

## TAX ALERT

### A SURPRISINGLY OPPORTUNE TIME FOR ESTATE PLANNING

In the current unstable economy, when your investment portfolio and, possibly, your retirement, may appear to be in jeopardy, estate planning may be the furthest thing from your mind. However, the combination of current low market values and low interest rates creates an exceptional opportunity to take advantage of certain existing estate planning strategies. This alert highlights two such strategies that have the potential to leverage depressed values and low interest rates into boons to your estate plan—and your heirs—by transferring future appreciation on assets in excess of a “hurdle rate” set by the Internal Revenue Service (IRS), with minimal gift tax costs or risks if structured properly.

### GIFT TO A GRAT

The first strategy to consider is a gift of assets to a grantor retained annuity trust (GRAT). A GRAT is a type of trust designed to transfer future appreciation on assets at a nominal, close to zero, gift tax cost. The GRAT’s creator, or “grantor,” transfers assets to a trust for a specified term of years. Over the GRAT’s term, the GRAT repays the grantor, in the form of fixed annuity payments, property equal in value to the initial value of the transferred assets plus an assumed rate of return. This assumed rate of return is based on the IRS’s published Applicable Federal Rate (AFR) in effect for the month in which the GRAT is funded and is often referred to as the GRAT’s “hurdle rate.” The GRAT will be successful if, among other things, the GRAT’s assets appreciate in excess of the hurdle rate, in which case that excess appreciation will pass to the GRAT beneficiaries (such as trusts for the grantor’s children) free of additional transfer taxes.

Assets such as publicly traded securities that have lost value as a result of current market conditions but are expected to regain value in the long run may be ideal assets to transfer to a GRAT. If the market rebounds during the term of the GRAT, any increase in the value of the GRAT assets in excess of the hurdle rate will pass to the GRAT beneficiaries and be removed from the grantor’s taxable estate, with minimal, if any, transfer taxes.

Furthermore, the hurdle rate applicable to a GRAT is currently nearing an historic low, making this a particularly advantageous moment for a transfer to a GRAT. The GRAT hurdle rate for December 2008 is 3.4 percent. By way of comparison, the hurdle rate for December 2007 was 5.0 percent and for December 1990 was 10.2 percent.

A GRAT is particularly useful in an economic climate such as the present, because there is no downside other than transaction costs if the GRAT assets do not perform as well as expected. If the GRAT assets appreciate at a rate lower than the hurdle rate, the assets simply will be repaid to the grantor through the required annuity payments. Although there is no estate planning benefit under such circumstances, the grantor will be in substantially the same position as if the GRAT had never been created in the first instance.

## INSTALLMENT SALE, OR LOAN, TO A GRANTOR TRUST

The second technique to consider is the sale of assets to a grantor trust, or, alternatively, a loan to a grantor trust to facilitate the trust's purchase of assets. With this strategy, the grantor creates a type of trust that is disregarded for income tax purposes, known as a "grantor trust". The trust, typically created for the benefit of the grantor's descendants, is structured so that all of the income, gains and deductions of the trust are reported directly on the grantor's income tax return as if the trust did not exist. After creating the grantor trust, the grantor sells assets<sup>1</sup> or loans cash to the trust in exchange for a promissory note bearing interest at a "hurdle rate" equal to the published AFR for the note's term in effect for the month of the transaction. The grantor ultimately will receive back from the trust the principal balance of the note plus the AFR interest. The sale/loan will be successful if the assets sold to, or reinvestments of the cash loaned to, the trust appreciate at a rate higher than the hurdle rate. Any such excess appreciation will pass to the trust beneficiaries without the imposition of transfer taxes.<sup>2</sup>

Choice assets to sell to a grantor trust are easily valued assets likely to appreciate in value over the note's term in excess of the hurdle rate. Assets undervalued as a result of current market fluctuations may be especially attractive candidates for such a sale or loan.

The hurdle rate applicable to this strategy, like the hurdle rate applicable to a GRAT, is currently extremely low. The AFR varies depending on the length of the note's term and is now especially favorable if the note term is nine years or less. For instance, the December 2008 rate applicable to a short-term (less than three years) note is approximately 1.36 percent; for a mid-term (three to nine years) note, approximately 2.85 percent; and for a long-term (greater than nine years) note, approximately 4.45 percent. Assuming a sale or loan this month for a mid-term note, if the trust's investments subsequently "pop" in value, any appreciation in excess of 2.85 percent will pass to the trust beneficiaries free of transfer taxes.

Additional complexity and risk may be involved in implementing the sale or loan strategy as opposed to the GRAT strategy, but, for a number of reasons, including that the AFR for short- and mid-term notes is lower than the GRAT hurdle rate, the potential benefit to the grantor's estate plan and the grantor's heirs may be greater.

Given the current economic environment, it may seem an inopportune time to think about transferring wealth to your heirs. However, the combination of market volatility and low interest rates provides an exceptional opportunity to transfer undervalued assets at a reduced tax cost. The professionals in Akin Gump Strauss Hauer & Feld LLP's private client services practice are ready to assist you and your family in making the most of these extraordinary times. Please contact us if you wish to hear more about these or any other planning strategies.

### CONTACT INFORMATION

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<sup>1</sup> In the case of a sale, the grantor does not recognize any gain or loss because the sale is disregarded for income tax purposes.

<sup>2</sup> It may be necessary to make an initial gift to the grantor trust prior to the sale/loan in order to establish the trust as "credit-worthy" and the bona fides of the sale/loan arrangement.