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With over a century of combined experience, the lawyers of Proskauer's Private Client Services Department regularly provide their diverse clientele – from business entrepreneurs and corporate executives to sports figures and performing artists – with their Personal Planning Strategies Newsletter, a critical source of information which identifies significant issues of interest to Proskauer's clients. The Personal Planning Strategies Newsletter provides articles addressing the latest statutory changes and developments affecting retirement, estate, insurance and tax planning, as well as cutting-edge corporate, real estate and tax concepts.

Low Interest Rates Yield Wealth Transfer Opportunities

Low interest rates can create wealth transfer opportunities. For various wealth transfer techniques, the IRS assumes that a certain minimum interest rate is in effect, known as the applicable federal rate (AFR), and in August 2016 this rate is near historic lows. To the extent that an investment return can be earned that is greater than the AFR, wealth is transferred to the next generation transfer tax free.

In this issue of *Personal Planning Strategies*, we focus on three estate planning strategies which work best in a low interest rate environment: grantor retained annuity trusts (GRATS); loans between family members; and charitable lead trusts (CLTS). All of these devices can be used to shift future appreciation from the donor to the lower generation outside of the transfer tax system. Moreover, when markets are depressed, the potential for appreciation is greater. Thus, the timing is right to do this type of planning.

Creating a "GRAT": Heads You Win, Tails You Break Even

Creating a grantor retained annuity trust (commonly referred to as a "GRAT") is a relatively simple way to transfer property to your children at virtually no gift tax cost. In addition, because of the low interest rate environment and down markets, the advantages of creating a GRAT are magnified. When properly structured, a GRAT can pass to your children all of the future appreciation of the transferred property and reduce the value of the gift to virtually zero.

Basic Operation of a GRAT

In a typical GRAT, you contribute assets to a trust which provides that you are to receive an annuity payment annually for a fixed number of years (the "annuity period"). The annuity amount is typically a stated percentage of the initial fair market value of the trust. It can be stated as a fixed percentage or as a percentage that can increase as much as 20% per year over the trust's term.

At all times during the term of the trust, you will receive the predetermined annuity amount, regardless of how much income the trust assets actually generate or whether the value of its assets rises or falls. To the extent that the income is insufficient to cover the annuity payments, trust principal will be paid to you to make up any shortfall.

At the end of the annuity period, any property remaining in the trust passes to the ultimate beneficiaries of the trust, typically your children or other family members, in further trust or outright, depending upon your preference. Alternatively, you can delay the transfer of assets to your children by naming a trust for your spouse and your descendants as the beneficiary until the spouse's death, at which time your children (or other family members) become the beneficiaries.

Gift Tax Is Minimized

The transfer of property to a GRAT constitutes a gift for gift tax purposes, but the value of that gift is only the value of the trust assets on the date of the transfer reduced by the present value of the annuity you have retained. The calculation of the present value of your retained annuity is based, in part, upon the interest rates promulgated by the IRS for the month the transfer is made, or the I.R.C. Section 7520 rate, commonly referred to as the "hurdle" rate. The hurdle rate is linked to the market yield on U.S. government-issued debt, which is largely determined by the Federal Reserve's monetary policy. The hurdle rate for August 2016 has dropped to 1.4%, nearly its lowest since the creation of the rate in 1989.

In order for a GRAT to be successful, the combined appreciation and income of the assets used to fund the GRAT must exceed the hurdle rate. At the end of the annuity period, the value of the appreciation and income exceeding the hurdle rate will pass to the beneficiaries (or to trusts for their benefit), free of transfer tax. As a result, when the 7520 rate is low, it is "easier" to have a successful GRAT. Since interest rates are currently near historic lows, the potential tax savings are maximized. Additionally, it may be easier to identify appropriate assets to contribute to a GRAT in a down market, where asset values are depressed and significant future growth is expected.

The most popular use of this device in sophisticated estate plans has been the short-term, "zeroed-out" GRAT, in which the term is typically limited to two or three years and the annuity amount is maximized in order to produce as small a taxable gift as possible. For zeroed-out GRATs, the gift, for gift-tax purposes, is usually negligible. In this way, it is possible to use anticipated short-term growth in the trust assets for estate planning purposes without risking longer-term uncertainty, and the risk of depreciation is neutralized by virtually eliminating the gift tax cost.

Suppose you create a GRAT with $5,000,000 to pay yourself an annuity of $2,552,557.50 per year for two years. Applying August's hurdle rate, the value of your retained interest is approximately $4,999,949.63, making the taxable gift about $50. This amount would be reported on a gift tax return, but no tax would be due unless you have no remaining gift tax exemption, which, as a practical matter, is extremely unusual. If the principal of the trust appreciates (including capital growth and income) over the two-year period, so that, after receiving your annuity payments, there are assets remaining in the GRAT – whether one dollar or millions of dollars – your children will receive that amount at no gift tax cost (other than the nominal tax paid, if any, on the initial gift of about $50). On the other hand, if the value of the trust falls or fails to beat the hurdle rate, you will simply get back everything you put in, and you will have lost nothing. Distributions may be made in-kind so there is no need to sell any property in order to receive your annuity payments or transfer assets to individuals or trusts upon completion of the annuity period.

In a two-year zeroed-out GRAT, your children or other named beneficiaries will receive the remaining principal in the trust at the end of two years at no gift tax cost to you or them.

No Extra Cost If You do not Survive the Annuity Period

If you die prior to the end of the annuity period, the annuity will continue to be paid to your estate and the value of the assets in the GRAT at your death will be included in your gross estate for estate tax purposes. Your estate will receive credit for any gift tax already paid, however. Thus, although you will have lost the tax advantage the GRAT was designed to achieve, your estate will be in the same position as if you had not created it.

Gift of Stock in a Closely-Held Business

From the perspective of the IRS, the hurdle rate represents a reasonable assumption of the generally expected yield at market based on general economic factors. From your perspective, however, it may be feasible to select "hot" assets that are expected to generate greater returns. You may be able to achieve substantial benefits by transferring a closely-held business interest or real estate, which you anticipate will increase in value, to your GRAT. In fact, this may be the ideal estate planning device for such a transfer to your children, because you may be in a unique position to predict the future growth of your own business or real estate assets.

Of particular appeal is the fact that the GRAT also removes the risk of undervaluing a closely-held business interest or real estate asset for gift tax purposes. With an outright gift, there is no way to guard against a substantial gift tax deficiency if the value of the property is later challenged by the Internal Revenue Service and increased on audit. But, if instead the gift is the remainder interest in a "zeroed-out" GRAT, and if the annuity amount is expressed as a percentage of the initial value of the trust principal (rather than a dollar figure), any increase in the value of the business (or real estate) determined on an audit of the gift tax return would result almost entirely in an increase in the value of the retained interest and, in turn, in only a nominal gift tax increase.

In the previous example, if the IRS successfully asserts that the value of your company's stock transferred to the trust is $6,000,000 instead of $5,000,000, because your annuity is defined as a percentage of the value of the stock, your annuity is now worth $5,999,939.56 and the value of the resulting gift to your children, is about $60 instead of $50.

Income Tax Considerations

Since the GRAT is a "grantor trust" for income tax purposes, all of its income and deductions are included on your personal return, as if there had been no transfer at all, until the property passes to the ultimate beneficiaries of the GRAT. Therefore, the GRAT is generally income tax-neutral, meaning that your income taxes should be the same whether or not you create the GRAT. If you choose to keep the property in trust for your children (or your spouse and children) after the annuity period, the continuing trust or trusts also can be structured as grantor trusts so that you can continue to pay the income tax attributable to the trusts' income each year until you choose otherwise. Ordinarily, payment of another person's income taxes would have potentially negative tax consequences. However, because a grantor trust is treated as your alter ego for income tax purposes, your payment of the trust's income tax essentially is an additional tax-free gift to your children and can further decrease the value of your estate. Paying the income tax liability from an external source (i.e., from individually owned assets that would have otherwise been includible in your estate) also allows the trust assets to continue to grow and compound on an internally "income tax-free" basis outside of your estate. This is an extremely effective estate planning tool.

Fixing 2015 GRATs that may be Underwater due to Recent Market Decline

A GRAT may include provisions to allow you, as the Grantor, to engage in a "substitution transaction" during the annuity period without triggering any tax. In other words, you can retain the right to swap assets held within the trust for other assets of equal value. This creates an opportunity to take advantage of market volatility or other factors that cause the value of the contributed assets to decline. Assume, for example, that, following the creation of the GRAT, the value of the asset decreases by 20% and it appears unlikely that the value will rebound to the extent necessary to beat the hurdle rate. During the annuity period, you could make the decision to "pull the plug" on the GRAT by substituting cash for the lower value assets. Then, immediately following the swap, you could contribute the same assets to a different GRAT and start the process again. A patient Grantor could simply implement multiple GRATs over time, using the same assets, until their values eventually rise. This is often an attractive option in an environment where asset values have declined and interest rates remain low. This strategy should also be considered for startup companies, which may experience substantial initial costs, but are expected to appreciate dramatically at some point in the future.

Similarly, you may choose to make the continuing trusts under your GRAT grantor trusts and include substitution provisions. This can produce a unique opportunity to eliminate capital gains tax, leverage timing to your advantage and create multiple GRATs using the same assets after the annuity period has ended. Returning to the first example discussed above, assume further that the initial $5,000,000 contribution to the GRAT experienced capital growth over the annuity period at an annual rate of 10% and that you have retained a substitution power over continuing trusts for your children. Making these assumptions, the GRAT will succeed and about $690,000 worth of value will pass to the continuing trusts.

You can now make the decision to substitute the $690,000 worth of assets for cash. By doing this, you are bringing the assets back into your estate, where the $690,000 worth of assets (in addition to any other gain in excess of your basis) will receive a new basis equal to fair market value on your death. This has the effect of eliminating capital gains tax that would otherwise be payable on a sale or exchange of the assets. You have now returned to where you started, except you have successfully transferred $690,000 out of your estate at virtually no tax cost, and you will have eliminated your capital gains tax liability on the assets that you retain in your estate. This technique can be especially effective if, prior to the substitution, you expect the value of the assets to fall dramatically.

By swapping a depreciating asset back into your estate in exchange for a stable asset, such as cash, you can "freeze" the value of assets excluded from your estate, expose your estate to the downside risk and eliminate any capital gains liability. If you subsequently believe the stock will rebound, you can simply contribute the stock to a new GRAT. In effect, a GRAT can be an excellent tool for both estate tax and income tax arbitrage.

Similarly, many clients opt to "reGRAT" the assets they receive in satisfaction of their annuity payments. This technique, often referred to as a "rolling GRAT" approach, allows the Grantor to exclude appreciation from his estate on a continual and incremental basis without the need commit to a lengthy annuity period. This creates a significant amount of flexibility to reassess your plan as interest rates and asset values change over time.

Summary
When properly structured, a GRAT can truly have a "heads you win, tails you break even" result. By adjusting the terms of your trust, you can nearly eliminate the gift tax associated with the transfer of property to your children.

Upon termination of the GRAT, all the appreciation on the assets in excess of the hurdle rate will pass to your children free of gift tax. But if the appreciation is not as expected, or if you do not survive the term of the trust, there are no adverse tax consequences.

GRATs are extremely versatile and can be designed with significant estate tax and income tax savings in mind. With thought and careful planning, they can be used to take advantage of fluctuations in value in a broad array of circumstances.

Finally, in designing the manner in which the ultimate beneficiaries of the GRAT are to receive the trust assets at the end of the GRAT period, you may choose among many options available to achieve the result most consistent with your family and financial objectives.

Intra-family Loans: A Simple Yet Effective Estate Planning Tool

An intra-family loan is a basic estate-planning technique which has a very low transaction cost. Under rules set forth in the Internal Revenue Code, it is possible to make loans to family members at lower rates than those charged by commercial lenders without it being deemed a gift. As discussed below, the lender, usually a parent or grandparent, must charge interest in order to avoid making a gift to the borrower. However, this interest rate may be as low as 1.18% for a loan for a term of three to nine years, with interest paid annually, made in August 2016. The lender can also structure the loan as a balloon note meaning that the borrower pays only interest during the term of the loan and only repays the principal at the end of the term.

Economic Benefits of Intra-family Loans
If a parent makes an interest-free loan to a child or grandchild, the Internal Revenue Service will treat the foregone interest as a taxable gift. In order to prevent the IRS from treating a part of the loan itself as a gift, the parent must charge a certain minimum interest rate, which is known as the applicable federal rate ("AFR"), which the Treasury determines every month. To the extent that the interest charged on the loan is lower than the interest calculated with the AFR, that amount will be imputed income to the parent, even though the parent does not actually collect it. Furthermore, the IRS will treat that

amount as a gift to the child, which would require the filing of a gift tax return. However, if a parent establishes a bona fide creditor-debtor relationship with adequate stated interest, the intra-family loan will not be characterized as a transfer subject to the gift tax.

Intra-family loans create an opportunity to shift wealth from one family member to another family member, usually a child or grandchild, if that child or grandchild can earn a greater return on the amount borrowed than the AFR. The minimum interest rate required to be used depends on the term of the loan, and the compounding period. In August 2016, if interest is paid annually on a loan, the AFR for short-term loans (demand loans and loans for up to three years) is 0.56%. The AFR for mid-term loans (loans from 3-9 years) is 1.18%, and the long-term AFR rate for loans over 9 years is 1.90%. To the extent that a child or grandchild is able to earn a higher rate of return on the borrowed funds than the interest rate being paid, he or she is able to keep the excess without any gift taxes being paid.

For example, if a parent makes a nine-year loan to a child of $2 million, the loan will be a successful estate planning tool if the child can earn over 1.18% with the money borrowed. If the child invests the $2 million for the nine years at an 8% annual rate of return, he or she will have about $3,998,008 at the end of the loan, and will only have to repay his or her parents $2,222,706 throughout the course of the loan. Therefore, the child is entitled to keep the difference of $1,775,302 without any gift tax consequences. If the parent was going to make the same investment that the child made anyway, the risk to the family as a whole has not changed and the loan was a successful way to transfer wealth in the next generation.

Other Benefits

Outside of a wealth transfer concept, intra-family loans may also be more beneficial than third party loans because they allow the total interest expense paid over the course of the loan to stay within the family rather than being paid to a bank. In addition, an intra-family loan can allow children who have poor credit history to buy a home or to start a new business. Furthermore, it allows families to avoid the normal expenses incurred with loans, such as administrative costs, closing costs and appraisal fees. Also, if a child wants to pay off the loan early, the terms on the loan can be structured so that there are no prepayment penalties.

The amount of savings for children who are looking to buy a house can be significant. For example, according to Freddie Mac, the average bank rate for a 30-year fixed mortgage rate is currently 3.45%. A $500,000 mortgage at 3.45% would require one to pay $2,231 a month. However, a mortgage at the long-term AFR for August 2016 (1.9%) would only require one to pay $1,823 per month. Therefore, a child would save about $408 per month and about $4,896 per year if a parent loans him or her money to buy a home.

Additional Tax Benefits

The IRS allows any individual to make a gift to another person free of the gift tax each year up to the amount of the annual exclusion, which is currently $14,000. In addition to the annual exclusion, every person is allowed a $5,450,000 lifetime exemption from the gift tax. Therefore, even if an individual gives more than $14,000 to a single person in a given year, the gift amount which is above $14,000 will not be subject to tax unless the individual has already given $5,450,000 in taxable gifts throughout his or her life.

Because intra-family loans are not gifts, they do not count towards an individual's lifetime gift tax exemption. Therefore, even if an individual has used up all of his or her $5,450,000 lifetime exemption from the gift tax, he or she can still make a loan to a family member without paying gift tax. Furthermore, a grandparent can make a loan to a grandchild without being subject to the generation-skipping transfer tax.

In addition, an intra-family loan can be used to take advantage of the $14,000 annual exclusion. A parent can forgive up to $14,000 per year per family member (and up to $28,000 if a married couple splits the gift) without any adverse gift tax consequences. However, the parent will have interest income in any year in which interest is forgiven.

Conclusion

An intra-family loan can be used as a simple and effective wealth transfer device. Such a loan is a successful estate planning tool if a family member earns a higher return on the money borrowed than the AFR, thus today's low AFR presents an opportunity to lock in a low interest rate on an intra-family loan.

Charitable Lead Trusts Can Save Transfer Taxes

A charitable lead trust (CLT) pays an annuity to one or more charities of your choice for a specified number of years or for the life of an individual. At the end of the term, the remaining assets in the trust (and any appreciation thereon) pass to one or more non-charitable beneficiaries, such as your children or other family members. The IRS anticipates that the property transferred to a CLT will grow at a rate equal to the prevailing interest rate dictated by the IRS when the trust is established. If the trust generates higher total returns over its term, the excess growth will pass to your family free of gift tax.

CLTs can be structured so that the gift tax on the remainder interest passing to family members will be small or even non-existent. The effectiveness of a CLT is determined in part by the interest rates that prevail at the time the trust is created. These trusts are particularly attractive right now because low interest rates increase the value of the charitable annuity, producing a greater tax deduction and reducing the gift tax on amounts passing to your family at the end of the CLT. Moreover, when markets are depressed, the potential for appreciation is that much greater.

Technical Rules Must Be Followed to Ensure Tax Deduction

An individual is deemed to make a charitable gift when he or she establishes a CLT. There are certain requirements under the Internal Revenue Code which must be met in order to qualify the charitable interest as deductible for estate and gift tax purposes. The interest must be either a "guaranteed" annuity with a fixed and determined annual payout based on the initial market value of the CLT, or a "unitrust" interest, in which the percentage is fixed, but is applied to the annually-revalued assets in the trust.

For example, if a transfer of $1,000,000 is made to a charitable lead annuity trust with a 5 percent payout to charity, $50,000 will be paid to charity each year of the trust. In the case of a charitable lead unitrust, if the payout rate is 5 percent and the trust property increases to $2,000,000 in a subsequent year, the annual payment to charity for that year will increase to $100,000.

A CLT created during your lifetime can be set up to produce tax benefits in the form of either a substantial income tax deduction in the year the trust is funded (for the present value of the charitable payments) or the exclusion of the trust's taxable income from your personal income tax return each year. If you choose the immediate income tax deduction, in each year of the trust term, you must report the trust's income on your tax return even though it is paid to charity. This option may be appropriate if you have an unusually large amount of income in a particular year so that the charitable deduction when the trust is established will more than offset the future income taxes on the trust income.

Trust Terms Can Be Tailored to Suit Your Needs

The amount of the charitable deduction is based on the size of the payments to charity, the length of the charitable term of the trust and the rate prescribed by the IRS to calculate the present value of the charitable payments (i.e., the rate set out in section 7520 of the Internal Revenue Code, or "7520 rate"). The 7520 rate changes monthly depending upon market interest rates and is presently near historic lows. If the payments to charity and the charitable term are structured to provide a tax deduction equal to the full amount transferred to the CLT, any growth of the trust assets in excess of the 7520 rate will pass to the non-charitable remainder beneficiaries (e.g., your family) free of gift tax. Given that the 7520 rate for August 2016 is only 1.4 percent, the potential exists for significant tax-free wealth transfers. (As a comparison, the 7520 rate for August 2000 was 7.6 percent.)

Set forth below is a chart demonstrating the benefits of creating a charitable lead annuity trust in August 2016. The chart shows how much will pass tax-free to your family depending on the length of the charitable term and the rate of return achieved by the trust. In this scenario, $5,000,000 is transferred to a charitable lead annuity trust, which is structured to produce as small a taxable gift to the remainder beneficiaries as possible. The higher the rate of return, the more property remains to pass to your family free of gift tax at the end of the charitable term.

Amounts Passing To Beneficiaries Free Of Gift Tax At The End Of The Charitable Term (Assuming Various Growth Rates)

Charitable Term	Beginning Principal	Annual Payment to Charity	*5.00% Growth*	*7.50% Growth*	*10.00% Growth*	*15.00% Growth*
10 Years	$5,000,000	$539,300	$1,361,216	$2,675,634	$4,373,659	$9,277,993
20 Years	$5,000,000	$288,350	$3,731,921	$8,752,351	$17,122,254	$52,293,080
30 Years	$5,000,000	$205,250	$7,973,138	$22,552,049	$53,484,613	$241,827,419

Tax Advantages of Charitable Lead Trusts

The tax benefit of a CLT is that it can reduce the amount subject to gift or estate tax to a significantly smaller amount than the value of the property ultimately transferred to the family beneficiaries. Furthermore, any future appreciation in the trust principal inures to the benefit of the family remaindermen, and that enhancement is not taxed in your estate upon your death.

CLTs can be created during your lifetime (an "inter vivos" trust) or under your will or revocable trust (a "testamentary" trust). A testamentary charitable lead trust is included in your estate at the date of death value of its assets but the estate receives a deduction for the value of the interest passing to charity, determined as described above. The same principles apply with respect to gift tax if the trust is created during your life, but no gift tax is actually payable (if a gift is even deemed to be made) if a portion of your unified credit is still available (i.e., generally if you have not already made taxable gifts in excess of $5,450,000).

The opportunity for significant estate and gift tax savings which the CLT presents should not be overlooked if you have the desire to benefit a favorite charity (including your own family foundation) and the willingness to delay for a number of years the receipt by your family of property transferred to the trust. If you are already making significant annual gifts to charity, a CLT may provide a more tax-efficient way to make such gifts. Your advisor can project the tax savings for you and help you choose among the many options available to achieve the result most consistent with your charitable and financial goals.

The Private Client Services Department at Proskauer is one of the largest private wealth management teams in the country and works with high net-worth individuals and families to design customized estate and wealth transfer plans, and with individuals and institutions to assist in the administration of trusts and estates.

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