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Estate Tax Schemes: How America's Most Fortunate Hide Their Wealth, Flout Tax Laws, And Grow the Wealth Gap

Report of the Senate Finance Committee Democratic Staff

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Introduction

For over 100 years the estate tax has worked to narrow the wealth gap in America. This tax serves as a brake on the buildup of dynastic wealth—the kind of extraordinary fortunes that let the powerful distort our democracy and increase the tax burden on our hardworking middle class. In short, the estate tax and other wealth transfer taxes ensure that those who receive extraordinary benefits from our country pay their fair share.

By any measure, it is clear that the current estate tax has been undermined by lobbyists and teams of sophisticated tax lawyers and accountants. The wealthy and well connected use elaborate trusts and secretive shell companies to dodge the tax, undermining our tax base and our democracy.

Grantor-retained annuity trusts, intentionally-defective grantor trusts, *Crummey* trusts, and dynasty trusts—most people have no idea what these are, but for sophisticated tax lawyers they're all code words for "billion-dollar tax dodge."

President Trump and his billionaire cabinet have proposed repealing the estate tax, which they view as an inconvenience meant to be avoided. According to media accounts, Trump Administration National Economic Council Director Gary Cohn recently remarked in a closed-door meeting with Senators that "only morons pay the estate tax."[1]

This report decodes these little known estate tax abuses for the American public and concludes that the nation's wealth transfer tax system requires wholesale reform to bring back the integrity of our tax system and our democracy.

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[1] Julie Hirschfeld Davis and Katie Kelly, "Two Bankers are Selling Trump's Tax Plan. Is Congress Buying?" New York Times, August 28, 2017.

"No one accumulates a fortune without the help of our society's investments. How much wealth would exist without America's unique property rights protections, public infrastructure, and academic institutions? We should celebrate the estate tax as an "economic opportunity recycling" program, where previous generations made investments for us and now it's our turn to pass on the gift. Strengthening the estate tax is important to our democracy."

- Bill Gates, Sr., Co-chair of the Bill & Melinda Gates Foundation

Strategies to Avoid Income, Gift, Estate, and Generation Skipping Transfer (GST) Tax

Below are some of the most common abuses used by sophisticated tax advisors to avoid wealth transfer taxes. In many cases these strategies are combined to avoid the maximum amount of tax. While the lifetime exemption from gift and estate tax is currently nearly $11 million for a married couple, as these examples show, with even basic gift and estate tax planning, wealthy individuals can avoid hundreds of millions of dollars in transfer taxes over a lifetime or generations, and can avoid tens of millions of dollars or more over just a few years.

1. Using "gift planning" strategies to avoid wealth transfer taxes. Strategic timing of gifts to younger generations is one of the primary methods tax planners use to avoid estate tax. The main goal of gift planning is to remove an asset from the taxable estate, locking in the value for gift tax purposes, and exempting future asset appreciation from transfer taxation. This practice can be combined with the use of the annual gift tax exclusion, which allows an individual to exclude the first $14,000 of gifts made to a donee each year. A married couple can exclude $28,000 per donee.[2] In many cases, this strategy can completely wipe out gift or estate tax liability for even wealthy families.

    Example 1:[3] A couple plans to transfer assets for the benefit of a child born in 2017, equal to the gift tax exclusion amount. The assets are worth $28,000 in 2017 and appreciate in value at 5 percent annually. The couple could hold onto the assets until the death of the second spouse in 2070 and bequeath

[2] The gift tax annual exclusion, which is indexed for inflation, is allowed in addition to the lifetime exemption from gift and estate tax ($5.49 million per person ($10.98 million per married couple) for 2017, indexed for inflation).

[3] Expanded versions of each example are contained in Appendix I of this report.

them to the child upon death. Alternatively, the couple could transfer the assets to the child free of gift tax in 2017 and remove any potential future estate tax liability. By making the transfer in 2017 rather than waiting until death, the amount includable in the couple's gross estate is reduced by $371,699.

The potential for gift tax avoidance increases with the number of children a couple has. This is because the gift tax annual exclusion is calculated not just on a per donor basis, but also on a per recipient basis. In other words, a married couple can exclude annual gifts worth $28,000 (in 2017) to an unlimited number of recipients. If, for example, a couple has multiple children, they can transfer $28,000 to each child tax free. For two children, this would be equal to $56,000 total in 2017.

Example 2: Assume the same facts as Example 1, except that the couple plans to transfer assets for the benefit of each of two children born in 2017, equal to the gift tax exclusion amount. The per-couple gift tax exclusion amount for each child is $28,000. The couple could hold onto the assets until the death of the second spouse in 2070 and bequeath them to the children upon death. Alternatively, the couple could transfer the assets to the children free of gift tax in 2017 and remove any potential future estate tax liability. By making the transfer in 2017 rather than waiting until death, the combined amount includable in the couple's gross estate is reduced by $743,397.

The gift tax annual exclusion applies on a per-year basis and is indexed for inflation. As such, parents can make successive annual gifts to each child throughout the couple's life free of gift tax up to the gift tax annual exclusion amount. Successive gifts can multiply the tax avoidance potential that would have been achievable by a single, one-time gift.

Example 3: Assume the same facts as Example 2, except that the couple plans to successively transfer assets each year for the benefit of two children born in 2017, equal to the gift tax exclusion amount. The couple could hold onto the assets until their death in 2070 and bequeath them to the children upon death. Alternatively, the parents could transfer the asset to the children in annual succession free of gift tax and remove any potential future estate tax liability. By making the successive annual bequests rather than waiting until death, the combined amount includable in the couple's gross estate is reduced by $5.8 million.

2. <u>Using grantor trusts to avoid taxes.</u> The income tax and wealth transfer tax regimes are designed to roughly coordinate with each other. However, certain small

differences between income tax and wealth transfer tax rules have been exploited by sophisticated tax planners to achieve significant tax avoidance.

Grantor trusts are generally trusts in which the person who establishes the trust (the grantor) retains certain powers to control the trust's assets or income. Under income tax rules, these powers cause the grantor to be treated as the owner of the trust. As such, the grantor generally includes the income of the trust and any related deductions on his or her personal income tax return.

Non-grantor trusts, by contrast, are generally trusts in which the grantor irrevocably releases those powers to control trust income or assets. Non-grantor trusts are treated as tax entities separate from the grantor, and are subject to the truncated income tax brackets generally applicable to trusts and estates.[4] In general, income taxable to the trust is reduced by amounts distributed to beneficiaries; and the distributed amounts generally are included as income by the beneficiaries on the beneficiaries' income tax returns.

Rules governing whether a transfer has been made for income tax purposes and wealth transfer tax purposes do not perfectly align. As such, a grantor can make a gift that qualifies as a completed transfer for gift tax purposes, but is not treated as a completed transfer for income tax purposes. The misalignment of the gift and income tax rules allows taxpayers to structure gifts using trusts that lock in the transfer tax consequences as of the time of the gift (i.e., the transfer is treated as having occurred for gift tax purposes), but the trust assets continue to be treated as owned by the grantor for income tax purposes under the grantor trust rules (i.e., no transfer has occurred for income tax purposes). Such trusts are known as "intentionally-defective grantor trusts," or "IDGTs."

As stated above, there are several ways in which taxpayers exploit this misalignment to achieve a tax benefit. Under a simple structure, for example, a grantor might retain a right to receive a stream of payments from the trust during the trust term (i.e., an income interest) and pay income tax on the trust income under the general grantor trust rules as part of his individual income taxes. If the grantor dies during the trust term, the entire amount in the trust reverts to the grantor and is included in his gross estate for estate tax purposes. If, however, the grantor outlives the trust term, the remaining assets in the trust pass to the remainder beneficiary (for example, the grantor's child) without further transfer tax consequences. This structure allows the transfer to avoid estate and gift taxes on any appreciation that occurs after the initial transfer to the trust, while shifting income tax liability from the trust to the grantor, preventing income taxes from

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[4] Non-grantor trusts and estates are generally subject to truncated tax brackets on undistributed income with the top individual tax rate applying to taxable income in excess of $12,500.

reducing the value of the property in the hands of the trust or beneficiary at the expiration of the trust term.

3. <u>Use of split-interest trusts and joint purchases to avoid wealth transfer taxes.</u> Transfers to irrevocable grantor trusts are valued for gift tax purposes at the time of the initial transfer to the trust. Taxpayers often use trusts to make "split-interest gifts," in which a partial interest (such as a remainder interest) is conveyed to the grantor's heir as a gift,[5] and a partial interest is retained by the grantor, such as an annuity or other income interest.[6] To determine the present value of these respective interests at the time of the transfer, taxpayers use actuarial projections and tables issued by the IRS. These projections generally assume that trust assets will appreciate at a modest rate significantly below common stock market or private business rates of return. As a result, they often significantly underestimate the value of trust assets that will remain at the expiration of the grantor's income interest and pass to the remainder beneficiary (heir). This actual appreciation in excess of the assumed modest rate of return is never subject to gift or estate tax.

   The table below describes three common types of trusts used for gift and estate tax planning.

Type	Income Trust	Annuity Trust	Unitrust
Description	Grantor retains right to receive trust income during the trust term. If the grantor survives the trust term, remaining assets pass to the remainder beneficiary.	Grantor retains right to receive a fixed periodic payment during the trust term. If the grantor survives the trust term, remaining assets pass to the remainder beneficiary.	Grantor retains right to receive periodic payments equal to a percentage of the amount held in trust during the trust term. If the grantor survives the trust term, remaining assets pass to the remainder beneficiary.

   Changes to tax laws enacted in 1987 and revised in 1990 established limitations on the use of certain split-interest trusts to transfer assets between certain family

[5] If the present value of the remainder interest (the gift portion of the transfer) exceeds zero and exceeds the grantor's remaining gift tax annual exclusion, she will have to use a portion of her lifetime exemption from gift tax or, if none remains, pay gift tax.

[6] Under gift tax rules, certain joint purchases between family members may also be treated as a split-interest gift transferred in trust.

members. As a result, sophisticated tax attorneys began developing new, alternative planning techniques, including the grantor-retained annuity trust (GRAT). The practice was pioneered by the Walton family, heirs to the Wal-Mart fortune, which won a 2000 Tax Court case upholding the loophole.[7] Since then the practice has become commonplace among sophisticated tax planners attempting to avoid wealth transfer taxes.

Sophisticated tax planners have devised methods to maximize the tax avoidance potential of GRATs which include the use of "zeroed-out" GRATs. Under this structure, planners design a GRAT that has a deemed value of $0 for gift tax purposes, but in actuality, transfers significant value to the heir. This is achieved by structuring the annuity payments to the grantor so that their present value (based on the IRS actuarial tables) is equal to the fair market value of the property transferred to the trust. The example below illustrates the tax avoidance potential under this structure.

> Example 4: A parent plans to transfer assets for the benefit of a child via three successive "zeroed-out" GRATs, each with annuities paid to the grantor over a trust term of two years. In 2017 the parent funds the first GRAT with $10 million. In 2019 the parent rolls the annuity payments from the first GRAT into the second GRAT, and in 2021 the parent rolls the annuity payments from the second GRAT into the third GRAT. Over the six year period the average IRS-deemed rate of return on the annuity for gift tax purposes is 2.2 percent, while the actual appreciation of the assets in the GRATs averages 10.7 percent. For gift tax purposes, the value of the gift is treated as $0. However, in reality the parent transfers $5.43 million to the child tax-free without using any annual gift tax exclusion or any lifetime exemption.

4. <u>Using debt obligations and installment sales to avoid taxes.</u> Following the popularization of GRATs, new, more aggressive tax avoidance techniques have emerged, including the use of installment sales to intentionally-defective grantor trusts (IDGTs). Like GRATs, the technique involves establishing an irrevocable grantor trust, with assets transferred to the trust treated as owned by the grantor for income tax purposes, but treated as completed gifts for gift tax purposes. Instead of solely transferring assets into the trust, the grantor transfers both assets and an installment note payable to the grantor equal to the value of the assets. The note carries an interest rate equal to the federal mid-term rate to ensure IRS considers the transfer a completed gift. This rate of return is 20 percent lower than the rate applicable to GRAT transactions, resulting in considerably more gift tax avoidance. In addition, because the assets are transferred alongside a note of equal

[7] *Audrey J. Walton v. Commissioner of Internal Revenue*, 115 TC No. 41 (U.S. Tax Court, 2000).

value, income and gift tax rules disregard the transfer, effectively treating it as a transfer of $0.

> Example 5: A couple plans to transfer an asset for the benefit of a child over a period of six years. In 2017 the couple transfer $10,980,000 in cash to an IDGT tax free, equal to the couple's maximum lifetime exemption from gift and estate tax ($5.49 million per person in 2017). The couple also transfers stock valued at $8 million to the IDGT alongside an installment note with a face value equal to $8 million, payable to the couple in six annual installments. Under income and gift tax rules this transfer of assets is disregarded, effectively treated as a transfer of $0. In 2022, at the end of the trust term the stock held by the IDGT has increased in value to $14 million. Over the six year period the couple will have succeeded in transferring more than $16 million to the child free of transfer tax (the initial transfer of $10.98 million, plus the excess of the appreciation in the value of the stock ($6 million) over the amount of interest paid by the trust).

5. <u>Using tax exempt investments and life insurance to avoid taxes.</u> As described earlier, one of the primary purposes of the grantor trust structure is to ensure that income tax does not reduce the value of trust assets that would otherwise pass to a beneficiary, such as the grantor's child. A trust (or a grantor in the case of a grantor trust) can also avoid income tax by investing in tax-exempt assets, including tax-exempt bonds and life insurance.

   Irrevocable life insurance trusts (ILITs) have become a common tax avoidance strategy, allowing avoidance of estate tax on life insurance proceeds by shifting ownership of a life insurance policy to an irrevocable trust. Under this structure the grantor establishes an irrevocable trust for the benefit of his heirs. The trust purchases an insurance policy on the life of the grantor, or the grantor transfers a policy to the trust that he or she owns. To fund the trust's premium obligations with respect to the insurance policy, the grantor makes periodic transfers to the trust, which are treated as gifts to the trust beneficiaries (generally, the grantor's children). In certain situations described below, these payments may be made free of gift tax up to the $14,000 gift tax annual exclusion threshold. The value of the life insurance policy grows tax free, and when the grantor dies, life insurance proceeds are distributed to the trust, and ultimately the trust beneficiaries, free of gift or estate tax. This practice is commonly combined with the use of *Crummey* powers, which are described in the next section and illustrated in Example 6.

   Recently, more aggressive forms of life insurance trust planning have emerged, including the use of so-called insurance dedicated funds (IDFs). These arrangements are often structured as a traditional ILIT, but the trust purchases a

bespoke life insurance policy invested in hedge funds and intended for maximum tax avoidance. While the IRS recently clarified certain rules prohibiting a grantor or trustee from directing the specific assets a life insurance policy invests in, nothing prohibits investment banks or hedge funds from marketing private-placement insurance policies specifically intended for tax avoidance.[8] According to media reports, IDFs currently hold at least $15 billion in investments, and major investment institutions offer this tax avoidance product, including JPMorgan Chase, Goldman Sachs, Paulsen & Co., and Millennium Partners.[9] SkyBridge Capital, founded by former Trump Administration Communications Director Anthony Scaramucci, began offering IDFs last year.

6. Using *Crummey* trusts to avoid wealth transfer taxes. Taxpayers make transfers for the benefit of children using trusts for a variety of reasons, such as to delay distributions until the children are older, or, in the case of an ILIT (discussed above), to avoid estate tax on life insurance proceeds. Transfers in trust, however, generally are treated as gifts to the trust beneficiaries for gift tax purposes. Taxpayers often seek to minimize gift tax liability on such transfers by structuring the transfers to qualify for the gift tax annual exclusion ($14,000 per person for 2017). The gift tax annual exclusion is only available for gifts of present interests in property. Gifts in trust, however generally are considered gifts of *future* interests in property to the trust beneficiaries. To convert a transfer of a future interest into a transfer of a present interest, grantors sometimes give trust beneficiaries *Crummey* powers, named after the court case *Crummey v. Commissioner* in which courts upheld the tax avoidance technique.[10] Generally, under this structure the grantor transfers an asset to the trust and notifies the beneficiary that he has a brief period of time (such as 30 days) in which to withdraw the transferred amount from the trust, though it is usually not in the beneficiary's interest to do so. If the heir does not exercise the withdrawal right, the transfer is treated as a completed gift of a present interest. As such, the transfer qualifies for the $14,000 annual gift tax exclusion.

   Though prohibited by IRS rules and some court rulings, this notification is often accompanied by an implicit warning from the donor that if the withdrawal right is exercised, the heir will lose out of future financial benefits.

   > Example 6: A couple establishes a trust in 2017 for the benefit of two children. The trust documents stipulate that property in the trust may only be distributed to the children after reaching the age of 25. In 2017 the trust purchases a $10 million whole life insurance policy on behalf of the trust insuring one parent's life. To fund premium payments the couple makes annual split gifts to the trust

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[8] IRS Private Letter Ruling 201417007, April 25, 2014.
[9] Sonali Basak and Tom Metcalf, "Insurance is the Hot New Way to Avoid Taxes," Bloomberg, June 28, 2017.
[10] *Crummey v. Commissioner* 397 F.2d 82 (9th Cir. 1968)

equal to the maximum gift tax annual exclusion of $56,000 ($28,000 in split gifts per child). To qualify for the gift tax annual exclusion, the couple utilizes a *Crummey* arrangement, and informs each child of their lapsing right to withdraw the funds for a 30-day period. In 2030 the insured parent dies and the $10 million death benefit is paid to the trust and subsequently distributed to the two children. As a result, the children received $10 million in insurance proceeds, while the parents paid no gift or estate tax either on the amounts used to fund premiums or on the life insurance proceeds, and without the use of any lifetime exemption. In addition, the children may exclude the insurance proceeds from income tax.

7. Using improper valuation to avoid wealth transfer taxes. Sophisticated taxpayers have developed tax planning techniques to artificially reduce the value of assets by placing them into a family partnership and claiming valuation discounts based on supposed lack of marketability and control, even though family members might collectively hold all of the partnership interests. In response to these tax avoidance techniques, Congress acted in 1990 to limit the use of valuation discounts for certain transfers among family members where the claimed discounts do not reflect a true economic decline in value, and provided the Secretary of the Treasury authority to describe additional circumstances where discounts might not be allowed. Since the original enactment of this provision, changes in state partnership law have largely rendered regulations that implement these anti-abuse rules ineffective. In 2016, the Treasury Department issued proposed regulations to address abusive valuation discounts, under explicit authority granted by Congress. However, the Trump Administration has suggested it intends to withdraw this proposed regulation. Minority (lack of control) discounts often result in claimed reductions in value of 15 to 40 percent, and marketability (illiquidity) discounts often result in claimed reductions in value of 20 to 30 percent.[11] Valuation discounts may also be combined with gift planning techniques to increase the amount of tax avoided.

Example 8: A parent owns a business worth $100 million and plans to transfer a 60 percent stake in the company to a child. If the parent directly transferred the property in 2017 the transfer would be subject to $24 million ($60 million x 40 percent tax rate) in gift tax assuming the parent had already used her entire lifetime exemption. Instead the parent places certain restrictions on the sale of transferred stock to artificially reduce the value of the interest by claiming a marketability discount of 10 percent. In addition, rather than transferring the 60 percent interest in a single transaction, the parent transfers four 15 percent interests over a period of four years. Because the 15 percent interests are not controlling interests, the parent

[11] "Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal," Joint Committee on Taxation, June 2012, p. 261.

claims an additional 20 percent minority discount, resulting in an overall valuation discount of 30 percent. As a result, the parent reduces the amount transferred for gift tax purposes from $60 million to $42 million, avoiding $7.2 million in gift tax.

8. Using Dynasty Trusts to avoid wealth transfer taxes. The Tax Reform Act of 1986 established the generation skipping transfer tax (GSTT) regime, which imposed a "back-up" tax to prevent donors from avoiding the estate tax by making transfers that skip generations (e.g., gifting assets to grandchildren or great grandchildren). Similar to the estate tax, a person may claim a separate $5.49 million exemption against GSTT liability (indexed for inflation). When the GSTT was enacted, all but three states had a rule against perpetuities (RAP), which generally requires that a trust terminate no later than 21 years after the death of a person who was alive at the time the trust was created. Many states have now repealed or limited their RAPs. This change, along with the increased GSTT exemption amount made permanent at the end of 2012 allows individuals to shield significant amounts of wealth from wealth transfer taxes over the course of many successive generations.

    Example 9: A couple establishes an irrevocable trust in a state without a RAP solely for the benefit of their grandchildren and beneficiaries in subsequent generations. In 2017 the couple transfers $10.98 million of dividend-paying publicly traded stock, equal to the amount of the couple's lifetime gift tax exemption and GSTT exemption. Assume the stock in the trust appreciates at a rate of five percent annually with dividends paid to the trust each year being distributed to the beneficiaries. In 2092, after three generations, the value of stock in the trust will have grown to $426.4 million. None of this appreciation, nor the dividends earned and distributed annually will be subject to gift, estate, or GST taxes.

9. Using shell companies to avoid wealth transfer taxes. The estate tax applies to a U.S. residents' worldwide assets as well as assets of foreign citizens located within the United States. To avoid the estate tax on assets located in the United States, foreign citizens often establish foreign companies or trusts to hold the assets and act as a "blocker." This practice may entirely eliminate U.S. estate tax liability on such individuals.

10. Using "gift planning" strategies to reduce effective wealth tax rates. As previous examples have shown, individuals may exploit tax avoidance techniques to transfer large amounts to lower generations without any payment of wealth transfer taxes. However, even in cases where wealth transfer taxes are unavoidable, sophisticated tax planners may significantly reduce the rate at which those taxes are paid. While both the gift and estate tax rates are set at 40 percent, they apply to significantly

different tax bases. The gift tax is paid by the donor out of assets separate from the gifted assets and thus is applied on a tax-exclusive basis. The estate tax is paid by the decedent's estate and is imposed on the assets used to pay the estate tax, i.e., it is applied on a tax-inclusive basis. As a result, it is often more advantageous or tax efficient to transfer assets by gift.

> Example 10: Assume a parent plans to transfer $10 million after tax to a child, but has no remaining credit against gift and estate tax and has already used the $14,000 annual gift tax exclusion amount. If the transfer were made at death and subject to estate tax the parent would need to set aside $16.67 million. Instead the parent decides to make the transfer during life, subject to the gift tax and sets aside $14 million. By making the transfer during life the transfer avoids $2.67 million in transfer taxes.

Transfers via gift are subject to less preferential basis rules for income tax purposes in the hands of the heir; however, numerous planning opportunities exist to defer income tax, including the use of like-kind exchanges and tax free reorganizations.

Additional Background on Wealth Transfer Taxes

Present law imposes an estate tax equal to 40 percent of the value of estates in excess of the $5.49 million exemption ($10.98 million per couple), indexed for inflation. A gift tax of 40 percent applies to lifetime gifts subject to a $14,000 annual exclusion, indexed for inflation. Taxpayers may apply all or a portion of the $5.49 million estate tax exemption to taxable gifts. Currently, fewer than two in every 1,000 estates pay federal estate tax. Of those, fewer than 50 nationally are family businesses or family farms, and pay estate tax at a rate of 6 percent on average.[12]

In addition to the gift and estate taxes, the generation skipping transfer tax (GSTT) regime acts as a "back-up" tax to prevent donors from avoiding the estate tax by making transfers that skip generations (i.e., gifting assets to grandchildren or great grandchildren). Similar to the estate tax, an individual may claim a $5.49 million exemption against GSTT liability (indexed for inflation); however, this exemption is separate from the unified gift and estate tax exemption amount.

While very few family businesses or family farms pay any estate tax, present law contains numerous provisions to reduce wealth transfer taxes on closely held businesses and farms, including the following:

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[12] Chye-Ching Huang and Chloe Cho, "Ten Facts You Should Know About the Federal Estate Tax," Center for Budget and Policy Priorities, May 5, 2017

Special valuation on closely held farm and business real property. This provision allows an estate to decrease the estate's value by up to $1.12 million for qualified real property used by a family business or farm, provided the heir continues business operations for a period of at least 10 years after death of the decedent.

Installment payments of estate tax where the estate consists largely of interests in closely held businesses. This provision generally provides estates consisting of a closely held business a ten year installment payment period for estate tax liability with preferential interest rates. In addition, qualifying estates may defer estate tax payments for up to five years.

Numerous additional deductions are allowed against the estate tax including those for transfers to a decedent's spouse, payment of state wealth transfer taxes, and charitable bequests.

Analysis and Policy Discussion

The wealth transfer tax system plays an important role in funding critical government programs, reducing inequality, and preserving the integrity of our democracy. But as this report illustrates, the wealth transfer tax system is rife with loopholes and opportunities for tax avoidance and evasion.

While there are countless combinations of tax avoidance schemes that can be abused by sophisticated tax attorneys and accountants, they are attributable to one primary source: complexity. The mind-numbing complexity of the current wealth transfer tax system has resulted in (1) the disconnect between income and gift tax rules that allow individuals to pick when they pay tax and how much tax they pay, and (2) the ability for individuals to artificially reduce the taxable value of assets transferred.

Congress and previous presidential administrations have proposed marginal changes over the years to make tax avoidance schemes less profitable for unscrupulous individuals. But, each time one loophole is closed down, sophisticated tax attorneys and accountants find a new loophole to replace it.

It is past time for Congress to reform wealth transfer taxes from the ground up to simplify the system and stop these abuses. This will require aligning the rules for income and wealth transfer taxes to prevent the use of grantor trusts to avoid tax, preventing the use of abusive gift planning techniques to dodge the estate tax, and preventing individuals from inappropriately undervaluing the transfer of assets. In addition, Congress should use this opportunity to simplify compliance and administration of wealth transfer taxes.

APPENDIX I:

Expanded Illustration of Examples

Example 1: Use of Gift Tax Annual Exclusion (One-Time Transfer to One Child)

Husband and Wife ("H" and "W") wish to use their gift tax annual exclusions ($14,000 per individual, and $28,000 per married couple in 2017) to make a gift to their daughter ("D") free of gift tax. On January 1, 2017, W makes an outright gift of publicly traded stock with a fair market value of $28,000 to D. Because H and W elect to "split" gifts for gift tax purposes,[13] the gift is treated as having been made one-half by H and one-half by W, allowing full use of each of their $14,000 annual exclusions for 2017. H and W have no gift tax liability with respect to the gift of stock, and the stock will not be included in their estates for estate tax purposes when they die. Assume instead that H and W hold the stock until the second spouse dies on January 1, 2070, and bequeath the stock to D. If the stock appreciates at an annual rate of five percent per year, it would have a value of $371,699 as of the date of death. Assuming H and W had previously used their lifetime exemption from gift and estate tax and the estate tax rate remains at 40 percent for 2070, the bequest would give rise to an estate tax liability of $148,680.

Example 2: Use of Gift Tax Annual Exclusion (One-Time Transfers to Two Children)

Assume the same facts as Example 1, except that H and W have two children, D and S. W makes gifts of publicly traded stock with a fair market value of $28,000 to each child ($56,000 total) on January 1, 2017, using the couple's full $28,000 (per couple) annual exclusion for 2017 with respect to each child. H and W have no gift tax liability with respect to the gifts of stock, and the stock will not be included in their estates for estate tax purposes when they die. Assume instead that H and W hold the stock until the second spouse dies on January 1, 2070, and bequeath the stock to D and S (one-half to each). If the stock appreciates at an annual rate of five percent per year, it would have a value of $743,397 as of the date of death. Assuming H and W had previously used their lifetime exemption from gift and estate tax and the estate tax rate remains at 40 percent for 2070, the bequests would give rise to an estate tax liability of $297,359.

Example 3: Use of Gift Tax Annual Exclusion (Annual Transfers to Two Children)

Assume the same facts as Example 2, except that H and W make gifts of stock to D and S with a fair market value equal to the gift tax annual exclusion each year beginning January 1, 2017, until they die on December 31, 2069. Also assume that an estate and gift tax regime identical to the 2017 regime applies throughout H and W's lives (with an annual exclusion of $14,000/$28,000 and a 40 percent tax rate). H and W have succeeded in transferring $2,968,000 of stock to S and D free of gift tax ($56,000 annual exclusion transfers each year for 53 years), and the stock will not be included in their estates for estate tax purposes when they die. Assume instead that H and W purchased $56,000 of stock each year, held the stock until they both die on December 31, 2069, and bequeath the stock to D and S (one-half to each). If the stock appreciates at an annual rate of five percent per year, it would have a value of $14,435,340 as of

[13] Code section 2513.

the date of death. Assuming H and W had previously used their lifetime exemption from gift and estate tax and the estate tax rate remains at 40 percent for 2070, the bequests would give rise to an estate tax liability of $5,774,136.

Example 4: Grantor Retained Annuity Trust ("GRAT")

Mom's ("M's") attorney advises her that she can transfer assets to Daughter ("D") at minimal or no gift tax cost by establishing GRATs and naming D as the remainder beneficiary. M agrees to establish three successive two-year GRATs, beginning in July 2017. M's attorney explains that M can pay little or no gift tax by structuring her GRATs so that they are "zeroed out," meaning that the assumed value of the remainder interest (using the IRS section 7520[14] discount rate for the month of the transfer) is near or equal to zero, because the present value of the grantor's annuity interest is equal to the fair market value of the assets transferred to the trust. If, however, the trust assets appreciate at a rate in excess of the section 7520 rate, the remainder interest will be greater than zero, and the excess appreciation will pass to D free of gift tax.

GRAT 1.–On January 1 of Year 1, when the section 7520 rate is 2.2 percent, M funds GRAT 1 with $10 million, with annuity payments of $5,165,598 to be made to M at the end of Year 1 and Year 2, when M's annuity interest expires. Applying the section 7520 discount rate, the present value of the remainder interest (*i.e.*, M's gift to D) is assumed to be zero[15] as of the date GRAT 1 is funded, and M pays no gift tax. The trust assets in fact grow at a rate of 12 percent each year, leaving a remainder of $1,592,931[16] to be distributed to D free of gift tax.

GRAT 2.–On January 1 of Year 3, M invests $10,331,197 (the sum of her two annuity payments from GRAT 1) in a new two-year GRAT, GRAT 2. Assuming the section 7520 rate remains 2.2 percent and the GRAT will make annual annuity payments to M of $5,336,681, the present value of the remainder interest (*i.e.*, M's gift to D) is assumed to be zero as of

[14] The section 7520 rate, which is equal to 120 percent of the Applicable Federal Rate, is an interest rate approved by the IRS for use in determining the discounted present value of a stream of future annuity payments and for certain other purposes. The IRS produces actuarial tables pursuant to section 7520 for determining the present value of such interests.

[15] During year 1, it is assumed that the $10 million contribution will grow by 2.2 percent to $10,220,000 ($10 million x 1.022), at which time annuity payment 1 ($5,165,198) will be made, reducing the value of the trust assets to $5,054,402 at the year of year 1. During year 2, it is assumed that the trust assets again will grow by 2.2 percent to $5,165,198, at which time annuity payment 2 will be made, reducing the value of the trust assets to zero, leaving no remainder interest for D that will be subject to gift tax upon funding of the trust.

[16] During year 1, the $10 million contribution grows by 12 percent to $11,200,000 ($10 million x 1.12), at which time annuity payment 1 ($5,165,198) will be made, reducing the value of the trust assets to $6,034,402 at the end of year 1. During year 2, the trust assets again grow by 12 percent to $6,758,530, at which time annuity payment 2 will be made, reducing the value of the trust assets to $1,592,931. This is the amount of the remainder interest that will pass to D. No gift tax is paid, because the value of the remainder interest for gift tax purposes is determined only using the section 7520 rate (2.2 percent in this example), not the actual rate of return.

the date GRAT 2 is funded, and M pays no gift tax. The trust assets in fact decline in value five percent each year, leaving no remainder interest to be distributed to D, and reducing the amount of the second annuity payment to $4,254,058. As a result, GRAT 2 did not result in a gift tax-free transfer to D.

GRAT 3.– On January 1 of Year 5, M invests $9,590,739 (the sum of her two annuity payments from GRAT 2) in a new two-year GRAT, GRAT 3. Assuming the section 7520 rate remains 2.2 percent and the GRAT will make annual annuity payments to M of $4,954,191, the present value of the remainder interest (*i.e.*, M's gift to D) is assumed to be zero as of the date GRAT 3 is funded, and M pays no gift tax. The trust assets in fact increase in value 25 percent each year, leaving a remainder of $3,838,601 to be distributed to D free of gift tax.

Summary.– Even though GRAT 2 did not result in a gift tax-free transfer to D, M still succeeded in transferring $5,431,532 to D free of gift tax as a result of GRATs 1 and 3. In addition, M received most of her initial investment in GRAT 1 ($10 million) back in the form of annuity payments from GRAT3 ($9,908,382). The only other costs to M of achieving this $5,431,532 gift tax-free transfer to D were the possible returns had M chosen other investments and the fees paid to her attorney.

Example 5: Installment Sale to an IDGT

Husband and Wife ("H" and "W") plan to give their closely held business to their daughter, D, in 2022. H and W's tax advisor suggests that they instead consider structuring the transaction as an installment sale to an intentionally defective grantor trust. As a result, H and W establish a trust for the benefit of D and retain a right to reacquire the assets of the trust by substituting assets of equivalent value; H and W do not retain any right or interest that would cause the trust to be included in either's gross estate. The trust is treated as a grantor trust under section 675(4)(C), meaning that for income tax purposes the trust is not a taxpayer separate from H and W. For gift tax purposes, by contrast, the trust is treated as a separate taxpayer. In early 2017, H and W fund the trust with $10,980,000 cash.[17]

In March 2017, H and W sell to the trust the shares of stock in their company; at the time of the sale, the shares have an appraised value of $8 million. In making the appraisal, the appraiser allows a lack-of-marketability discount, because the shares are closely held and are not publicly traded. In exchange for the shares, the trustee issues an installment note with a face value of $8 million payable in six equal, annual installments and carrying an interest rate equal to the Federal mid-term rate for March 2017 (2.05 percent).[18] The trustee makes six annual payments to H and W in the amount of $1,430,617, for a total

[17] For 2017, the gift tax lifetime exemption amount is $5.49 million ($10.98 million for a married couple). Assuming H and W have not previously used any of their available lifetime gift tax exemption, they will not pay gift tax on the $10.98 million transfer to the trust (even though the trust is a separate taxpayer and the transfer is a gift for gift tax purposes).

[18] Rev Rul. 2017-07, 2017-10 I.R.B. 1007.

repayment amount of $8,583,704 (of which $583,704 represents interest and $8 million represents the repayment of principal). The interest payments are not taxable as interest income to H and W, because they and the trust are treated as the same taxpayer for Federal income tax purposes. At the end of the term, the shares owned by the trust have increased in value to $14 million.

H and W have succeeded in transferring to the trust (and ultimately to their daughter) without payment of gift tax not only the $10.98 million used to fund the trust, but also the excess of the $6 million in appreciation over the $583,704 in interest paid by the trust, or $5,416,296. Therefore – even disregarding any potential further appreciation on the assets used to fund the trust – H and W have succeeded in transferring assets worth $16,396,296 ($10,980,000 + $5,416,296) to their daughter with no transfer tax consequences beyond the use of their lifetime gift tax exemption. Moreover, by paying the income taxes of the trust during the six-year note term, H and W further reduced the value of their taxable estates without being treated as having made an additional taxable gift to D by reason of the income tax payments.

If H and W instead wait until 2022 and give outright to D assets with an equivalent value (*i.e.*, $16,396,296, comprised of the shares in the business then worth $14 million, and an additional $2,396,296 in cash), H and W will incur a gift tax liability of $2,155,318,[19] assuming a gift tax regime identical to the 2017 regime (*i.e.*, a $5.49 million lifetime gift tax exemption amount and a gift tax rate of 40 percent).

Example 6: Combined Example of Irrevocable Life Insurance Trust and *Crummey* Powers

In 2017, a married couple, H and W, establish an irrevocable trust for the benefit of their two minor children. The terms of the trust allow distributions to the children only upon reaching age 25. The trustee of the trust purchases a $10 million whole (or permanent, as opposed to term) life insurance policy on behalf of the trust insuring H's life. H has no incidents of ownership with respect to the policy, *i.e.*, the policy is owned by the trust, and H has no rights or powers with respect to the trust that would cause him to be treated as an owner of the policy for estate tax purposes. The trustee employs a non-interest bearing checking account for the trust such that the trust has little or no annual income for income tax purposes.

Use of *Crummey* powers to fund premiums.–To fund premium payments, H and W, who make a gift splitting election for purposes of applying the gift tax annual exclusion, make annual gifts of cash to the trust equal to the gift tax annual exclusion (currently $28,000 per married couple ($14,000 for each individual) per donee). Because both of their children are beneficiaries of the trust, H and W transfer $56,000 to the trust each year ($28,000 x 2 children). To qualify for the gift tax annual exclusion, a gift must be a gift of a

[19] This amount represents the gift tax computed at a rate of 40 percent on $5,388,296, which is the total value transferred ($16,396,296) reduced by H and W's lifetime gift tax exemption ($10.98 million) and by the gift tax annual exclusion amount (assumed to be $28,000 for a married couple for purposes of this example).

present interest in property. In the absence of any grant to trust beneficiaries of a right to enjoy trust property currently, however, gifts in trust are treated as gifts of future interests to the beneficiaries of the trust. To ensure that the annual cash transfers are treated as gifts of present interests to the children and thus will qualify for the gift tax annual exclusion, the children are given a lapsing, 30-day right to withdraw the cash immediately after each annual transfer by H and W.[20] The children are properly notified of their withdrawal rights each year from 2017 through 2030, but decline to exercise their withdrawal rights. H and W's annual transfers thus are treated as gifts of present interests in property and escape gift taxation by reason of the gift tax annual exclusion.

Treatment of death benefit.–In year 2030, H dies, and the $10 million death benefit is paid to the trust and then distributed, along with any remaining cash in the trust, to the children, who are now over age 25. Because H had no incidents of ownership with respect to the insurance policy, the $10 million insurance proceeds are excluded from his gross estate for estate tax purposes.[21] In addition, the child may exclude the insurance proceeds from his gross income for Federal income tax purposes.[22]

Example 7: Valuation Discounts

Mom ("M") owns a family business corporation with assets worth $100 million. M would like to transfer a 60-percent interest in the business to Son ("S"). M wishes to reduce her gift tax liability through valuation discount planning. In other words, she will structure her gifts so that minority and/or marketability discounts reduce the gift tax value of transferred business interests to an amount that is less than a proportionate share of the assets of the business. M first adds a shareholder agreement that restricts shareholders from transferring shares to a third party without first offering stock to the corporation or its remaining shareholders. Such a restriction sometimes can give rise to a valuation discount based on lack of marketability, even though family members collectively have the power to remove the restriction.

Scenario 1 (marketability discount only).–In 2017, M transfers a 60-percent interest in the business to S. Because the transferred interest is a majority interest in the business, the transfer does not qualify for a minority discount. Because of the shareholder agreement limiting transfers of shares to a third party, M claims a 10-percent discount for lack of marketability. This discount reduces the gift tax value of the transfer from $60 million (60 percent of the value of the business assets) to $54 million ($60 million - ($60 million x 10 percent)). Assuming M had already used her lifetime exemption from the gift tax and her gift tax annual exclusion for 2017, this discount results in a gift tax savings of $2,400,000 ($6,000,000 reduction in value x 40 percent tax rate).

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[20] Assume also that the trust is drafted or funded such that a failure to exercise *Crummey* powers within the 30-day period is not itself treated as a taxable gift by reason of section 2514(e) of the Internal Revenue Code.

[21] Code section 2042.

[22] Code section 101(a).

Scenario 2 (marketability and minority discounts).–M instead transfers 60 percent of the business to S in four separate, annual transfers of 15-percent interests in the business from 2017 through 2020. Because each transfer represents a minority interest in the business, M claims a minority discount of 20 percent, even though family members at all times collectively own a majority of the business. This 20 percent minority discount is in addition to the 10-percent discount for lack of marketability described in Scenario 1, for a total discount of 30 percent. As a result, the gift tax value of each 15-percent transfer is reduced from $15,000,000 ($100 million x 15 percent) to $10,500,000 ($15,000,000 - ($15,000,000 x 30 percent discount)), representing a reduction in value of $4,500,000. The combined reduction in value achieved by the four separate transfers is $18,000,000, resulting in a gift tax savings of $7,200,000 ($18,000,000 reduction in value x 40 percent tax rate).

Example 8: Perpetual Dynasty Trust

H and W establish an irrevocable trust in State X solely for the benefit of their grandchildren, great-grandchildren and other descendants in future generations. State X has repealed its rule against perpetuities. H and W fund the trust in 2017 with dividend-paying publicly traded stock with a fair market value of $10.98 million, which equals their remaining lifetime exemption from gift and estate tax ($10.98 million for a married couple in 2017) and their remaining lifetime GST tax exemption (also $10.98 million in 2017). All of their GST tax exemption is allocated to the transfer.

The transfer to the trust does not create gift tax liability, because H and W's remaining gift tax exemption shields the transfer from gift taxation, and the assets will not be included in H's or W's estates when they die. In addition, because H and W allocated GST tax exemption to the trust equal to the value of assets transferred to the trust, the trust is permanently exempt from GST tax. As such, neither the initial transfer of assets to the trust nor any future distributions from the trust will result in GST taxation, even though the GST tax is intended to ensure that transfer tax is collected when transfers skip a generation (for example, when property is transferred directly by a grandparent to a grandchild). In other words, all future income and appreciation will escape gift, estate, and GST taxation.

Assume, for example, that the stock transferred to the trust in 2017 appreciates in value at a rate of five percent annually, with all dividends paid to the trust each year being distributed to beneficiaries as received. By the year 2092, after three generations (assuming for purposes of this example that a generation equals 25 years), the stock will have grown in value to $426.4 million. None of this appreciation in value will be subject to gift, estate, or GST taxation, whether or not the stock is retained by the trust or distributed to beneficiaries. Similarly, the dividend income that is received by the trust and distributed to beneficiaries during the intervening years will not be subject to gift, estate or GST taxation.

Example 9: Tax Inclusive Versus Tax Exclusive

As discussed above, the estate tax is tax inclusive, which means that the tax is imposed on the value of the estate, which includes the value of assets that will be used to pay the estate tax. The gift tax, on the other hand, is tax exclusive, because the tax generally is paid by the transferor out of his or her separate assets on the value of assets transferred to the recipient, but is not imposed on the value of assets used to pay the tax. As a result, because the tax rate is the same under the gift tax and the estate tax, a person who wants to transfer a given amount of post-tax proceeds to a beneficiary must set aside a larger amount under the estate tax than under the gift tax.

Assume, for example, that Mom ("M") wishes to transfer $10 million to Daughter ("D"). M has no remaining lifetime exemption and has already used her $14,000 gift tax annual exclusion for 2017 on an earlier gift to D. To transfer $10 million to D by gift, M will need $14 million (the $10 million gift plus $4 million to pay the gift tax). If M instead wishes for D to receive a $10 million bequest when M dies, M must set aside $16.67 million ($16.67 million less 40 percent is $10 million).