

## Planning Ideas—Net Gifts

With the maximum gift tax rate down to 35 percent, the applicable federal rate (AFR) hovering near historic lows, and the return of the estate and generation-skipping transfer tax (GST tax) looming in 2011, 2010 presents opportunities for gifts to children and grandchildren, even for those clients that have exhausted their lifetime gift tax exemption of \$1 million. One strategy that's sometimes overlooked in lieu of more complex transactions, such as grantor retained annuity trusts (GRAT) and intentionally defective grantor trusts (IDGT), is the net gift.

With a net gift, the transfer is conditioned on the donee's agreement to pay the gift tax. Under Rev. Rul. 75-52, 1975 CB 310, "Gift tax paid by the donee may be deducted from the value of transferred property where it is expressly shown or implied that payment of tax by the donee or from the property itself is a condition of the transfer." The revenue ruling contains a formula for calculating the net value of the gift. The formula is as follows:

$$\text{Net Gift} = \frac{\text{Fair market value of gift} \times \text{Gift tax rate}}{1 + \text{Gift tax rate}}$$

For example, based on the formula for determining the amount of the net gift, a transfer of \$1 million, conditioned on the donee's payment of gift tax (assume exemption has been exhausted and donor is in the 35 percent gift tax bracket), results in a net gift of \$740,741. At the 35 percent rate, the gift tax on the net gift is \$259,259.

If the same gift were made without the condition of payment of the gift tax by the donee, the gift tax would be \$350,000. The net gift saves nearly \$100,000 in gift tax. If the net gift were made in 2010 to grandchildren and younger-generation beneficiaries, the GST tax might also be saved.

## Financing the Gift Tax

Clients often balk at paying gift taxes today to save estate taxes (and, potentially, GST taxes) tomorrow. The net gift strategy theoretically addresses this concern by shifting the tax liability to the donee or the property itself. However, for clients who wish to take advantage of the net gift strategy while easing the donee's pain, consider financing the payment of gift taxes with a loan from the donor to the donee or a trust established for the donee's benefit.

### *Example*

*Charlie makes a gift of \$10 million of securities to a trust with a 9-year term. The gift is conditioned on the trust paying the gift tax, thus the net gift is \$7,407,407 with a gift tax due of \$2,592,593 (at a 35 percent rate), which Charlie will lend the trust next April. The balloon note issued by the trust in exchange for the loan to pay the gift tax bears interest at the assumed AFR of 4%. Assuming a 10 percent rate of return on the securities, at the end of 9 years the trust will have **\$13,465,439** (after repaying the debt).*

### **Comparing the Net Gift with other Alternatives**

When evaluating whether the net gift is right for your clients it makes sense to compare it with other alternatives including both the GRAT and the IDGT. Consider the IDGT first.

### *Example*

*Charlie owns securities currently valued at \$10 million. He has created an irrevocable trust that already has \$1.5 million. He sells the securities to the trust in return for a 9-year note paying the mid-term AFR of 4 percent. A balloon payment of the principal is due at maturity. If the trust realizes a 10 percent return, at the end of 9 years the beneficiaries will have \$11,684,608 after debt repayment. Of this amount, **\$8,147,686** is attributable to the assets sold to the trust.*

Now, take a look at the GRAT.

### *Example*

*Charlie transfers securities currently valued at \$10 million to a GRAT that will pay him an annuity of \$1,345,000 annually for 9 years. Assuming an AFR of 4 percent, there is no gift tax. If the assets transferred in trust enjoy a 10 percent return, the beneficiaries will receive **\$5,315,080** at the end of the trust term.*

If the goals are to minimize gift taxes while maximizing the ultimate gift to the donees, and if the grantor has sufficient cash on hand to loan the donee the gift taxes (or the donee has funds with which to pay the gift taxes), the net gift appears to be the best alternative from a financial standpoint.

## Tax Considerations

*Gift Taxes*—From a gift tax perspective, neither the IDGT nor the GRAT generate current gift taxes. Although the net gift results in current gift taxes due in April of the year following the gift, the effective rate of tax is a relatively low 26 percent, assuming a 35 percent maximum gift tax rate. Furthermore, less cash flow is required to implement the net gift than the IDGT—the loan to cover the gift taxes associated with the net gift is only about 26 percent of the value of the gift, while the note in return for the asset sale to the IDGT is the entire \$10 million gift.

Although no cash flow is required to implement the GRAT (assuming a zeroed-out GRAT), the annuity payment of \$1,345,000 is due at the end of the year. This is considerably more than the interest on the note to pay gift taxes (net gift) or the installment sale note (IDGT).

Finally, neither the net gift nor the GRAT strategies require the grantor to maintain the 10:1 debt to equity ratio that is typically recommended in connection with the IDGT.

*Estate Taxes*—From an estate tax perspective, there is less risk of estate tax inclusion with the net gift strategy than either the GRAT or the IDGT strategy. The Section 2036 is minimized, because all that the donor receives in return for the gift is the donee's promise to pay gift taxes. The greater concern with the net gift strategy arises if death occurs within three years of the gift. In that case, the gifts taxes are included in the grantor's gross estate and much of the benefit of the strategy is lost.

On the other hand, if the grantor dies within the term of the GRAT, there is no doubt that IRC Section 2036 will require inclusion of the trust in the gross estate. Under the now final regulations, the value included is the amount of the annual annuity payment divided by the AFR. For example, if the annual payment is \$100,000 and the AFR at the time of death is 7 percent, the amount included in the estate is \$1,428,571 (\$100,000 divided by .07). This is the amount of capital required to generate sufficient income at the AFR to pay the required annuity.

*On the other hand, if the grantor dies within the term of the GRAT, there is no doubt that IRC Section 2036 will require inclusion of the trust in the gross estate. Under the now final regulations, the value included is the amount of the annual annuity payment divided by the AFR. For example, if the annual payment is \$100,000 and the AFR at the time of death is 7 percent, the amount included in the estate is \$1,428,571 (\$100,000 divided by .07). This is the amount of capital required to generate sufficient income at the AFR to pay the required annuity.*

With the IDGT there is a concern that the IRS could collapse the transaction and argue that sale for an installment not is really a gift with a retained interest. Utilizing a 10:1 debt to equity ratio and an independent appraisal should alleviate this concern.

*Income Taxes*—From an income tax perspective, a major concern with the IDGT is that death of the grantor before the end of the term will result in loss of grantor trust status and trigger income in respect of a decedent (IRD). This issue remains unresolved, and the planner has his or her pick of experts to rely on.

In *Gain is Realized at Death, Trusts and Estates, Feb. 10, 2010*, Carol Cantrell makes a persuasive argument that the conversion to a non-grantor trust at death triggers IRD on an installment sale:

*“In my opinion, the available authorities now strongly suggest that the death of the grantor of an irrevocable grantor trust with an outstanding note balance is a ‘part sale-part gift’ occurring on the last day of the grantor’s taxable year. The grantor realizes gain equal to the excess of the note balance over his basis in the property. That gain constitutes IRD, which the grantor’s estate or successors recognize when they collect the note payments. And the trust’s basis in the property is the greater of the note balance or the grantor’s basis in the property on the date of death.”*

In *No Gain is Realized at Death, Trusts and Estates, Feb. 10, 2010*, Mitchell Gans and Jonathan Blattmachr make an equally persuasive argument that the conversion to a non-grantor trust at death triggers IRD on an installment sale:

*“In Chief Counsel Advice 200923024, the Service, analyzing a tax-shelter-type transaction, reviewed what it called the primary authorities on the cessation of grantor trust status ... Most significant, after reviewing the cited authorities, the Service concludes in the CCA that these authorities apply only in the inter vivos setting and not when grantor trust status ends by reason of the grantor’s death.”*

Although a grantor is required to include the annuity payments received from a GRAT in income, payment of the tax on such amounts reduces the estate and future estate taxes. The only income tax concern with the net gift is that the donor experiences gain to the extent the gift tax paid by the

*In Gain is Realized at Death, Trusts and Estates, Feb. 10, 2010, Carol Cantrell makes a persuasive argument that the conversion to a non-grantor trust at death triggers IRD on an installment sale.*

*On the other hand, in No Gain is Realized at Death, Trusts and Estates, Feb. 10, 2010, Mitchell Gans and Jonathan Blattmachr make an equally persuasive argument that the conversion to a non-grantor trust at death triggers IRD on an installment sale.*

donee exceeds the donor's adjusted basis in the transferred property. This concern should be eliminated if the transfer is to a grantor trust.

*GST Taxes*—Assuming GST taxes are not retroactively reinstated for 2010, but are reinstated for years 2011 and beyond, the net gift creates potentially greater opportunity for GST tax savings than either the IDGT or the GRAT. This is because the net gift can be structured as a “direct skip” in 2010. The IDGT transaction involves a sale, not a gift, so any GST tax-savings opportunities are deferred into the future. As for the GRAT, the grantor cannot allocate GST exemption to property transferred during an estate tax inclusion period (ETIP), unless the actuarial chance of the Grantor not surviving the ETIP period is less than five percent. The ETIP is the period of time after the transfer in trust during which the value of the trust property would be includable in the grantor's gross estate. Practically speaking, this means that in many instances GST exemption cannot be allocated until expiration of the trust term, at which time the trust assets are likely to have appreciated.

### **Bottom Line**

Add the net gift financed with a donor balloon loan to your quiver. With the GST tax repeal in 2010 and low gift tax rates, this may be the ideal time for transferring wealth to younger-generation beneficiaries.

Planning Ideas and similar topics are covered in great detail in many of Cannon's professional development solutions. To find out more visit: [www.cannonfinancial.com](http://www.cannonfinancial.com).

Copyright ©2010 Cannon Financial Institute - All Rights Reserved

Subscribe to Cannon Insights at <http://www.cannonfinancial.com/newsletter/subscribe>

**Disclaimer:** The materials and information contained herein are intended for educational purposes, to stimulate thought and discussion so as to provide the reader with useful ideas in the area of wealth management planning. These materials and information do not constitute and should not be considered to be tax, accounting, investment, or legal advice regarding the use of any particular wealth management, estate planning, or other technique, device, or suggestion, nor any of the legal, accounting, tax, or other consequences associated with them.

While the content herein is based upon information believed to be reliable, no representation or warranty is given as to its accuracy or completeness. For this reason, the program of study should not be relied upon as such. Although effort has been made to ensure the accuracy of these materials, you should verify independently all statements made in the materials before applying them to your particular fact pattern with a client. You should also determine independently the legal, investment, accounting, tax, and other consequences of using any particular device, technique, or suggestions, and before using them in your own wealth management planning or with a client or prospect. Information, concepts, and opinions provided herein are subject to change without notice.

The strategies contained within these materials may not be suitable for all clients. For many concepts discussed herein, clients are strongly urged to consult with their own advisors regarding any potential strategy and will need to discuss their particular circumstances with their legal and tax advisors beforehand to determine whether a particular strategy described herein is suitable for their particular circumstances.

Examples, provided throughout these materials, are for illustrative purposes only, and no representation is being made that a client will or is likely to achieve the results shown. The examples shown are purely fictional and are not based upon any particular client's circumstances.