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THE SILVER LINING: FALLING ASSET VALUES AND DECLINING INTEREST RATES CAN CREATE GIFT AND ESTATE TAX WINDFALLS

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While the current bear market has crippled many portfolios and frightened many investors, there is a silver lining to the recent economic woes. Depressed asset values, illiquid markets, and historically low interest rates present opportunities for you to transfer assets to junior generations. If you have investments you believe are likely to appreciate, you may be able to make use of a variety of wealth transfer techniques that will significantly reduce or eliminate your family's estate, gift, and generation-skipping transfer ("GST") taxes. Especially given the likelihood of federal tax changes with an incoming administration — regardless of which presidential candidate prevails in November — it may be especially important to act now.

A SIMPLE TECHNIQUE: BELOW-MARKET LOANS TO FAMILY MEMBERS

If your goal is to provide liquidity to children or other family members without making gifts, you can simply make a loan at a minimum, IRS-sanctioned interest rate. For example, in

November, 2008 you can lend an unlimited amount of money to your child at a rate of just over 1.6%. Your child can use the proceeds for anything — starting a new business venture, purchasing or improving a home, making opportunistic investments, paying down higher-cost debt. For loans of more than three years and up to nine years, the current rates are in the high 2% range; for loans with terms longer than nine years, the current rates are in the low 4% range — in each case a bargain compared to bank loans and without the need for stellar credit history or even collateral.

A MORE COMPLEX BUT POTENTIALLY MORE POWERFUL TECHNIQUE: THE GRANTOR RETAINED ANNUITY TRUST ("GRAT")

You establish a GRAT by gifting an asset and retaining the right to receive a fixed dollar amount, in cash or in other assets, each year during a set term of years (the "GRAT Term"). The annual payment is based on the value of the contributed asset on the contribution date. Typically, the payment is structured so that you receive the original value plus a modest rate of return (fixed by the IRS; the November rate for this purpose is 3.6%). Essentially, the GRAT is a bet

that the contributed asset's value will grow by more than the IRS return rate. If you win the bet, your family receives the excess growth tax-free. If you lose the bet (e.g., the asset's value stagnates or declines during the GRAT term), your economic result is essentially the same as if you had not created the GRAT (i.e., the GRAT simply returns the asset to you). Thus, when both the asset value and the interest rate are low, the likelihood of the bet's success is high. For example:

You have a large block of publicly traded stock that is trading at an historic low. Despite the market's downturn, you have no intention of selling the stock. (Perhaps the stock has been in your family for generations, or maybe you simply have a strong belief that the market will come back in the next several years.)

You transfer the stock to a GRAT in November 2008, which provides for annuity distributions back to you each year for a three-year

GRAT term. If the stock is worth \$1,000,000 at the time the GRAT is funded, you will receive annuity payments of just under \$358,000 each year during the three-year GRAT term. Using the 3.6% interest rate, the present value of the annuity stream is virtually equal to the \$1,000,000 contribution value. Thus, the taxable gift to your family is valued at less than \$1.

As you predicted, the market turns around and the value of the stock grows by an average of 10% each year after the GRAT is established. At the end of the third year, over \$147,000 remains in the GRAT for distribution to your children — without any gift or estate tax. Your children receive all of the incremental growth above the IRS's assumed interest rate. Thus, if the stock grows by an average of 15% each year during the three-year GRAT term, your children will receive over \$279,000 for every \$1,000,000 contributed — again, free of gift and estate taxes.

The GRAT's potential benefit increases as the funding level increases. If you were to fund the GRAT in this example with \$10,000,000, the tax-free amount passing to your family would be about \$1,470,000 (with a 10 percent investment return) or about \$2,790,000 (with a 15 percent investment return), while the taxable gift remains less than \$1.

This technique can be repeated over and over again, rolling each year's annuity payment into another GRAT, multiplying the tax savings by moving additional

appreciation out of your taxable estate each year or at least strategically capturing appreciation following dips in market values. You also may consider using a longer term GRAT, locking in the low interest rate.

A GRAT can be even more effective for interests in closely held businesses. For example, let's assume that under current market conditions and after taking into account applicable discounts, the value of your equity in an operating business is \$1,000,000. Let's assume further that you contribute that interest to a GRAT and that during the GRAT term, the company's prospects improve to the point where the entire company is sold. If the GRAT's share of the (undiscounted) proceeds is \$5,000,000, almost \$4,000,000 will pass to your children free of gift and estate tax.

In addition to marketable securities and business interests, almost any type of asset with appreciation potential can be a candidate for a GRAT, including, for example, real property, precious metals and artwork. A key element in designing a GRAT is selecting the appropriate GRAT Term. Factors to consider in making that decision include the anticipated timing of appreciation in the GRAT assets, the GRAT's liquidity (that is, the ability to fund annual payments without "giving back" growth to you) and your life expectancy (since GRATs produce tax savings only if you survive the GRAT term).

CONSIDER SELLING ASSETS TO SPECIALLY DESIGNED TRUSTS

Another planning option available to exploit today's low interest rate environment and depressed asset

values is a sale to a grantor trust. As in the case of a GRAT, the goal of this planning approach is to transfer asset value growth from your taxable estate to trusts or the benefit of your family at a minimal or zero gift tax cost.

To exploit this technique, you can create a new trust or use an existing trust. Suppose you wish to transfer an asset with a current fair market value of \$9,000,000. The trust will purchase that asset from you for a \$9,000,000 note, so that there is no gift for tax purposes. The note, representing a loan from you to the trust, uses the lowest permitted interest rate for intrafamily loans. For a loan made in November 2008, the minimum rate for a loan of more than three and up to nine years is just under 3%. The note may be structured so that the entire principal is due at the end of the loan term, although the trust must pay interest annually.

To support the tax treatment of the note as debt rather than as a retained equity stake in the trust, it is essential that the trust have sufficient "seed capital" from which it can service the debt. Typically, the trust should have seed capital equal to at least one-ninth of the debt balance owing to its grantor (or related parties) — i.e., \$1,000,000 in the case of a \$9,000,000 installment sale. If you are using a new trust, you will need to make a taxable gift of the \$1,000,000; however, your lifetime gift exemption may be sufficient to shelter that gift from gift tax.

The trust will be structured as a grantor trust, so that you and the trust are deemed to be the same taxpayer for income tax purposes. Thus, under current law, you will not recognize any

capital gain on the sale of the assets to the trust. Moreover, the interest you receive from the trust under the note is deemed an amount paid to yourself, so that you are not taxed on that interest. (Note, however, that the trust maintains your tax basis in the purchased asset, so that if the trust sells the asset, any capital gain will be taxed to you as the trust's grantor.)

To supercharge this sale technique, the trust can be structured as a "dynasty trust." Under such a trust, assets not needed by a child can pass to grandchildren and successive generations completely free of gift, estate, and GST tax. Although you will need to use some or all of your GST exemption (\$2,000,000 for 2008, scheduled to increase to \$3,500,000 for 2009) to shelter the initial gift to the trust, the installment sale technique allows you to transfer more value to the trust without further use of that exemption. Over a long time horizon, the tax savings can be astronomical.

MORE WORTHWHILE THAN EVER: ANNUAL EXCLUSION GIFTING

In addition to the more sophisticated strategies discussed above, the recent market downturn can provide a benefit for basic annual exclusion gifting. You can transfer up to \$12,000 in 2008 (and up to \$13,000

in 2009) to any other individual without incurring any gift tax and without the need to use any portion of your \$1,000,000 lifetime gift tax exemption. If you are married, you and your spouse together may give a total of \$24,000 to each donee in 2008 and \$26,000 in 2009. Taking maximum advantage of the annual exclusion by making gifts to your children, their spouses, and your grandchildren (or any other individuals) has always been a worthwhile "core" gifting strategy, since it helps to reduce your taxable estate in a tax-free manner. You also can exploit the annual exclusion through certain types of trusts, which may be preferable if your goal is to defer your family's enjoyment of the gifted asset. The recent decline in the market value of securities presents an opportunity to leverage an annual exclusion gifting program by permitting you to gift low-value securities instead of cash, thereby transferring any future value rebound in those securities to your descendants. Care should be taken in undertaking an annual exclusion gifting program to ensure that these gifts are coordinated with other wealth transfer techniques that you may already have in place.

The gifting strategies discussed above vary in complexity; the decision about which strategy or strategies to employ depends upon your goals and your family's particular circumstances. It is important to gain a full understanding of the various options available to you before embarking on a gifting program. We encourage you to reach out to any of the following Lowenstein Sandler attorneys to explore available strategies and design a gifting program tailored to you:

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