
Covid-19, A Perfect Storm for Estate Tax Avoidance

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“In the midst of every crisis,” noted Albert Einstein, “lies great opportunity.”

Ordinary Americans aren't seeing much opportunity in the current Covid-19 crisis, however. We're focused on staying healthy and figuring out how to pay the bills.

The great opportunities in this crisis seem to be reserved for the ultra-rich.

Not only has the Covid-19 crisis helped them pad their already [overstuffed pockets](#), but it has also presented them with a gargantuan estate tax avoidance opportunity. Most, no doubt, are seizing on it, through two strategies: the intentionally defective grantor trust and the grantor retained annuity trust.

The Intentionally Defective Grantor Trust (IDGT)

The tax avoidance planning industry in America, which includes tax lawyers, accountants, appraisers, wealth managers, and trust companies, uses various strategies to shelter the large fortunes of their clients from estate tax. When their objective is to leverage the exemption from estate and gift tax to shelter a much larger amount from the reach of the tax, their go-to strategy is the combination of a family limited partnership, or FLP, and a type of trust known as an intentionally defective grantor trust, or IDGT.

This avoidance strategy builds on large-scale estate tax avoidance planning that the ultra-rich already have implemented. Back in 2011 and 2012, they feared that the law that allowed for such planning – a \$10 million per couple exemption from estate and gift tax -- would expire, as it was scheduled to do. But Congress extended that exemption and, in 2017, doubled it. Thus, the large-scale estate tax avoidance planning has continued to this day.

Here's an example of how the strategy would have been employed in 2012:

Late in 2012, John and Mary Rich, then in their mid-40s, make a \$10 million gift to an IDGT set up to benefit their descendants; first, their children, then, after their children's death, their grandchildren, and so on. John and Mary also place over \$500 million of investment assets in a family limited partnership. The IDGT then purchases a limited partnership interest from John and Mary. The partnership interest represents \$117 million of investment assets but, because of the manner in which John and Mary's advisers have structured the partnership, is valued for estate and gift tax purposes at only \$100 million. That fifteen percent valuation discount is on the conservative side in the tax avoidance industry. Many planners recommend discounts of 30% or more.

The IDGT pays John and Mary \$10 million in cash (the gift they made to it a short time earlier) and a \$90 million promissory note, which bears a one percent interest rate. The IDGT must pay interest on the note yearly at this one percent rate. The IDGT will have to repay the principal by the end of nine years, but it could refinance at that time if necessary. John and Mary's tax

planner advised them that in order for this strategy to withstand IRS scrutiny, the IDGT should have at least 10% equity in its investment.

Assume the assets initially generate \$2.4 million of dividend income per year and that income increases over time as the assets appreciate and unused income is reinvested. That income flows to the IDGT, but is taxable, under the convoluted rules of intentionally defective grantor trusts, to John and Mary.

The IDGT uses \$1 million per year from this income to pay its yearly interest obligation. John and Mary then use the \$1 million payment to pay the tax on the income from the assets and fund their living expenses.

To sum up, John and Mary's children, the beneficiaries of the IDGT, are able to purchase assets at a substantial discount and realize a rate of return vastly exceeding the rate of interest paid on the amount borrowed to purchase them, while John and Mary continue to pay the tax liability attributable to the income on the assets.

Fast forward to June 2020. John and Mary now are in their early 50s. Their net worth now stands at \$1.5 billion. With the runup in the stock market, the discounted value of the IDGT's partnership interest has appreciated to \$240 million, representing \$280.8 million of partnership assets.

John and Mary now sell an additional partnership interest to the IDGT for \$1.26 billion, along with the IDGT's \$90 million promissory note, for a total sale of \$1.35 billion. Because the IDGT now has \$150 billion in equity, it may pay the entire purchase price with a new promissory note for \$1.35 billion. This note bears interest at a 1.01 percent annual rate and has a term of 30 years.

Although the IDGT only is required to pay the interest on the note, it uses the dividend yield attributable to its share of the partnerships assets to make note payments each year.

Now, make some modest assumptions about the dividend yield paid to the IDGT, the income tax payable by John and Mary on that dividend yield, the appreciation in the value of the partnership's assets, and John and Mary's living expenses, and assume that the partnership distributes the IDGT's share of the assets to it after 30 years, which the IDGT then liquidates. Here's where things will stand after 30 years, when John and Mary are in the early 80s:

The IDGT will have paid the promissory note in its entirety.

The IDGT will hold over \$4.2 billion of cash.

The note payments John and Mary receive will allow them to fund their living expenses, the annual income tax on the dividend income, and the tax on all gains from the sale of investment assets by the IDGT.

That's \$4.2 billion passed in trust to John and Mary's children with an estate tax cost of zero.

But that's only a fraction of the estate tax that ultimately will be avoided. The IDGT's \$4.2 billion value undoubtedly will grow during the Rich children's remaining lifetimes. When they die, their children will become the beneficiaries of the IDGT, with no estate tax paid. And a generation later, John and Mary's great-grandchildren will become the beneficiaries of the IDGT, which by then could have a value of over \$100 billion.

The Grantor Retained Annuity Trust (GRAT)

The IDGT typically involves the use of some amount of a wealthy person's exemption from estate and gift tax. The second strategy, the Grantor Retained Annuity Trust, works even for those who have entirely consumed their exemption from estate and gift tax. And the current environment turbocharges the obscene estate tax avoidance achieved through the GRAT as much as, perhaps more than, it does the IDGT.

The technical aspects of GRATs may be difficult to grasp. The estate tax avoidance planning strategy associated with GRATs, however, is fairly simple. GRATs are used by the ultra-rich to sell investment assets, repeatedly, to trusts for the benefit of their descendants, with a slight twist: If the assets appreciate substantially in value, the trust pays the purchase price. Otherwise, the sale is undone, and the assets revert back to the ultra-rich seller. Now, think how rich you might become if you could see how a stock performed before paying for it. And think of how bad your investment results would be if every time you sold a stock its value increased, and every time you held a stock it lost value.

That's the essence of estate and gift tax avoidance with GRATs. The senior generation gradually loses wealth over time, while the junior generations steadily gain wealth. The net-net is a transfer of enormous wealth from one generation to the next that is not considered a taxable gift.

Avoiding estate tax through the use of GRATs is like spearfishing in a bucket even in ordinary times. If a billionaire establishes enough GRATs, sooner or later she'll have transferred billions in wealth to her children free of gift and estate tax.

Still, some times are better than others for avoiding massive amounts of estate and gift tax with GRATs.

Two factors drive the efficiency of GRAT estate tax avoidance: interest rates and investment market volatility. When Mary Rich "sells" assets to a GRAT, she does so by exchanging the assets for a two-year annuity -- two annual payments, that is -- payable on the first and second anniversaries of the GRAT formation. Those annuity payments must include an IRS-determined amount of interest, which is based on then-prevailing interest rates. So, the lower interest rates are, the less Mary must be paid for her assets. The interest Mary must charge is the hurdle, in terms of performance, that the GRAT must clear to move wealth to her descendants. If the GRAT fails to clear that hurdle, all its assets will return to Mary.

Mary typically would not create just one or two GRATs. Instead, she might create a GRAT every month, or every week, or even multiple GRATs every week. If the financial markets are volatile, Mary is more likely to time some of her sales shortly before the assets she sells to the GRAT

jump sharply in value. At that point, the GRAT may sell the appreciated assets, and lock in a gain. Yes, there will be other sales where volatility causes an immediate drop after Mary sells to a GRAT. But Mary is not concerned about those sales. She can undo them.

Which makes the current pandemic the perfect storm for estate tax avoidance through GRATs. Interest rates are at all-time lows, and the financial markets are as volatile as they've been in decades.

The required interest rate on sales to GRAT's has been below one percent per year since May. It now stands at 0.4% per year.

At the same time, the stock market has been on a roller coaster ride. In the second quarter of 2020, the major stock indices rose over 17%. The Nasdaq increased over 30% in those three months. The price of Amazon stock has nearly doubled since March.

The bottom line: The best time ever for avoiding estate and gift tax through GRAT planning is now. And America's billionaires and wannabe billionaires are seizing on the opportunity. Every time the stock market swings in one direction and then in the other, billions of dollars of wealth move beyond the reach of the estate and gift tax system. Under current federal and state law, it will remain beyond reach for the next century or so.

Difficulties Closing the Loopholes

It's too late to stop the massive estate and gift tax avoidance taking place. And, truth is, the current orgy of avoidance planning is just the grand finale of a decades-long process by which the ultra-rich have placed trillions of dollars in wealth beyond the reach of the estate and gift tax system.

The state of South Dakota has built a dynasty trust industry with an [estimated \\$350 billion](#) sheltered from estate and other forms of taxation, up from \$57 billion a decade ago.

Our tax system was designed to prevent dynastic wealth concentrations. In 1976, Congress enacted the generation skipping tax, or GST. Prior to the enactment of the GST, ultra-wealthy families could establish dynasty trusts which might be subject to estate tax upon the passage of the generation that created them but would be sheltered from estate tax with the passage of each succeeding generation.

The Mars family may have its wealth protected through the creation of dynasty trusts. Although the family has not divulged any details of its estate planning, the reported wealth of Mars family members, according to Bloomberg and Forbes, suggests this is the case, for two reasons. First, with the passing of Forrest Mars, Sr., in 1999 and Forrest Mars, Jr., in 2016, the family's total reported wealth did not decrease, as it logically would if estate tax were paid. Second, the reported wealth of family members in the same generation tends to be exactly equal, suggesting that their wealth is held in a trust separated into equal shares.

If Forrest Mars, Sr., did establish a dynasty trust, he likely did so prior to the enactment of the GST, and he would have been in a position to do so. After 1976, dynasty trust planning became far more difficult.

The GST imposes an additional tax on transfers that skip a generation or more, like gifts or bequests from grandparents to their grandchildren. When applied to multi-generation trusts, including most IDGTs and GRATs, the GST imposes that additional tax each time a generation benefitting from a trust passes on and the following generation steps up to become the primary beneficiaries.

But after working reasonably well in the decades following its enactment, the GST no longer is reliable as a brake on dynasty trust planning.

Here's the problem: Congress provided for an exemption from the GST. The original purpose of the exemption was to allow for modest gifts and bequests made by grandparents out of affection for their grandchildren without triggering a second tax in addition to estate or gift tax. But the exemption has grown over the years along with the exemption from estate and gift tax, and avoidance planners have devised ways to use that exemption to shelter massive fortunes from the GST. In addition, the development of GRATs, first made possible by the 1990 tax act and enhanced by a favorable court ruling in 2000, further limited the reach of the GST. At the same time, most states have relaxed laws that limited the duration of dynasty trusts. Now, many states allow trusts to remain in existence for a century or more.

So, a large portion of the wealth that's been sheltered from estate and gift tax through IDGTs and GRATs also is beyond the reach of the GST.

Could Congress solve the problem by plugging the IDGT, GST and other loopholes? Not very easily. Amending the tax code to stop further avoidance planning would be straightforward enough. Senator Sanders and others have introduced legislation to do exactly that

The far tougher task is addressing the avoidance planning that already has taken place. The dynasty trusts that have been formed already and hold trillions of dollars of wealth are exempt from the GST. And the current beneficiaries of those dynasty trusts don't have sufficient control of the assets they hold to subject the beneficiaries to estate or gift taxation.

Essentially, the massive fortunes already lodged in IDGTs, GRATs and other dynasty trust arrangements is grandfathered. Just as the dynasty trusts established by wealthy families prior to 1976 were beyond the reach of the GST, the IDGTs, GRATs and other tax avoiding dynasty trusts established in the past 20 years would be beyond the reach of a strengthened estate, gift and generation skipping tax system if it were enacted today. Legislation proposed by Senator Sanders addressed this by creating a rule that the GST exemption for trusts in existence on date of enactment of the legislation would expire after 50 years. Under that rule, the passage of the beneficial interests in dynasty trusts on the death of nearly all current beneficiaries currently in their 40's or older would be sheltered from the GST.

There are critical differences between the trusts sheltered from the GST in 1976 and the trusts that would be sheltered from a strengthened transfer tax system today: their size. In 1976, one hundred million dollars was a massive fortune. In 1982, when the Forbes 400 list debuted, a net worth of \$75 million was enough to make the list. Today, America has over 600 billionaires. Families that may have established dynasty trusts in recent years – those holding \$30 million or more in wealth – control over 25% of the nation's wealth. Further, the tax avoidance activity of recent decades dwarfs that of the pre-1976 era.

All that makes for what would be a very unfair transfer tax system even if the existing loopholes were plugged. A substantial portion, possibly more than half, of the wealth that otherwise would be subject to transfer tax would be sheltered in pre-existing dynasty trusts, whereas newly created wealth would not. Over time, that could actually worsen the country's concentration of wealth, as new fortunes would be trimmed with the passing of their creators, whereas the fortunes already in existence today would grow unabated.

The Alternative: An Inheritance Tax

There is an alternative, however: an inheritance tax. Under an inheritance tax system, it is the recipient of a gift or inheritance who is subject to tax, rather than the donor. Essentially, the gift or inheritance is considered income to the recipient, subject to tax like all other income, although perhaps at a different rate. Just as the current estate and gift tax system exempts more modest transfers from taxation, an inheritance tax system could as well.

Under a newly established inheritance tax system, would the beneficiaries of already existing dynasty trusts be sheltered from taxation? Generally, no. If America transitioned from an estate and gift tax system to an inheritance tax system, the exemptions already conferred upon those who established dynasty trusts would not be reversed; they'd simply be rendered meaningless.

To be sure, some of the avoidance planning already in place would allow beneficiaries to escape a newly established inheritance tax. Outright gifts and bequests that already are under the control of descendants of the uber wealthy, for example, could not be retroactively subjected to an inheritance tax.

But most of the transfers used by avoidance planners to place wealth beyond the reach of the estate and gift tax system are incomplete transfers in that the ultimate beneficiaries of those transfers do not yet control the transferred wealth. If the incidence of a new inheritance tax were defined as the moment when the recipient obtains full control of the inherited wealth – the receipt of a trust distribution, for example – a significant portion of today's massive fortunes could be taxed, and at the appropriate time.

This would not work perfectly, of course. The typical dynasty trust has escape clauses which allow a designated person, the trust protector or perhaps the trustee, to accelerate trust distributions. Upon the introduction of inheritance tax legislation likely to become law, such accelerated trust distributions would occur on a massive scale in order to allow trust beneficiaries to avoid the inheritance tax.

Little could be done to prevent those tax-motivated distributions from taking place or to subject them to a new inheritance tax, but it would be one last slurp at the tax avoidance trough for the ultra-rich. Future transfers would be fully taxable. And while the descendants of today's uber-wealthy who are alive today might largely escape taxation, the more remote, yet-to-be-born descendants would not.