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Opportunities: Cloud Over Economy Creates Estate Planning Silver Lining

Interest rates are nearing historic lows, which creates unique estate planning opportunities, as investment returns merely have to outperform these new low rates in order to provide estate planning benefits. In addition, the recent drop in stock prices further increases the possibilities for planning. Both of these changes in the economy present extraordinary opportunities to pass assets to children or others.

The lower interest rates and stock prices sink, the better the environment to transfer assets with little or no gift or estate tax consequences. The reason for this result is that there are a number of techniques that turn on assets outperforming IRS assumed rates of return, which are now nearing historic lows. For example, if the IRS assumes that an asset will earn a return of 4% and you have assets that are significantly depressed in value, you may transfer the “spread” between the 4% assumed rate of return and the actual future increase in value to your children or others with minimal or no gift or estate tax cost. There are a number of estate planning techniques which become significantly more valuable as stock prices and interest rates dip further: charitable lead annuity trusts, private annuities, sales to “defective” grantor trusts and grantor retained annuity trusts (“GRATs”).

A very brief summary follows of two of the most beneficial techniques that work for common assets such as marketable securities:

- GRATs

A GRAT provides you with a fixed annual amount (the “annuity”) from the trust for a short term of years (generally two years). The annuity you retain may be equal to 100% of the amount you use to fund the GRAT, plus the IRS assumed rate of return applicable to GRATs (currently 4.2% and likely to go lower). You may act as sole trustee of the GRAT during the GRAT term.

Because you will retain the full value of the GRAT assets, according to the IRS’s assumptions, assuming you survive the annuity term, at the end of the annuity term, the value of the GRAT assets in excess of your retained annuity amount will pass to whomever you have named with no gift or estate tax, either outright or in further trust.

For example, if you currently hold stock valued at \$5 a share that you believe will increase to \$10 a share at the end of two years, you will be able to transfer \$5 a share (less the 4.2% IRS assumed rate of return that you must retain), outright or in trust to your children free of transfer taxes. For maximum effectiveness, we often structure “rolling” GRATs, where each annuity payment is transferred to a new GRAT.

- Sales to “Defective” Grantor Trusts

Another option for transferring assets without any transfer tax is an installment sale to a “defective” grantor trust (a trust for which you would be responsible for the income taxes payable on the income generated by the assets therein, but which is not included in your taxable estate upon your death).

You would sell assets likely to appreciate in value to the trust in exchange for a promissory note. From an income tax perspective, no taxable gain would be recognized on the sale of the property to the trust because the trust is a defective grantor trust, which makes this essentially a sale to yourself. For the same reason, the interest payments on the note would not be taxable to you or deductible by the trust.

If the value of the assets grow at a greater pace than the prevailing Applicable Federal Rate (now as low as 3.4%), as with a GRAT, the appreciation will pass free of gift and estate tax. An additional benefit is that this type of transaction allows you to transfer assets to your grandchildren free from generation-skipping transfer tax (a flat tax at the then-highest estate tax rate – currently 45%). Unlike with a GRAT, however, you must seed the trust with a down payment, which usually is at least 10% of the purchase price.

For Additional Information

If these techniques are of interest to you, please call us for further details.

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