

ADVANCED SOLUTIONS FOR TRANSFERRING WEALTH WHEN INTEREST RATES ARE LOW: GRANTOR-RETAINED ANNUITY TRUSTS AND CHARITABLE LEAD ANNUITY TRUSTS

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For those desiring to transfer wealth with minimal gift and estate tax, now may be the ideal time. The current low interest rate environment creates a unique opportunity for two planning techniques, Grantor-Retained Annuity Trusts ("GRATs") and Charitable Lead Annuity Trusts ("CLATs"), which become more effective in terms of increased benefits when interest rates are low. In each technique, there are two components: (1) the value of the stream of income that is either retained by the taxpayer or gifted to charity, and (2) the value of the remainder interest in trust, which is treated as a gift and subject to gift tax. The value of the remainder interest, or gift, is the excess of the current value of the property transferred to trust over the present value of the stream of income. When interest rates are low, the value of the income stream is relatively high and the value of the remainder interest is relatively low, resulting in a low transfer (gift) tax to transfer the remainder interest to family members.

These values are determined by applying the interest rate provided by Internal Revenue Code Section 7520 ("7520 rate"), which is based on current market interest rates. As of November, 2003, the 7520 rate was 4%. As noted, a low 7520 rate translates into a high present value for the annuity payments and thus a smaller taxable gift. Planning opportunities exist because the gift amount is calculated based on what the IRS assumes the remainder beneficiaries will receive (based on current market conditions) by valuing what the annuity is worth under the 7520 tables, and not what the beneficiaries actually receive at the termination of the GRAT or CLAT.

GRAT - Nontaxable Gifts to Family

Today many assets, including equities, venture capital funds, and property subject to valuation discounts such as closely held business interests or limited partnership interests may be at very low valuations for various reasons. Undervalued assets that are expected to appreciate significantly provide an even greater opportunity for wealth transfer at low transfer tax rates through the use of these techniques.

Operation of GRAT. With this estate planning technique, an individual, (the "Grantor") establishes an irrevocable trust for a specified number of years. (An irrevocable trust is one that cannot be terminated or amended by the grantor once it is created.) The Grantor transfers assets - ideally those expected to appreciate substantially - to the trust, which is to last for a specified number of years, but it also terminates on the earlier death of the Grantor. In return, the Grantor retains the right to receive an annuity payment at the end of each year of the trust's existence. The assets transferred to the GRAT may consist of cash, stocks, mutual funds, real estate, or other investment and income producing property. Non-cash property may be used to make the annual annuity payment. The payment may be level or graduated, although increases cannot exceed 120% of the prior year's payment. The payment can be specified in dollar terms, or as a percentage of the assets held in trust. At the end of the trust term, the assets remaining in the GRAT are passed on to the remainder beneficiaries of the trust (i.e., the Grantor's heirs) without gift tax, and they are not included in the Grantor's taxable estate.

Reduced Transfer taxes. The transfer of assets to a GRAT is a taxable gift at the time the trust is established. The amount of the taxable gift (the amount the IRS assumes will ultimately pass to the beneficiaries) is the excess of the fair market value of the assets contributed to the GRAT over the present value of the annual annuity payments that the Grantor will receive over the term of the trust. When forming a GRAT, the Grantor should typically select the combination of annuity amount and trust term that, when applying the existing 7520 rate, will result in the present value of the annuity payments exactly equaling the amount contributed to trust. Under that scenario, the IRS assumes that the GRAT will have zero assets left to pass to the beneficiaries upon its

termination. Therefore, there is no gift tax upon forming the GRAT. However, to the extent the assets of the GRAT actually produce a return in excess of the 7520 rate (in effect at trust formation), the additional value is transferred to the Grantor's beneficiaries when the GRAT terminates, free of gift tax. When the value of the assets transferred to the GRAT is already discounted at the time of transfer, the likelihood of appreciation during the GRAT term enhances the value of this technique. The value of the technique is thus a function of (1) the earnings of the assets, and (2) the appreciation of the assets, exceeding the 7520 rate over the term of the GRAT.

Example. Assume father transfers property valued at \$5 million into a GRAT with a term of two years. At the end of the trust period, any remaining assets will be paid to daughter. According to the trust agreement, an annuity payment of 53%, or \$2,650,972, will be paid to father at the end of each of the two years. Assume that the rate of return on the trust assets will be 10% annually, and the 7520 rate in effect at the trust's inception is 4%.

The present value of the annuity payments to father is \$4,999,999.23, based on the 7520 rate. Subtracting this present value from the market value of the trust's assets (\$5 million) leaves a taxable gift valued at 77 cents, so the gift tax liability will effectively be zero. At a 10% rate of return, the assets will generate \$482,958 that will pass tax-free to daughter at the end of the trust period. Since the annuity payments may be made with trust assets, father, at the end of the trust term, will have recouped the assets used to establish the trust.

In sum, a GRAT is an effective strategy for transferring wealth where the assets of the trust can be expected to outperform the applicable 7520 rate. In this low interest rate environment, now may be the time to consider using a GRAT, particularly if the assets to be transferred are undervalued and expected to significantly appreciate (e.g., depressed stock or discounted minority interests in family businesses).

Tax Risks. If the Grantor does not survive the trust period, the trust assets will be considered part of the Grantor's taxable estate subject to estate taxes. However, the estate will not bear any additional tax liability, and, if the Grantor paid no gift tax when the GRAT was set up, the Grantor's estate is no worse off in terms of taxes than if the GRAT had never been created at all.

Another risk is that the trust assets will not generate a return in excess of the 7520 rate, resulting in the annuity payments exhausting the assets of the GRAT. With no assets to pass on to the beneficiaries, the Grantor will fail to realize any transfer tax value from the trust. In terms of total transfer taxes, however, the Grantor will be no worse off than if he had not established the GRAT in the first place.

CLAT - Nontaxable Gifts to Charity and Family

For those philanthropic individuals desiring to make charitable contributions and to transfer wealth to family members, a CLAT may be a suitable device for simultaneously accomplishing both objectives. A CLAT is a trust that is administered for the benefit of a charity for a set term and then for the benefit of one or more individuals, usually family members, selected by the donor. Properly structured under the right circumstances, a CLAT allows the donor to transfer assets to a charity and to family and friends without any gift or estate tax consequences. It should be noted, however, that in most circumstances a CLAT will not provide the donor with any current charitable deduction for income tax purposes (although it could be structured to do so under the appropriate circumstances).

Operation of CLAT. In this estate planning strategy, an individual ("the Donor") establishes a trust for a specified number of years and funds the trust with cash or other assets. Under the terms of the trust, one or more charities designated by the Donor receive a specified amount from the trust each year. At the expiration of the charitable term, the remaining assets of the trust are distributed to, or held in further trust for, the remainder beneficiaries free of gift tax. The assets

are not included in the Donor's estate.

Reduced transfer taxes. Similar to a GRAT, the funding of a CLAT is treated as a taxable gift to the remainder beneficiaries. Again, the taxable gift amount is the excess of the fair market value of the assets transferred to the trust and the present value of the total distributions (annuity payments) to charity. As in the case of the GRAT, the value of the annuity is determined with reference to the 7520 rate and is a function of the amount of the annuity payments and their duration. Gift tax can be avoided entirely where the present value of the charitable distributions (annuity) exactly equals the market value of assets contributed to trust. In such case, the IRS assumes there will be no remainder interest passing to the non-charity beneficiaries. However, to the extent that the assets of the CLAT outperform the 7520 rate, whether through current earnings, appreciation, or both, at the end of the term of the annuity, the CLAT will have assets remaining to transfer to the remainder beneficiaries free of transfer tax.

Example. Assume father desires to make annual gifts of \$100,000 to his favorite charity and simultaneously reduce the transfer tax costs of gifts to son. Father transfers \$803,074 to a CLAT the terms of which require the trustee to make 10 annual \$100,000 payments to the charity and then to pay the remaining principal to son. Assume that the rate of return on the trust assets will be 12% annually, and the 7520 rate in effect at the trust's inception is 4.2%.

The present value of the 10 annuity payments to charity is \$803,074, based on the 7520 rate. Subtracting this present value from the market value of the trust's assets (also \$803,074) leaves a taxable gift of zero. At the end of the 10-year trust term, after making its last payment to charity, the trust will have property worth \$739,352, all of which will pass to son free of gift tax.

Risks. Unlike a GRAT, even if the Donor does not survive the trust period, the trust assets will NOT be considered part of the Donor's taxable estate subject to estate taxes. Thus, the main tax risk when using a CLAT arises when the return on the contributed property does not outperform the 7520 rate in effect at inception.

Conclusion

In the present environment with historically low interest rates, a GRAT may be the most viable strategy for shifting the maximum amount of future income and appreciation to another individual free of gift and estate taxes. A CLAT offers the same potential benefit to individuals who are interested in making gifts to charity.

In either case, however, the actual results will depend on the 7520 rate in effect when the trust is established and, more importantly, the investment performance (appreciation and earnings) of the assets held in trust. Indeed, for either of these techniques to produce the intended benefits, it is necessary that the assets of the trust have an overall rate of return in excess of the 7520 rate.