Implementing and Utilizing Estate Planning Strategies in the Real World

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Planning Strategies

1. Grantor Retained Annuity Trusts
2. Grantor Trusts
3. Qualified Personal Residence Trusts

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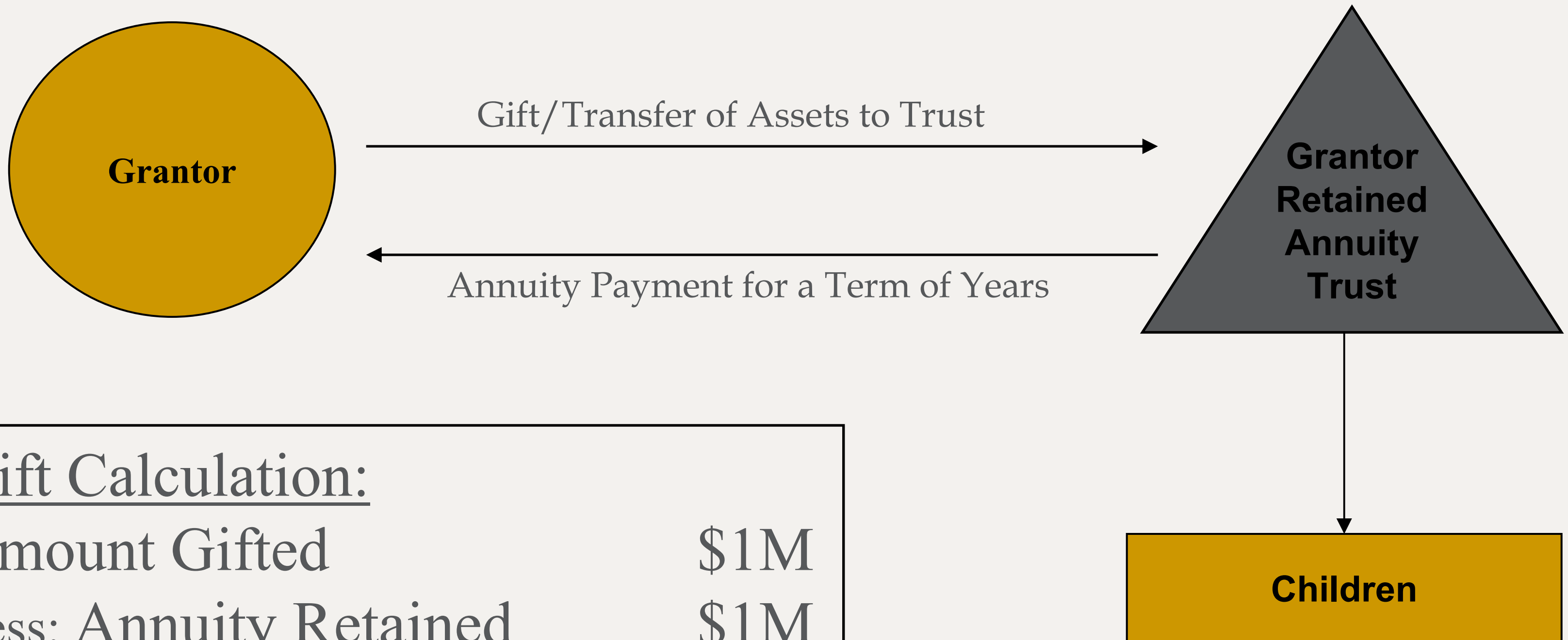
What’s a Grantor Retained Annuity Trust (GRAT)



Gift Calculation:	
Amount Gifted	$1M
Less: Annuity Retained	$1M
Value of Gift	**-0-**

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Grantor Retained Annuity Trust (GRAT)

Benefits:

- Zero gift tax value for gifted assets.
- Future appreciation above Federal interest rate on property in GRAT passes to children.
- “Freezes” the appreciation of the GRAT assets in Grantor’s estate.
- Maintain control of property during GRAT term and ability to retain property in trust after GRAT term.
- No adverse income tax consequences.

Drawbacks:

- You must survive the stated term or the GRAT property will be included in your estate.

Grantor Retained Annuity Trust (GRAT)

ASSUMPTIONS:
- Gift of $5,000,000
- Annual Annuity Payment for Two Years: $2,582,778
- 7520 Rate = 2.2%

FINANCIAL RESULTS:
- $.08 Taxable Gift
- Assuming a 8% Growth Rate:

Year	Beginning Value	Growth 8%	Annuity Payment	Ending Value
1	$5,000,000	$400,000	($2,582,778)	$2,817,222
2	$2,817,222	$225,378	($2,582,778)	$459,821
Summary	**$5,000,000**	**$625,377**	**($5,165,556)**	**$459,821**

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Practical Considerations of a GRAT

- Recommended GRAT Provisions:
  - Power of Substitution: Give specific power to Grantor to substitute assets of equal value.
  - Trustee: Grantor can be trustee during GRAT term

- Required GRAT Provisions:
  - Additional Contributions: must prohibit additional contributions.
  - Additional Beneficiaries: must prohibit other beneficiaries.
  - Commutation: must prohibit prepayment of the annuity.
  - No Notes: must prohibit trustee from paying annuity with a note or debt

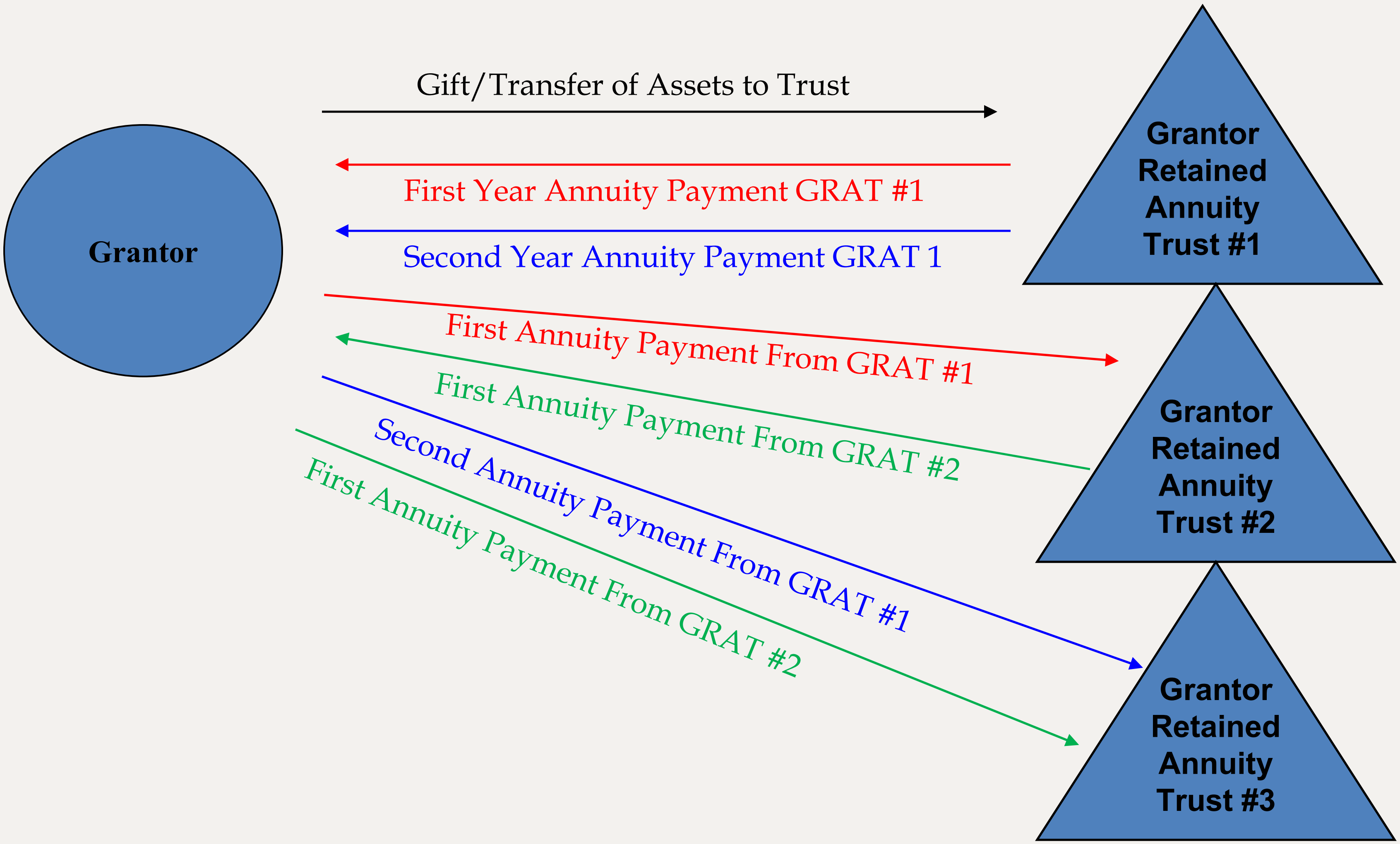
Practical Considerations of a GRAT

Funding Issues: Need to fund GRAT all at one time to avoid prohibition of additional contributions. To avoid transfer issues, use an irrevocable assignment that specifically identifies the securities to be transferred.

Valuation: The value of the securities transferred is determined in the same manner as for gift tax purposes.

Annuity Amount: Prefer to state it as a percentage of the original amount funded in GRAT, rather than an stated dollar amount. Assures that there will be no change in gift calculation if funded amount changes.

Rolling GRATS



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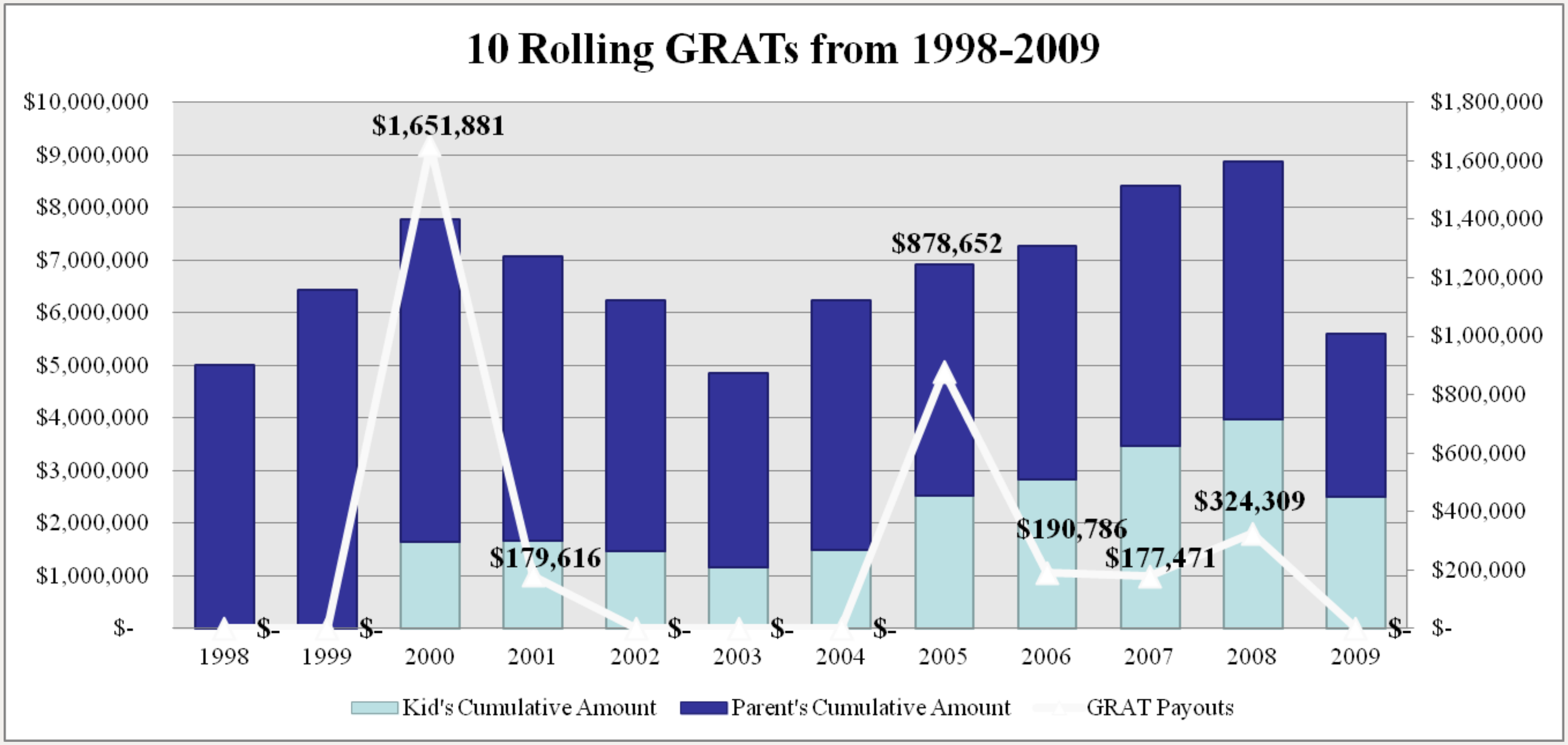
Key Drivers of a GRAT-Volatility

"Heads I win, Tails I tie" proposition/ "Use it or Lose it" opportunity



45% of the portfolio value is transferred to the kids!

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Key Drivers of a GRAT-§7520 Rate

- §7520 Rate: Published monthly in an IRS Revenue Ruling.
  - -7520 Rate sets the "hurdle" rate of performance for GRAT assets
  - -The §7520 Rate is 120% of the mid-term applicable federal rate rounded to the nearest even percent (it's never an odd number).
  - - Usually published around the 20th of each month. So, you can plan to do a GRAT in the current month or following month.
  - - www.irs.gov/app/picklist/list/federalRates.html

- Example: $1M, 2yr. GRAT; 8% Growth; Results based on 7520 Rates:

7520 Rate	Amount to Kids
2%	$95,119
3%	$79,386
4%	$63,595
5%	$47,760

7520 Rate	Amount to Kids
6%	$31,896
7%	$15,958
8%	-0-

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Strategies to Increase Performance – 120% Rule

<u>120% Rule</u>: Treas. Regs. allow the annuity payment to increase by 120% of the preceding years annuity payment.

- <u>Example:</u> $5 Million; 2yr. GRAT; 7520 Rate is 3.4%; 8% Growth
- 1st Payment=47.85833%; 2nd Payment=57.4300%
- Fixed Payment=52.56518%

Year	Beginning Value	Growth 8%	Annuity Payment	Ending Value
1	$5,000,000	$400,000	($2,350,287)	3,049,713
2	$3,049,713	$243,977	($2,820,344)	$473,347
Summary	**$5,000,000**	**$643,977**	**($5,170,630)**	**$473,347**

Differences: *$18,600* + *($5,074)* = *$13,526*

Year	Beginning Value	Growth 8%	Annuity Payment	Ending Value
1	$5,000,000	$400,000	($2,582,778)	$2,817,222
2	$2,817,222	$225,378	($2,582,778)	$459,821
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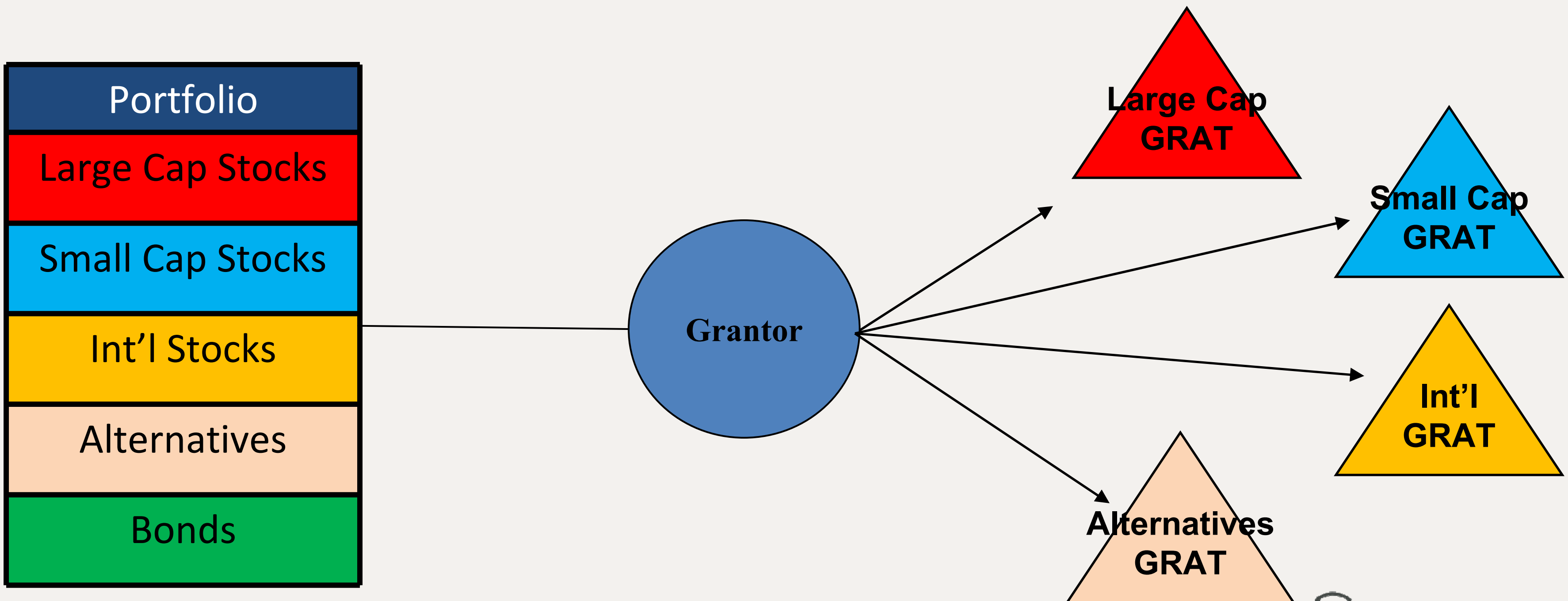
Strategies to Increase Performance-Asset Class

- Segregation of Asset Classes: Ideally, put each security into it's own separate GRAT to prevent negative performance from cancelling out positive performance.

- Recommended to put each asset class in a separate GRAT. Again, GRATs love volatility



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Strategies to Increase Performance-Asset Class

- Example: In 2000 & 2001, the Russell 2000 index was -3% and 2.5%, respectively. The Russell 2000 Value index was 23% and 14% respectively, and the Russell 2000 Growth index was -22% and -9%.
- Here's the results of various 2 yr GRATs:

Russell 2000 GRAT

Year	Beg. Bal.	Gain/Loss	Annuity	Ending Bal.
2000	$ 2,000,000	$ (60,000)	$(1,112,347)	$ 827,653
2001	$ 827,653	$ 20,691	$(1,112,347)	**$ (264,003)**

Russell 2000 Growth GRAT

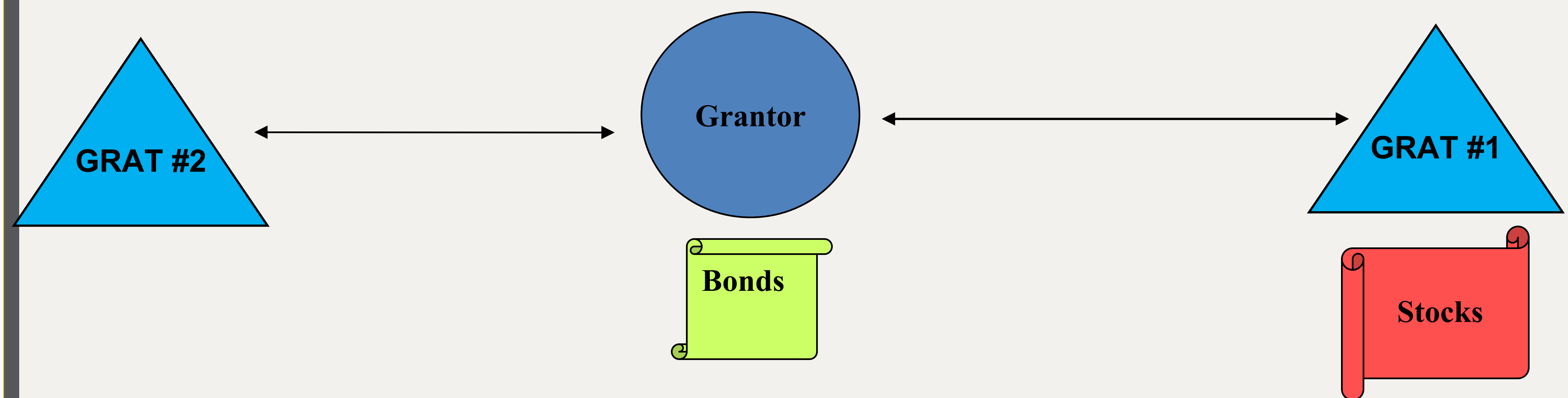
Year	Beg. Bal.	Gain/Loss	Annuity	Ending Bal.
2000	$ 1,000,000	$ (220,000)	$ (556,174)	$ 223,826
2001	$ 223,826	$ (20,144)	$ (556,174)	**$ (352,492)**

Russell 2000 Value GRAT

Year	Beg. Bal.	Gain/Loss	Annuity	Ending Bal.
2000	$ 1,000,000	$ 230,000	$ (556,174)	$ 673,826
2001	$ 673,826	$ 94,336	$ (556,174)	**$ 211,988**

Strategies to increase Performance-Reloading GRATs

- Reloading GRATs: Grantor can swap assets of equal value with GRAT assets.
- Enables to Grantor to take loss assets out of an existing GRAT and fund a new GRAT. (Reload at lower market values).
- Typically, a Grantor swaps in bonds for the depressed equities held in a GRAT.



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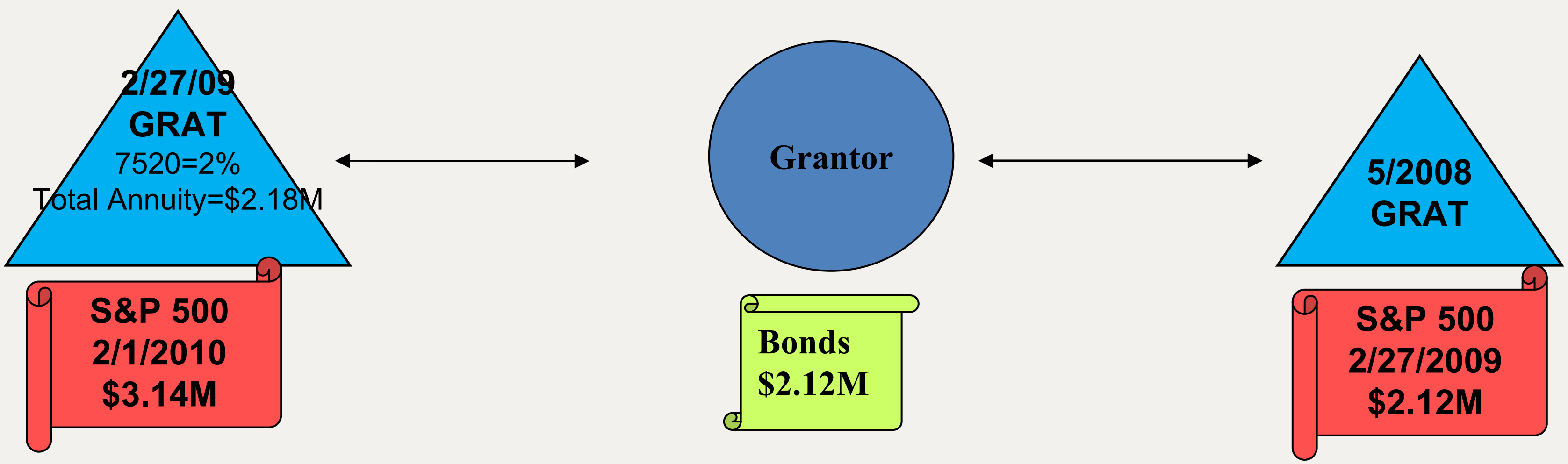
Strategies to Increase Performance- Reloading GRATs

- Example: $4M of S&P 500 Index funded into a GRAT on 5/30/2008. 7520 Rate was 3.2% creating an annuity payment of $2,096,545. On 2/27/2009, reload GRAT by swapping bonds of equal value.



Potential Payoff to Kids
$960,000

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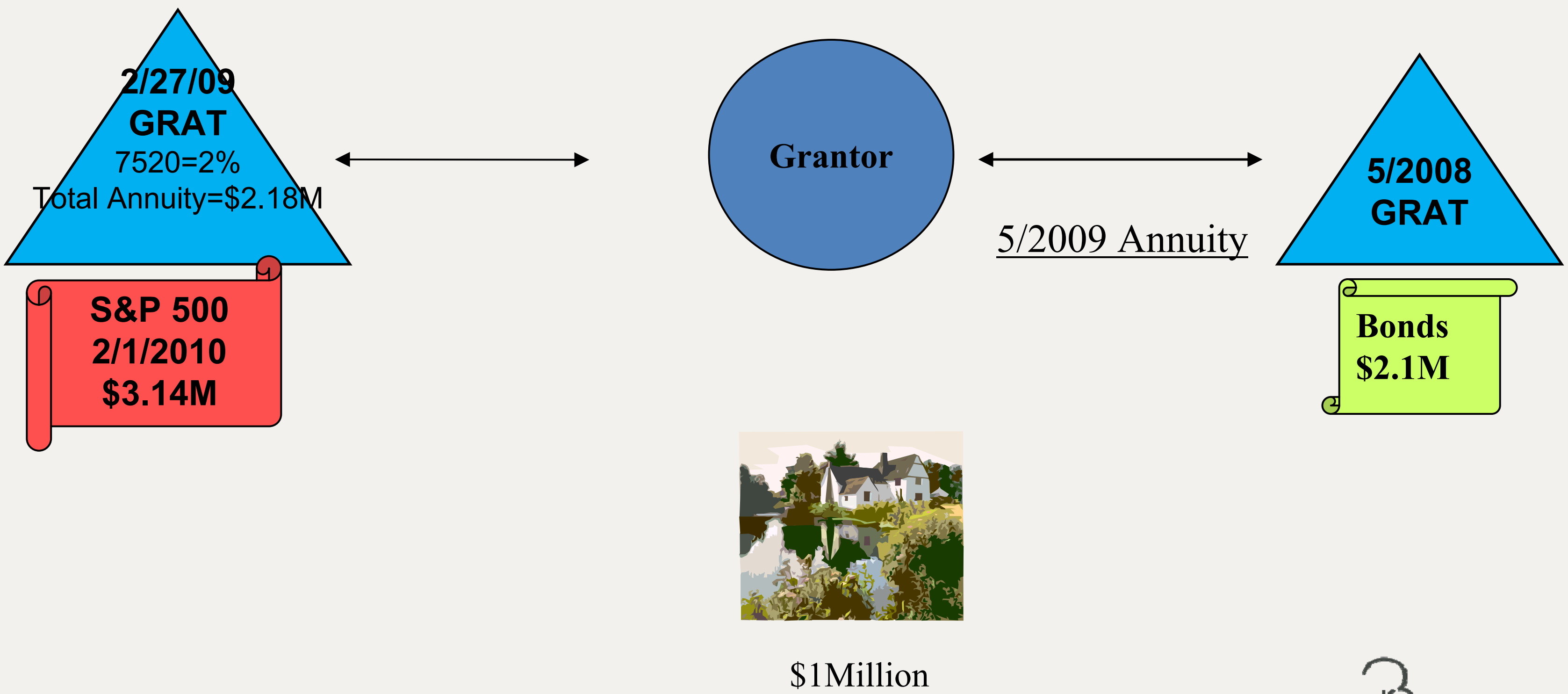
Strategies to Increase Performance-
Locking in Gains

- <u>Locking in Gains:</u> Grantor can swap less volatile assets to better lock in potential payoff to kids



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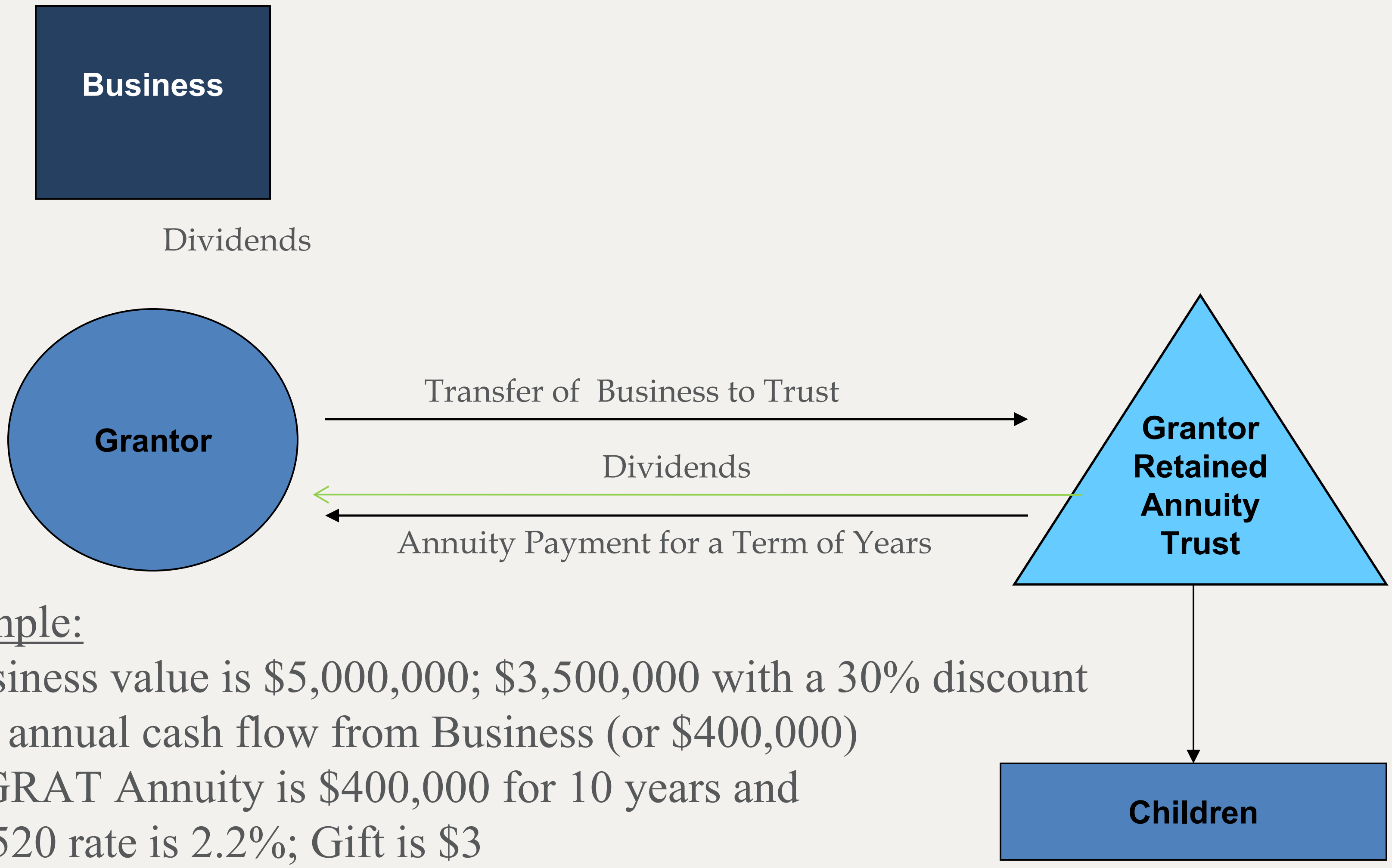
Grantor Retained Annuity Trust (GRAT)



<u>Example:</u>

- Business value is $5,000,000; $3,500,000 with a 30% discount
- 8% annual cash flow from Business (or $400,000)
- If GRAT Annuity is $400,000 for 10 years and
  7520 rate is 2.2%; Gift is $3

•Annual Annuity is $393,731

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Grantor Retained Annuity Trust (GRAT)

Financial Result:

- $120,000 Gift ($3,500,000 less the $400,000 annuity stream)
- After 10 years, the entire value of Business is transferred to children.
- Grantor has received almost all of the cash flow from Business by receiving the cash flow has paid the GRAT Annuity.
- **Best with pass-through entity (S corp, LLC, LP)**

Distribution Strategies

- Considerations of who, what when, where and how?

- **Who?** GRATs are inefficient at transferring wealth to a grandchild.
  - GST Regs require allocation of GST exemption to residual value transferring at the termination of the GRAT (ETIP Rule)
  - Children are typical beneficiaries of a GRAT.

- **What?** As Trustee and by swapping assets, Grantor can control what assets the children will receive at the end of the GRAT.

- **When, Where and How?** Grantor can decide if the residual assets of the GRAT are distributed outright to children or held in a trust for future management, control and distribution.

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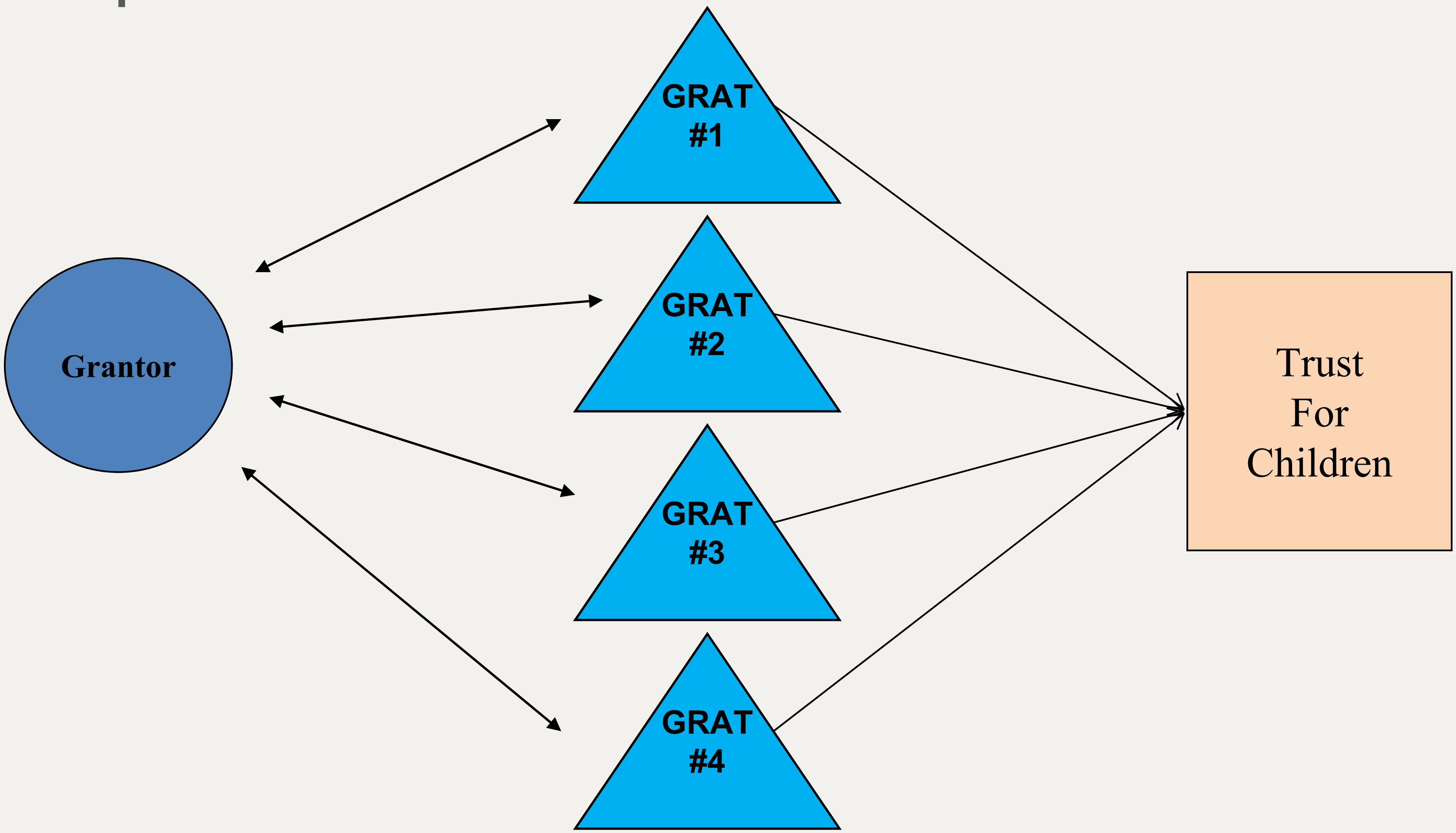
Distribution Strategies-Continuing Trust Example



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Potential Threats to GRATs

- President Obama's Budget Proposal and now a bill would:
  1. require that a GRAT have a minimum term of 10 years;
  2. require that a GRAT have some minimum remainder interest;
  3. prohibit GRATs which have a decreasing annuity amount during the trust term.

Alternative:

- -Short-term (< 3 year notes) loan/sales to a Grantor Trust.

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Grantor Trust

- **What is it?** A trust that is treated as being owned by the Grantor for income tax purposes.

- **How's it created?** The Grantor has retained certain powers over the trust's property.
  - Common powers are:
    - Power to borrow without adequate security
    - Power to substitute assets
    - Power to add beneficiaries

- **Impact?** Shifts additional wealth to beneficiaries by providing tax free growth to trust property (like a Roth IRA for beneficiaries)

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Grantor Trusts-Flexibility in Planning

- Swap assets on a tax-free basis with Grantor or other Grantor trusts
  - Get a step-up in basis
  - Determine which assets go to beneficiaries
  - No transfer-for-value issue with life insurance

- Loans to the trust without recognition of interest income
  - Intra-family loans
  - Move assets in and out of trust

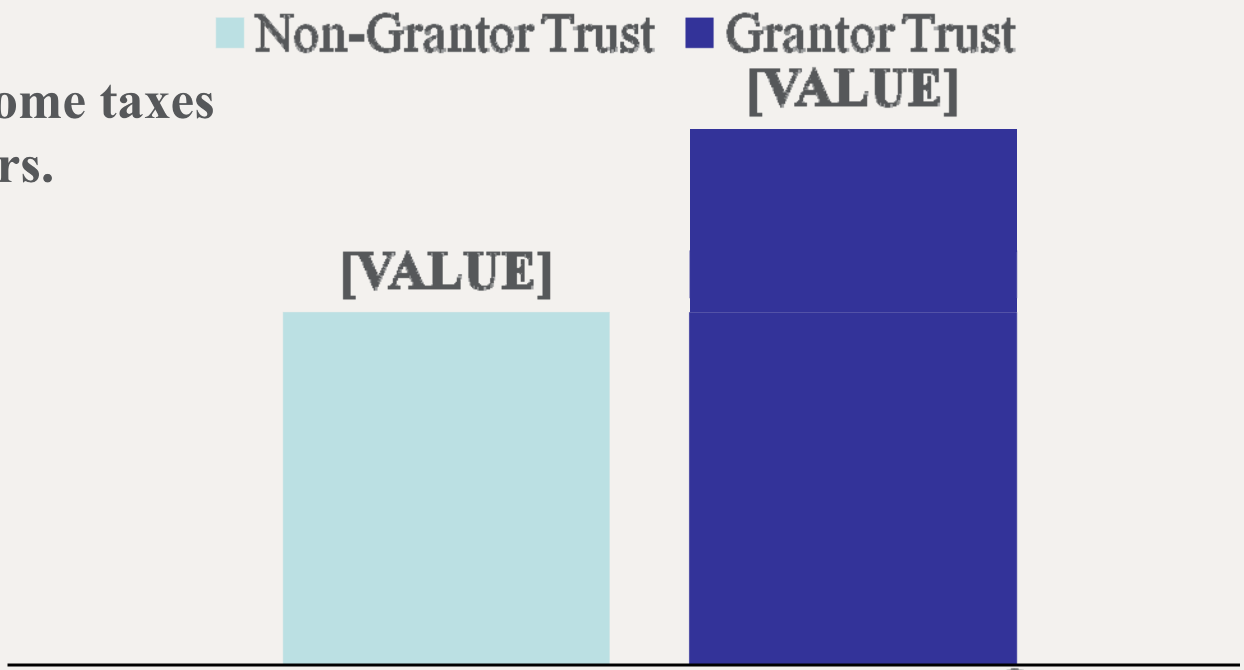
- Sell assets to trust without recognition of gain

- Payment of income taxes is a tax-free, non-reportable gift

Grantor Trusts–Economic Impact

- **Example**: Compare the net-after tax amount of a $1M portfolio in a Grantor Trust to $1M in a Non-Grantor Trust over a period of 20 Years (Assuming a 2% yield, 6% growth, 40% ordinary tax rate, 20% capital gain tax rate; basis of $250,000 and 10% annual turnover)

- **$940,000 paid in income taxes by Grantor over 20 years.**



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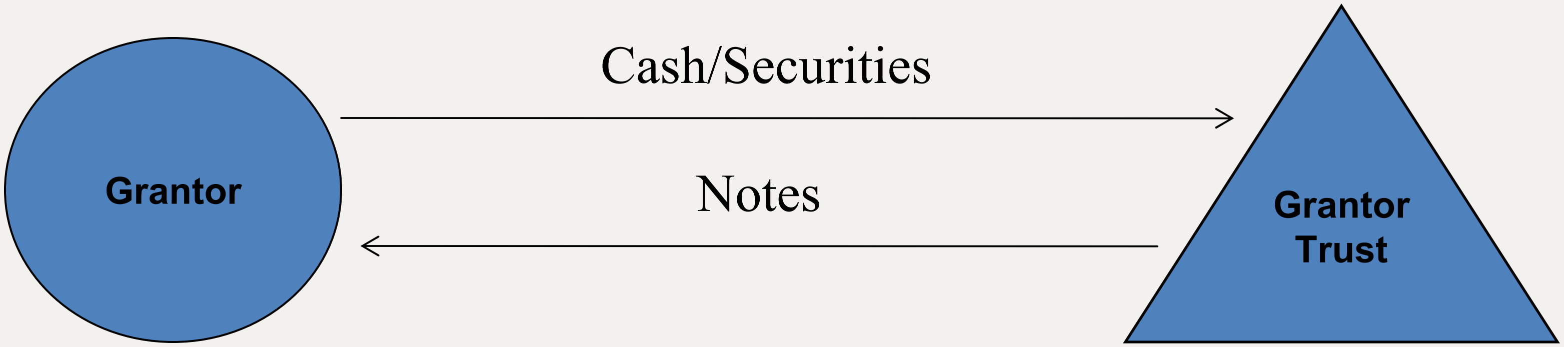
Grantor-Loan Example



- Note bears interest at AFR rate depending on it's term.
  - 1.27% if less than 3 years; 1.85% if 3-9 years; 2.5% if over 9 years
- No interest income is recognized on the note by Grantor
- Flexibility in structuring note repayments
- Prepayment of note
- Refinance note?
- Recommended to have 10% equity over promissory note
- Volatility can create problems for note repayment

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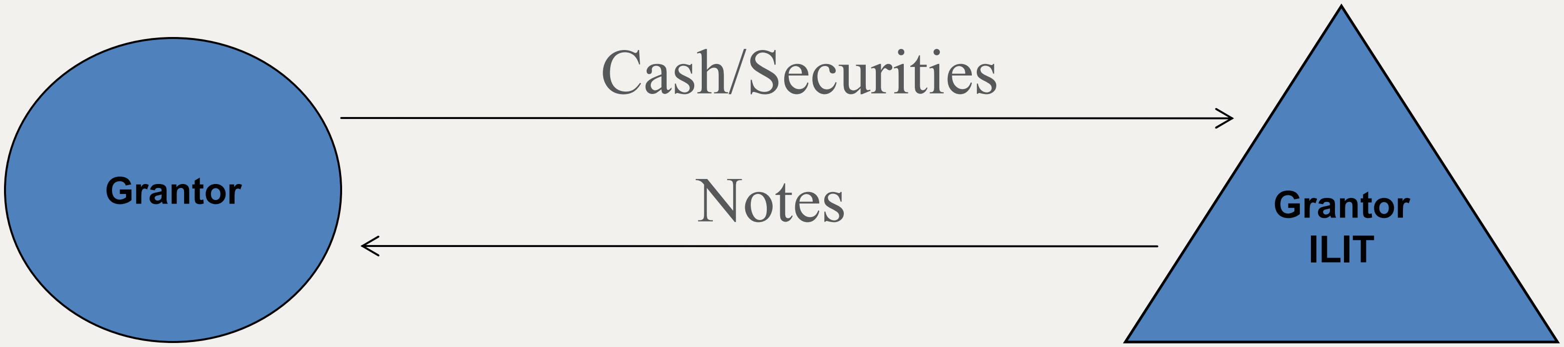
Irrevocable Life Insurance Trust (ILIT)



- Large premiums can be paid with loans to ILIT
- Crummey withdrawal provisions won't change Grantor Trust status
- Policy can be swapped to a Grantor Trust without a transfer-for-value
- Have GRATs payout to ILIT to help pay premiums or repay note

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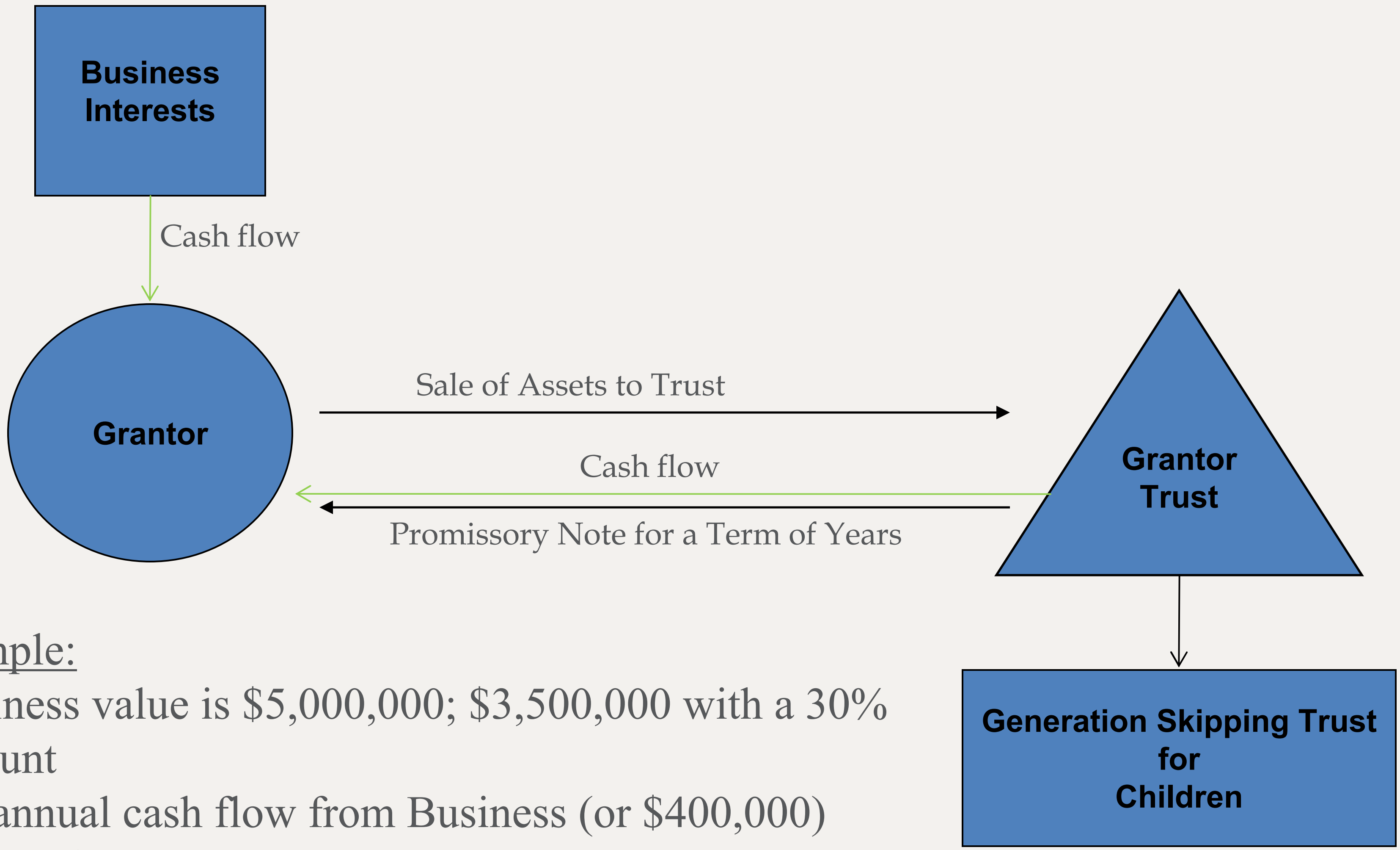
Sale to a Grantor Trust



<u>Example:</u>

- Business value is $5,000,000; $3,500,000 with a 30% discount
- 8% annual cash flow from Business (or $400,000)
- Sell Business to Grantor Trust for a 9 year note at 1.85%
- Amortizes at $425,740/year or $64,750/year with interest-only

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Sale to a Grantor Trust

How a Sale to a Grantor Trust differs from a GRAT:

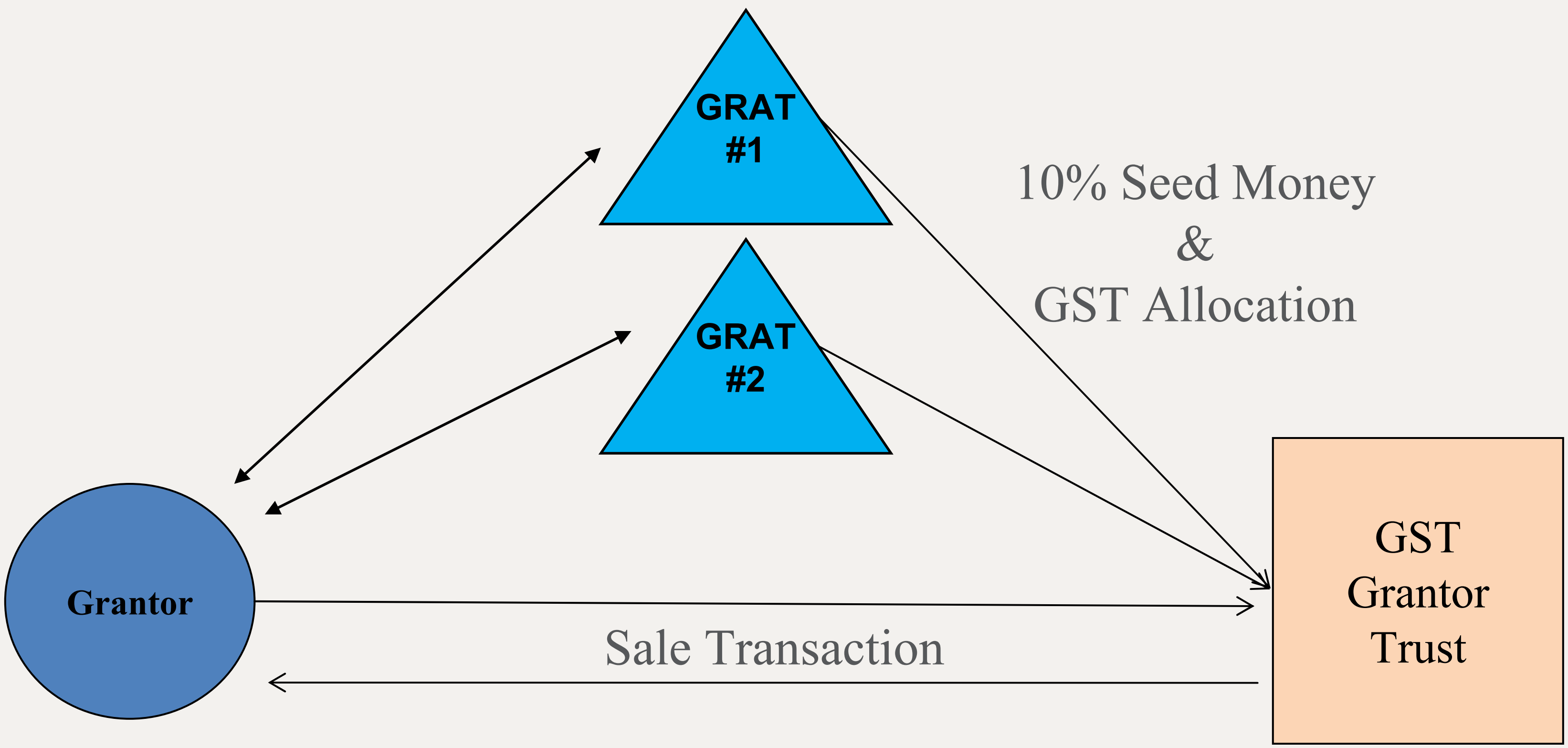
Positives:

- Ability to transfer property into a generation skipping trust
- Flexibility in structuring note payments
- Prepayment of the note
- Cheaper interest rate than GRAT transaction
- If you die, only the note value is included in your estate (SCINS?)

Negatives:

- Grantor Trust should have 10% equity over promissory note (seed gift)
- Underperformance
- Not a transaction that is specifically recognized in IRS Code
- A poor valuation of sold property could result in a gift

Integration with GRATs



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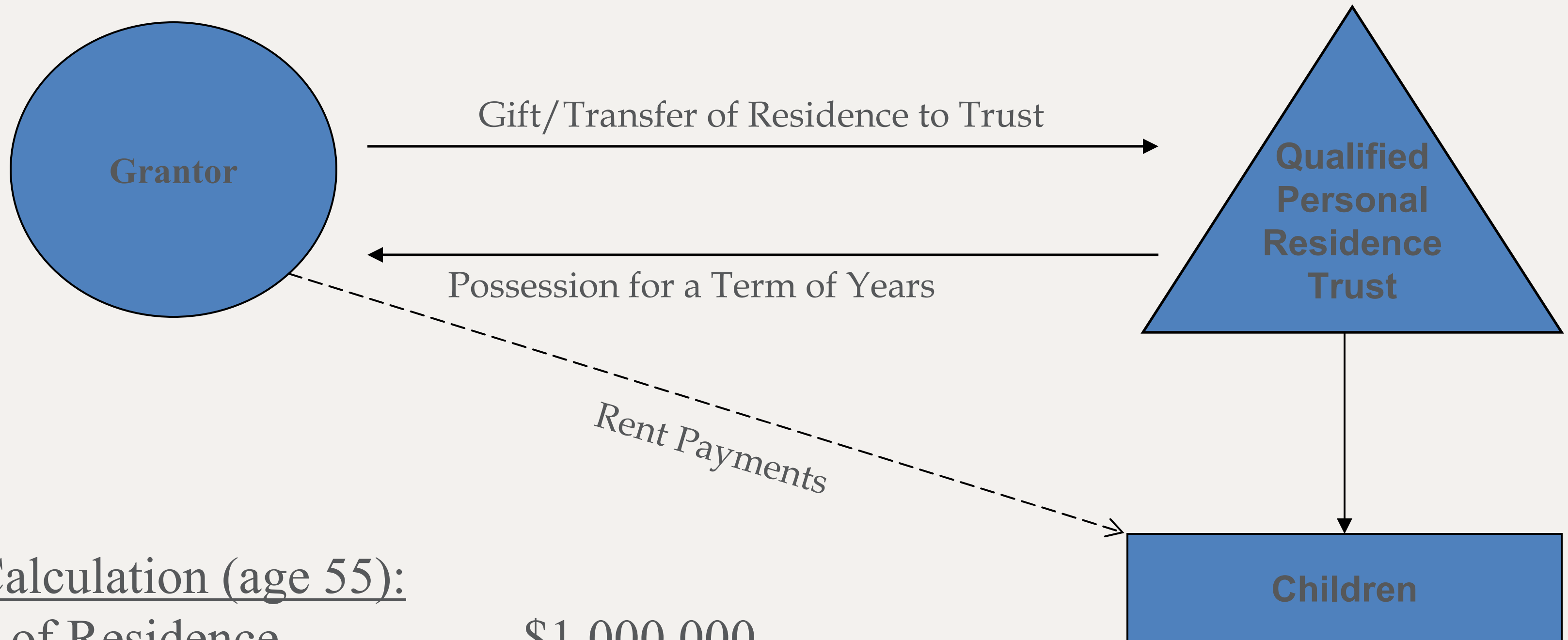
Qualified Personal Residence Trust (QPRT)



Gift Calculation (age 55):

Value of Residence	$1,000,000
Less: 20 Yr. Retained Term	($ 541,960)
Value of Gift	**$ 458,040**

Value of Property in 20 Years: $1,806,111

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Qualified Personal Residence Trust

Benefits:

- Reduced gift tax valuation of residence.
- Future appreciation of residence is removed from your estate.
- At end of term, children own the residence and you must pay rent for its use. This rent is a tax-free gift to your children.

Drawback:

- You must survive the stated term of the QPRT or the residence will be included in your estate.

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Required QPRT Provisions

- **Rev. Proc. 2003-42**: IRS has provided a model QPRT form

- **Required Provisions**:
  -Only one personal residence and 6 months of cash for expenses or improvements
  -All income must be distributed annually
  -No commutation of Grantor's interest
  -Prohibit purchase of residence by Grantor during QPRT term

- **Provisions that cause a QPRT to cease**:
  -If residence is sold, replacement must be purchased in 2 years
  -If residence is not used as a personal residence
  -If residence is unusable due to damage, residence must be repaired or replaced in 2 years

- **If QPRT ceases, it converts to a GRAT**

QPRT–Strategies to Enhance Performance

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QPRT—Strategies to Enhance Performance

Comparison of Contributing a Partial Interest vs a Full Interest
(assuming age 65, 10 year term, 7520 Rate of 2.2%)

	Partial Interest	Full Interest	Differences
Property Transferred	$800,000	$1,000,000	($200,000)
Gift Valuation	$505,300	$631,630	($126,330)
Value in 10 years (3% growth)	$1,343,000	$1,343,000	-0-
Total Discount on Gift	55%	44%	11%

- Utilizing partial interests, client saves additional estate tax of **$55,500**

- 7520 rate would need to be 4.6% to outperform the partial interest result

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Practical Issues during QPRT Term

- Understanding the Interests of the Grantor and Beneficiaries
  - Grantor has a term interest (or income interest)
  - Beneficiaries has a remainder interest (or principal interest)

- Remembering these interests are helpful in addressing the following issues that can arise during the QPRT term:

  - Expenses – Check the state's principal and income act.

  - Mortgages – Allowed but complicates the transaction

  - Improvements – an additional gift to the QPRT

  - Sale – need to replace in 2 years or it converts to a GRAT

  - Undoing a QPRT

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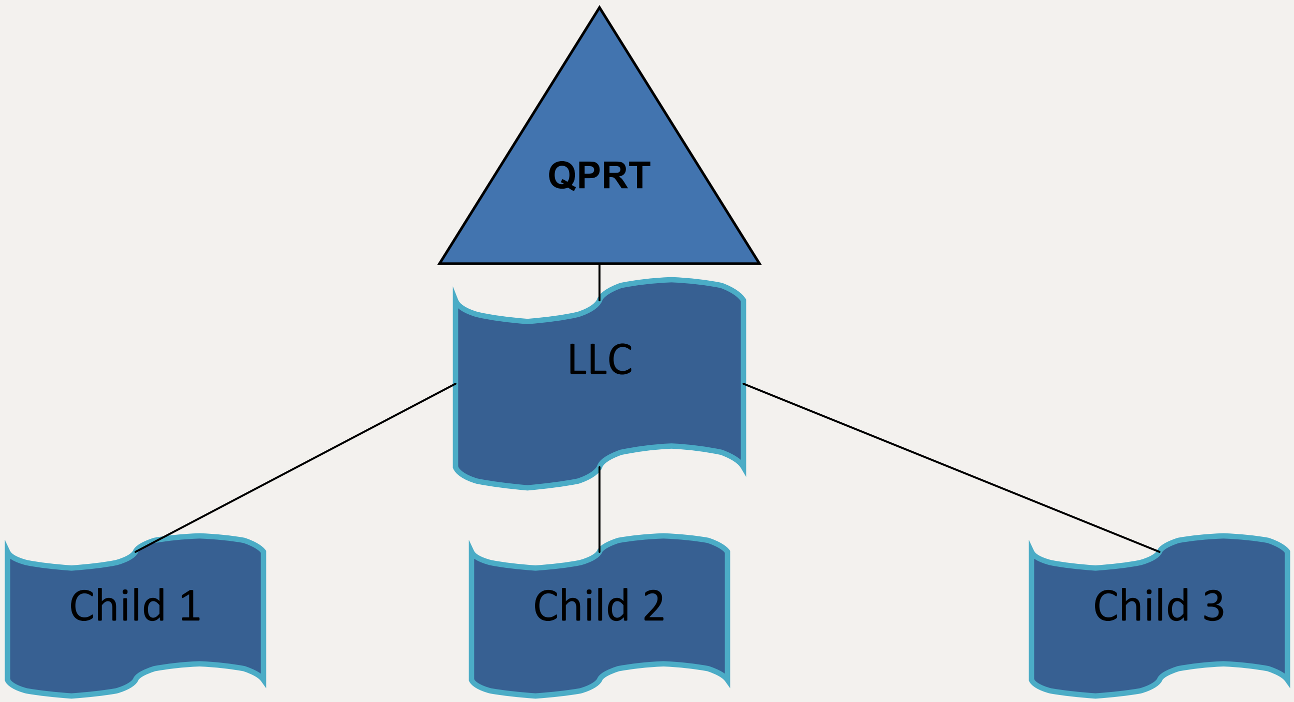
Practical Issues after QPRT Term

- **Distribution of Residence:** Residence stays in trust or partial interests are distributed out to children. Co-Tenancy Relationship
- **Alternative:** Trustee of QPRT forms an LLC prior to distribution to children. On termination, children receive membership interests in LLC.



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QPRT Alternative—Joint Purchase

Grantor

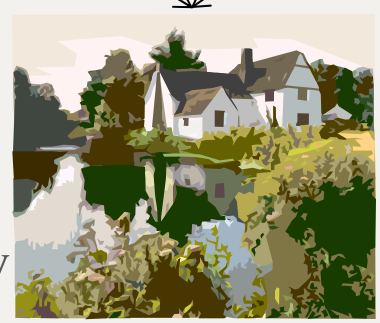
Trust
For
Children

$410,980 for life interest

$598,020 for remainder interest

- $410,980 is out of Grantor's estate
- Estate tax savings of $851K if home was purchased individually

(assumes 3% growth and 40% estate tax rate)



$1 Million

- Value at life expectancy=$2.13M
- Rate of return is 5.1%

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Remember:

It's about Clients' Goals

Be cautiously creative!