VEDDER PRICE

Estate Planning Bulletin

August 17, 2007

Stock Market Decline Creates Estate Planning Opportunity

The recent sharp decline in the stock market has rattled the confidence and resolve of many investors. Some investors sold at the first sign of trouble, while others hung on, only to sell as the decline became more painful. Many investors are simply waiting it out. Still other, more intrepid investors have already begun hunting for bargains. As even the leading investment experts will confess, it is difficult, if not impossible, to determine which investment strategy is correct. Fortunately, the correct estate planning strategy in times like these is far more clear than the correct investment strategy.

As every investor knows, you should buy a stock when its price is low and sell it when its price is high. A similar principle applies for estate planning purposes: you should make gifts to children and other family members when the value of an asset is low so that future increases in value will avoid gift and estate tax. Thanks to the broad decline in the stock market, the values of many top stocks are now much lower than they have been for quite some time. For many individuals, this creates a golden estate planning opportunity.

Take Bob, for instance, who owns 5,000 shares of Goldman Sachs (symbol GS), which he bought for $500,000 ($100 per share) in 2005. Just a few months ago, in May 2007, GS was trading around $230 per share and Bob's 5,000 shares were worth roughly $1,150,000. Recently, the shares were trading down around $165 per share and Bob's 5,000 shares were worth roughly $825,000. Although the decline has been painful for Bob, he is convinced that GS will bounce back and will eventually go much higher. Accordingly, Bob has decided to wait it out on the investment side. But is doing nothing the correct estate planning move? The answer is, probably not.

Direct Gift

If doing nothing is the wrong estate planning move for Bob, what is the right move? Bob could make outright gifts or gifts in trust to his three children, sheltering the gifts from gift tax with his $12,000 per donee gift tax annual exclusion and, to the extent the annual exclusion is exceeded, with his $1,000,000 lifetime gift tax exemption. However, as the following example shows, this strategy may backfire:

> **Example 1:** Bob makes a gift of 5,000 shares of GS to a trust for his children when the stock is trading at $165 per share, resulting in a total gift of $825,000. The trust is structured so the gift qualifies for the annual exclusion. Accordingly, $36,000 of the gift is sheltered by this exclusion, leaving a taxable gift of $789,000, which is sheltered from gift tax by Bob's $1,000,000 lifetime gift tax exemption (leaving him with $211,000 of exemption). The taxable gift of $789,000 will also reduce Bob's $2,000,000 estate tax exemption to $1,211,000.

If the shares of GS bounce back relatively quickly to $230 per share, for a total value of $1,150,000, and then are sold by the trust, this strategy will be a big winner because $325,000 (plus the $36,000 covered by the annual exclusion and any future income and growth) will be sheltered from estate tax upon Bob's death. However, unless the trust is structured as a grantor trust (that is, a trust whose income is taxed to Bob), it will incur a federal capital gain tax of $97,500 upon the sale ($1,150,000 sale price less $500,000 basis multiplied by 15% long term capital gain rate), which will reduce the net tax savings.

On the other hand, if the price of GS drops further, to $120 per share, for example, Bob may regret pulling the trigger on the gift because, had he waited, the gift would have been only $600,000 instead of $825,000. In other words, Bob will have "wasted" $225,000 of his $1,000,000 lifetime gift tax exemption. Of course, if the stock bounces back, the gift will still be a winner, only less so. If the stock does not bounce back or bounces back only after several years, Bob may regret having used $789,000 of his $1,000,000 lifetime gift tax exemption on a nonperforming investment.

GRAT

Fortunately, there is a better alternative that will give Bob nearly as much benefit on the upside, with very little risk on the downside. This alternative is a grantor retained annuity trust, commonly known as a GRAT. In very simple terms, a GRAT is a trust that can avoid estate tax on a significant portion of the future total return (income and/or appreciation) of an asset at a zero or nominal gift tax cost.

Example 2: In August 2007, Bob transfers 5,000 shares of GS with a value of $825,000 ($165 per share) to a GRAT with a 2-year term. The GRAT will make a payment of $451,238.70 to Bob at the end of each year during the term, for a total of $902,477.40. The payments have a present value upon creation of the GRAT of $825,000, thereby resulting in a gift for gift tax purposes of $0.00. Assume GS bounces back to $230 per share within the next year. The 5,000 shares will then be worth $1,150,000. If the stock is sold, the capital gain tax will be paid by Bob and the GRAT will receive net proceeds of $1,150,000, which it can use to make the two payments to Bob. At the end of the GRAT term, the remaining net proceeds ($247,522.60) will pass to Bob's children free of gift and estate tax. Any future income and growth on this amount also will avoid these taxes. While $247,522.60 is less than the amount that would have passed to his children with a direct gift (Example 1), Bob will not use any of his $1,000,000 lifetime gift tax exemption to transfer this amount and instead can use that exemption (and the $36,000 annual exclusion) to transfer other property.

In addition, the GRAT has no downside. If the price of GS drops to $120 per share, the 5,000 shares held by the GRAT will be worth $600,000. If GS does not bounce back during the GRAT term, the GRAT will not have enough assets to make the two payments to Bob. As a result, Bob will get back his 5,000 shares. Importantly, neither the GRAT nor its beneficiaries will be liable to Bob for the deficiency. Also, because the gift to the GRAT is $0.00, Bob will not waste any part of his $1,000,000 lifetime gift tax exemption.

In addition to offering the advantages described in Example 2, a GRAT is a surprisingly flexible vehicle in terms of timing and performance. For example, if it appears that Bob's GRAT may not perform because of a drop in the price of GS shares, Bob can simply buy the shares back from the GRAT for an installment note at the lower price and then transfer the shares into a new GRAT that takes advantage of the lower price. Conversely, if GS rebounds quickly to $230 per share, the gain can be "locked in" by the GRAT selling the stock on the open market or by Bob buying the stock from the GRAT in exchange for an installment note. A purchase of shares from the GRAT by Bob will have no income tax consequences.

Although few investors welcome a stock market decline, such a decline almost invariably creates an estate planning opportunity that should be taken advantage of. In terms of overall risk and reward, a GRAT may be the best way to take advantage of an upturn in the market if and when it comes, with no estate planning downside if the market continues to decline.

For questions about using a direct gift or GRAT, please contact any member of the estate planning group.

Principal Members of the Estate Planning Group

Igor Potym 312-609-7542

Michael G. Beemer 312-609-7630

Charles H. Wiggins 312-609-7525

Christine M. Rhode 312-609-7575

Jean M. Langie 312-609-7735

Robert F. Simon 312-609-7550

The *Estate Planning Bulletin* is published by the law firm of Vedder, Price, Kaufman & Kammholz, P.C. It is intended to keep our clients and interested parties generally informed on developments in the Estate and Financial Planning industry. The discussion in this bulletin is general in nature and is not a substitute for professional advice. For purposes of the New York State Bar Rules, this bulletin may be considered ATTORNEY ADVERTISING.

If you have any questions regarding material in this issue of *Estate Planning Bulletin* or suggestions for a specific topic you would like addressed in a future issue, please contact the executive editor, Igor Potym (group leader), at 312-609-7542 or at ipotym@vedderprice.com.

Contributing Author: Igor Potym.

VEDDER, PRICE, KAUFMAN & KAMMHOLZ, P.C.

About Vedder Price

Vedder, Price, Kaufman & Kammholz, P.C. is a national, full-service law firm with approximately 240 attorneys in Chicago, New York, Washington, D.C. and New Jersey.

The Estate and Financial Planning Group

Vedder, Price, Kaufman & Kammholz, P.C. long has recognized the importance of estate and financial planning and has been in the forefront of this changing area of the law. The firm's practice has both a national and an international scope. Vedder Price's attorneys combine technical experience in all aspects of estate and financial planning with a strong appreciation of personal objectives and concerns in servicing clients in this uniquely personal area.

The firm represents clients with diverse personal objectives and financial interests, including individuals with large estates, individuals with personal situations requiring special planning, owners of closely held businesses, corporate executives and professionals. Vedder Price's Estate and Financial Planning attorneys also represent executors, administrators, trustees and guardians. In addition, the firm provides estate and financial planning counsel to businesses and not-for-profit organizations, as well as other professionals who consult Vedder Price with respect to their own clients.

Chicago
222 North LaSalle Street
Chicago, Illinois 60601
312-609-7500
Fax: 312-609-5005
Contact: Igor Potym

New York
1633 Broadway, 47th Floor
New York, New York 10019
212-407-7700
Fax: 212-407-7799
Contact: Neal I. Korval

Washington, D.C.
875 15th Street NW, Suite 725
Washington, D.C. 20005
202-312-3320
Fax: 202-312-3322
Contact: Theresa M. Peyton

New Jersey
Five Becker Farm Road
Roseland, New Jersey 07068
973-597-1100
Fax: 973-597-9607
Contact: John E. Bradley

www.vedderprice.com