Wealth Preservation Through Tax Reduction

~ Daniel L. Tullidge

Introduction

Careful planning can significantly reduce estate and gift tax, also known as transfer taxes. The simplest and most effective method to minimize transfer taxes is to spend or transfer enough assets during your lifetime to fall below the taxable exemption when you pass away. If, however, you wish to leave a substantial inheritance to your heirs or to charity, consider increasing that inheritance by reducing its transfer tax cost. This article explains the fundamentals of this approach and provides some useful methods for achieving success.

Overview of Estate and Gift Tax System

The first step in planning to avoid or minimize transfer taxes is to understand the mechanics of the tax system and how they may apply to you. The federal transfer tax system applies to transfer of wealth during one's lifetime (the gift tax) and the transfer of wealth at death (the estate tax). Florida does not impose a separate state estate or gift tax.

The gift tax and estate tax are interrelated systems. As of 2017, US citizens and residents are entitled to a $5,490,000 equivalent exemption amount. The equivalent exemption applies to the total of your lifetime taxable gifts and the value of your taxable gross estate at death. For example, during 2017, you may decide to make your first taxable gift to your child of $1,000,000. Neither your child, as the donee, nor you, as the donor, would pay transfer tax on the gift. However, you would have used up $1,000,000 of your equivalent exemption, thereby reducing it to $4,490,000. If you were to pass away shortly thereafter, then your estate would not be subject to tax, provided you made no other taxable gifts and the value of your taxable gross estate at death did not exceed $4,490,000, which is your remaining equivalent exemption. Once your equivalent exemption has been exhausted, additional lifetime taxable gifts and the value of your taxable gross estate at death will be subject to federal estate or gift tax at an effective rate of 40 percent.

Simple Lifetime Gifting

If you do not plan on spending your wealth, then consider lifetime gifting. You will notice in the above example that only "taxable gifts" apply against your equivalent exemption. For each potential donee of a gift, you receive an annual exclusion amount that is indexed each year for inflation. For 2017, the annual exclusion amount is $14,000. Gifts are only considered "taxable gifts" if you gift to any one donee during the year more than the annual exclusion amount.

For example, if you have two children and four grandchildren, then you could gift each child and grandchild $14,000 in 2017, for a total of $84,000, without using any part of your equivalent exemption. If your spouse joins you in this endeavor, then you could double the results by making a nontaxable gift of $168,000. If the spouses of your children are additional donees, then the effect is increased even further. Whenever you gift at or near the annual exclusion amount, you will need to limit other possible forms of gifts to the donees (e.g., birthday gifts, holiday gifts, or picking up the tab at dinner). For this reason, it is often prudent to leave a little breathing room by gifting somewhat less than the annual exclusion amount per donee, per year.

By consistently implementing a lifetime gifting program, you can slowly reduce the value of your taxable gross estate without creating taxable gifts and using up your equivalent exemption. This is a simple and straightforward way to pass wealth to lower generational levels while avoiding transfer taxes.

Tax Exclusivity Versus Tax Inclusivity

If lifetime gifting within the annual exclusion amount is not sufficient, then you should consider additional strategies. The equivalent exemption and 40 percent rate for the estate and gift tax would seem to imply that the tax benefits of a transfer of wealth during life or at death are the same. To the contrary, while the rate and credit are interrelated, the outcome of transferring wealth during life, as opposed to at death, can be substantially different.

The estate tax is tax inclusive, which means that the assets used to satisfy the estate tax are themselves subject to the estate tax. The estate tax is imposed on the entire value of your taxable gross estate at death, including the amount that will be paid to the United States Treasury in satisfaction of the estate tax. The gift tax, on the other hand, applies only to the assets received by the donee and, therefore, can be described as tax exclusive. This distinction between tax exclusivity and tax inclusivity means that the lifetime transfer of wealth is more efficient from a transfer tax perspective.

By way of example, assume that you have $1,000,000 you would like to transfer to your child. Further assume that you have completely used up your equivalent exemption through prior taxable gifts and the estate and gift tax rates are at 40 percent. If you transfer the $1,000,000 to your child upon your death, then your estate would be liable for $400,000 in estate tax and your child would receive $600,000. Alternatively, you could make a lifetime transfer to your child of $714,285 and use the remaining $285,715 to pay the 40 percent tax on the $714,285 that was received by your child. The tax exclusive nature of the gift tax would result in a transfer tax savings of $114,285, as long as you live for at least three years after the date of the gift.

You can gain benefits by selecting the correct assets to give during lifetime and at death. For example, there is the step-up in basis that results when assets are transferred at death. If the $1,000,000 you intended to transfer in the above example was highly appreciated IBM stock, as opposed to cash, then there could be substantial built-in gain and attendant capital gains tax considerations. Assume the IBM stock was purchased for $400,000 and had appreciated to $1,000,000. Your basis in the stock is $400,000, and there is a potential capital gain of $600,000, taxable at 23.8 percent. If you transfer the IBM stock to your child at death, then your child would receive a step-up in basis equal to the fair market value of the IBM stock at your date of death. In other words, your child would receive a $1,000,000 basis in the IBM stock, and the built-in capital gain would be eliminated. This results in a tax savings of up to $142,800. By contrast, if you had gifted the IBM stock during your lifetime, then your child would have received a transferred basis of $400,000 and the $600,000 of built-in gain. The $114,285 of transfer tax savings resulting from the tax-exclusive nature of lifetime gifting would be nullified by the loss of the step-up in basis at death.

Valuation Discounts

You can minimize estate and gift tax by ensuring that the property transferred, either during life or at death, is strategically valued. For purposes of the estate and gift tax, the valuation of transfers is based on fair market value, which is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. This definition of fair market value is the baseline from which adjustments are made for other factors that may affect value.

If you are transferring $1,000,000 in cash, then the valuation is quite simple. You are transferring $1,000,000. If, by contrast, you are transferring shares of the family company or membership interests of a limited liability company that holds rental real estate, the answer is not so straightforward.

What is the value for transfer tax purposes if you, as the sole owner of a limited liability company that holds $1,000,000 worth of rental real estate, transfer 25 percent of your interest in the limited liability company to your child? It is not necessarily 25 percent of the appraised value of the underlying real estate. A third party would not be willing to pay you 25 percent of the value of the real estate, or $250,000, as he or she would not have a controlling interest. The 25 percent ownership interest in the limited liability company is also not readily marketable. Persons would much rather buy real estate directly than buy an ownership interest in a limited liability company. To account for this discrepancy, the Internal Revenue Code allows for the application of valuation discounts. Lack of control and lack of marketability discounts can reduce the value of the underlying assets by up to 40 percent. In our example, the 25 percent interest could be valued as low as $150,000. When applying valuation discounts, it is important to work with qualified appraisers and to resist the temptation to overreach.

Leveraging Your Unified Credit

In addition to considering when a transfer takes place (i.e., during life or at death) and the value of the property you intend to transfer, you should also use several different tools for maximizing and leveraging your equivalent exemption. While a comprehensive review is beyond the scope of this article, there are some interesting tactics for you to consider.

Irrevocable trusts can provide a vehicle for leveraging your equivalent exemption. When you transfer assets to an irrevocable trust during your lifetime, you are typically making a completed gift to the beneficiaries of the trust for transfer tax purposes, and the value of the irrevocable trust is not included in your gross estate at the time of your death. The amount of the gift will be valued at the time the transfer occurs, taking full advantage of any applicable valuation discounts discussed above.

While there are multiple types of irrevocable trusts, with varying purposes and mechanics, they have some common characteristics that are aimed at leveraging your equivalent exemption. One straightforward advantage is that the amount of the gift is locked in when the transfer occurs. Any increase in value due to income earned or appreciation of the assets of the trust will not create any additional gifts or be included in your gross estate at death. While the same is true of an outright gift to your children, the irrevocable trust allows you to exercise some level of control over your children's use of the trust assets, whether that is by including spendthrift provisions to protect against creditors or by delaying distributions until an age of maturity. If the irrevocable trust is structured as a grantor trust under the Internal Revenue Code, then you will have the opportunity to transfer additional wealth without affecting your equivalent exemption. In a grantor trust, all trust income will be taxed as if the trust assets were directly owned by you, the grantor, instead of by the trust; therefore, all income earned by the trust will be reported directly on your income tax return. By paying the income taxes associated with the irrevocable trust, you are, in effect, transferring additional assets to the next generation without using your equivalent exemption.

A *Grantor Retained Annuity Trust* (GRAT) is one specific example of an irrevocable trust that is commonly used to minimize transfer taxes. The GRAT is an irrevocable trust designed to transfer a future interest in property as a gift. When a GRAT is created, you transfer property to the GRAT but retain the right to receive an annual distribution or annuity from the trust for a certain number of years, typically two to six. Following the expiration of your annuity term, the remainder beneficiaries (e.g., your children) receive the remaining assets in the GRAT. A favorable Tax Court case involving a relative of the Walmart entrepreneur Sam Walton (Walton v. Commissioner) approved the creation of a GRAT with an annuity term that did not expire upon the grantor's death. This type of GRAT is often referred to as a Walton GRAT and provides for a lower valuation of the remainder interest.

Clyde Butcher
Florida Bay 3, Everglades National Park

A gift of the remainder interest occurs at the time of the creation of the GRAT for gift tax purposes. However, the gift is not valued at the full fair market value of the property you transferred to the GRAT. Instead, the value of the gift is calculated using the amount of the annuity payments you will receive and the expected rate of return of the trust during the term. The rate, called the 7520 rate due to the corresponding section of the Internal Revenue Code, is promulgated by the Treasury and set each month, and it is often significantly lower than the expected rate of return on your typical investment.

Using a large enough annuity payment in conjunction with the 7520 rate can reduce the present value of the gift to zero. However, if the assets in the GRAT provide a rate of return greater than the 7520 rate, then the remainder beneficiaries will receive the difference at the end of the term, without you having made any additional gift. For this reason, GRATs work best in low interest rate environments with assets that are expected to appreciate in value.

For example, assume you establish a Walton GRAT with a three-year term and fund the GRAT with $10,000,000 worth of Apple stock. We will use the 7520 rate for August of 2017, which is 2.4 percent. In order to zero out the remainder gift, you would need to receive an annuity payment each year of 34.945 percent of the trust assets—or $3,494,548. However, if the trust assets produce 5 percent annual income and 5 percent growth of principal, then the actual value of the remainder interest would be $1,774,489. You would have successfully passed $1,774,489 to your children without the use of your equivalent exemption and without the incursion of any estate or gift tax. As noted above, these types of results are best obtained in a low interest rate environment with assets that will appreciate during the GRAT term.

Conclusion

Minimizing estate and gift tax is not the sole goal of estate planning. Ensuring proper liquidity for payment of estate taxes, protecting assets for future generations, maintaining family harmony, transitioning a business, and establishing charitable legacies are just a few additional considerations. However, if you are fortunate enough to have the misfortune of being subject to estate and gift tax, then taking the time to plan is a worthwhile endeavor.

Dan is a Williams Parker associate.

He focuses his practice on taxation, estate planning, and estate and trust administration. He earned an LLM in Taxation and his JD and BA from the University of Florida.