Estate Planning Topics

DFK Multidicipline Conference

June 18, 2003

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Phase-out of State Death Tax Credit and Substitution of Deduction

EGTRRA reduces the credit for state death taxes under IRC Sec 2011 in the years 2002, 2003 and 2004 by 25% each year. Beginning in 2005, there will be no credit, but state death taxes will be deductible under new Section 2058. EGTRRA's phase out of the credit causes its reductions in the 55% tax rate in the first three years to come largely or entirely from the 16% state credit tax rather than the 39% federal tax. The Federal rate which declined one percent to 38% in 2002, will rise to 44% in 2004. If a state freezes its rates at those in effect under section 2011 before EGTRRA, estates in such states will incur an increase in their combined effective tax rate.

Year	Federal Rate	State Rate	Effective Combined Rate After Credit or Deduction
2001	39%	16%	55%
2002	38%	16%	54%
2003	41%	16%	57%
2004	44%	16%	60%

Massachusetts and Decoupling:

1. Since 1997, the Massachusetts estate tax has been a typical "sponge tax" measured by the amount of the credit for state death taxes allowable to a decedent's estate under code Section 2011.

2. If the decedent had out of state property subject to estate tax in another state, the Massachusetts tax was reduced by the amount of the out of state tax or, if less, a amount proportional to the value of the out of state property to " the value of the entire federal gross estate where your situated". Similarly, for a nonresident decedent with real or tangible personal property in Massachusetts, the Massachusetts tax was an amount equal to the proportion of the credit which the value for the Massachusetts property bears to "the value of the decedent's total federal gross estate".

3. The phase-out of the state death tax credit for federal estate tax purposes by EGTRRA had the collateral result for states like Massachusetts, which automatically incorporated Code changes in their measure of state estate tax, that the state would lose entirely in 2005 when the federal credit is replaced with a deduction for state death taxes (IRC S2058). In order to avoid the result Massachusetts, like a number of other states, has now "decoupled" its sponge tax from current federal law. In essence this means that the state will continue to have a tax measured by what the state death tax credits would have been under the pre-EGTRRA code.

4. This means that the Massachusetts estate tax will no longer track the federal exemption and many Massachusetts residents will pay estate taxes even when the estate is below the federal exemption. The new law which is applicable to estates of decedents dying on or after January 1, 2003 creates a Massachusetts exemption of $700,000. In 2003, the federal exemption amount is equal $1,000,000. As a result, a Massachusetts domiciliary who dies in 2003 with a $1 million taxable estate will owe no federal estate tax but will owe $33,200 in Massachusetts estate taxes.

5. Nullification—Some states that have not decoupled have a nullification clause that makes the sponge tax void if the federal credit for state taxes is repealed or if the federal estate tax is repealed.
    - Although this will no doubt remain a limited part of our practice, it has been immensely complicated by the increasing number of states which have decoupled their sponge through legislative action after EGTRRA or whose sponge tax was automatically decoupled after EGTRRA because it was tied to the Code as of a specific date in the past.
    - All decoupling sponge taxes are not the same. Practitioners in other states are facing precisely the same kinds of questions you are and each state must be individually looked at.

Gift Tax Annual Exclusion Present Interest Requirement

One well established requirement for gift tax annual exclusion qualification is that the gift be of a so called present interest rather than a prohibited future interest in property. Fondren V CIR 324US18, 20-21 (1945) held that to qualify as a present interest, such a gift must confer on the donee a substantial present economic benefit by reason of use, possession or enjoyment of either the property itself or income from the property. It is an old requirement and cases have for decades denied the annual exclusion, if for example, the transferred property does not produce income and cannot be converted into either personal use or income producing property. There must be an ascertainable income flow or other personal enjoyment.

In Hackl v. Comr 118 TC No. 14(2002) Tax Court held that interests transferred by gift in a closely held limited liability company that owned and operated tree farming property did not qualify for the gift tax annual exclusion. The Tax Court based its decision on the restrictive nature of the LLC interests transferred and its holding that the interests did not confer, in the court's opinion, substantial presently realizable economic interests on the donees. The Court rejected taxpayer's contention that when a gift takes the form of an outright transfer or an equity interest in a business property, "No further analysis is needed or justified." The court seemed particularly concerned with the inability of a donee to withdraw from the entity, the restrictions upon sale and the lack of regular distributions. If any of these three defects were not present, it is possible that the Court would hold the LLC units qualified as present interests.

Consider The Following

A. Right of Withdrawal

The entity agreement could include the rights to withdraw from the entity at Fair Market Value. The donees in that circumstance have the ability to realize immediate value through withdrawal much like a beneficiary of a trust with a Crummy withdrawal provision.

B. Transfer Restrictions

Rather than completely restricting the transfer, the entity or family owners could be given a right of first refusal so that if a family member desires to transfer interests for cash, the holder could exercise the right to purchase that interest before it is transferred to the outsider.

C. Lack of Distributions

A required annual distribution of a specified sum should meet this requirement. The opinion reminds taxpayers that planning that may succeed for one purpose (by preventing withdrawal or assignment, and guaranteeing no distributions, indeed the entity was created with timber plantation property that was expected to operate at a loss for years) maybe counterproductive for another.

Topic Family Limited Partnerships:

***Strangi*, *Knight* and *Jones* have left the IRS with two major arguments:**

1. The IRS is left primarily arguing over the value of the partnership From the IRS perspective, agents and appeals officers are taking the **Strangi** and **Knight** holdings as IRS victories because of the small discounts granted by the Tax Court. Au Contra. The Tax Court is stating that the valuation experts must thoroughly explain their analysis and conclusions. The Tax Court is also going to hold taxpayers to produce truly comparable comparisons. If they do not, the Tax Court will not accept their testimony.

Case	Assets	Discount From NAV
Strangi	Securities	31%
Knight	Securities/Real Estate	15%
Jones	Real Estate	8% 44%

2. The IRS, emboldened by its victories in the **Estate of Harper** 83 T.C.M1641(2002) and the **Estate of Thompson** 84TCM374(2002) will argue that the entity should be ignored under S2036 where there is a commingling of assets, disproportionate distributions that did not respect the partnership agreement and delays and other improprieties in proper funding of the entities. The IRS is now routinely requesting the opportunity to examine the books and records of the partnership, the partnership's bank statements and the documents conveying assets into the partnership. The IRS is inquiring, as did Judge Cohen in the **Estate of Strangi**, whether the proverbial i's are dotted and t's are crossed.

   It seems likely that 2036 arguments will succeed under the right facts and circumstances, making taxpayer's ability to respect the entity an important factor in deciding whether to create the entity in the first place.

3. Challenges based upon Chapter 14 arguments have failed **Church, Strangi, Knight**.

4. The gift on creation argument will not succeed if the taxpayer did its capital accounts properly. **Church, Strangi**

Wealth Transfer Planning Opportunities in a Low Interest Rate Environment

Introduction:

I. Background

A. Many gift planning techniques rely on a difference between assumed and actual rates of return for their effectiveness.

B. Low interest rates and other factors have changed the advantages and disadvantages of certain strategies.

II. Current Situation

A. In May 2003 the IRS discount rate for valuing split interests reached 3.8%

B. The applicable federal rate (AFR) was also very low

C. Depressed stock market-despite recent gains in the markets are down from historical highs (nowhere to go but up)

	Short Term AFR	Mid Term AFR	Long Term AFR
May, 2003	1.53%	3.17%	4.79%

D. Federal Estate Tax Uncertainty

- The primary focus of transfer tax planning is the minimization of estate tax
- Increase exemptions, decreasing top rates
- Possibility of repeal (2010)
- Budget deficits—Can we afford increased exemptions and repeal?

E. Lifetime Gifts

- Lifetime transfers of assets remain desirable for many reasons including protection against potential estate tax costs to provide correctly for beneficiaries, etc.
- Clients dislike paying any taxes (but gift taxes are effectively lower than estate taxes)
- Potential repeal of estate taxes makes clients reluctant to pay gift taxes.

F. Estate planning transfers

- Clients prefer deferral through the martial deduction
- Increasing exemption will remove many estates from federal estate tax liability
- **Walton** case—enhances the zeroed out GRAT as a no—cost gift strategy
- Decoupling of state estate taxes—the 2001 Tax Act phases out the state tax credit over 4 years, leaving more money for the federal government and less for the states.
- States which formerly relied on "sponge tax" (amount of federal state tax credit) have decoupled their state estate tax systems from the federal estate tax system.
- The combined federal and state estate tax liability may be increasing for some estates.
- Many state exemptions are now lower than the federal exemption complicating planning
- Lifetime gifts may offset or minimize the effect of decoupling

III. Potential Winners

A. GRATS

Defined: A GRAT is a transfer in trust in which the grantor retains an annuity interest that constitutes a qualified interest under IRC2702(a)(2) and IRC2702(b)(2)

Gift Tax

Donor's retained annuity is valued by discounting annuity payments by the discount rate (gift tax determined by subtracting value of annuity payments from the value of the property transferred to the GRAT)

Estate Tax

If donor dies before end of the term some or all of the GRAT property is included in donor's gross estate

Income Tax

GRAT is a grantor trust, donor taxed on income during annuity term

Practical Aspects of GRAT

- Gift tax calculation assume asset transferred to GRAT will generate a return equal to the IRS discount rate in effect on funding. Planning that uses this technique is based upon defeating this assumption.
- If the GRAT assets earn income or grow in excess of the IRS discount rate, the excess passes to the children free of gift tax.
- If the GRAT assets do not outperform the IRS discount rate most or all of the GRAT assets will be returned to the donor, leaving no assets for children.
- Terms and payout-short term high payout GRAT v. long term low payout
- Short term GRAT minimizes risk of outperforming IRS discount rate in some years and underperforming in other years.
- Short term GRAT minimizes risk of death during term
- Risk of series of short term GRATS—is there a possibility the IRS discount rate will increase significantly before the later GRATS are established?

  Long term GRAT permits lock in of historically low IRS discount rate

Zero Out

IRS position: valuation of retained interest must contain a mortality factor making it impossible to zero out the taxable gift

Walton case—donor and donor's estate are one economic unit and mortality factor not relevant in valuing retained interest.

B. Intra Family Loan

Gift Tax

None if note is set at AFR

Estate Tax

If lender dies before the note is repaid, unpaid balance is included in lender's estate

Income Tax

- Lender has annual interest income
- Borrower may or may not be entitled to an interest deduction depending on use of the proceeds

Practical Aspects

- If the assets loaned earn income in excess of the AFR the excess passes to the borrower tax free.
- If the assets loaned decline in value or do not outperform the AFR the borrower must use other assets to make the required payments (in contrast to a GRAT which is a no-lose proposition to the recipient, a loan may be a detriment if the assets loaned do not produce a sufficient return).

Refinancing

- Clients who have previously engaged in this type of planning may have existing notes outstanding with interest rates that are considerably higher than the current AFR. The question exists as to whether such notes can be "refinanced" to reflect the current lower interest rates.

- Although there does not appear to be any authority directly on point, such refinancing should probably not be viewed as resulting in a taxable gift, particularly if, as would typically be the case, the borrower has the right to prepay with out a penalty.
- For estate tax purposes Prop Reg 20.7871-1 provides that a related party loan must generally be valued at the LESSER of the face value and the value of the remaining note payments, discounted at the current AFR. Under that standard, the outstanding note would be valued at its face value.
- If the borrower has a prepayment right, it is difficult to see how the outstanding note could be valued at anything other than face value under a willing buyer willing seller test.
- For income tax purposes, a change in interest rate would normally be a significant modification that would result in a constructive exchange under the debt modification rules in Regs. 1.1001-3.
- If the loan has a basis equal to its face value as would typically be the case with a cash loan, the constructive exchange would presumably not have any income tax consequences.

IV. Potential Losers

A. Qualified Personal Residence Trust (QPRT)

Defined: A QPRT is a transfer of a residence in trust which gives the transferor the right to use the residence for a period of time.

Gift Tax

The taxable gift resulting from the creation of the QPRT is determined by discounting the value of the remainder interest in the transferred residence.

Estate Tax

If donor dies before expiration of QPRT term, property (residence) is included in donor's estate.

Practical Aspects

- A decrease in the IRS discount rate increases the value of the remainder (taxable gift)
- An increase in the IRS discount rate decreases the value of the remainder (taxable gift)

Issues

- Donor must outlive term to avoid inclusion in estate—all or nothing proposition because the decrease in the 7520 rate has decreased the value of the discount that can be claimed for the grantor's retained interest, a longer term is required, which, in turn increases the likelihood of death occurring during the QPRT term.
- Consider splitting ownership of residence 50/50 with spouse-splits in risk and also entitled to a fractional interest discount
- Children take carryover basis in property
- QPRT's are best suited for property likely to be kept in family and not sold
- QPRT's remain attractive as a relatively painless way to use the gift tax exemption for clients who are not willing or able to make other substantial gifts.

B. Charitable Remainder Annuity Trust

- Unlike a GRAT the goal is to maximize the deductible value of the remainder passing to charity
- A drop in interest rates increases the value of the annuity, and therefore decreases the value of the remainder passing to charity and the amount of the charitable contribution.

V. Neutral Arrangements

A. Taxable gifts utilizing donors $1,000,000 Lifetime Exemption

- Unlike a GRAT, an outright gift removes the transferred property and any income on the property from the donor's estate.
- The value at the time of the gift freezes the value for future gift and estate tax computations.
- For temporarily depressed assets, now is a good time to make use of the donor's $1,000,000 lifetime exemption.
- Lifetime gift may reduce state death tax cost if state has decoupled from Federal estate tax system—can donor and spouse do without property? Suitable strategy for unmarried individual.