

**Advanced Estate Planning
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Ann B. Burns, Attorney
Gray Plant Mooty
612-632-3402
ann.burns@gpmlaw.com

I. Techniques to Maximize Wealth Transfer

This presentation outlines advanced planning opportunities that allow clients to reduce the estate tax liability and thereby maximize wealth transfer. It is also important for the client to consider other non-tax objectives for the estate plan, however. As you have conversations with your clients about estate planning, keep both goals in mind.

A. Using the Credit Shelter Trust

Using a “credit shelter trust” or “family trust” to house the client’s estate tax exemption is a simple and powerful tool for the estate plan. Typically, a client funds the family trust at death by including instructions to do so in the will or revocable trust. A client may also fund a family trust during life using the lifetime gift tax exemption. This technique avoids estate taxation of future trust appreciation and income. In addition, if the grantor structures the trust so as to pay the income tax on trust income, the growth within the trust will be even greater without consuming trust assets. The result is that the client shelters asset growth, protects the assets from the reach of creditors, and leverages the estate tax and generation-skipping tax (GST) exemptions.

Example:

A married couple in 2009 has a combined \$2 million of lifetime gift tax exemption and \$7 million of GST exemption. Assume the couple funds lifetime trusts to \$2 million today. The couple will pay no federal or Minnesota gift tax on the \$2 million gift. In addition, all of the future appreciation and income of the assets transferred into the trusts escapes income, estate and gift tax. Assuming the trust increases in value by 6% per year for 20 years, the trust will be worth \$6,414,271 in the year 2029. If the trust increases by 8% per year, the trust will be worth \$9,321,914 in the year 2029.

B. Preserving Family Business Valuation Discounts

An interest in a family business is a particularly good asset to contribute to the family trust. As discussed above, future appreciation and income are sheltered from the estate tax. In addition, the trust may help maintain valuation discounts for lack of control

and lack of marketability. When using this technique, it is important for the grantor to specifically enable the trustee to retain family business assets as part of the trust portfolio.

C. Borrowing to Increase Leverage

An additional estate planning tool involves the family trust borrowing assets from the surviving spouse or the surviving spouse's marital trust. The family trust could also buy the assets using a promissory note. The family trust need not pay interest currently – the IRS has decided cases in which the borrowing trust allowed the interest to accrue until the death of the surviving spouse.

II. Grantor Retained Annuity Trusts (GRATs)

A GRAT is a trust that pays an annuity for a fixed term of years to the grantor. The trust is irrevocable – that is, it cannot be altered, amended, or revoked. The annuity amount is a percentage of the initial value of the assets transferred to the trust. The annuity amount can be paid in cash or in kind. The property remaining in the trust at the end of the GRAT term passes to the remainder beneficiaries outright or in trust. The benefit to the GRAT is as follows: If the GRAT's rate of return on its assets exceeds the IRC § 7520 rate, the trust property remaining after the annuity payments is distributed to the remainder beneficiaries free of gift or estate tax. GRATs are particularly beneficial when interest rates are low because a smaller annuity must be paid to the Grantor.

The objective of a GRAT is to transfer appreciating and income-producing assets to the grantor's children over time. As long as the GRAT assets appreciate at a higher rate than the IRS rate, the grantor reduces gift and estate taxes that would otherwise be paid when the grantor transfers that property to the next generation. In addition, the grantor is able to retain the same standard of living because the grantor gives up nothing that he or she didn't already own prior to establishing the GRAT.

If the grantor dies during the trust term, the full value of the trust assets are likely included in the grantor's estate for estate tax purposes. If the grantor survives the trust term, the annuity payments that the grantor received and retained are included in the grantor's estate for estate tax purposes. Currently, there is no minimum trust term for GRATs. Because the purpose of the trust is defeated if the grantor dies during the trust term, the grantor may choose to establish shorter term GRATs and create and fund additional trusts with the annual payments received and/or other assets.

Additional income and gift tax implications of the GRAT are as follows: The grantor files a gift tax return to report the transfer to the trustee. The return should include a qualified appraisal of any hard-to-value assets that are transferred to start the statute of limitations period running with respect to the gift tax value. At the end of the trust term, the remaining trust assets, if any, are distributed to grantor's children (and often to the descendants of any deceased child). The IRS taxes income and gain or loss events to the grantor because the trust is described for income tax purposes as a "grantor trust". The transfer to the trustee is a taxable gift that does not qualify for the \$13,000 annual gift tax exclusion, so it uses a portion of grantor's lifetime gift exclusion amount (\$1,000,000 in

2009). The amount of the gift is the value of the assets transferred from the grantor to the trustee reduced by the actuarial value of the annuity payments from the trustee to the grantor.

III. Installment Sale to a Grantor Trust

Planning with an installment sale to a grantor trust also involves the creation of an irrevocable trust. The grantor transfers assets to the trustee and, in exchange for an installment note, sells additional assets to the trustee that are expected to appreciate rapidly and/or generate significant income. As part of this process, the grantor must file a gift tax return to report both the transfer and the sale to the trustee. The return should include a qualified appraisal of any hard to value assets to start the statute of limitations period running with respect to the gift tax value.

The trustee pays the installments on the note to the grantor until the note is paid in full or until a date specified by the terms of the note. After the loan is paid in full, all of the trust assets are available to provide for the grantor's children and also typically the descendants of any deceased child.

Similar to a GRAT, this technique allows the grantor to transfer appreciating and income producing assets to his or her children over time while retaining the same standard of living. It also reduces the grantor's overall gift and estate tax liability.

For income tax purposes, the income and gain or loss events are taxed to the grantor. For gift tax purposes, the transfer to the trustee is a taxable gift that does not qualify for the \$13,000 annual gift tax exclusion, so it uses a portion of the grantor's \$1,000,000 lifetime gift exclusion amount. Unless the valuation of the assets is incorrect, the sale to the trustee is not a taxable gift. If the trust's total return during the note term exceeds the note's interest rate (the Applicable Federal Rate), then that excess passes to grantor's children without any additional gift tax. The grantor retains no control over the trust after it is created, so the trust assets are excluded from the grantor's estate for estate tax purposes. The installment payments on the note that the grantor received and retained are included in the donor's estate, however.

IV. Charitable Lead Annuity Trusts (CLATs)

A CLAT allows a donor to transfer appreciating and income producing assets to his or her children over time. This estate planning vehicle also reduces overall gift and estate tax liability, but has the added benefit of helping charitable organizations. This is an excellent tool for clients with large estates who are also charitably inclined.

Here is how the CLAT works: The donor creates an irrevocable trust that cannot be altered, amended, or revoked. The donor then transfers assets to the trustee that are expected to appreciate rapidly and/or generate significant income. The trustee pays fixed annual payments to one or more charities for a term of twenty years, for example.

The donor could name a donor advised fund or private foundation as the charitable beneficiary for more flexibility in how the payments to charity will be used. Donor should not retain control over future charitable gifts, however. At the end of the trust term, the remaining trust assets, if any, are distributed to the donor's children.

The donor must file a gift tax return to report the transfer to the trustee. The actuarial value of the trust "remainder," which passes to the children after twenty years, is a taxable gift. The transfer to the trustee is a taxable gift that does not qualify for the \$13,000 annual gift tax exclusion, so it uses a portion of the donor's \$1,000,000 lifetime gift exclusion amount. The amount of the gift is the value of the assets transferred from the donor to the trustee reduced by the actuarial value of the annuity payments from the trustee to charity.

No income tax charitable deduction is available on the initial gift. Trust is not exempt from income tax, but it receives an income tax charitable deduction for income distributed as part of the annual payment.

If the trust's total return during the trust term exceeds the IRS's § 7520 rate, then the donor successfully passes that excess to the donor's children without any additional gift tax. Since the donor retains no control over the trust after it is created, the trust assets are excluded from the donor's estate for estate tax purposes.