



Marketplace

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Market Watch - Planning Before Interest Rates Rise.

MARKET TREND: Planning with estate “freezes” has been popular in this low interest rate environment. The potential for rising rates before year-end may incentivize clients to move sooner rather than later on these opportunities.

SYNOPSIS: Over the past several years, the volatile stock market, historically low interest rates, and the availability of higher gift and generation-skipping transfer tax exemptions have provided a unique environment for “estate freeze” planning, which transfers the appreciation in an asset to family members or trust for their benefit. Typical freezes include GRATs, CLATs, intra-family loans and installment sales, all of which work best when there is maximum growth potential for the transferred assets. Also, since freezes, like GRATs and installment sales to grantor trusts, can be implemented using little to no federal gift tax exemption, it has allowed clients who may have exhausted their federal transfer tax exemption back in 2012 to continue their legacy planning.

TAKE AWAYS: Increases in federally-set interest rates could gradually change the economics of several popular wealth transfer planning opportunities, particularly estate freezes like GRATs and installments sales to grantor trust. Clients already contemplating this planning should move promptly to take advantage of the current market environment.

Despite recent U.S. market volatility and concerns over global markets, it appears the Federal Reserve continues to consider an increase in raise interest rates this year, after several years of keeping them at historical lows. Below are some wealth transfer planning alternatives that clients may want to implement in the near future, before rates rise.

LOW RATE PLANNING

Over the past several years, the volatile stock market, historically low interest rates, and the availability of higher gift and generation-skipping transfer (“**GST**”) tax exemptions (\$5.43 million in 2015) have provided a unique environment for “estate freeze” planning,

which transfers the appreciation in an asset to family members or trust for their benefit. Freeze plans work best when there is maximum growth potential between the transferred asset's return rate and certain federally-set rates (e.g., the Applicable Federal Rate ("AFR") and the IRC §7520 rate ("7520 rate")).

Additionally, freezes generally allow clients to retain an annuity or income stream from the transferred asset and can be implemented using little to no federal gift tax exemption. These features may appeal to clients nervous about parting with wealth in a volatile market or who have exhausted their gift and GST tax exemptions (or who wish to preserve their estate tax exemption to obtain a basis step-up at death). Typical "freezes" include the following:

GRATs and CLATs. With a grantor retained annuity trust ("GRAT"), the grantor funds an irrevocable trust that pays the grantor an annuity for a fixed term, based on the 7520 rate in the month of creation. At the end of the term, the trust assets pass to the designated remainder beneficiaries. For charitably inclined clients, a charitable lead annuity trust ("CLAT") is similar to a GRAT,¹ except that a charity, not the grantor, receives the annuity payments, and funding the CLAT can provide the grantor with a current income tax charitable deduction, if properly structured.² Both GRATs and CLATs require appreciation of trust assets in excess of the 7520 rate to pass wealth to the trust beneficiaries after expiration of the annuity term. Lower interest rates can increase the likelihood that a GRAT/CLAT will produce a positive result.

Example: X sets up a five-year GRAT at the September 2015 7520 rate of 2.2% and transfers \$5 million in appreciating assets to the trust. The annuity payments to the grantor will increase annually by 20%. The present value of the total annuity payments to the grantor will equal \$5 million (i.e., a zero-out GRAT), so there is no taxable gift upon transfer to the GRAT. The annual growth on the trust assets over the GRAT term is 6%, leaving over \$750,000 to the remainder beneficiaries. Note that if ***the 7520 rate increases by just 1%, to 3.2%, the amount passing to the beneficiaries is reduced by almost \$190,000.***

Intra-Family Loans and Installment Sales. These planning options benefit from asset growth in excess of the AFR (AFRs for September 2015 are 0.54% (short-term), 1.77% (mid-term), and 2.64% (long-term)). Thus, to the extent that the borrower in a loan transaction earns a rate of return on the borrowed funds in excess of the AFR, the lender will successfully transfer wealth to the family member. A similar result applies on an installment sale transaction where the asset sold appreciates at a rate higher than the AFR.

Example: Assume X sells assets valued at \$5 million to an existing grantor dynasty trust benefiting his descendants in exchange for a 20-year, interest-only note charging interest at the September 2015 AFR of 2.64%. If, over the note term, the assets earn a 6% annual return, the client will have transferred over \$6.2 million to the trust. If, however, the ***AFR charged is increased by just 1%, to 3.64%, the growth transferred to the trust is reduced by almost \$1.9 million.***

OTHER PLANNING CONSIDERATIONS

Desire to Gift Appreciation Only. Unlike a straight gift, freezes return the initial value of the asset transferred (and growth up to the applicable hurdle rate (i.e., AFR or §7520 rate)) to the client over time, transferring only the future appreciation over the hurdle rate to the desired beneficiaries. Clients who do not want to retain any benefit from the transferred property may simply want to consider gifting the assets.

Asset Selection. Clients should carefully select the type of assets they transfer in freeze planning. Assets with significant appreciation or income generation potential will generally work best in this type of planning, such as assets that pay higher yields or dividends (e.g., high dividend stocks, seller notes, structured notes), or with anticipated high growth, such as shares or other business interests with depressed values (e.g., start-ups) although these assets may create issues in funding annuity or loan payments (see below).

Term Selection. The type of freeze used and the choice of the term will depend on several issues, including the grantor's life expectancy, the type of assets contributed, their projected performance, the desire to lock-in low rates etc. In particular, the regularity and timing of the anticipated return of the transferred assets is critical to the plan and term selection. For example, if the assets are not expected to increase in value or generate income for some time (e.g., start-up business interests), the plan may need to consider a longer term and/or lower initial payments.³

Availability of Valuation Discounts. Transferring discounted assets in freeze planning can significantly enhance the probability that the freeze will out perform the specified hurdle rate.

Example:⁴ X funds a 10-year, zero-out GRAT with public stock worth \$1 million, subject to a 15% "blockage" discount that results in an \$850,000 value for federal gift tax purposes. The annuity payments will increase by 20% each year, and the applicable 7520 rate is 2.2%. The blockage discount will not apply to any stock distributed to satisfy the annuity payments (the number of shares distributed will be insufficient). To leave \$150,000 as a remainder at the end of the term (the value of the discount), the GRAT must only achieve an annual return of 1.8% (**0.4% less than 7520 rate**). If the GRAT's performance matches the 7520 rate, it will leave a remainder of \$186,000 (rather than \$0 with undiscounted assets). If the GRAT's performance equals 6% annually, the **GRAT will pass \$596,000 to the remainder beneficiaries (compared to \$385,000 with undiscounted assets)**.

As discussed in *WRMarketplace #15-23*, however, the IRS could propose regulations limiting the use of discounts in the context of family limited partnerships and LLCs ("FLPs"). Clients already engaged in freeze planning with FLPs have even more incentive to complete the process in a timely manner.

Flexibility. For freeze planning, advisors and client will want to provide flexibility to adjust to changing circumstances, particularly with regard to the investment performance of the assets transferred. For example, if a grantor trust is used, the trust can provide the grantor with a non-fiduciary power to substitute or swap trust assets for

assets of an equivalent value. This allows the grantor to exercise the power to either bail out underperforming assets by substituting higher return assets, or lock in the gains of a very successful freeze by swapping in lower growth assets.

Using Grantor and Dynasty Trusts. If the trust used in freeze planning continues as a grantor trust for income tax purposes after expiration of the freeze term, the client, as grantor, will continue to pay the trust's income tax obligations, which permits the trust growth to compound without reduction for annual tax liabilities.⁵ Further, use of a perpetual, dynasty trust can allow that trust growth to benefit multiple generations.

COMBINING WITH LIFE INSURANCE

Since some estate freezes are closely linked to a client's life expectancy for success, (e.g., GRAT) life insurance can serve as protection if an unexpected death occurs. In addition, properly-structured freezes can support life insurance purchases by providing exit planning for split-dollar arrangements or generally offering funding options that require relatively low gift tax exemption, which may complement or eliminate the need for annual exclusion gifts to the trust (and the corresponding administrative hassles of providing *Crummey* withdrawal powers and notices to the trust beneficiaries).

TAKE-AWAYS

Increases in federally-set interest rates could gradually change the economics and effectiveness of several popular wealth transfer planning opportunities, particularly estate freezes like GRATs and installments sales to grantor trust. Clients already contemplating this planning should move promptly to take advantage of the current market environment.

NOTES

¹ Unlike GRATs, CLATs can choose to use the §7520 rate in the month of creation or the rate from one of the prior two months. CLATs also can be structured as non-grantor trusts for income tax purposes, in which case the trust grantor would not receive an income tax deduction for his or her contribution to the CLAT (although the CLAT would receive an income tax deduction for its charitable distributions).

² The ability to take a full deduction for the amount contributed to a grantor CLAT in a given calendar year will be subject to the various percentage and other limitations and requirements imposed on charitable income tax deductions, although any unused deduction generally can be carried forward for up to five years.

³ Longer-term planning may offer benefits for consistently high return assets, such as high-dividend paying stock. The longer term can lock in a low AFR or §7520 rate and maximize the benefits of compounding growth. If using more volatile assets, however, long-term planning, particularly with GRATs, may face higher performance hurdles, since periods of asset growth can be countered by periods of depreciation. Capturing investment volatility may suggest short-term planning, such as with a series of short-term or "rolling" GRATs, which can have a "smoothing" effect by capturing interim investment volatility and avoiding offsetting periods of growth and depreciation. Short-term planning also hedges against the mortality risk of the grantor's death during the term but will face the risk of future increases in applicable interest rates. See *WRMarketplace* #14-08 for additional considerations in planning with GRATs.

⁴ See Jonathan G. Blattmachr and Diana S.C. Zeydel, "Playing the Tables: Current Developments in GRATs, SCINs and Other Wealth Transfer Strategies." Note, however, that clients and advisors must factor in the "flip-side" of discounts, particularly if in-kind distributions of the transferred assets are needed to satisfy annuity or note payments. In-kind distributions will require valuations, which can be time-consuming and expensive for hard-to value assets. In addition, property subject to a discount going into the freeze may incur a discount coming out. This will undermine the planning benefits.

⁵ Of course, the continuation of grantor trust status and the grantor's payment of the trust's income tax burden must consider the financial impact to the grantor. Thus, the trust may want to allow for the termination of grantor trust status during the grantor's lifetime, in the event the tax burden becomes economically impractical for the grantor to bear.

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