

WEALTH MANAGEMENT: TRUSTS, ESTATES & FOUNDATIONS UPDATE

A Silver Lining to the Market Turmoil: A Great Time for Estate Planning

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There are actually some advantages to the recent market turmoil from an estate planning perspective. In fact, because of the low current value of assets and (hopefully) significant potential for future appreciation of these assets, there may never be a better time to transfer assets to children or others using a direct gift, a gift to a grantor retained annuity trust (GRAT), or a sale to a defective grantor trust.

A Great Time to Make Gifts

If the value of your stock portfolio or closely held business interests has dropped significantly, you can transfer these assets directly to your children and use the reduced value of the assets to determine the applicable gift tax. In other words, you can transfer property to your children at a lower tax cost during a market downturn. In 2008, you can transfer \$12,000 to each of your children using your “annual exclusion” from gift tax. In addition, you can transfer \$1,000,000 in total during your life to your children using your lifetime exemption from gift tax. Any transfers in excess of these amounts will be subject to gift tax.

A Gift to a GRAT

If you create a GRAT, the trust will make an annuity payment to you each year for a term of years. If you are living at the end of the GRAT’s term, the balance of the trust property is either distributed outright to your children (or any other beneficiaries you choose) or is held in trust for their benefit. You should fund a GRAT with assets that are likely to appreciate substantially in the future.

A Great Time for GRATs

Now is a great time to create a GRAT for the same basic reason that it is a great time to make a direct gift. If you transfer an asset to a GRAT at a reduced value, then that reduced value is used to determine the amount of the annuity that is paid back to you. If the value of the asset rebounds, the appreciation in excess of your annuity payments will be transferred to your children free of gift and estate taxes.

An additional benefit to creating a GRAT now is that interest rates are at near historic lows. The lower the interest rate is when the GRAT is established, the easier it will be for

actual growth to exceed the rate required by the IRS, and the more wealth that will be transferred to your children free of tax.

How Does a GRAT Work?

The IRS assumes that assets that are contributed to a GRAT will grow at a certain rate, called the §7520 rate. If the GRAT actually grows at a rate that is higher than the §7520 rate, and you are still living when the GRAT terminates, then the excess appreciation will be transferred to your children (or other designated beneficiaries) tax-free. In November 2008, the §7520 rate is 3.6 percent.

EXAMPLE

If you transfer \$6,000,000 to a GRAT that is created in November of 2008 and will terminate in November of 2016, then the annual annuity amount will be \$876,501. This amount will be paid to you in November of 2009 and again every November until 2016. Therefore, if the assets contributed to the GRAT actually grow at 10 percent per year, and you live to the end of term, then there will be approximately \$2,838,000 transferred to your children free of gift and estate tax at the end of the eight years.

Federal Gift and Estate Tax Consequences

The GRAT that we described can be created without utilizing any gift tax exemption or incurring any gift tax liability. Furthermore, there are no gift tax consequences upon

termination. If you survive until the end of the term of the GRAT, then the value of the trust property passing to your children will not be included in your gross estate for federal estate tax purposes. However, if you die before the end of the term, then substantially all of the trust property in the GRAT will be included in your gross estate for federal estate tax purposes.

Federal Income Tax Consequences

A GRAT is a “grantor trust” for federal income tax purposes. As such, you, as the grantor, are treated as the owner of the trust property, and any income of the GRAT is taxable to you during the term of the GRAT. Because the GRAT is a grantor trust, there are a number of favorable tax consequences. You should be able to exchange assets with the GRAT and receive distributions of low basis assets as payment of the annuity without any income tax consequences. Further, your payment of income tax on GRAT income may further benefit your children as the ultimate beneficiaries. For example, you might transfer low basis assets to the GRAT and then sell them during the term of the GRAT, leaving cash instead of low basis assets for your children, without further gift or estate tax consequences to you.

A Gift and Sale to a Grantor Trust

Another estate planning strategy that is likely to be more effective if used during a down market is a gift and sale to a grantor trust. As explained above, a grantor trust is treated, for income tax purposes, as entirely owned by the person who transfers property

to the trust. Accordingly, there are no tax consequences arising from a sale by you to a grantor trust created by you for the benefit of your descendants.

If the sales price is equal to the full fair market value of the property, then the property would be removed from your estate without gift tax consequences. The sale is usually in exchange for a promissory note from the trust, in which case the trust property (including both property given to the trust and property sold to the trust) should include sufficient cash or provide a sufficient income stream (such as dividends) to support the required payments on the promissory note. Further, to ensure that the loan is respected for tax purposes, it should have reasonable terms (including a rate of interest at or above the IRS published rate), so that it would be agreed to by the parties even if they were unrelated persons, such as in a commercial setting.

EXAMPLE

You create an irrevocable grantor trust for the benefit of your son and daughter, and make a gift to the trust of an interest in a limited partnership. For gift tax purposes, the value of the limited partnership interest is \$1,000,000, but if the partnership was dissolved, the interest is worth \$1,250,000 (\$1,250,000 discounted by 20 percent is \$1,000,000). One year later, you sell the trust an interest in the partnership for \$4,000,000, which would have an “underlying value” of \$5,000,000 (again,

this assumes a 20 percent discount). You take back a note from the trust with a term of seven years and a 3 percent interest rate, and provide for a balloon principal payment at the end of the seven-year period. The trust is required to pay interest of \$120,000 to you per year. The hope would be that the trust property would generate sufficient income to pay the interest annually and would appreciate significantly over time to enable the trust to eventually pay the principal at the end of the seven-year period. At that time, the note is paid off and the trust property is distributed to your son and daughter. In this example, assuming the trust property generates income of 3 percent per year and principal growth of 7 percent per year, your children will receive assets with an “underlying value” of approximately \$7,285,000 (or, \$3,642,500 for each of your children).

Conclusion

As described above, down markets can have significant estate planning benefits. For example, it may be the perfect time to make a direct gift of stock or closely held business interests because the gift tax assessed on that gift may be much lower now than it would have been previously. Additionally, these interests could be transferred to a GRAT or through a sale to a grantor trust. Any of these strategies may be effective at transferring wealth to your descendants or other beneficiaries, and these strategies can be used alone or in combination, depending upon your specific situation. Your goals,

assets and philosophy toward transferring wealth are all important factors to consider when determining the right combination of estate planning strategies for you.

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