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Lemons Into Lemonade

Wealth transfer strategies for tough economic times.

By Deborah L. Jacobs

Savvy investors have always known that an economic downturn presents opportunities for anyone willing to bet on a recovery. Likewise, with estate planning, there are distinct advantages in taking action while market values and interest rates are low. Whether the recession lingers in 2010 or the economy picks up, clients who transfer property now can reduce the size of a taxable estate while giving their beneficiaries substantial potential for those assets to increase in value later.

Depending on the circumstances, here are some strategies to consider:

1. In some cases, the client has plenty of cash and would like to help others. Many people don't realize that donating to those who are less fortunate is an activity regulated by tax law. This is often a confusing topic, but it suddenly became more relevant after the economic meltdown of 2008. So it's worth reminding clients of the rules.

Each of us can give \$13,000 per year to as many recipients as we like without paying a gift tax. Spouses can combine these annual exclusions to jointly give \$26,000 to any person tax-free. This practice, known as gift-splitting, generally requires each spouse to file a gift-tax return on April 15 of the year after the gift, and to consent, on the other's return, to gift-splitting. When making cash gifts, the easiest way to avoid filing a return is for each spouse to make out a separate check for the \$13,000 annual exclusion amount, rather than writing one check for the entire \$26,000.

Gifts that exceed the annual exclusion count against the \$1 million lifetime gift-tax exemption (or the \$2 million exemption for married couples). After someone has given away more than that, a gift tax of up to 45% applies.

It does not trigger gift tax if a client lends family members money—for example, by helping them buy a house or start a business at a time when credit is tight. These intrafamily loans require the formalities of a bank loan, including a note and security, but the interest rate can be more favorable than it would be at a financial institution. Family must charge each other the applicable federal rate (AFR), which in October, was 4.03% for long-term loans (those lasting more than nine years).

2. In other cases, the client might want to transfer noncash assets in excess of the annual exclusion or the lifetime exemption. In this case, he or she can sell assets to family instead of giving them away. The client can enter into the transaction with family members directly, but it is better to use an irrevocable trust, which protects the assets from creditors.

The client can use the annual exclusion or lifetime exemption to cover initial gifts to this trust, but also sell additional assets to the trust in return for a promissory note with interest. Here too, the AFR applies. And it is important to set a fair sale price or the Internal Revenue Service could argue that the transfer was a taxable gift. To avoid disputes with IRS, it is preferable to use assets that are not difficult to value. This strategy is most beneficial if the assets have fallen in value before they are transferred and they appreciate later.

Making the trust a grantor trust—one in which the person creating the entity retains the obligation to pay tax on the trust's income and realized gains—is a powerful financial strategy. A 2004 revenue ruling by the IRS made it clear that paying the tax is not considered a gift to the trust beneficiaries. Yet this tax on income that the grantor probably never receives shrinks the individual's estate. At the same time, assets can appreciate inside the trust without being depleted by ordinary income taxes or capital gains taxes.

When funding trusts that will benefit grandchildren, clients need to be mindful of the potential generation-skipping transfer tax (GST). Each person can give up to \$3.5 million to grandchildren or to trusts for their benefit during life or at death without incurring a 45% generation-skipping tax on top of gift and estate taxes. Someone who applies the GST exemption to the initial seed gift to the trust will be able to shelter all of the assets in the trust from the GST tax.

3. Sometimes the client has a liquidity event, such as a sale, on the horizon, or expects depreciated assets to recover. A volatile asset can be an ideal candidate for a grantor-retained annuity trust (GRAT). This device allows someone to put assets into an irrevocable trust and retain the right to receive distributions back over the trust term. The annuity is equal to the value of what's been contributed plus interest at a rate set each month by the Treasury called the Section 7520 rate (named after the section of the Internal Revenue Code that applies). In October, this rate was 3.2%, a historical low.

If the value of the trust assets increases by more than the annuity and the interest (otherwise known as the "hurdle rate"), the GRAT will be economically successful. In that case, the excess appreciation will go to family members (the remainder beneficiaries) or to

trusts for their benefit when the GRAT term ends. But if the appreciation never occurs, the client is no worse off; the trust would simply satisfy its payout obligations by returning more of the assets to the client.

It is currently possible to set up a GRAT that results in either no taxable gift or only in a very nominal one. Under these circumstances, there's little lifetime gift-tax exemption wasted if the asset does not perform as hoped.

Various features of the GRAT may change if Congress enacts ambitious estate tax reform. This is something that seems increasingly unlikely this year given the logjam over health care. But ultimately, the legislators may eliminate so-called zeroed-out GRATs—those in which the remainder is theoretically worth nothing, so there is no taxable gift. Instead, someday the law may call for the remainder interest in new GRATs to have a minimum value, such as 10%.

Another possibility is that Congress will require GRATs to have a longer minimum term, such as ten years. Right now, two years is the minimum, and many clients gravitate toward short-term GRATs since the grantor must live until the end of the trust term for this type of trust strategy to work. It's possible that GRATs put in place before the law changes will be grandfathered, so there could be a distinct advantage to doing them before it happens.

For now, there are many possible variations on the theme, and you can engineer both the GRAT term and the annuity for maximum economic benefit. This is also the better approach if you're dealing with a volatile asset, if you anticipate significant appreciation in the near term—and if you want to capture it before the value dips in another down cycle. If you want to hedge the risk of dying or choosing troublesome investments, you can create a series of short-term GRATs that work over certain periods of time—say, five GRATs, each having a two-year term and holding a different investment.

With longer-term investments—for example, shares in a family business passing to children through a GRAT—those who are optimistic might opt for longer trust terms. This locks in both the current low Section 7520 rate and the chance that the trust will be grandfathered if the rules change. Whether you choose to invest for the short term or the long term, you can use the annuity stream to fund additional trusts, creating a series of cascading GRATs.

Likewise, it may be possible to structure the payout to reflect your expectations about investment performance. Often, GRAT annuities are designed to be lower in the first year and increase by a preset percentage in successive years, with a goal of capturing more appreciation inside the trust. But if you expect a big capital gain in year number one, you can also specify a higher initial payment to reflect that.

With assets that are difficult to value, such as closely held stock or real estate, a GRAT offers an additional benefit. By expressing the annuity as a percent of the initial value of the GRAT, you permit the trust to simply pay a larger annuity (at no gift-tax cost) if the IRS determines the property is worth more than you initially figured.

A GRAT is not generally appropriate for transfers to grandchildren or more remote descendants since it is not possible to apply the GST exemption until the trust ends. By then, the grandchildren's interest could be worth much more than it was when your client set up the GRAT.

4. In some cases, the asset values in an existing GRAT have dropped and are not likely to bounce back in the remaining years of the trust. Someone who has created a GRAT is not allowed to add any assets to it. However, it is possible to reacquire trust assets and substitute others of equivalent value.

Let's say asset values have declined, making an existing GRAT unsuccessful, but the client believes that the asset will bounce back, which would allow a newer GRAT to succeed. In that case, there may be a benefit to moving the volatile asset out of an existing GRAT and putting it into a new one at the lower rate, essentially giving the client a fresh start. This can be done by exchanging the property either for cash or for another asset of equal value. Alternatively, the asset can be bought from the GRAT using a promissory note.

5. In some cases, the client wants to benefit charity and, ultimately, specific individuals. Current low interest rates and depressed asset values may make charitable lead annuity trusts appealing for some people. This structure resembles a GRAT except that the initial payout goes to one or more charities rather than to the client. After that, the remainder goes to family or friends, either directly or through a trust. The longer it takes to get the funds to the individuals and the higher the value of the annuity going to charity, the less gift tax the grantor will have to pay. (These trusts rarely last less than seven years and often go as long as 15 or 20.)

If the trust earns more than it must pay out to charity, the difference gets added to the principal. Further into the future, this appreciation not only goes to family members but—more important—it goes to them gift-tax-free. On the other hand, if the trust investments don't do as well as hoped, the trust might be depleted by the end of the term, leaving nothing for family.

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