

GlobalNote®

To: Our Clients and Friends April 7, 2008
Re: Increased Estate Planning Opportunities in Current Low Interest Environment.¹

This memo describes an estate planning opportunity that has become even more attractive as a result of the lower interest rates that exist today. It may be of interest to you.

Overview

Grantor retained annuity trusts (known as “GRATs”) and certain other estate planning devices utilize and exploit the typically low interest rate assumptions the Internal Revenue Service (“Service”) requires that we use in valuing certain gifts. This rate, determined under Internal Revenue Code Section 7520 and known as the “7520 rate,” is historically low. It was 3.6% for March transfers and has dropped to 3.4% for transfers during April. The Service determines the 7520 rate monthly, based on the average market yield of outstanding Treasury obligations with remaining periods to maturity of 3 to 9 years. The 7520 rate is generally much lower than the rate at which an individual’s investment portfolio appreciates, and in fact is often very low in comparison with the return on assets that have potential for dramatically greater appreciation. A prime example would be a start-up venture with little value initially but huge potential for appreciation.

By utilizing a GRAT with the right assets, it is possible to transfer substantial wealth to the next generation at very little or no gift tax cost. Even in those cases where an asset is not expected to experience a huge upswing in value, a successful GRAT will cause all appreciation above the 7520 rate to be transferred to the next generation free of gift and estate taxes.

What is a GRAT?

A GRAT is a trust that pays the creator, also referred to as the grantor or the donor, a defined annuity amount each year for a certain number of years, known as the “term” of the trust. The annuity amount is a percentage of the initial fair market value of the property transferred to the trust. It may be the same in each year of the trust term, or may increase each year by up to 20% of the previous year’s annuity amount. The trust must make a payment in each year of the term, and may not borrow from the donor if it has insufficient assets. It can borrow from third parties or may return to the donor a portion of the transferred property in satisfaction of the annuity amount.

At the end of the term, if the donor is alive, the property remaining in the trust passes to the remainder beneficiaries. Many donors provide that the balance remaining in the GRAT after all

¹ Note that this Memorandum is for educational purposes only, may constitute “attorney advertising” in some jurisdictions and is not to be construed as giving legal advice in any jurisdiction.

annuity amounts have been paid will be transferred to a separate trust for the benefit of the donor's family, typically spouse and descendants or just descendants. Once the GRAT has terminated, the property transferred from the GRAT to the second trust would not thereafter be subject to gift or estate tax in the donor's estate.

If the donor dies during the term of the GRAT, the property will be includible in the donor's gross estate for federal estate tax purposes.² The result is essentially the same as if the trust had never been created, and the only cost would be the expenses incurred in establishing the trust. There is no other disadvantage.

A GRAT is generally a grantor trust for *income tax purposes*, meaning that all income earned on trust property is taxable to the donor in the same manner as if the trust had never been established. It is often recommended that the property that is paid to the "family trust" at the conclusion of the GRAT term also be a grantor trust. This enables the grantor to be taxable on income that belongs to the trust, insuring that the trust's assets are not depleted by the amount of the income tax.

Gift tax exposure: Minimal

A GRAT is generally structured to virtually "zero-out" the gift. This is because the value of the donor's retained annuity interest is calculated to equal almost 100% of the value of the property transferred; as a result the taxable gift reported on a gift tax return is very small. For example, assume an individual transfers property to a GRAT (such as an interest in a new entity) with a value of \$1 million on the transfer date, retaining an annuity that is worth 99.9% of its initial value. The transferor is required to report a taxable gift of only \$1000. If the transferor has not used his entire \$1 million federal gift tax exemption, no federal gift tax would be due. Obviously this is quite a favorable result, especially if the asset appreciates in the GRAT and assuming the transferor outlives the term.

In addition, by defining the annuity by means of a formula, even if the Service asserts that the transferred property had a substantially higher value than what was reported, the taxable gift could never (in this example) exceed 0.1 % of the transferred property's value. For example, assume that the Service challenges the transferor's valuation and successfully assigns a \$10 million value to the interest in the property transferred to the GRAT. The valuation adjustment would be \$9 million but the reportable gift would be adjusted from \$1,000 to only \$10,000. Since the gift percentage stays the same - 0.1% in the example –there is a great deal of "protective" leeway. Of course, the annuity payments going back to the grantor must be adjusted upwards, which diminishes the amount of property that is likely to remain in the trust after all annuity payments are made. Note, however, that any original property returned to the grantor in satisfaction of an annuity payment can itself be used to establish a new, separate GRAT. Lastly, there is no limit on the number of GRATs one may establish.

² If the donor died a resident of a state that has an estate tax like the federal estate tax, similar consequences would follow on the state level. State estate tax consequences should not be ignored, however.

Low interest means GRATs are more desirable then ever

Traditionally, GRATs have been a useful way to make gifts, especially with hard to value assets and with assets that have good appreciation potential. When, as now, the 7520 rate falls, GRATs become even more attractive because the spread between the 7520 rate and the actual appreciation rate increases, often dramatically. In addition, a lower 7520 rate will cause the annuity that must be paid to the donor each year to be smaller. Especially with transfers of large initial value, lower rates may make it easier for the trustee of the GRAT to pay the donor without borrowing and without returning any of the transferred assets to the donor.

The following tables illustrate the differences in payments and wealth shifted to the next generation when the donor transfers property valued at \$1,000,000 to a 3-year GRAT when the 7520 rate is alternatively 3.6% and 6.0%. In each case, the annuity increases 20% per year, and its value for transfer tax purposes will equal approximately 99.9% of the initial value of the property transferred, or approximately \$999,000. ***The donor's taxable gift in each case will equal 0.1%, or \$1,000.*** The transferred property appreciates³ at the rates indicated. Greater overall appreciation will result in the transfer of more wealth at the end of the GRAT term.

Table I –3.6% 7520 rate

Year 1	\$ 295,700.00
Year 2	\$ 354,840.00
Year 3	\$ 425,808.00
Amount transferred to next generation with 15% appreciation	\$ 295,937.75
Amount transferred to next generation with 35% appreciation	\$1,016,619.75

³ This includes both cash that may be distributed to the GRAT from the transferred interest, as well as unrealized appreciation. As noted above, if there is insufficient liquidity to pay the annuity, it will be necessary for the trust to borrow or to distribute a portion of the property the donor transferred to the GRAT.

Table II –6.0% 7520 rate

Year 1	\$ 307,400.00
Year 2	\$ 368,880.00
Year 3	\$ 442,656.00
Amount transferred to next generation with 15% appreciation	\$ 247,470.50
Amount transferred to next generation with 35% appreciation	\$ 959,494.50

Should you create a GRAT now?

Every situation is unique and needs to be understood before giving legal advice but the current low rates make this an excellent time to create a GRAT. If you may be interested in establishing a GRAT or if you would like to discuss other planning vehicles, please contact the partner with whom you work or any partner in the firm. Feel free to call 212.508.6700 or consult our website: www.thshlaw.com

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