

# Personal Planning Strategies

A report for clients and friends of the firm.

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### **Low Interest Rates Yield Wealth Transfer Opportunities**

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Low interest rates can create wealth transfer opportunities. For various wealth transfer techniques, the IRS assumes that a certain minimum interest rate is in effect, known as the applicable federal rate (AFR), and in June 2008 this rate is near historic lows. To the extent that an investment return can be earned that is greater than the AFR, wealth is transferred to the next generation transfer tax free.

In this issue of *Personal Planning Strategies*, we focus on three estate planning strategies which work best in a low interest rate environment: loans between family members; grantor retained annuity trusts (GRATS); and charitable lead trusts (CLTS). All of these devices can be used to shift future appreciation from the donor to the lower generation outside of the transfer tax system. Moreover, when markets are depressed, the potential for appreciation is greater. Thus, the timing is right to do this type of planning.

### **Creating A "GRAT": Heads You Win, Tails You Break Even**

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**Thanks to Low Interest Rates and Wal-Mart, GRATs are better than ever!**

Creating a grantor retained annuity trust (commonly referred to as a "GRAT") is a relatively simple way to transfer property to your children at virtually no gift tax cost. In addition, because of the low interest rate environment and down markets, the advantages of creating a GRAT are magnified. When properly structured, a GRAT can pass to your children all of the future appreciation of the transferred property and reduce the value of the gift to virtually zero.

#### **Trust Pays an Annuity to You**

In a typical GRAT, you contribute assets to a trust which provides that you are to receive an annuity annually for a fixed number of years. The annuity amount is typically a stated percentage of the initial fair market value of the trust. It can be stated as a fixed percentage or as a percentage that can increase as much as 20% a year over the trust's term.

At all times during the term of the trust, you will receive the predetermined annuity amount, regardless of how much income the trust actually generates or whether its value rises or falls. To the extent that the income is insufficient to cover the annuity payments, trust principal will be paid to you to make up any shortfall.

At the end of the period, the property remaining in the trust passes to the ultimate beneficiaries of the trust, typically your children or other family members, in further trust or outright, depending upon your preference. Alternatively, you can delay the transfer of

assets to your children by naming a trust for your spouse and your descendants as the beneficiary until the spouse's death, at which time your children (or other family members) become the beneficiaries.

### **Gift Tax Is Minimized**

The creation of a GRAT constitutes a gift to the ultimate beneficiaries for gift tax purposes, but the value of that gift is only the initial value of the trust assets reduced by the present value of the annuity you have retained. The calculation of the present value of your retained annuity is based, in part, upon the current interest rates promulgated by the IRS, commonly referred to as the "hurdle" rate (i.e., the applicable federal rate or AFR). In order for a GRAT to be successful, the assets used to fund the GRAT must appreciate faster than the IRS hurdle rate. At the current hurdle rate for June, 3.8%, it is easier to have a successful GRAT. Since interest rates are near historic lows, the potential tax savings are maximized.

The most popular use of this device in sophisticated estate plans has been the short-term, "zeroed-out" GRAT, in which the term is limited to two or three years and the annuity amount is maximized in order to produce as small a taxable gift as possible. In this way, anticipated short-term growth in the trust assets can be availed of without risking longer-term uncertainty, and the risk of depreciation is neutralized by virtually eliminating the gift tax cost. With this short-term GRAT, the gift to your children can be nearly "zeroed-out," thanks to a case involving a GRAT that was created by the family that founded Wal-Mart. In that case, the IRS challenged the ability to create a GRAT without incurring a substantial gift tax. The government lost the case and in 2003 acquiesced to the court decision.

Suppose you create a GRAT with \$5,000,000 to pay yourself an annuity of \$2,620,680 per year for two years. Applying June's IRS factors, the value of your retained interest is approximately \$4,999,991 and the taxable gift is only \$9. If the principal of the trust appreciates over the two-year period, so that, after receiving your annuity payments, there are assets remaining in the GRAT – whether one dollar or millions of dollars – your children will receive that amount at virtually no gift tax cost. If the value of the trust goes down, you will simply get back everything you put in, and you will have lost nothing. Distributions may be made in-kind so there is no need to sell any property in order to receive your annuity payments.

In a two-year zeroed-out GRAT, your children or other named beneficiaries will receive the remaining principal in the trust at the end of two years at no gift tax cost to you or them. Set forth below is a chart showing the advantages of creating a \$5,000,000 two-year GRAT if different rates of return are achieved over the two-year period. The chart shows that the annuity payments remain constant over the two-year term of the GRAT. The greater the growth rate, the greater the amount that is left to pass to your children free of gift tax at the end of two years.

### **No Extra Cost If You Die Prematurely**

If you die prior to the end of the annuity period, the annuity will continue to be paid to your estate and the value of the assets in the GRAT at your death will be included in your gross estate for estate tax purposes. Your estate will receive credit for any gift tax already paid, however. Thus, although you will have lost the tax advantage the GRAT was designed to achieve, your estate will be in the same position had you not created it.

### **Gift of Stock in a Closely-Held Business**

You may be able to achieve substantial benefits by transferring a closely-held business interest or depressed real estate, which you anticipate will increase in value, to your GRAT.

In fact, this may be the ideal estate planning device for such a transfer to your children, because you may be in a much better position to predict the future growth of your own business than that of other property.

Of particular appeal is the fact that the GRAT also removes the risk of undervaluing a closely-held business interest or real estate for gift tax purposes. With an outright gift, there is no way to guard against a substantial gift tax deficiency if the value of the property is increased by the Internal Revenue Service. But if instead the gift is the remainder interest in a “zeroed-out” GRAT, and if the annuity amount is expressed as a percentage of the initial value of the trust principal (rather than a dollar figure), any increase in the value of the business (or real estate) determined on an audit of the gift tax return would result almost entirely in an increase in the value of the retained interest and, in turn, in only a nominal gift tax increase.

In the previous example, if the IRS successfully asserts that the value of your company’s stock transferred to the trust is \$6,000,000 instead of \$5,000,000, because your annuity is defined as a percentage of the value of the stock, your annuity is now worth \$5,999,989 and the value of the resulting gift to your children, is \$11 instead of \$9.

### Income Tax Considerations

Since the GRAT is a “grantor trust” for income tax purposes, all of its income and deductions are included on your personal return, as if there had been no transfer at all, until the property passes to the ultimate beneficiaries of the GRAT. Therefore, the GRAT is generally income tax-neutral, meaning that your income taxes should be the same whether or not you create the GRAT. If you choose to keep the property in trust for your children (or your spouse and children) after the two-year GRAT period, the continuing trust or trusts also can be structured as grantor trusts so that you can continue to pay the income tax attributable to the trusts’ income each year until you choose otherwise. Your payment of the trust’s income tax essentially is an additional tax-free gift to your children.

### Summary

When properly structured, a GRAT can truly have a “heads you win, tails you break even” result. By adjusting the terms of your trust, you can nearly eliminate the gift tax associated with the transfer of property to your children.

Upon termination of the GRAT, all the appreciation on the assets in excess of the hurdle rate will pass to your children free of gift tax. But if the appreciation is not as expected, or if you do not survive the term of the trust, there are no adverse tax consequences.

Finally, in designing the manner in which the ultimate beneficiaries of the GRAT are to receive the trust assets at the end of the GRAT period, you may choose among many options available to achieve the result most consistent with your family and financial objectives.

| Year           | Beginning Principal | 10.00% Growth    | Annual Payment     | Remainder                                 |
|----------------|---------------------|------------------|--------------------|---|
| 1              | \$5,000,000         | \$500,000        | \$2,643,400        | \$2,856,600                               |
| 2              | \$2,856,600         | \$285,660        | \$2,643,400        | \$498,860                                 |
| <b>Summary</b> | <b>\$5,000,000</b>  | <b>\$785,660</b> | <b>\$5,286,800</b> | <b>\$498,860 to pass free of gift tax</b> |

| Year           | Beginning Principal | 20.00% Growth      | Annual Payment     | Remainder                                   |
|----------------|---------------------|--------------------|--------------------|---|
| 1              | \$5,000,000         | \$1,000,000        | \$2,643,400        | \$3,356,600                                 |
| 2              | \$3,356,600         | \$671,320          | \$2,643,400        | \$1,384,520                                 |
| <b>Summary</b> | <b>\$5,000,000</b>  | <b>\$1,671,320</b> | <b>\$5,286,800</b> | <b>\$1,384,520 to pass free of gift tax</b> |

| Year           | Beginning Principal | 30.00% Growth      | Annual Payment     | Remainder                                   |
|----------------|---------------------|--------------------|--------------------|---|
| 1              | \$5,000,000         | \$1,500,000        | \$2,643,400        | \$3,856,600                                 |
| 2              | \$3,856,600         | \$1,156,980        | \$2,643,400        | \$2,370,180                                 |
| <b>Summary</b> | <b>\$5,000,000</b>  | <b>\$2,656,980</b> | <b>\$5,286,800</b> | <b>\$2,370,180 to pass free of gift tax</b> |

### **Intra-family Loans: A Simple Yet Effective Estate Planning Tool**

An intra-family loan is a basic estate-planning technique which has a very low transaction cost. Under rules set forth in the Internal Revenue Code, it is possible to make loans to family members at lower rates than those charged by commercial lenders without it being deemed a gift. As discussed below, the lender, usually a parent or grandparent, must charge interest in order to avoid making a gift to the borrower but this interest rate may be as low as 3.20% for a loan for a term of three to nine years, with interest paid annually, made in June 2008. The lender can also structure the loan as a balloon note meaning that the borrower pays interest only during the course of the loan and only repays the principal at the end of the term.

#### **Economic Benefits of Intra-family Loans**

If a parent makes an interest-free loan to a child or grandchild, the Internal Revenue Service will treat the foregone interest as a taxable gift. In order to prevent the IRS from treating a part of the loan itself as a gift, the parent must charge a certain minimum interest, which is known as the applicable federal rate (“AFR”), which the Treasury determines every month. To the extent that the interest charged on the loan is lower than the interest calculated with the AFR, that amount will be imputed income to the parent, even though the parent does not actually collect it. Furthermore, the IRS will treat that amount as a gift to the child, which would require the filing of a gift tax return. However, if a parent establishes a bona fide creditor-debtor relationship with adequate stated interest, the intra-family loan will not be characterized as a transfer subject to the gift tax.

Intra-family loans create an opportunity to shift wealth from one family member to another family member, usually a child or grandchild, if that child or grandchild can earn a greater return on the amount borrowed than the AFR. The minimum interest rate required to be used depends on the period of time of the loan, and the current AFR are very low. In June 2008, if interest is paid annually on a loan, the AFR for short-term loans (demand loans and loans for up to three years) is 2.08%. The AFR for mid-term loans (loans from 3-9 years) is 3.20%, and the long-term AFR rate for loans over 9 years is 4.46%. To the extent that a child or grandchild is able to earn a higher rate of return on the borrowed funds than the interest rate being paid, he or she is able to keep the excess without any gift taxes being paid.

For example, if a parent makes a nine-year loan to a child of \$2 million, the loan will be a successful estate planning tool if the child can earn over 3.20% with the money borrowed. If

the child invests the \$2 million for the nine years at an 8% annual rate of return, he or she will have about \$3,998,008 at the end of the loan, and will only have to repay his or her parents \$2,655,507 throughout the course of the loan. Therefore, the child is entitled to keep the difference of about \$1,340,000 without any gift tax consequences. If the parent was going to make the same investment that the child made anyway, the risk to the family as a whole has not changed and the loan was a successful way to transfer wealth to the next generation.

### **Other Benefits**

Outside of a wealth transfer concept, intra-family loans may also be more beneficial than third party loans because they allow the total interest expense paid over the course of the loan to stay within the family rather than being paid to a bank. In addition, an intra-family loan can allow children who have poor credit history to buy a home or to start a new business. Furthermore, it allows families to avoid the normal expenses incurred with loans, such as administrative costs, closing costs and appraisal fees. Also, if a child wants to pay off the loan early, the terms of the loan can be structured so that there are no prepayment penalties.

The amount of savings for children who are looking to buy a house can be significant. For example, according to Freddie Mac, the average bank rate for a 30 year fixed mortgage rate is currently 6.01%. A \$500,000 mortgage at 6.01% would require one to pay \$3,000.97 a month. However, a mortgage at the long-term AFR for June 2008 (4.46%) would only require one to pay \$2,521.56 per month. Therefore, a child would save about \$480 per month and about \$5,760 per year if a parent loans them money to buy a home.

### **Additional Tax Benefits**

The IRS allows any individual to make a gift to another person free of the gift tax each year up to the amount of the annual exclusion, which is currently \$12,000. In addition to the annual exclusion, every person is allowed a \$1,000,000 lifetime exemption from the gift tax. Therefore, even if an individual gives more than \$12,000 to a single person in a given year, the gift amount which is above \$12,000 will not be subject to tax unless the individual has already given \$1,000,000 in taxable gifts throughout his or her life.

Because intra-family loans are not gifts, they do not count towards an individual's lifetime gift tax exemption. Therefore, even if an individual has used up all of his or her \$1,000,000 lifetime exemption from the gift tax, he or she can still make a loan to a family member without paying gift tax. Furthermore, a grandparent can make a loan to a grandchild without being subject to the generation-skipping transfer tax.

In addition, an intra-family loan can be used to take advantage of the \$12,000 annual exclusion. A parent can forgive up to \$12,000 per year per family member (and up to \$24,000 if a married couple splits the gift or makes his or her own gift) without any adverse gift tax consequences. However, the parent will have interest income in any year in which interest is forgiven.

### **Conclusion**

An intra-family loan can be used as a simple and effective wealth transfer device. Such a loan is a successful estate planning tool if a family member earns a higher return on the money borrowed than the AFR, thus today's low AFR presents an opportunity to lock in a low interest rate on an intra-family loan.

## **Charitable Lead Trusts Can Save Transfer Taxes**

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A charitable lead trust (CLT) pays an annuity to one or more charities of your choice for a specified number of years or for the life of an individual. At the end of the term, the remaining assets in the trust (and any appreciation thereon) pass to one or more non-charitable beneficiaries, such as your children or other family members. The IRS anticipates that the property transferred to a CLT will grow at a rate equal to the prevailing interest rate dictated by the IRS when the trust is established. If the trust generates higher total returns over its term, the excess growth will pass to your family free of gift tax.

CLTs can be structured so that the gift tax on the remainder interest passing to family members will be small or even non-existent. The effectiveness of a CLT is determined in part by the interest rates that prevail at the time the trust is created. These trusts are particularly attractive right now because low interest rates increase the value of the charitable annuity, producing a greater tax deduction and reducing the gift tax on amounts passing to your family at the end of the CLT. Moreover, when markets are depressed, the potential for appreciation is that much greater.

### **Technical Rules Must Be Followed to Ensure Tax Deduction**

An individual is deemed to make a charitable gift when he or she establishes a CLT. There are certain requirements under the Internal Revenue Code which must be met in order to qualify the charitable interest as deductible for estate and gift tax purposes. The interest must be either a “guaranteed” annuity with a fixed and determined annual payout based on the initial market value of the CLT, or a “unitrust” interest, in which the percentage is fixed, but is applied to the annually-revalued assets in the trust.

For example, if a transfer of \$1,000,000 is made to a charitable lead annuity trust with a 5 percent payout to charity, \$50,000 will be paid to charity each year of the trust. In the case of a charitable lead unitrust, if the payout rate is 5 percent and the trust property increases to \$2,000,000 in a subsequent year, the annual payment to charity for that year will increase to \$100,000.

A CLT created during your lifetime can be set up to produce tax benefits in the form of either a substantial income tax deduction in the year the trust is funded (for the present value of the charitable payments) or the exclusion of the trust’s taxable income from your personal income tax return each year. If you choose the immediate income tax deduction, in each year of the trust term, you must report the trust’s income on your tax return even though it is paid to charity. This option may be appropriate if you have an unusually large amount of income in a particular year so that the charitable deduction when the trust is established will more than offset the future income taxes on the trust income.

### **Trust Terms Can Be Tailored to Suit Your Needs**

The amount of the charitable deduction is based on the size of the payments to charity, the length of the charitable term of the trust and the rate prescribed by the IRS to calculate the present value of the charitable payments (i.e., the applicable federal rate, or AFR). The AFR changes monthly depending upon market interest rates and is presently near historic lows. If the payments to charity and the charitable term are structured to provide a tax deduction equal to the full amount transferred to the CLT, any growth of the trust assets in excess of the AFR will pass to the non-charitable remainder beneficiaries (e.g., your family) free of gift tax. Given that the AFR for June 2008 is only 3.8 percent, the potential exists for significant tax-free wealth transfers. (As a comparison, the AFR for June 2000 was 7.9 percent.)

Set forth below is a chart demonstrating the benefits of creating a charitable lead annuity trust in June 2008. The chart shows how much will pass tax-free to your family depending on the length of the charitable term and the rate of return achieved by the trust. In this scenario, \$5,000,000 is transferred to a charitable lead annuity trust, which is structured to produce as small a taxable gift to the remainder beneficiaries as possible. The higher the rate of return, the more property remains to pass to your family free of gift tax at the end of the charitable term.

**Amounts Passing To Beneficiaries Free Of Gift Tax At The End Of The Charitable Term (Assuming Various Growth Rates)**

| Charitable Term | Beginning Principal | Annual Payment to Charity | 5.00% Growth | 7.50% Growth | 10.00% Growth | 15.00% Growth |
|-----------------|---------------------|---------------------------|--------------|--------------|---------------|---------------|
| 10 Years        | \$5,000,000         | \$592,000                 | \$696,468    | \$1,927,953  | \$3,531,359   | \$8,204,932   |
| 20 Years        | \$5,000,000         | \$342,322                 | \$1,947,261  | \$6,415,077  | \$14,030,964  | \$46,763,918  |
| 30 Years        | \$5,000,000         | \$261,734                 | \$4,220,346  | \$16,711,543 | \$44,193,184  | \$217,270,881 |

**Tax Advantages of Charitable Lead Trusts**

The tax benefit of a CLT is that it can reduce the amount subject to gift or estate tax to a significantly smaller amount than the value of the property ultimately transferred to the family beneficiaries. Furthermore, any future appreciation in the trust principal inures to the benefit of the family remaindermen, and that enhancement is not taxed in your estate upon your death.

CLTs can be created during your lifetime (an “inter vivos” trust) or under your will or revocable trust (a “testamentary” trust). A testamentary lead trust is included in your estate at the date of death value of its assets but the estate receives a deduction for the value of the interest passing to charity, determined as described above. The same principles apply with respect to gift tax if the trust is created during your life, but no gift tax is actually payable if a portion of your unified credit is still available (i.e., generally if you have not already made taxable gifts in excess of \$1,000,000).

The opportunity for significant estate and gift tax savings which the CLT presents should not be overlooked if you have the desire to benefit a favorite charity (including your own family foundation) and the willingness to delay for a number of years the receipt by your family of property transferred to the trust. If you are already making significant annual gifts to charity, a CLT may provide a more tax-efficient way to make such gifts. Your Personal Planning advisor can project the tax savings for you and help you choose among the many options available to achieve the result most consistent with your charitable and financial goals.

**Other Estate Planning Techniques That Work Best In A Low Interest Rate Environment**

In future issues of *Personal Planning Strategies* we intend to discuss sales to defective grantor trusts (assets are sold to this trust free of income and gift taxes and future appreciation passes to the beneficiaries of the trust), private annuities (an arrangement whereby property is transferred to another individual in exchange for the transferee’s unsecured promise to make periodic payments back to you) and self-cancelling installment notes (“SCIN” – a sale where the purchase price is payable over a number of years with a cancellation provision at your death). Please contact us if you would like detailed information concerning these strategies.

## **Personal Planning Newsletter**

**Editor: Henry J. Leibowitz**

**Contributors: Laura B. Greenberg, Robert Jacobowitz and David J. Posner.**

Proskauer's Personal Planning Department includes lawyers with significant and diverse personal planning experiences. The following individuals serve as contact persons and would welcome any questions you might have.

### **Boca Raton**

**Elaine M. Bucher**

561.995.4768 — ebucher@proskauer.com

**Albert W. Gortz**

561.995.4700 — agortz@proskauer.com

**George D. Karibjanian**

561.995.4780 — gkaribjanian@proskauer.com

**David Pratt**

561.995.4777 — dpratt@proskauer.com

### **New York**

**Henry J. Leibowitz**

212.969.3602 — hleibowitz@proskauer.com

**Lawrence J. Rothenberg**

212.969.3615 — lrothenberg@proskauer.com

**Philip M. Susswein**

212.969.3625 — psusswein@proskauer.com

**Ivan Taback**

212.969.3662 — itaback@proskauer.com

**Jay D. Waxenberg**

212.969.3606 — jwaxenberg@proskauer.com

### **Los Angeles**

**Mitchell M. Gaswirth**

310.284.5693 — mgaswirth@proskauer.com

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