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Estate Planning Bulletin

Bad Economic Times Create Great Estate Planning Opportunities

I don't have to tell you things are bad. Everybody knows things are bad. It's a depression. Everybody's out of work or scared of losing their job. The dollar buys a nickel's worth; banks are going bust . . . and there's nobody anywhere who seems to know what to do, and there's no end to it . . . I don't want you to protest . . . I don't want you to write to your Congressman . . . All I know is that first, you've got to get mad.

— Howard Beale in the 1976 movie *Network*

To paraphrase Howard Beale, we don't have to tell you things are bad. The stock market is falling, the economy is slowing and may be entering a recession, and solutions to the credit crisis are just getting started. However, contrary to the advice of Howard Beale, now is not the time to get mad. Instead, now is the time to act calmly and take advantage of what may prove to be one of the greatest estate planning opportunities of our lifetimes.

Our April 2008 Estate Planning Bulletin, *Declining Interest Rates Yield High Estate Planning Returns*, described how low interest rates and a declining stock market had created opportunities for certain estate planning techniques. Six months later, after the stock market has suffered an even steeper decline and interest rates have remained low, these techniques are now even more attractive.

There are many ways to transfer wealth to children or other family members without incurring estate or gift tax, ranging in complexity from a simple loan, to an installment sale, to transferring assets to a trust in exchange for an annuity (known as a Grantor Retained Annuity Trust, or GRAT). These techniques work well when interest rates are low and stocks have depreciated but have the potential for significant appreciation. Current conditions therefore favor these planning techniques.

It is important to recognize that publicly traded stocks are not the only assets that work with these techniques. Because of market volatility, economic weakness and other factors, the valuations of many closely held businesses are now lower than they have been in years, even for businesses that continue to perform well. Accordingly, stock or other interests in such businesses may now be particularly attractive assets to use with these techniques.

Loan or Installment Sale

The simplest way to take advantage of low interest rates and a *prospectively* favorable market is a direct loan to a child or other family member (or a trust for their benefit) for investment purposes.

Example 1: Jay would like to share his wealth with his heirs and reduce the portion of his estate subject to estate taxes. He is already making annual exclusion gifts to his children and is looking for additional ways to shift wealth without paying gift taxes. Jay can make a loan to his daughter Kaye (or to a trust for her benefit) with the funds to be used for investment purposes, as follows:

- Jay loans $500,000 to Kaye for a promissory note with a 3-year term, annual interest payments at 1.63 percent (the November 2008 IRS interest rate for short-term loans) and a balloon principal payment of $500,000 upon maturity.

- Kaye invests the $500,000 in stocks that have depreciated significantly over the last month.
- The market improves over the 3-year term and the original $500,000 doubles in value to $1,000,000.
- Each year Jay receives an interest payment from Kaye of $8,150, for a total of $24,450 over 3 years.
- Upon the note's maturity, Kaye pays off the loan and keeps the remaining funds of $475,550.

In this example, Jay transferred $475,550 to Kaye without gift or estate tax. Jay will pay income tax on the interest he receives, but Kaye could receive an investment interest deduction to the extent the proceeds of the original loan are traceable to the investments. Kaye will pay capital gain tax when the stocks are sold to repay the loan.

Alternatively, Jay could make the loan to a trust for Kaye. If the trust is a grantor trust, the tax and economic benefit to Kaye will be even greater, as described in the grantor trust discussion below.

An alternative to a cash loan is an installment sale of property. If the sale is for a price that can be documented as fair market value, the installment sale can avoid gift treatment.

GRAT

A GRAT can be described as a nonrecourse loan in which the donor retains the downside investment risk while shifting any appreciation in excess of the interest rate on the loan to donees of the donor's choice. A GRAT can avoid estate tax on a significant portion of the future total return of various assets without incurring gift tax.

Example 2: Elle owns stock in XYZ Inc. XYZ stock has depreciated over the last few months, but Elle thinks it will rebound. Elle establishes a GRAT naming her children as beneficiaries, which operates as follows:

- Elle funds the GRAT with 200,000 shares of XYZ stock worth $7.50 per share, or $1,500,000.
- The GRAT has a 2-year term and will make annuity payments to Elle of $720,012 and $864,014 on the first and second anniversaries, respectively. The payments increase by 20 percent per year (the maximum increase permitted by the GRAT rules) and are calculated to have a present value that exactly offsets Elle's contribution based on the interest rate set by the IRS (3.6 percent for November 2008).
- Because the annuity payments have a present value of $1,500,000, the amount of the gift is $0. Therefore, Elle will not use any of her lifetime gift tax exemption.
- Elle's prediction was correct, and XYZ stock increases by 15 percent annually over the 2-year term.
- The trust transfers stock back to Elle in satisfaction of the annuity payments. The transfer does not trigger capital gain tax because the GRAT is a grantor trust.
    - On the first anniversary, the $720,012 payment is satisfied with 83,432 shares at $8.63 per share.

- On the second anniversary, the $864,014 payment is satisfied with 87,099 shares at $9.92 per share.

- After the payments, the GRAT retains 29,469 shares worth $9.92 per share, or $292,332 in value. This amount will pass free of gift and estate tax and will either be retained in trust or distributed to Elle's children, according to the terms of the GRAT.

But what if Elle guessed wrong? The XYZ stock might depreciate further, stay at the same price, or increase by less than 3.6 percent. In that case, the GRAT will not have enough assets to satisfy the annuity payments to Elle. Fortunately, neither the GRAT nor the beneficiaries will be liable for the deficiency. This is one of the benefits of a GRAT. Thus, Elle has the opportunity to transfer significant appreciation to the next generation with little risk, and without incurring gift or estate tax.

Leveraged Technique	Description (All can be gift-tax-free)	Applicable Interest Rate (November 2008)	
Loan *(may be interest-only with balloon payment)*	Simple loan to individual or trust (usually a grantor trust), with proceeds used to make investments or pay down other higher-interest debt	Short-Term (≤ 3 yrs)	**1.63%**
Installment Sale *(may be interest-only with balloon payment)*	Installment sale to individual or trust (usually a grantor trust) of an asset with potential growth above the interest rate	Mid-Term (> 3 yrs but ≤ 9) Long-Term (> 9 yrs)	**2.97%** **4.24%**
GRAT	Nonrecourse transfer to a trust of an asset with potential growth above the interest rate, in exchange for a fixed-term annuity		**3.60%**

Grantor Trusts and Their Tax Benefits

As discussed above, a loan or installment sale could be made to a trust, rather than to an individual. When a trust is used for a loan or installment sale, the trust is typically set up as a grantor trust. Similarly, a GRAT will usually be a grantor trust.

Grantor trusts are treated as the grantor's (donor's) own property for income tax purposes, with two results that are usually advantageous. First, the grantor's transactions with the grantor trust are ignored for income tax purposes. The grantor's sales to the grantor trust do not trigger gain or loss, and interest paid to the grantor on a loan or installment note is not taxable income. Second, because the income of a grantor trust is taxed to the grantor, the trust and its beneficiaries will effectively receive tax-free income and the grantor's estate will be depleted by the income tax payment, thereby saving estate tax.

Retaining Some Economic Benefits as a Hedge against Harder Times

Many people who are good candidates for these techniques may be feeling substantially less wealthy under our current economic conditions. However, one great advantage of these leveraged techniques is that the donor does not give up the current economic value of the transferred property. Instead, the donor retains a note or annuity interest that should be paid back. Assuming the person or trust receiving the loan (or, in the case of a GRAT, receiving assets for an annuity) does not invest with more risk than the donor would have, the donor's economic risk is low. For all these techniques, the donor is giving away only the appreciation of the assets above the rate of return that applies to the note or annuity. The donor might even retain some indirect access to the appreciation, if the appreciation passes to a trust of which the donor's spouse is a beneficiary.

Time to Act

Recent grim reports of the depressed stock market and a faltering economy should not discourage anyone from taking decisive action. The estate planning techniques we have described in this bulletin are excellent ways to take advantage of current market and economic conditions. By implementing these techniques now, you may be able to achieve significant gift and estate tax savings.

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For questions about estate planning opportunities created by the current economic environment, please contact any member of the estate planning group.

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The Estate Planning Group
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If you have any questions regarding material in this issue of the *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.

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