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Estate Planning Bulletin

April 2008

DECLINING INTEREST RATES
YIELD
HIGH ESTATE PLANNING RETURNS

As every investor knows, interest rates and equity values have declined significantly over the past few months. Interest rates are now lower than they have been in years and the stock market recently reached its lowest level since the summer of 2006. In our August 17, 2007 bulletin, *Stock Market Decline Creates Estate Planning Opportunity*, we addressed how the stock market decline last summer had created an opportunity to save gift and estate tax by transferring depreciated assets. Since then, interest rates have declined precipitously. This decline, coupled with lower equity values, has made many estate planning techniques—including GRATs, installment sales to grantor trusts, intrafamily loans and loans to family limited partnerships or limited liability companies—more attractive than ever.

Many estate planning strategies achieve gift and estate tax savings by giving a parent a minimum rate of return (the "break even" rate) and shifting total return in excess of this rate to children or other family members. The lower the break even rate, the greater the potential gift and estate tax savings. In addition, the decline in stock values makes it more likely that stocks will produce a rate of return in excess of the break even rate than when the market was at its peak last year.

For April 2008, the break even rate for some loans and installment sales is now less than 2 percent. The break even rate for a GRAT created in April 2008 is now only 3.4 percent. By comparison, the lowest break even rate for a loan or installment sale in August 2007 was just under 5 percent and the GRAT rate in that month was 6.2 percent.

Installment Loan or Sale

One of the most simple ways to take advantage of low interest rates and low equity values is a loan, either directly to a family member or to a trust for his or her benefit.

> **Example 1:** Some time ago, Bob created a trust for the benefit of his children. The trust currently has $500,000 of assets. For federal income tax purposes, the trust is a grantor trust. As a result, all of the income of the trust is taxed to Bob and no transaction between Bob and the trust will have any income tax consequences. Earlier this year, Bob liquidated a significant portion of his stock portfolio and now is sitting on a big pile of cash. Bob is encouraged by recent signs that the market may have bottomed and believes that now may be a good time to get back into the market. Bob would like to shift some wealth to the trust, but has no gift tax exemption remaining and does not want to pay gift tax.
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> Bob decides to make a loan of $1,000,000 to the trust that the trust can use to invest in the stock market. The loan will be for a 3-year term, with annual interest payments at 1.85 percent (the break even rate) and a balloon principal payment of $1,000,000 at the end of the term. The

trust makes some good stock picks and the $1,000,000 doubles in value to $2,000,000 during the term of the loan. Each year, the trust pays interest to Bob of $18,500, for a total of $55,500 over 3 years. At the end of 3 years, the trust pays off the loan ($1,000,000) and keeps the balance of $944,500 ($2,000,000 less interest of $55,500 and principal balance of $1,000,000). This amount, plus any future income and appreciation, will avoid estate tax upon Bob's death. As an added benefit, all of the income of the trust, including capital gains if the stocks are sold, will be taxed to Bob rather than to the trust or his children.

A variation on an installment loan is an installment sale, either directly to a family member or to a trust for his or her benefit.

Example 2: Assume the same facts as in Example 1, except Bob did not liquidate his portfolio and now holds some stocks that were beaten up in the recent stock market decline. Bob believes that these stocks are market leaders and are likely to take off first when the market rallies. Bob sells $1,000,000 worth of stocks to the trust in exchange for a note with the same terms as in Example 1. The stocks double in value to $2,000,000 during the term of the note. The result will be the same as in Example 1.

A loan or installment sale also can be made directly to a child or other family member. However, a direct loan or sale will not be as attractive as a loan or sale to a grantor trust in terms of shifting wealth because any interest received will be taxable income to the lender or seller (but interest paid may be deductible by the payor), capital gain will be recognized by the seller in the case of an installment sale of an appreciated asset and future income will be taxed to the child or other family member rather than to the parent. Nonetheless, such direct transactions still can shift significant amounts of wealth free of gift and estate tax.

GRAT

Another attractive 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 at no gift tax cost.

Example 3: In April 2008, Amy transfers $1,000,000 of stock to a GRAT with a 2-year term. The GRAT will make a payment of $525,652 to Amy at the end of each year during the term, for a total of $1,051,304. The payments have a present value upon creation of the GRAT of $1,000,000, thereby resulting in a gift of $0. Because the gift is $0, Amy will not use any part of her gift tax exemption. The payments are determined by using the GRAT break even rate of 3.4 percent set by the IRS for April 2008. Assume the stock increases in value to $2,000,000 within the next year. If the stock is sold, the capital gain tax will be paid by Amy and the GRAT will receive net proceeds of $2,000,000, which it can use to make the two payments to Amy. If the stock is not sold, it can be used to make the payments in kind. At the end of the GRAT term, the remaining net proceeds of $948,696 (plus any future income and appreciation) will pass to Amy's children, outright or in trust, free of gift and estate tax.

If the value of the stock drops so the GRAT does not have enough assets to make the two payments, neither the GRAT nor its beneficiaries will be liable for the deficiency. In effect, Amy will retain the downside investment risk.

Loan to Partnership or Other Entity

A loan also can be made to a partnership, limited liability company or other entity in lieu of a capital contribution. There may be a variety of business and investment reasons for using a loan instead of a capital contribution. In addition, a loan has a gift and estate tax advantage. A loan can be used to freeze the value of the lender's estate, thereby shifting future total return in excess of the break even rate to the partnership, limited liability company or other entity and, indirectly, to the other equity owners.

> **Example 4:** Mike is thinking of creating a limited liability company (the "LLC") for the purpose of investing in marketable securities, real estate and private equity ventures. Mike is planning on contributing $4,010,000 and his children and trusts for their benefit are planning on contributing $990,000, for total assets of $5,000,000. Mike would like to remain in control of the LLC. He is aware that the IRS has challenged family limited partnerships and limited liability companies under section 2036 of the Internal Revenue Code, with the result that assets transferred to the entity (plus future growth on such assets), rather than the interest in the entity, will be subject to estate tax upon the contributor's death, unless there are one or more significant nontax reasons for forming the entity. Mike would like to structure the LLC in a manner that saves estate tax, but is concerned about the section 2036 risk.
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> Mike decides to take advantage of the current low interest rates. He makes a capital contribution of $10,000 to the LLC in exchange for voting units representing 1 percent of the total units of the LLC. Mike's children and their trusts contribute $990,000 to the LLC in exchange for nonvoting units representing 99 percent of the total units. Accordingly, the LLC has $1,000,000 of capital. Mike then makes a loan of $4,000,000 to the LLC in exchange for a note with a term of 9 years, annual interest payments at 2.87 percent (the break even rate) and a balloon principal payment of $4,000,000 at the end of the term. As a result, the LLC's balance sheet consists of $5,000,000 of cash and $4,000,000 of debt.
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> The LLC pursues a variety of attractive investment and business opportunities and realizes an annual total rate of return of 20 percent. The LLC makes annual interest payments to Mike of $114,800 (2.87 percent of $4,000,000). At the end of 9 years (after the $4,000,000 loan is paid), the LLC has $19,411,188 of assets.
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> Assume Mike dies shortly after the loan is paid. Upon Mike's death, only his 1 percent interest in the LLC, worth approximately $194,112, plus the principal and interest payments on the note, will be subject to estate tax. This should be the result even if the IRS makes and wins a section 2036 argument. The balance of the assets of the LLC ($19,217,076) will avoid estate tax upon Mike's death.

Time to Act

The recent declines in interest rates and equity values have created one of the most attractive estate planning environments we have ever seen. This bulletin has provided a small sample of the different types of techniques that can be used to transfer wealth to children or other family members free of gift and estate tax. There are many others and the determination of which technique is best will depend on the specific circumstances. Because there is no guarantee that the economic conditions that have made these estate planning techniques so attractive will last, the time to act is now, while the window of opportunity is still open.

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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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