2010 Gap Year Gift Planning

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GAP YEAR

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("the 2001 Act") made significant changes in the transfer tax laws (estate tax, generation-skipping transfer tax, gift tax). The 2001 Act lowered transfer tax rates to 45% by 2009, increased exclusion and exemption amounts to $3.5 million by 2009, and repealed the estate tax and the generation-skipping transfer tax altogether for the single year of 2010. The gift tax was not repealed but the top gift tax rate was reduced to 35% for 2010 only.

The 2001 Act provided that all of its provisions will expire at the end of 2010 as if never enacted, thereby reinstating the harsher transfer tax laws that were in effect before the 2001 Act. Estate planners did not think that Congress would allow a one-year gap in the transfer tax laws followed by reinstatement of the harsher pre-2001 laws, but that is just what may happen. In the absence of Congressional action, the estate tax will return in 2011 with an exclusion of only $1 million compared with a pre-repeal exclusion of $3.5 million, and with a top estate tax rate of 55% (plus a 5% surcharge for estates between $10 million and $17 million). The generation-skipping transfer tax will return with a reduced exemption and a top tax rate of 55%. The top gift tax rate will increase to mirror the top estate tax rate of 55% (plus the potential surcharge).

Earlier in this "gap year," it appeared likely that Congress would reinstate retroactively the law as it was in 2009; therefore, planning based on the ostensible 2010 transfer tax regime was perilous. It is increasingly likely, however, that the 2009 transfer tax law will not be reinstated retroactively but that, if or when Congress acts, Congress will reform the law only for years 2011 and forward. Assuming no retroactive reinstatement by Congress, the current state of repeal offers unique planning opportunities, such as no generation-skipping transfer tax on outright gifts to grandchildren. This article focuses on gift planning before the end of this year because the reduced top gift tax rate of 35% enhances substantially the estate planning economics of gifting; plus, unlike other potential planning opportunities, gifting would offer estate planning benefits even if a higher gift tax rate were to be reinstated retroactively.

LIFETIME GIFTS

There have always been estate planning benefits to making lifetime gifts, even if gift tax must be paid because the donor's lifetime gift exclusion amount of $1 million is exceeded. *First*, income and appreciation of the gifted assets are removed from the donor's taxable estate. *Second*, because of the manner in which the gift tax is calculated, a gift transfer generates 30% less tax than a transfer subject to estate tax at death. *Third*, the gift tax amount is removed from the donor's taxable estate (if the donor lives for 3 years following the gift). *Fourth*, the gifted property may be valued at a discount if the gift property is an undivided interest in real property or a minority interest in a business. *Fifth*, the donee may enjoy the gift currently.

The current reduced gift tax rate of 35% increases the estate planning benefits of lifetime gifting and, in conjunction with the following factors, makes the remainder of 2010 a uniquely favorable time for gift transfer planning: *(1)* asset values are lower than they may be in the future; *(2)* intra-family discounting has not been eliminated by Congressional action; *(3)* the interest rates that constitute "hurdle rates" for gift and loan transactions are at an all-time low.

Example. Assume *(i)* an amount deployed ("Available Fund") of $1,350,000, *(ii)* no lifetime gift exclusion remaining, *(iii)* an estate tax rate of 55%, and (iv) that the after-tax income and appreciation of the transferred assets cause the assets to double in value by the time of the donor's death. In the chart below, the Available Fund is passed through the estate in the No Gift column, and is allocated between a gift portion and a tax portion in the Gift column.

	NO GIFT	GIFT
Available Fund	$1,350,000	$1,350,000
Gift	0	$1,000,000
Gift tax (35%)	0	$(350,000)
Funds invested:	$1,350,000	$1,000,000
Growth before death	+ $1,350,000	+$1,000,000
Subtotal:	$2,700,000	$2,000,000
Estate tax (55%)	($1,485,000)	0
Net to donee	$1,215,000	$2,000,000

NET GIFT PLUS INTRA-FAMILY LOAN

Net Gift Component. The economics of a lifetime gift may be enhanced by making the gift as a "net gift" and combining the net gift with an intra-family loan. A net gift is a gift in which the donor makes a transfer of property subject to the condition that the donee pay the gift tax involved. The value of the net gift is determined by reducing the amount of the gift by the gift tax to be paid by the donee, and the gift tax is computed on the resulting amount. A net gift is similar to giving property subject to debt, in which the value of the gift is the equity portion. Under the net gift tax computation of applying the gift tax rate to what the donee receives net of the tax liability, a net gift if the gift tax rate is 35% reduces the effective gift tax rate to just under 26% (*viz.*, to 25.93%), thereby saving 9% for the family as a unit. Deploying the Available Fund of $1,350,000 from the above example, a net gift of $1,072,000 would generate a net gift tax of $278,000 payable by the donee. The $72,000 reduction in the tax amount increase the funds available for the donee to invest.

Intra-Family Loan Component. The donor could lend to the donee the money required to pay the gift tax. In fact, because of the low interest rate permitted for loans (the Applicable Federal Rate for November is 1.58% for a 9-year loan), the donor should consider lending an amount larger than needed to pay the gift tax. Doing so would confer on the donee the benefit of the difference ("arbitrage") between what the donee can earn on the borrowed amount and the 1.58% interest payable. The net benefit of the arbitrage may defray both the interest on the borrowing and the repayment of the principal; and, in addition, the arbitrage may create a gift tax-free transfer of an amount to the donee. *For example*, in the net gift variation above, the donor could lend more than the gift tax amount of $278,000. The additional amount remaining after the gift tax is paid would be available for the donee to invest. If the donee earns a net 6% total return (income plus appreciation less income tax) annually, then after payment of the interest each year and after repayment of the total principal amount borrowed at the end of 9 years, the amount shown in the chart below would be transferred tax-free to the donee. Note that the tax-free amount shown in the chart is the amount attributable only to the additional amount loaned and therefore is in addition to the net gift amount transferred ($1,072,000 and earnings thereon).

Loan of gift tax amount paid in yr. 1	Loan of additional amount	Net tax-free transfer to Donee after payment of gift tax, after payment of interest annually, and after repayment of principal of the gift tax loan and intra-family loan
$278,000	$1,000,000	$179,445
$278,000	$2,000,000	$687,363
$278,000	$3,000,000	$1,195,277
$278,000	$4,000,000	$1,703,195
$278,000	$5,000,000	$2,211,111
$278,000	$10,000,000	$4,750,688

GRANTOR TRUST

Income Tax Grantor Trust. The gift planning described above can be further enhanced if the net gift and loan are made not directly to the donee but to a "grantor trust" (sometimes referred to as an "intentionally defective grantor trust" or "IDGT") for the donee. A grantor trust is a trust that is a completed transfer for gift and estate tax purposes but that is ignored for income tax purposes. As a result, if a grantor trust has real economic substance for gift and estate tax purposes, then transactions between the donor (the "grantor") and the grantor trust (e.g., a sale of assets by the grantor to the trust) have no income tax consequences. Note that the net gift planning component described above accomplishes the purpose of funding the grantor trust with real economic substance.

Economic Benefit of Grantor Trust. If the net gift and loan are made to an IDGT, then: *(1)* the interest payments received by the donor-grantor will not be taxable income to the donor; and *(2)* the arbitrage return earned from the investment of the borrowed funds will be the pre-tax total return, undiminished by income tax, because the donor will pay the income tax.

In-Kind Loan. A grantor trust also affords a mechanism by which the donor-grantor can, effectively, lend assets in-kind, thereby avoiding the income tax consequences of sales that would be required for a loan of cash. Instead of selling assets, the donor could sell the assets to the grantor trust for a promissory note. The transaction would have no income tax consequences but would create the functional and economic equivalent of a loan of the assets in-kind.

There are considerations and some complexities to net gift planning. For example, if the gift tax liability assumed by the donee exceeds the donor's income tax basis, the donor will recognize taxable gain. The planning can be structured, however, to minimize tax recognition and to minimize or avoid any impact on the donor's economic security or cash flow.

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