

Estate Planning Opportunities Resulting from Today's Low Rates and Discounted Values

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The current economic environment provides an excellent opportunity to transfer assets at historically low interest rates, removing future appreciation from your estate. The low rates coupled with discounted asset values have created opportunities to maximize estate tax savings. Strategies such as grantor retained annuity trusts (GRATs), installment sales to an intentional grantor trust (IGT) and intra-family loans are some of the ways to capitalize on the low rates and depressed asset values.

Each month the IRS issues the Applicable Federal Rates (AFRs), which are a group of interest rates used for various purposes including the calculation of the minimum interest to be charged on certain loans, and for calculating the value of an annuity or remainder interest. Because these rates are at historical lows-- less than half of what they were a year ago, the cost to transfer assets either by loan, gift or sale is minimized (see table below for 2008/2009 comparison). The low cost provides greater likelihood that the value of the transferred asset will grow in excess of the low rate. This allows a gift-tax free transfer of value to heirs, while also removing the estate tax on the growth from the estate.

Comparison of Applicable Federal Rates (AFRs)	<u>Feb 2009</u>	<u>Feb 2008</u>
Short Term (up to 3 years):	.60%	3.11%
Mid Term (3 -9 years):	1.65%	3.51%
Long Term (more than 9 years):	2.96%	4.46%
IRS §7520 Rate (used for GRATs):	2.00%	4.42%

Grantor Retained Annuity Trust (GRAT)

A GRAT is a transfer of an asset, (typically income producing closely held stock, investments or real estate), to a trust in exchange for an annuity income stream. This is paid to the transferor for a period of any number of years. At the end of the term, the asset passes to the beneficiaries of the trust. The amount of transfer can be structured to minimize the gift value, reserving a taxpayer's \$1M lifetime gift exclusion for other uses. If the transferor does not survive the term of the GRAT, a portion up to the full value of the asset will be included in their estate.

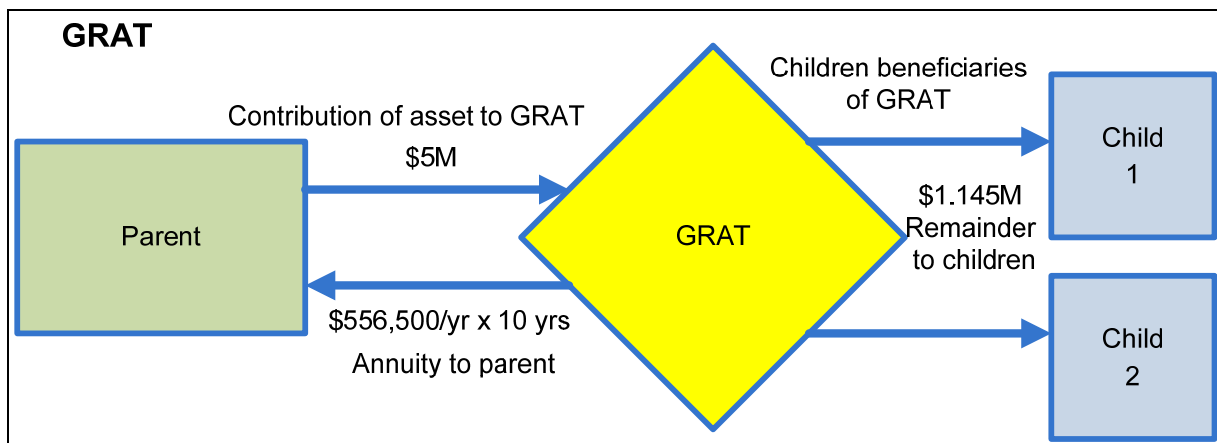
Estate Tax Benefits: The value of the annuity paid to the transferor "freezes" the value of the asset included in the transferor's estate, removing the future appreciation of the asset from the estate and as a result, reduces the amount subject to estate tax.

Income Tax Treatment: The GRAT is a "grantor trust", since the person setting up the trust, (the "grantor") pays the income tax on all income earned by the trust. Payment of tax by the grantor can be

considered a tax-free gift to the trust beneficiaries, and allows the assets in the trust to grow without being depleted to pay taxes.

Example of a GRAT:

Joe transfers assets worth \$5M to a trust (GRAT) for the benefit of his 2 children, (the term of the GRAT is 10 years). The annual annuity payable to Joe for 10 years will be \$556,500, based on the current IRS §7520 rate of 2%. If the assets in the GRAT appreciate at an annual 5%, there will be \$1.145M remaining in the GRAT to pass to the children at the expiration of the term. This is a transfer of \$1.145M exempt of the gift tax, and provides for an estate tax savings of \$572,500 to Joe (\$1.145M x current 50% combined federal and state estate tax rate).



Installment Sale to an Intentional Grantor Trust (IGT)

This technique involves the sale of an asset to a trust, with the buyer (the trust) paying the seller with installments on a promissory note. The beneficiaries of the trust are typically the children of the seller, but can also include grandchildren and future generations. The trust is a “grantor trust” since it is ignored for income tax purposes, but is recognized for estate tax purposes. Put another way, the person is selling an asset to a trust, which is treated as a sale to themselves for income tax purposes--so no gain or loss is recognized. This is considered a completed sale to the trust, for estate taxes.

Prior to the sale, the trust is typically funded with cash or assets equivalent to at least 10% of the sale amount. Although no specific IRS guidance exists regarding this initial funding, this is considered to provide equity to the trust that would normally exist in an arm’s length purchase.

Estate Tax Benefits: The sale price of the asset/value of the promissory note “freezes” the value of the asset that is included in the seller’s estate. This removes future appreciation of the asset from the estate, and as a result reduces the amount subject to estate tax.

Income Tax Treatment: Similar to the GRAT, (because the IGT is also a “grantor trust”), the “grantor” pays the income tax on all income earned by the trust. Payment of tax by the grantor can be considered a tax-free gift to the trust beneficiaries, and allows the assets in the trust to grow without being depleted to pay taxes.

Many commentators have taken the position that if the seller dies prior to the note being paid off, an income tax at the long term capital gains rate can apply on the value of the unpaid balance in excess of the grantor’s basis in the asset sold. The IRS has not provided guidance in this area.

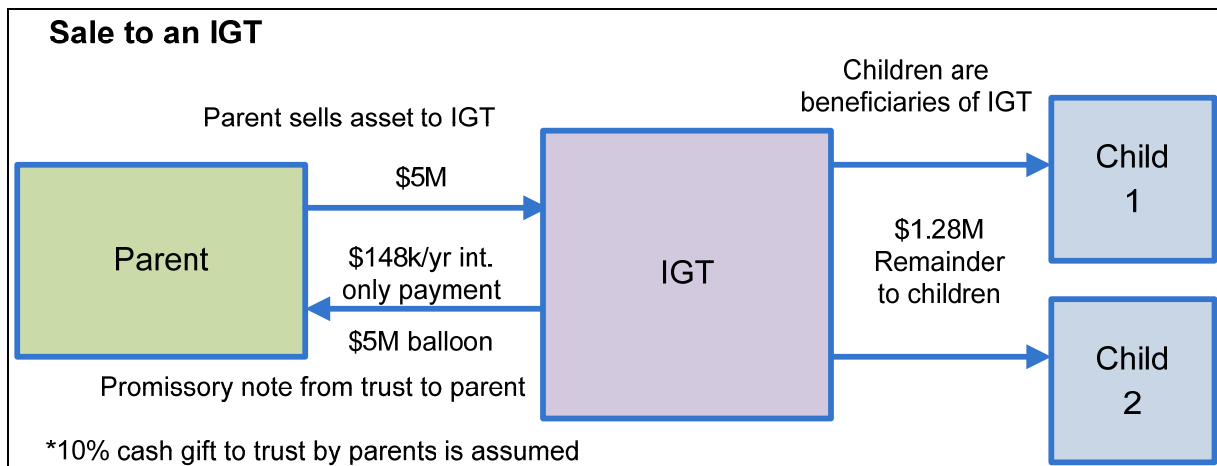
As discussed in the example, if a self canceling installment note is used and the seller dies before the note is paid off, the note balance is excluded from the seller’s estate for estate taxes.

Example of an IGT:

Joe sells an asset valued at \$5M to a trust (IGT) for the benefit of his 2 children. The trust will pay him \$5M over 10 years with an installment note at the February 2009 LT AFR of 2.96%. The annual interest only payments would be \$148,000 for 10 years, with a balloon principal payment of \$5M in year 10. If the asset owned by the trust continues to grow annually at 5%, there will be \$1.28M remaining in the trust for the beneficiaries when the note is paid off.

Joe will pay the annual income tax liability on the income earned from the asset owned by the trust. This can be considered an additional tax free gift to the trust beneficiaries, and allows the assets inside the trust to continue to grow without being impacted by income tax.

Also, a self canceling installment note provision (SCIN) can be used on the promissory note, so that in the event Joe dies before the note is paid off, the unpaid balance is excluded from his estate—saving further estate taxes. However, the note balance can be subject to income tax at the LT capital gains rate. The use of a SCIN provision will increase the principal balance or interest rate on the note, in order to compensate for the mortality risk of Joe dying before the note is paid off.



Intra-Family Loans

This is perhaps the simplest way to take advantage of the current low rates. A parent can make a loan to their children at the low rates: .60% for a loan of up to 3 years, 1.65% for more than 3 years but not more than 9, and 2.96% for loans longer than 9 years. A child could use this loan for the financing of a new home purchase. Or, if the loan proceeds are invested at a rate of return greater than the interest rate, that appreciation is considered a gift tax-free transfer of wealth, and is outside of the parent's estate.

As is mentioned above, the promissory note can utilize a SCIN provision to remove the value of the note from the parent's estate, if the parent were to die before the note is paid off.

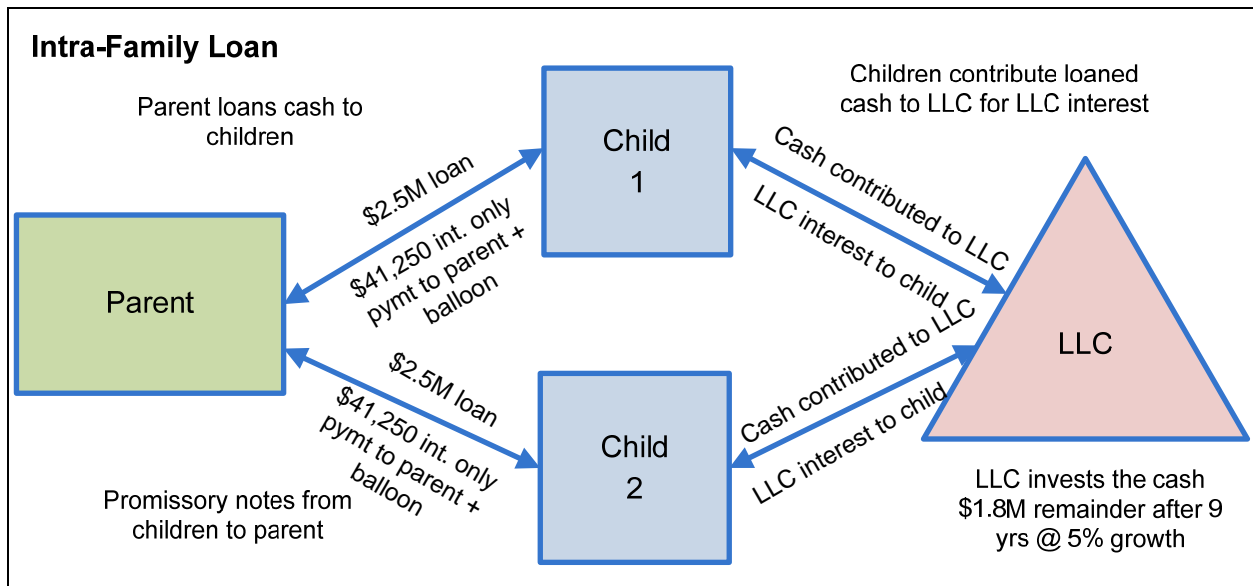
For control purposes, the parent could make the loan to the children and the children could contribute the loaned cash to an LLC, in return for an LLC interest. The parent is the manager of the LLC and the investments are made inside the LLC. This allows the parent to maintain control of the assets.

Estate tax benefits: The appreciation of assets purchased with the loaned cash, in excess of the interest rate on the loan, is removed from the estate of the lender. This reduces the amount subject to estate tax. The use of a loan also preserves the lender's \$1M lifetime gift exclusion for other uses.

Income tax treatment: Because the child is making an investment of the cash, even through the LLC structure, they will bear the associated income tax liability. If the child is under age 18 or is a student under age 24, the "Kiddie Tax" rules may apply, subjecting the income to tax at the higher parent's rate.

Example of Intra-Family Loan:

Parent makes a nine year loan of \$5M to their two children at the mid-term AFR of 1.65%. The cash is contributed by the children to an LLC. Annual interest only note payments of \$41,250 are due to the parents from each child, along with a balloon principal payment of \$2,500,000 in year nine. If the money is invested in the LLC and achieves an annual return of 5%, then \$1.8 M or \$900,000 per child would remain after the note is paid.



Conclusion

After the writing of this article, the March 2009 rates were issued by the IRS. The rates have increased slightly from February to .72% short term, 1.94% mid-term and 3.52% long term, and the \$7520 rate of 2.4%.

The current, historically low interest rates used in the calculations of wealth transfers such as grantor retained annuity trusts (GRATs), installment sales to an intentional grantor trust (IGT), and intra-family loans are providing an opportunity for clients to reduce their estates and projected estate tax liabilities. Depressed asset values combined with the low interest rates, provide the additional opportunity to transfer wealth for discounted amounts. If you believe that over the long term, assets will appreciate in value from current levels, now is the time to consider transferring assets to lower your estate tax.

If you would like additional information about these estate planning techniques, or want to discuss our range of Wealth Management services, please contact:

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