable "grantor" trust is perhaps the most powerful way to make gift-tax-free gifts, in *unlimited* amounts, to children or other individuals. In effect, a parent may create and fund an irrevocable trust for children or other individuals and the trust could be structured so that the parent must pay the income taxes on the income generated by the trust's assets, even though the parent

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[11] The IRS rate for this purpose is 120% of the mid-term Applicable Federal Rate for the month in which the GRAT is established.

[12] The Sale is not considered a "sale" for income tax purposes – there would be no gain to report – because IRS considers the grantor as the owner of the trust assets and the grantor cannot have a taxable sale with himself. Rev. Rul. 85-13. However, the Sale is respected for state law purposes and for gift and estate tax purposes.

[13] Frequently the promissory note is structured as a nine year balloon note, with interest payable annually at the mid-term AFR, which in February 2018 is 2.31%. Because the trust is a "grantor" trust, the interest paid on a loan is ignored for income tax purposes. The interest payments are not included in the lender's income and are not deductible by the borrower. Notwithstanding this income tax non-recognition of interest, interest should be paid on any such promissory notes to avoid gift tax implications.

[14] Technically, some interest would also be due and payable under the promissory note.

does not receive income from the trust and is not entitled to be reimbursed for the tax expenses.[15] The grantor's payment of the income tax is not considered a taxable gift for gift tax purposes.[16] The parent's payment of the income taxes enhances the value of the trust, and this effect may be in *unlimited* amounts.

In the example in item #3 above, after 5 years, assume the company is sold and the irrevocable "grantor" trust receives sale proceeds of $2,857,142 (i.e., a 50% appreciation in the undiscounted value of the 49% equity interest). After paying off the $1 million promissory note, the trust has remaining proceeds of $1,857,142.[17] Who pays the capital gains taxes on the proceeds? Assuming the income tax basis in the 49% equity interest is zero and a 30% aggregate state and federal capital gains rate, the total income taxes to be paid would be $857,142 ($2,857,124 x 30%). If the trust pays the taxes, it would have a net remaining value of $1 million ($1,857,142 - $857,142.) But because the trust is structured as a "grantor" trust, the parent must pay the taxes of $857,142. The effect of the parent paying the taxes is not considered a gift for gift tax purposes, yet it enhances the value of the trust by $857,142 (which is a very substantial gift-tax-free gift). Similarly, if the 49% equity interest sold is worth $50 million, the net to the trust after 5 years and a 50% appreciation would be approximately $93 million and a gift-tax-free gift by the parent of paying the income taxes on the sales proceeds would be $43 million.

Continuing with these examples, following receipt of the sales proceeds, the irrevocable "grantor" trust would have substantial assets for reinvestment, perhaps in a diversified portfolio of publically traded stocks and bonds. Each year the parent would pay the income taxes on the earnings, which allows the trust to grow income tax free. Over time this ability to pay the income taxes on the trust's earnings is very powerful and can be used to move large amounts of wealth to trusts for children and other individuals without the imposition of gift taxes.

Exploring the limits of gifts and "grantor" trust status, firm members Richard Franklin and Lester Law developed a new annual gift strategy to irrevocable "grantor" trusts with an extensive economic analysis.[18] Richard and Lester have spoken about this strategy at many of the largest continuing legal education conferences around the country in 2016 and 2017.[19] The core point of this analysis is that moving wealth during lifetime is far more efficient for transfer tax purposes (even when incurring gift taxes) than transferring wealth upon death and incurring an estate tax.

*Conclusion*

These "tax-free" methods of transitioning wealth represent some of our favorite approaches to minimizing the governmental share of family wealth. It's not much of an overstatement to say that with sufficient time to allow these "tax-free" methods to operate the governmental share of family wealth can be eliminated. This is especially so today because of the New Exclusion Levels.

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[15] When structured in this manner, all items of income, deductions, and credits against tax of the "grantor" trust are included in computing the taxable income of the grantor. IRC § 671.

[16] Rev. Rul. 2004-64.

[17] Technically, some interest would also be due and payable under the promissory note.

[18] The title to our paper is *Never Pay Estate Taxes - The Annual Taxable Gift Approach with a CLAT Remainder*. If you would like a copy of our paper, please email Sharon at smcdermott@fkl-law.com.

[19] Among other programs we presented our idea at the 46th Annual Estate Planning Seminar, Estate Planning Council of Portland, Oregon (January 20, 2017); 51st Heckerling Institute on Estate Planning, Orlando, Florida (January 11, 2017); 2016 Federal Tax Institute of New England CLE, Hartford, Connecticut (November 18, 2016); 42nd Annual Notre Dame Tax and Estate Planning Institute, South Bend, Indiana, (October 27, 2016); Charlotte Estate Planning Council, Charlotte, North Carolina (Oct. 19, 2016); ABA Spring Trusts & Estates Symposia, Boston, Massachusetts (May 13, 2016); Carter Center's Planning Giving Advisory Council, Atlanta, Georgia (May 16, 2016).

If you have any questions about gifts, tax-free or otherwise, please call one of our lawyers.

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LEADERSHIP UPDATE: At FKL, we are committed to being innovative and creative leaders in the trusts & estates practice. Recently, George Karibjanian and Lester Law wrote an article entitled *"Just Say 'NO' … to the Credit Shelter Trust! Revisiting Existing Estate Plans in Light of the 2018 Tax Act!"*, which was published in the national Leimberg Estate Planning Newsletter. George and Lester outlined why the traditional credit shelter trust planning is a dated idea. In January and February, Richard Franklin made presentations to trusts officers and estate specialists at several national banks relating to family dynamics and inheritance planning based on positive psychology and why the "limited inheritance" approach attributed to Warren Buffett is an unfortunate idea. You can read Richard's Family Wealth Series here.

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