Estate planning for the large estate

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Estate planning for larger estates (typically above $10 million for a married couple[1]) generally includes one or more of the following components: annual exclusion gifts, lifetime exclusion gifts and taxable transfers, interest rate arbitrage, valuation discounts, "tax burn," and multi-generational planning.

This article discusses these strategies and provides examples to illustrate their application.

Annual Exclusion Gifts

Annual exclusion gifts are the first strategy taxpayers who expect to have taxable estates should consider. These gifts are simple to effect and expressly authorized by the Internal Revenue Code (IRC). The exclusion is indexed for inflation as well (the amount for 2018 is $15,000 per donor-donee). If a husband and wife both make annual exclusion gifts, they can transfer $30,000 to each beneficiary each year with no transfer tax consequences. Over time, the cumulative amount of tax-free transfers can be quite dramatic.

Example 1. Husband and wife have three children (all of whom are married) and nine grandchildren and make annual exclusion gifts every year to each child, each child's spouse, and each grandchild. This makes the annual transfer $450,000 (15 beneficiaries x $30,000). The following shows the cumulative tax-free transfers and estate tax savings over various periods of time, assuming the current 40% estate tax rate and a 7% after-tax growth rate for the transferred assets.

Years	Total transfer	Tax savings
5	$2,587,832	$1,035,133
10	$6,217,402	$1,035,133
15	$11,308,060	$2,486,961
20	$18,447,972	$4,523,224
25	$28,462,067	$11,384,827

Lifetime Gifts

Lifetime gifts have two important advantages over transfers at death.

First, they can be used to freeze the value of assets at their current level for transfer tax purposes, removing any future increase in value from the tax base.

Example 2. Taxpayer (T) owns an asset with a current value of $1 million that is expected to be worth $3 million when T dies. By gifting the asset now, T can remove the $2 million of growth from the taxable estate and avoid excess wealth transfer tax.

In addition, *taxable* lifetime transfers (after lifetime exemptions have been utilized) are taxed at a lower effective rate than transfers at death. While the estate tax applies to the full value of the property included in a taxpayer's estate (a tax inclusive basis), gift tax applies only to the amount received by the donee after the tax has been paid (a tax exclusive basis). In other words, the gift tax paid is not subject to tax. Relative to the current 40% estate tax rate, the tax exclusive gift tax rate is only 28.5714% (0.4/1.4).

1 Under current law, estates of married couples in excess of $22.36 million are subject to federal estate tax. However, the combined exemption is scheduled to revert to approximately half of this amount in 2026. Note also that many states impose a state estate tax at much lower thresholds.

Example 3. T has an estate of $30 million that includes Blackacre, vacant land with a fair market value (FMV) of $1,000,000. T can either transfer the property during life or at death. Assume that T has already utilized his lifetime gift tax exemption and that the value of Blackacre remains constant. If T transfers the property during life, the gift tax payable will be $285,714. If T dies with the property, the tax will be $400,000. Note that $285,714 is 40% of $714,286, the amount of the transfer minus the amount of gift tax paid.

Two caveats should be noted, however. First, property transferred at death receives a full income tax basis step-up to FMV, while property transferred during life receives only a partial basis increase for the portion of the gift tax paid that is attributable to the appreciation in the property. Also, if the taxpayer dies within three years after making the gift, the gift tax paid is added back to the tax base (IRC §2035(b)).

Interest Rate Arbitrage

Some of the most effective estate planning strategies take advantage of assumed IRS rates on split-interest transfers. These include grantor retained annuity trusts (GRATs) and charitable lead annuity trusts (CLATs). Other strategies take advantage of the minimum interest rates the IRS requires taxpayers to charge on sales or loans. These include sales to intentionally defective grantor trusts (IDGTs), intra-family sales, and intra-family loans.

GRATS. A GRAT is a split-interest trust that pays an annuity interest to the grantor for a term of years, with the remainder interest passing to heirs (typically the grantor's children) at the end of the term. The amount of the taxable gift is the value of the property transferred to the trust minus the value of the annuity payments received by the grantor. The value of the annuity payments is calculated by reference to the IRC §7520 interest rate. If the GRAT assets produce an actual rate of return that exceeds the assumed rate, large amounts will remain in the trust at the end of its term to pass to the remainder beneficiaries tax free.

Example 4. T transfers $1 million worth of assets to a GRAT in July 2018 when the IRC §7520 rate is 3.4%. T sets the value of the retained annuity interest equal to $1 million so there is no taxable gift (this type of GRAT is referred to as a "zeroed-out" GRAT). If the actual return on the GRAT assets is 3.4% or less, nothing will remain in the trust to pass to the remainder beneficiaries. If the assets produce a substantially higher return, however, there will be a large tax-free transfer, as shown below. The greater the return on the trust assets, the greater the tax benefit will be.

Return	Tax-free transfer[2]
3.4% or less	$0
6.0%	$93,257
9.0%	$216,883
12.0%	$359,297
15.0%	$522,283

CLATS. Charitable lead annuity trusts produce tax-free transfers to heirs in the same way as GRATs. The only difference is that the lead interest is paid to charity instead of to the settlor.

INTRA-FAMILY SALES AND LOANS. For intra-family sales, sales to IDGTs and intra-family loans, the IRS generally requires that taxpayers charge an interest rate at least equal to the applicable federal rate (AFR) for the term of the note. In September 2018, this rate was 2.51% for short-term notes (< 3 years), 2.86% for mid-term notes (more than 3 years but less than 9 years), and 3.02% for long-term notes (9 years or more). If taxpayers sell assets to heirs and the assets grow faster than the AFR, a gift tax-free transfer of value can be effected. Given the relatively low interest rate environment, many taxpayers might possess assets expected to grow at a substantially higher rate that could offer an opportunity for wealth shifting.

Valuation Discounts

Valuation discounts can be used to significantly enhance the tax benefits of the above transfer techniques. By placing certain assets inside a family limited partnership (FLP), limited liability company (LLC), or closely held corporation, transfers of interests in such entity may be valued lower than the relative value of the underlying assets for transfer tax purposes.

The primary discounts available are the minority interest discount (reflecting a reduction in value for lack of control over the entity), and the marketability discount (reflecting the lack of a market for interests in a closely held business). Combined discounts can range from 20% to 50%. Note that discounts also may be available for fractional interests in real property based on the cost to partition undivided interests.

Discounted assets also can be used to greatly increase the amount of annual exclusion gifts. The following shows the increase in value for each $15,000 annual exclusion amount for various discount percentages.

Discount %	Effective exclusion amount
20%	$15,000/0.08 = $18,750
30%	$15,000/0.07 = $21,429
40%	$15,000/0.06 = $25,000
50%	$15,000/0.05 = $30,000

Tax Burn Advantage

If a taxpayer creates a trust and retains certain strings over the

2 Based on 5 year zeroed out GRAT with fixed payments, using an AFR rate of 3.4%.

trust assets, the trust is treated as a "grantor trust," and the taxpayer is responsible for the income tax on the trust's income. Payment of income taxes on behalf of such trust (designed to otherwise be outside of the grantor's taxable estate) creates, in effect, a tax-free transfer from the grantor to the trust beneficiaries. The tax payments by the grantor enable the trust assets to grow at their pre-tax rate of return, resulting in a benefit referred to as the "tax burn."

Generational Planning

By combining transfers with a dynastic, multi-generational trust, taxpayers can pass property down through the generations of their families free of transfer tax for the maximum trust duration allowed under applicable state law. The Generation Skipping Transfer (GST) tax is meant to tax wealth on a generational basis where a parent otherwise attempts to avoid taxation in a child's estate by transferring wealth to grandchildren. If, however, large estate owners use their gift and GST tax exclusions at the time a trust is created and funded, wealth transfer tax can be avoided regardless of how many generations the trust spans.

Example 5. T transfers $10 million to a dynasty trust for the benefit of his heirs. Assume that all trust income is transferred to descendants at each generation. The chart below compares the family's wealth at the end of each generation if a dynasty trust is used, with the family's wealth if the family does no planning and simply distributes all property (which is subsequently estate taxed). Assume a 40% estate tax rate applies throughout the time period.

Generation	Dynasty Trust	No Dynasty Trust
1	$10,000,000	$10,000,000
2	$10,000,000	$6,000,000
3	$10,000,000	$3,600,000
4	$10,000,000	$2,160,000
5	$10,000,000	$1,296,000

As always, the strategies and techniques most appropriate for a given client will be based on a thorough review of his or her individual circumstances and specific planning objectives. It also iscrucial to obtain insight from the client's other professional advisors who may be uniquely positioned to opine on the suitability of a given strategy in light of the myriad factors involved.

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Watch Bob's interview with The Nautilus Group®'s Chief Counsel, Matt Pate, JD, LL.M., on the New York Life YouTube channel.