Seizing Wealth Transfer Opportunities in a Low Interest Rate Environment

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In the past few months, the Federal Reserve has embarked on a program of cutting interest rates as a way to stimulate the economy, resulting in a period of low interest rates. The Federal Reserve has recently indicated that its days of rate cutting might soon be over. This current low interest rate environment presents unique wealth transfer opportunities including Grantor Retained Annuity Trusts (“GRATs”) and Sales to Grantor Trusts. GRATs and Sales to Grantor Trusts allow entrepreneurs, private equity investors, and high net worth individuals the opportunity to pass large amounts of wealth to children, grandchildren and charities, gift and estate tax free.

Currently, a person may gift during their lifetime the total sum of only $1,000,000. Any gifts in excess of that amount are subject to a 45% maximum gift tax. At death, a person may leave the total sum of $2,000,000 estate tax free. This estate tax exemption amount is inter-related to the lifetime gift tax exemption. For example, to the extent the person made a full gift of $1,000,000 during his or her life, then that person may only leave $1,000,000 at death without incurring an estate tax. The maximum estate tax on assets passed at death over $2,000,000 is currently 45%. Because of this high rate of gift and estate tax, clients seek to transfer wealth during their lives to their children, grandchildren and charities gift and estate tax free.

Interest Rate Cuts affect Applicable Federal Rates and the Section 7520 rate

The interest rate cuts issued by the Federal Reserve have affected two important interest rates used in estate planning – the “applicable federal rates” (“AFRs”) under Internal Revenue Code §1274 and the “7520 rate” under Internal Revenue Code §7520. AFRs are calculated and published each month by the IRS and represent the minimum rates of interest that must be charged to debt instruments to avoid imputed interest for gift and income tax purposes. The 7520 rate is also calculated and published each month by the IRS and represents the interest rate used to calculate the present value of term interests, life interests, annuities and remainder interests.

The AFR rate for June for a mid-term note is only 3.20%. The recent historic low for the 7520 rate was 3% in 2003; its highest was nearly 12% in 1989. The 7520 rate for June 2008 is 3.8%. This is up from a 7520 rate in May of only 3.2%.

Loans to Grantor Trusts

The simplest way to take advantage of current low interest rates for estate planning purposes is
through the use of intra-family loans. Typically, a parent (or other family member) loans money to a grantor trust created for a child or grandchild and the parent retains control as the trustee of the trust. Transactions between the parent and a grantor trust are ignored for income tax purposes, but the grantor trust is still a separate legal entity for estate and gift tax purposes. In exchange for the loan to the grantor trust, the parent receives a promissory note for the amount loaned, plus interest at the AFR corresponding to the month that the loan was made and for the length of time of the note. For example, a promissory note given in June 2008 for 9 years would carry an interest rate of 3.20%.

If the parent, as trustee for the grantor trust for the child or grandchild, can invest the borrowed funds and achieve a greater rate of return on the investments over a period of 9 years than the 3.20% interest rate on the note, the grantor trust for the child or grandchild, will retain the excess and will have done so free of gift and estate tax.

Because transactions between the grantor trust and the parent are ignored for income tax purposes, the parent does not have to report the interest received on the note as income, nor is there an interest deduction at the grantor trust level.

Both the grantor trust for the child or grandchild and the promissory note should be adequately documented. There should be a real expectation of repayment to avoid an argument by the IRS that the transaction is really a disguised gift.

**Sale of Assets to Grantor Trusts**

A very similar estate planning technique that works well in an environment of low interest rates is a sale of assets to a grantor trust. Closely held business owners and private equity investors are typical clients for sales to grantor trusts.

In a typical sale transaction, the parent/grantor “sells” an asset that is expected to appreciate over time to a grantor trust for a child or grandchild in exchange for a promissory note. Ideally, the asset is an income-producing asset and the income on the asset is used to pay off the note during the term. The promissory note is usually structured as a 9 year interest-only note with a balloon payment at the end of the 9th year. Thus, the interest rate that would apply to such a note would be the mid-term AFR for the month of the sale.

If the assets of the grantor trust allow for the payoff of the note and further appreciation, then the appreciation of the asset in the grantor trust for the benefit of the parent/grantor’s children or grandchildren at the end of the note’s term is transferred free of gift tax.

There is also no capital gain recognized by the parent/grantor when the assets are sold to the grantor trust (for income tax purposes, the sale is treated as being made between the parent and himself or herself). Because of the fairly long term of the note, it is reasonable to expect that the investment return of assets sold to the grantor trust will be greater than the note’s low interest rate.

There are several potential pitfalls to be aware of when utilizing this sale technique. First, if the parent/grantor dies during the term of the promissory note, the unpaid portion of the note will be included in the estate of the parent/grantor. Also, it is important that the grantor trust is adequately capitalized before the sale in order for the transaction to be respected by the IRS. This must often be done through a “seed” gift by the grantor to fund the trust (if the trust does not already have adequate assets).

There is also more cost and complexity for sales to grantor trusts rather than a straight loan of cash to a grantor trust. The asset sold must be professionally appraised to establish the sale price. The documentation for the sale is similar to the sale of a business and will require a purchase and sale agreement, pledge
Grantor Retained Annuity Trusts ("GRATs")

A GRAT is a certain type of trust that is used to shift the growth and appreciation of assets from one generation to a lower generation, often with very little or no gift tax cost. A typical GRAT client is one with real estate, a closely held business owner, a private equity investor or an owner of a company that is likely to go forward with an Initial Public Offering (IPO). Many real estate, pre-IPO clients, and clients with blocks of publicly traded securities are implementing GRATs this summer due to current low values and low interest rates.

In a typical GRAT transaction, the parent/grantor creates a trust to last for a certain term (usually 2-5 years) and transfers appreciating property to the GRAT. In return, the parent/grantor receives an annuity payment for each year that the GRAT is in existence, calculated based on the 7520 rate. During the term of the GRAT, the parent/grantor acts as the trustee and retains investment control over the contributed property.

At the end of the GRAT term, any assets that remain (after all annuity payments have been made), are transferred to the GRAT’s remainder beneficiary (usually a grantor trust for the benefit of the children). If the assets in the GRAT appreciate a higher rate than the 7520 rate, the excess appreciation is transferred to the GRAT’s remainder beneficiaries free of gift tax. Thus, the lower the 7520 rate, the greater the potential appreciation that can pass to the remainder beneficiaries.

When a GRAT is formed, there is a gift made by the parent/grantor, which is equal to the value of the property contributed less the value of the parent/grantor’s retained interest using the 7520 rate for that month. To avoid the potential gift tax issue on the formation of the GRAT, the GRAT can be structured as a “zero-out” GRAT so that there is no taxable gift on its formation. To accomplish this, the terms of the GRAT state that all of the assets contributed to the GRAT plus earnings at the 7520 rate must be returned to the parent/grantor. Thus, for gift tax purposes, the remainder interest will have a zero value (or a number close to zero) when the GRAT is formed, and there will be no taxable gift on formation.

There are several possible risks that must be considered when setting up a GRAT. First, if the parent/grantor dies during the term of the GRAT, some value of the GRAT’s assets may be included in the parent/grantor’s estate. Also, if the assets contributed to the GRAT lose value or do not outperform the 7520 rate, there will be no remainder interest at the end of the GRAT to pass to the remainder beneficiaries. However, under that scenario, the parent/grantor will be in no worse position than if he or she had not established the GRAT in the first place (except for the transaction costs). Finally, a parent/grantor normally cannot allocate generation-skipping transfer ("GST") tax exemption to a GRAT until the end of the GRAT term. Because of this rule, GRATs are not usually used to transfer assets to generation-skipping trusts or directly to grandchildren.

Charitable Lead Annuity Trust ("CLAT")

A CLAT is similar to a GRAT, except that the annuity payments are made to a designated charity rather than back to the parent/grantor, with the remainder interest paid to children or grantor trusts established for their benefit. Typical CLAT clients are those who are charitably inclined or who are on the verge of a large pledge to a school, hospital or favorite charitable organization. Such clients appreciate the benefits of a CLAT as it allows them to accomplish their charitable pledge while reserving any appreciation in the assets of the CLAT for their own children.

Like a GRAT, a CLAT can be structured as a “zero-out” CLAT so that no taxable gift occurs on its formation. If the investments of the CLAT
grow at a rate higher than the 7520 rate used to calculate the present value of the annuity payments to the charity, the excess is distributed to the remainder beneficiaries free of gift tax. The charity receiving the annuity payments can be a public charity or charities and even a private foundation established by the parent/grantor.

CLATs can be formed as either grantor trusts or non-grantor trust (where the trust is a separate taxpayer and is taxed on the income of the trust assets). If formed as a grantor trust, the parent/grantor of the CLAT will be entitled to a charitable income tax deduction for the present value of the annuity interest in the year the CLAT is formed. If formed as a non-grantor trust, the CLAT will be entitled to a charitable income tax deduction for each annuity payment made to the charity. A CLAT is subject to same GST allocation rules as a GRAT (see above).

Summary

The current environment of low interest rates presents unique opportunities for clients to make gift and estate tax free transfers to children, grandchildren and charities. Because of the uncertainty as to how long these low interest rates will last and the unknown tax environment after the 2008 election, clients should consider the tax advantages of entering into one of the transactions described above.

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