(Reprinted from the Cleveland Metropolitan Bar Journal - December 2008)

# Rethinking Your Holiday Gift List — Why Now May Be a Great Time to Give It Away

*by Rennie Rutman*

THE COMBINATION OF low interest rates and the precipitous reduction in the market value (although perhaps not the intrinsic value) of, well, most things worth gifting, makes this an opportune time to implement certain leveraged wealth transfer strategies. Several of these techniques, one of which is discussed below, effectively permit a transfer of assets with absolutely no estate tax, gift tax, or even income tax cost to the transferor.

The transfer tax system literally taxes the transfer of wealth from one person to another. Transfers during lifetime are subject to the gift tax, and transfers at death are subject to the estate tax. Both types of transfers may be subject to the generation skipping transfer-tax, a discussion of which is beyond the scope of this article.

During lifetime one may gift an amount equal to the federal annual exclusion, currently $12,000, to an unlimited number of people each year, provided the gift is a gift of a "present interest." In general, if the recipient of the gift has the ability to utilize and enjoy the gift when it is made, the gift will satisfy the present interest requirement. If an individual makes a gift during lifetime in excess of the annual exclusion, she may elect to apply some of her federal $1,000,000 lifetime gift tax exemption amount ("gift tax exemption") to the excess and shield that excess from federal gift tax. The State of Ohio does not impose a gift tax on lifetime transfers.

The general rule in 2008 is that an individual may transfer at death (e.g. by trust, last will and testament, beneficiary designation, or joint ownership arrangement) up to $2,000,000 to anyone free of federal estate tax and up to $338,333 to anyone free of Ohio estate tax. The excess transferred is taxed at a maximum rate of 45% by the federal government and 7% by the State of Ohio.

One exception to this general rule is that any gift tax exemption utilized to shield lifetime gifts reduces, dollar for dollar, the amount that may be transferred at death without incurring federal estate tax. The Ohio rule is different, and generally, Ohio's $338,333 estate tax applicable exclusion amount is reduced only by the value of gifts made within the last three years of one's life, with a $10,000 per donee, per year, exemption from the calculation.

The federal *estate* tax applicable exclusion amount is scheduled to increase to $3,500,000 in 2009, become unlimited in 2010, and decrease substantially in 2011. However, the lifetime *gift* tax exemption amount is not scheduled to increase; thus, even if the estate tax applicable exclusion amount adjusts as set forth above (and few estate planners believe it will), there is still an effective $1,000,000 cap (exclusive of annual exclusion gifts) on gift tax-free transfers during lifetime. For those who do not wish to make taxable gifts, or those who wish to transfer more than $1,000,000 during lifetime, leveraged wealth transfer strategies must be employed.

The efficacy of several wealth transfer strategies is largely determined by certain rates of interest published monthly by the Internal Revenue Service ("IRS"). These interest rates are known as the "applicable federal rates" ("AFRs"), and as market rates of interest decline, so do the AFRs. The

AFRs are factors in certain algebraic formulas which are used to determine the gift tax cost of certain transfers. They are also used as benchmarks to test certain transfers between related parties to determine if those transactions are disguised gifts.

One technique that is particularly effective when the AFRs are low is the implementation of a grantor retained annuity trust ("GRAT"). A GRAT is an irrevocable trust into which assets are transferred by the "grantor." The terms of the trust provide that the grantor will receive a fixed annuity payment each year for a specified term of years. Whatever remains in the GRAT (the "remainder") when the annuity term ends is transferred to the named beneficiary as a gift. IRS regulations require that one determine the value of the gift, for gift tax purposes, at the moment of transfer of assets to the GRAT, not at the time the remainder actually transfers to the beneficiary. To determine the projected value of the remainder, and thus the (gift tax) value of the gift, one must make an assumption regarding to what extent the assets in the trust will appreciate and what "rate of return" those assets shall fetch over the annuity period. Here is where the current economic conditions become relevant: one of those market sensitive AFRs published by the IRS each month is the Section 7520 Rate. Although the calculations vary depending on certain elements of the transaction, in practice, the lower the Section 7520 Rate, the less is projected to remain in the GRAT at the end of the annuity term, and thus the less is projected to be "gifted" to the beneficiary. If the assets in trust actually outperform the Section 7520 Rate, the difference between the *projected* value of the remainder and the *actual* value of the remainder entirely escapes the transfer tax system.

It is possible to create a "zeroed-out GRAT" wherein the value of the annuity payments and the length of the term are structured so that there is projected to be nothing left in the GRAT at the end of the annuity term. In that case, there is no *projected* gift at all, and the grantor can preserve his entire gift tax exemption. Further, because the GRAT is treated as a "grantor type trust" for *income* tax purposes, the receipt of each annuity payment by the grantor is not an income taxable event. Instead, the grantor is taxed on the income generated by the assets in the GRAT itself. The grantor pays the income tax from other (non trust) assets, the GRAT assets are not reduced by the income tax burden, and the GRAT assets grow income tax free.

The effectiveness of the GRAT (as compared to an outright gift or sale) is illustrated below.

Assume Mom wants to transfer $1,000,000 of either closely held or publicly traded stock to her child in November, 2008, but does not want to use her gift tax exemption or pay income tax on any sale.

Presume that her closely held business interests have an appraised value, after discounts, (including a particularly aggressive discount for lack of liquidity due to the overall lack of credit available in the marketplace) of $1,000,000. Or, presume, instead, that she has a brokerage account with stocks which have declined in value to $1,000,000.

If she simply gifts the assets outright, Mom will have nearly exhausted her gift tax exemption. She will not be able to make any gifts (with a few limited exceptions) in excess of the annual exclusion amount for the balance of her lifetime; if she does, she will incur gift tax.

If she sells the assets to her child for $1,000,000, Mom will not utilize any of her gift tax exemption. However, capital gain will be owed in the year of the sale, and the child must find a way to fund the $1,000,000 purchase price. If Mom loans some portion of the purchase price to the child and takes back a promissory note, that note must bear a rate of interest no less than the 1.67% short-term (three years or less), 2.97% mid-term (in excess of three years but no greater than nine years) or 4.24% long-term (in excess of nine years) AFR or the IRS will treat the foregone interest as a gift to the child, thereby requiring the use of Mom's gift tax exemption. In addition, if Mom forgives portions of the debt each year, perhaps equal to the annual exclusion, she will generally be required to include in her taxable income each year the amount of any foregone interest.

Now assume that Mom transfers the assets to a GRAT and retains the right to receive an annuity, paid from the GRAT assets and the earnings thereon, of $120,848 per year for ten years. Based on November's Section 7520 Rate of a mere 3.6%, the gift tax cost of this transaction, that is, the amount *projected* to remain in the trust at the end of the term is $0. None of Mom's gift tax exemption is utilized. The trust is ignored for income tax purposes, and Mom pays no tax upon the transfer to the GRAT or upon the receipt of the annuity payments. At the end of the annuity term, the assets transfer to the child and *neither gift tax nor income tax* has been triggered by the transfer. If the GRAT assets generated an annualized rate of return in excess of 3.6%, the GRAT has been a success; if they have not, there is no harm done, no tax paid, no exemption wasted.

If Mom believes that over the next decade, the average, annualized rate of return of the GRAT assets shall exceed 3.6% she will likely view this as a technique with great potential for reward, with almost no tax risk.

One caveat: if Mom dies before the annuity term ends, the value of the GRAT assets unreduced by any of the annuity payments, shall be included in her gross estate for estate tax purposes. In order to minimize this mortality risk, and to address additional planning issues and opportunities beyond the scope of this article it is always prudent to weigh the potential rewards and risks of a single long term GRAT against those of "rolling GRATS" – a series of short term GRATS, to consider the contribution or sale of the GRAT remainder, and to evaluate the possibility of implementing another technique that leverages the gift tax exemption - the installment sale to a defective grantor trust.

Suffice it to say that fear, or at least discomfort, engendered by the current economic conditions, and uncertainty regarding the nature of the gift tax, estate tax, and income tax under the new administration are daunting psychological obstacles to implementing wealth transfer techniques that have significant tax costs. However, the confluence of depressed market values and low interest rates make a low tax risk wealth transfer strategy such as the GRAT a powerful and perhaps palatable wealth transfer technique. ■

*Rennie C. Rutman is an Associate in the Cleveland office of Tucker Ellis & West LLP. As a member of the firm's Business group, she practices extensively in the areas of estate and business succession planning, probate, estate administration, trust administration, and the interrelated fields of estate, gift, and income taxation. She has been deemed a certified specialist in estate planning, trust and probate law by the Ohio State Bar Association. She can be reached at rennie.rutman@tuckerellis.com.*

ASPIRE AUCTIONS
FINE ART & ANTIQUES
www.aspireauctions.com

AUCTIONEERS & APPRAISERS OF FINE ART, ANTIQUES & JEWELRY

12730 LARCHMERE BLVD
CLEVELAND, OH 44120
PHONE: 216-231-5515