

Making Hay While the Sun Shines

By Baird's Financial and Estate Planning Team

A "perfect storm" of marketplace conditions has created once-in-a-lifetime estate planning opportunities for high-net-worth clients.

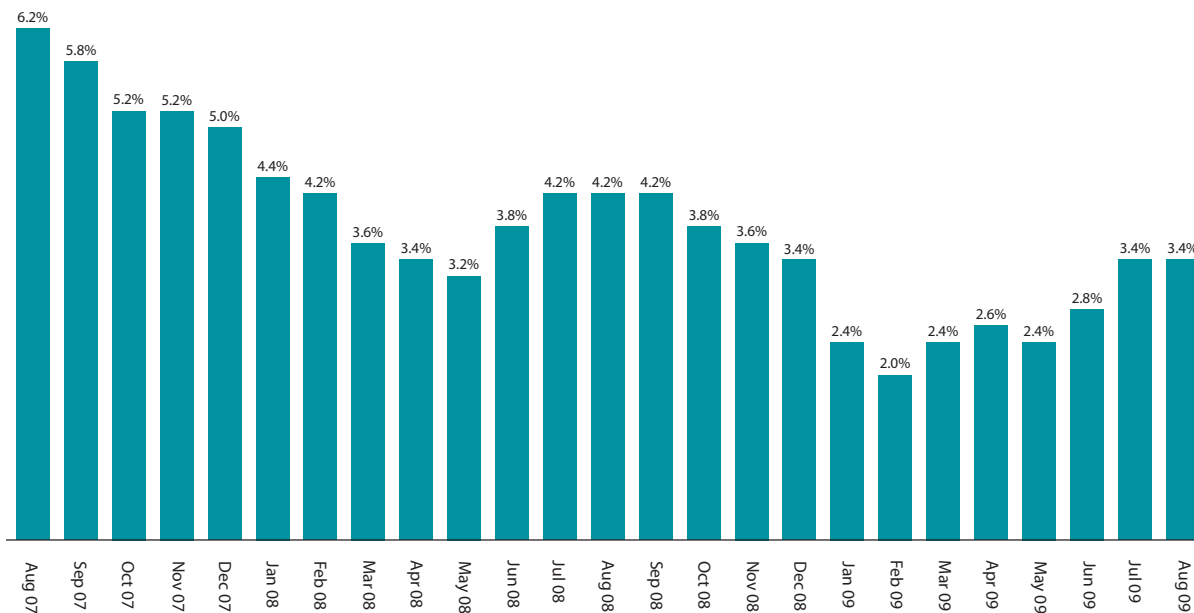
"Opportunity is knocking." That's been the mantra of estate planners recently as the first half of 2009 has been ripe for high-net-worth clients to consider some very robust estate planning.

In many ways, it's the "perfect storm" of conditions, a confluence of depressed stock valuations and unprecedented lows in interest rates have created once-in-a-lifetime estate planning opportunities. Advanced estate planning techniques such as grantor-retained annuity trusts (GRATs), intentionally defective grantor trusts and charitable lead trusts can all be taken advantage of to transfer wealth to the next generation in a very tax-efficient manner.

That's because the actuarial computations used for these vehicles are sensitive to an interest rate, published monthly by the government, which has plunged recently. Known under the Internal Revenue Code as the "7520 rate," the rate is derived from the average market yield on outstanding government obligations with a remaining maturity of between three and nine years. For January 2009, this 7520 rate dropped to an all-time low of 2.4%, shattering the previous low of 3.0% for June 2003. In February, the 7520 rate dropped even further to the new all-time low of 2.0%.

As is indicated in the chart on the following page, the 7520 rate began falling in late 2007, just as the stock market began declining. The old 3.0% low was first skirted last May and then again in December. But it was only after the Federal Reserve announced in December that it was cutting its target interest rate to historic lows (between zero and a quarter percentage) that the 7520 rate dipped to these new all-time low levels.

Monthly Internal Revenue Code 7520 Interest Rates



The “7520 rate” dropped to an all-time low in February, and remains historically low, which creates unique estate planning opportunities.

The Fed suggested that it may keep interest rates “exceptionally low” for some time, but procrastinators should be wary of missing out on this rare opportunity. Now that the economy has begun to show some signs of a gradual recovery, the 7520 rate has begun to rise gradually, but it is still historically low and planning opportunities are still available.

The estate planning strategies that can be used to best effect in the current low-interest-rate environment may be best understood as “freeze” techniques. Essentially, these strategies allow a grantor to transfer property in trust while *freezing* the value of the payments they will get back in return, based on an actuarial computation that is tied to the 7520 interest rate. A lower 7520 rate decreases the value of the payments the grantor gets back, and so it increases the likelihood that

there will be leftover assets in the trust after the grantor has received the final return payment. This remainder balance of trust assets will pass to the grantor’s beneficiaries as a tax-free gift.

Suppose, for example, that a client creates a Grantor Retained Annuity Trust (GRAT) when the 7520 rate is 3.4%, and transfers \$10,000,000 to the trust in exchange for a right to receive fixed annual annuity payments over a five-year period. The transaction will typically be structured as a “zeroed-out” GRAT, meaning that no taxable gift is made upon creation of the GRAT because the grantor will receive annuity payments equal in value to the amount transferred (\$10,000,000), plus the assumed 7520 rate of return (3.4%). In this case, the grantor would receive an actuarially determined annuity payment of about \$2,209,000 at the

end of each of the five years. If the trust assets are invested and *outperform* the 3.4% government rate, there will be a remainder balance to pass from the grantor as a tax-free gift after the five-year period has elapsed.

The size of the tax-free gift will ultimately depend on the rate at which trust assets appreciate during the duration of the GRAT. For example, if the trust assets grow at an annual rate of 7% over the five-year period, the trust will have a remainder balance of more than \$1,290,000 to pass from the grantor as a tax-free gift. If the stock market snaps out of the current recession and the trust assets appreciate at an annual rate of 10%, the tax-free gift will be approximately \$2,578,000. By comparison, a GRAT created and funded with the same amount as recently as August 2007 (when the 7520 rate was a much higher 6.2%) would have created a tax-free gift of only \$300,000 at a 7% annual rate of appreciation, and only \$1,500,000 with a 10% rate of appreciation.

The very worst that can happen with a GRAT is that the investments *underperform* the 7520 interest rate, in which case the annuity payments coming back to the grantor would completely deplete the GRAT and no gift would be made. But that outcome seems rather unlikely when the trust investments only need to beat the low hurdle rate of 3.4% to be successful.

Alternatively, our client could use an Intentionally Defective Grantor Trust (IDGT) to make an even larger tax-free gift. The IDGT is a more complex variation on the same “freeze” concept underlying a GRAT, but several factors allow it to produce more favorable results.

Using this strategy, our client, starting with the same \$10,000,000, would create a family limited partnership (FLP), or a limited liability company (LLC), and transfer the entire \$10,000,000 to this newly created entity. The “fair market value” of a non-controlling interest in this entity would be determined by a qualified appraiser, who factors in combined valuation discounts (typically 30 to 40%) for the lack of marketability and lack of control. For this example, we will use a combined discount of 33%, which results in a discounted value of \$6,700,000 for the entire FLP on a non-controlling, non-marketable basis.

Next, our client would create the IDGT trust, which is designed to be excluded from the client’s gross estate for federal estate tax purposes, but is also subject to a set of “grantor trust” rules for income tax purposes. By making the IDGT a grantor trust, our client may sell assets to the IDGT without recognizing a capital gain or loss and receive tax-free interest payments under an installment sale.

After making a “seed” gift to the IDGT of about 1/10 of the discounted value of the FLP, or \$670,000 (which gives economic substance to the transaction) our client would sell the entire discounted FLP to the IDGT and take back a promissory note for the full discounted value of \$6,700,000. The note would be structured as an interest-only loan, followed by a balloon payment of the face amount after five years (A longer loan term is more commonly used, but a five-year term is used here to compare results with our previous example of a five-year GRAT). The interest on the promissory note need only be 2.8% (even lower than the 3.4% used for the GRAT) to meet IRS

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guidelines for intra-family loans. And, as noted above, neither the sale of the FLP nor the interest payments received on the promissory note will have any income tax implications for the client because the IDGT has been designed as a grantor trust.

If we take the same 7.0% rate of annual appreciation that was used for the GRAT illustration—after making annual interest payments of \$187,600 for five years, followed by a balloon payment of the \$6,700,000 loan principal—the undiscounted remaining trust balance that would pass as a tax-free gift to the grantor’s beneficiaries could be as much as \$6,739,000. If the trust assets appreciate at an annual rate of 10% coming out of the current recession, the tax-free gift could approach a staggering \$9,000,000!

Additional wealth transfer can be achieved if the trustee of the IDGT purchases survivorship life insurance on the grantor and his or her spouse using a portion of the trust assets to pay the insurance premiums. Further, by allocating some of the grantor’s generation-skipping tax exemption along with the seed gift to the IDGT, the trust will have *dynastic* characteristics that will compound the wealth transfer objectives across multiple generations without ever being reduced by federal estate taxes.

While our examples show that the IDGT sale can yield a significantly better result than the GRAT, risk-averse clients may opt for the more modest results achieved using the GRAT knowing that the technique is sanctioned by Congress under the Internal Revenue Code. However,

IDGTs have heretofore withstood the test of IRS scrutiny, even though the strategy isn’t based on any IRS rule but only on an interpretation of previous IRS rulings. An honest assessment of the relative risks and rewards of these techniques will help clients make a well-informed choice of which technique is the right one for their individual goals and objectives. The first step is to inform your higher-net-worth clients that these and other wealth transfer techniques and strategies are available.

For high-net-worth clients who might benefit from this unique opportunity to use these or other wealth-transfer strategies, the appropriate message just might be that opportunity is knocking, but it may not continue for much longer.

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