Income and Estate Planning Techniques That Work Well in a Volatile Market & Low Interest Rates Environment

Presented by:

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Opportunities & Disasters in a Volatile Market

- Income Tax Planning
  - Roth Conversions – Dollar cost averaging
  - Loss Harvesting
  - ISO & NQSO Exercise
  - Unwinding NUA positions
- Tax Issues with Concentrated Positions
- Income Tax Planning, for Estates
  - Estate administration in a volatile market, including liquidity issues
  - Effective loss harvesting

Income Tax Planning in a Volatile Market

Roth IRA Conversions

Specific Down Market Strategy

- Taxable income is determined based on the value of the assets on the date of the conversion
- Recovery is sheltered from all future income tax

- Recalling undoing the conversion (recharacterization) in the event of further market decline is NO LONGER POSSIBLE after the TCJA

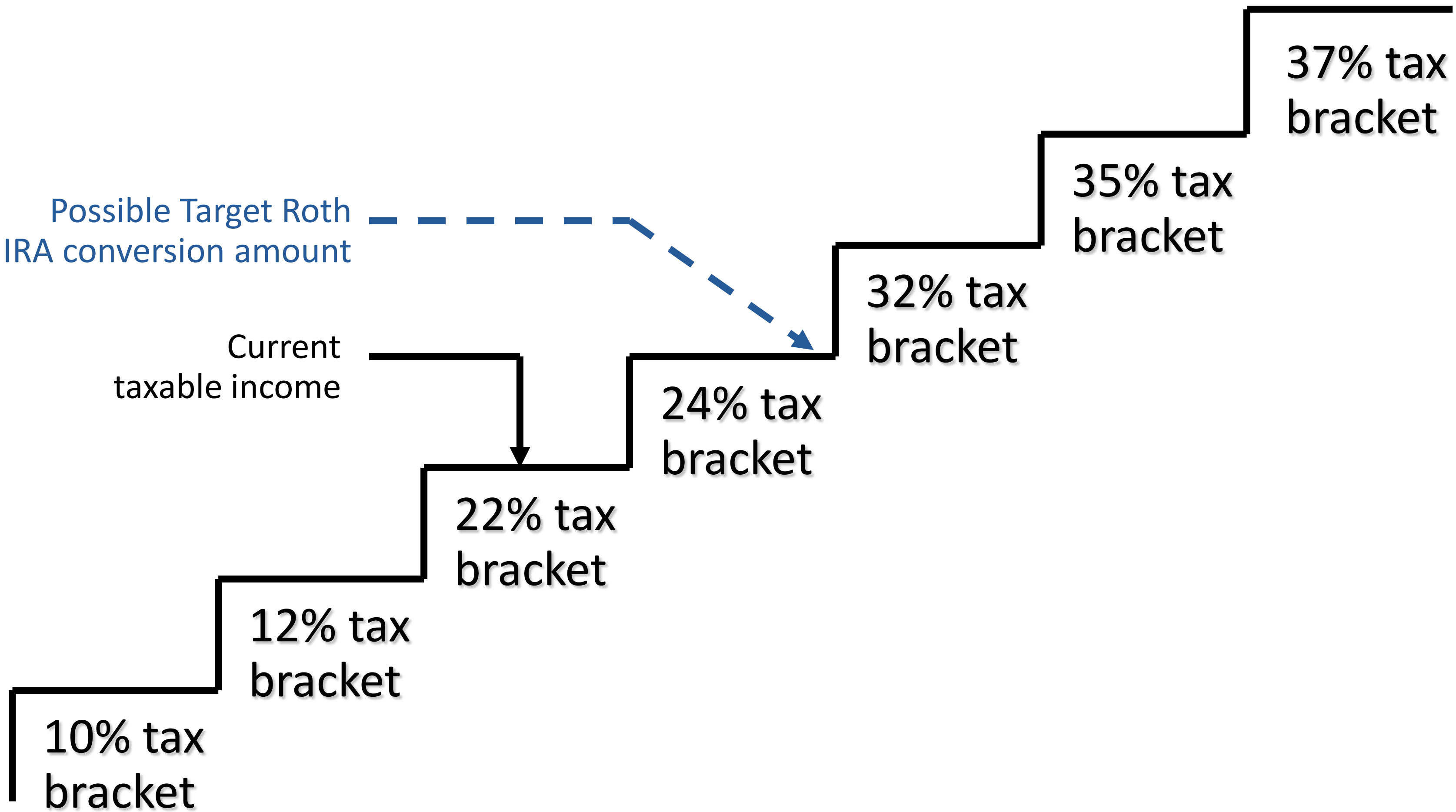
Roth IRA Conversions

Mathematics of Conversion

- Critical decision factors
  - Tax rate differential (year of conversion vs. withdrawal years)
  - Use of “outside funds” to pay the income tax liability
  - Need for IRA funds to meet annual living expenses
  - Time horizon

Roth IRA Conversions

Target Roth IRA Conversion Amount



Harvesting Capital Loss(es)

Overview

- Selling assets at a loss and using those losses to offset capital gains realized on other assets
- Basic Strategy:
  - It reduces or eliminates current capital gain
  - Once the asset is repurchased, it gives the taxpayer a lower basis in the repurchased asset
  - Thus, it increases the amount of gain that is recognized when the asset is later sold
  - Therefore, total gain recognized is the same, but loss harvesting creates tax deferral
    - Provides only a timing benefit

Harvesting Capital Loss(es)

Key Issues

- “Wash sale” rule (IRC § 1091)
- Diminishing value of capital losses
- Inefficiency of capital loss offsetting

Harvesting Capital Loss(es)

"Wash Sale" Rule (IRC Section 1091)

- Capital losses are denied to the extent that a taxpayer has acquired (or has entered into a contract or option to acquire) a "substantially identical" stock or securities within a period beginning 30 days before the sale and ending 30 days after the sale of a stock which was sold at a loss (i.e. "loss stock")
  - This rule also applies to ETFs and index funds
  - Disallowed loss on "loss stock" is added to the cost basis of the new stock
  - The holding period of the "loss stock" is carried over to the new stock

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Harvesting Capital Loss(es)

Diminishing Value of Capital Losses

- Over time capital losses lose their value as a result of a taxpayer's cost of capital
  - Example: Taxpayer has a $100,000 capital loss in the current tax year. Assuming a 5% discount rate, the following chart illustrates the diminished value of the capital loss carryover if the loss is recognized ratably over a ten-year period (vs. recognizing the loss all in the current year).

	Capital Loss Recognized in Current Year	Capital Loss Recognized Over 10 years
Present value of tax benefit	$20,000	$15,443

NOTE: The above comparison assumes that the $100,000 capital loss is offset by long-term capital gain taxed at a 20% capital gains tax rate.

Harvesting Capital Loss(es)

Inefficiency of Harvesting Capital Losses

- In general, capital losses are more tax effective if they can be used to offset income taxed at higher tax rates (e.g. short-term capital gains and ordinary income)
  - Thus, long-term losses used against short-term gains are more tax-efficient than short-term losses being used against long-term capital gains

	Short-Term Gain	Long-Term Gain
Short-Term Loss	NEUTRAL	INEFFECTIVE
Long-Term Loss	EFFECTIVE	NEUTRAL

Harvesting Capital Loss(es)

Strategies

- Buy stock of similar company
- Double-up “loss stock” – wait 31 days
- Double-up “loss stock” – enter into “cashless collar”
- Buy call option at-the-money
- Loss Harvesting Within CRTs to Reduce NIIT

Harvesting Capital Loss(es)

Similar Stock Strategy

- Taxpayer has a stock (e.g. Coke) with an unrealized loss (i.e. "loss stock")

- Taxpayer purchases a similar stock (e.g. Pepsi) at any time prior to (or after) the sale of the "loss stock"

  – <u>NOTE</u>: The sale and purchase can occur on the same day in that the two stocks are not "substantially identical"

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Harvesting Capital Loss(es)

Double-Up Strategy

- Taxpayer has a stock (e.g. Coke) with an unrealized loss (i.e. “loss stock”)

- Taxpayer purchases the same stock (i.e. Coke) at least 31 days before the anticipated sale date of the “loss stock”

Harvesting Capital Loss(es)

"Cashless Collar" Strategy

- Taxpayer simultaneously purchases a put option and sells a call option (to finance the cost of the put option) on the new stock (i.e. a "cashless collar") with an exercise date 31 days or more from the date of the cashless collar was entered into

- At the expiration date, taxpayer tenders the "loss stock" to the respective counterparty
  - Conversely, if the stock price stays inside of the cashless collar's price range, taxpayer would sell the stock

Harvesting Capital Loss(es)

In Trusts & Estates

- The IRC § 1014(a) "step-up" provides many loss harvesting opportunities.

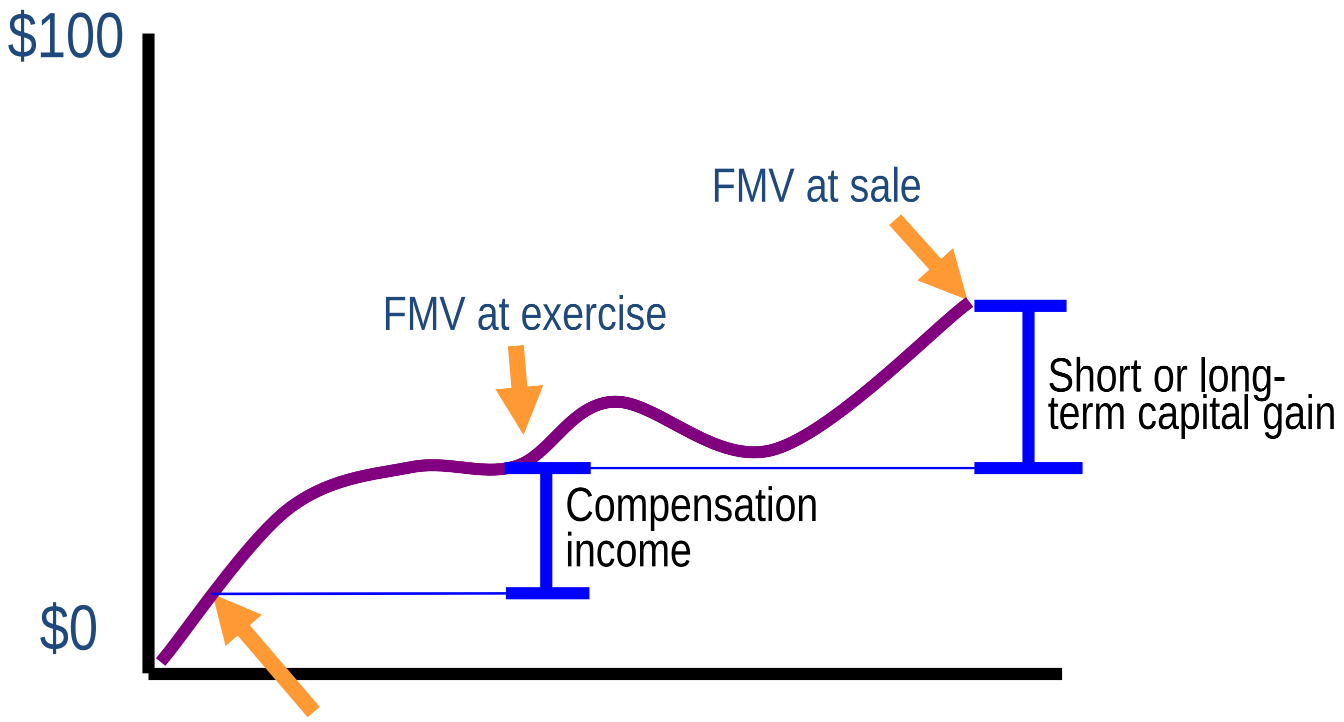
- However, the complications of fiduciary income taxation must be considered:
  - Losses in excess of income are trapped in the trust or estate until termination
  - The asset with the built-in loss could be distributed to a beneficiary thereby shifting the loss

ISO & NQSO Exercise

- ISO and NQSO exercise will cause a recognition event
- Simply put, the lower the FMV at exercise the lower the income recognized

ISO & NQSO Exercise

Non-Qualified Stock Options (NQSOs) Tax Consequences



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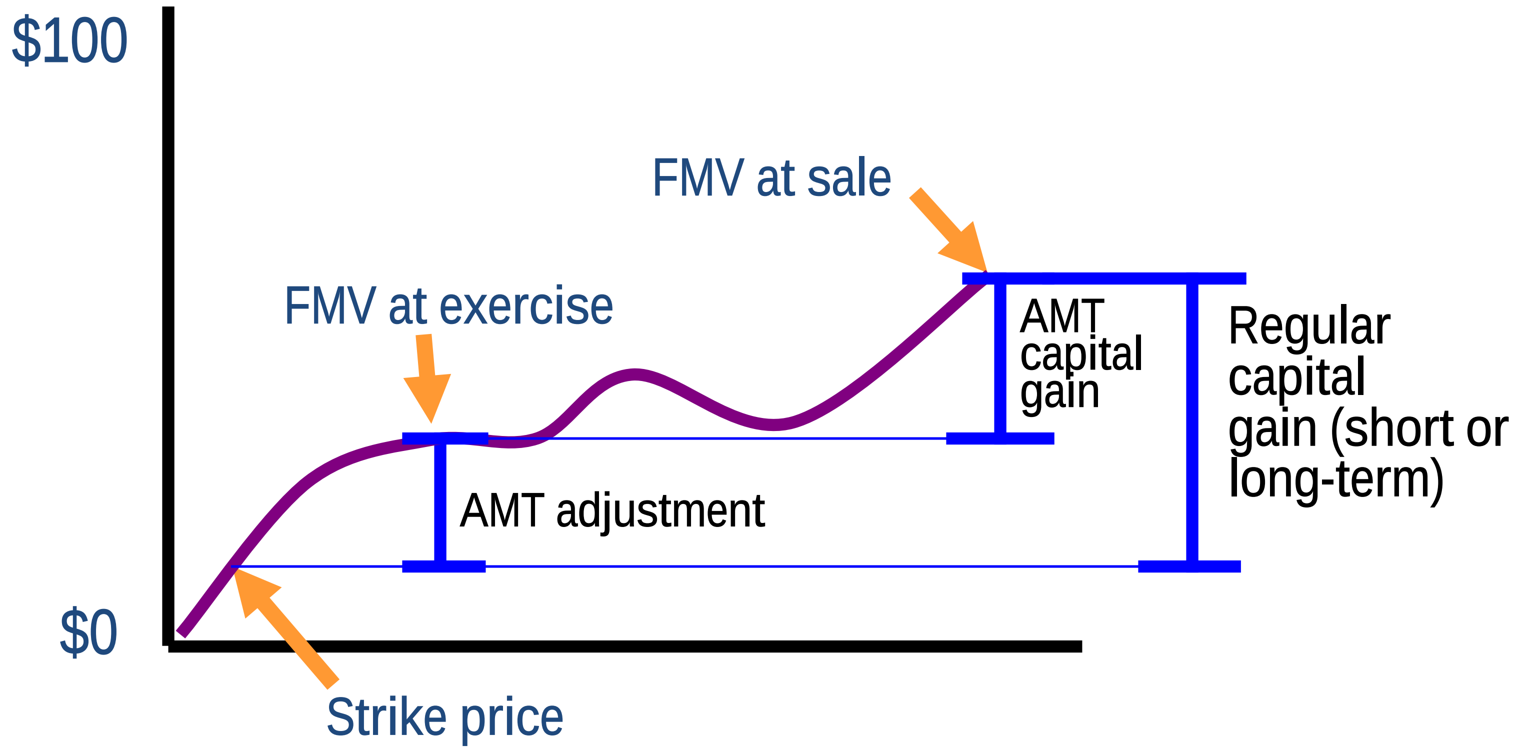
ISO & NQSO Exercise

Incentive Stock Options (ISOs) Tax Consequences



Unwinding NUA Positions

- Net Unrealized Appreciation rollout is taxed according the basis in the securities – no market-timing opportunity

- However, many are left with a significant concentrated position after rollout

Unwinding NUA Positions

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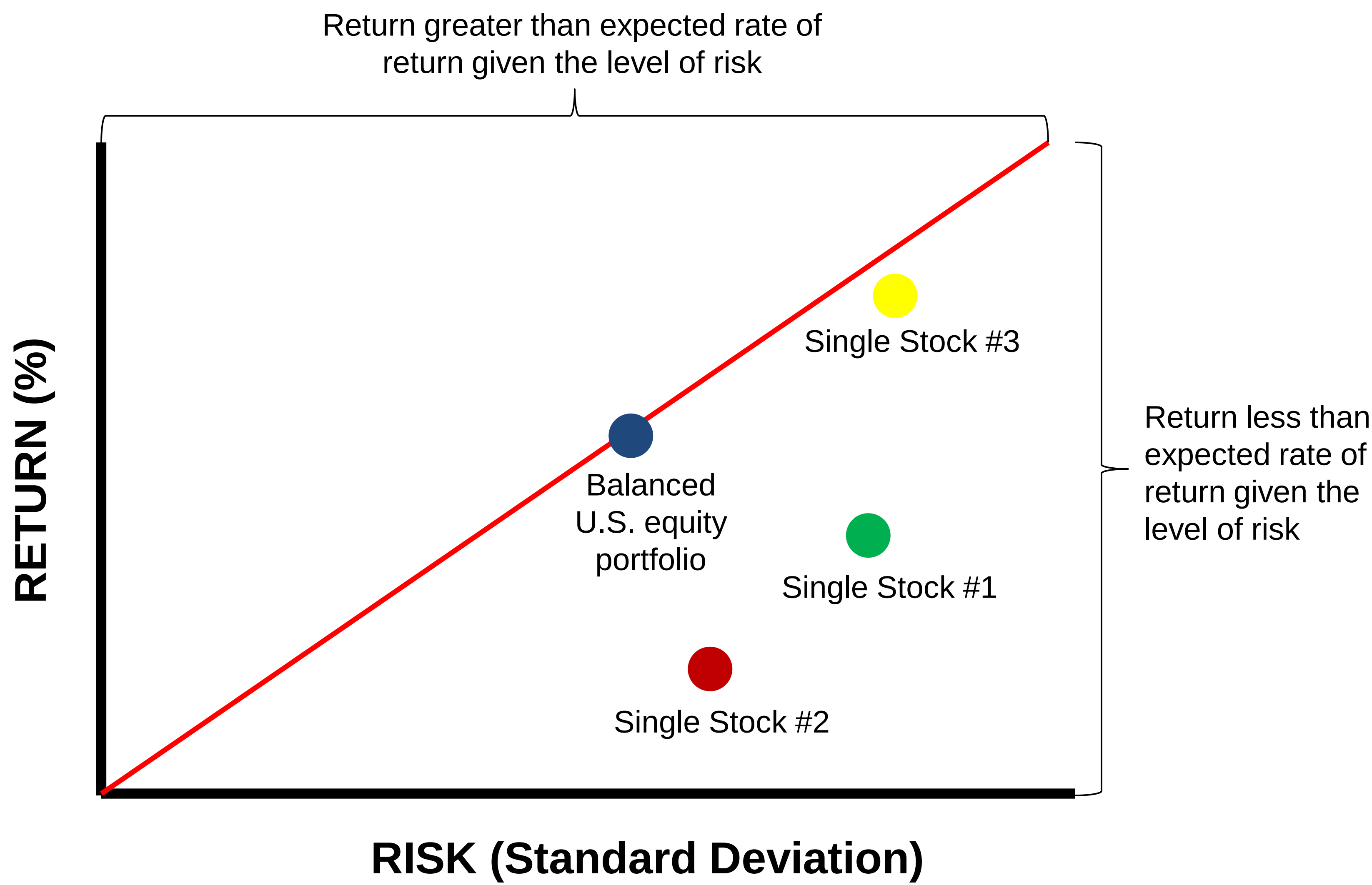
- However, many are left with a significant concentrated position after rollout

Tax Issues with Concentrated Positions

Efficient Frontier Chart



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Sell & Reinvest

- Simply sell stock and reinvest in a diversified portfolio
  - Locks in gain and eliminates downside risk
  - Permits diversification
- Issues
  - Tax payable on sale reduces amount that can be reinvested (can invest only after-tax proceeds)
  - T owns X stock with a basis of $10 and FMV of $100
  - T sells and recognized gain of $13.50 (.15 x $90 gain)
  - T is left with $86.50 to reinvest
  - Possible cash-flow problems
  - Lose basis step-up that would be available from dying with the stock
  - Specific identification method

Short Sales "Against the Box"

- Short sale in which T already owns the replacement shares when the short sale is made

- Gives T a long position and a short position on the same number of shares of stock

Short Sales "Against the Box" – Advantages & Disadvantages

- Accomplished all 4 objectives—
  - Perfect hedge—no downside risk if stock price increases or decreases
  - Locks in price making it possible to borrow up to 95% of value of underlying stock and use proceeds to diversify portfolio
  - Defers or eliminates gain recognition
  - Low cost

- Disadvantage
  - Following TRA 1997, T must go without hedge for at least 60 days per year to avoid a constructive sale under section 1259

Protective Put Options

- T buys right to sell stock at a given price no matter how low the market price drops

- Example:
  - T owns 1,000 shares of X stock
  - T bought the stock for $10/share and it has a current FMV of $40/share
  - T buys puts at $35
  - T has locked in a sale price of $35/share and ensured a profit of at least $25/share

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Protective Put Options – Advantages & Disadvantages

- Advantages
  - Downside protection
  - No current capital gain

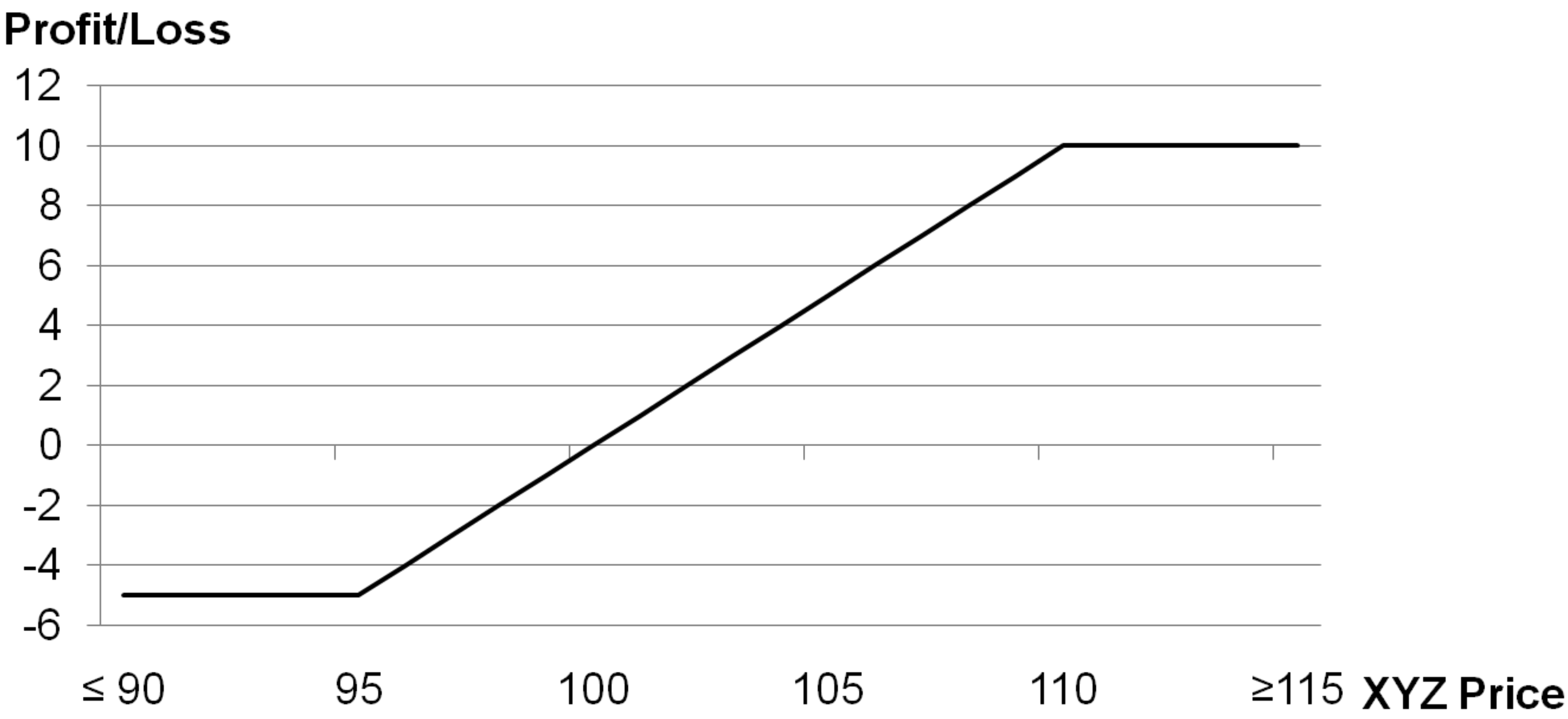
- Disadvantages
  - No diversification
  - Expensive to maintain over a long period of time
  - Straddle rules apply
  - Dividends received from the appreciated position don't qualify for the 15% tax rate

“Cashless” Collars

- T has a concentrated low basis stock position
- T buys a protective put with a strike price below the current stock price to provide some downside protection
- T simultaneously sells a call with a strike price above the current stock price to pay for the put
- The amount received for the call equals the amount spent for the put, eliminating any current cash outlay

“Cashless” Collars - Example

Current stock Price = $100, Put Strike Price = $95, Call Strike Price at $110



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“Cashless” & “Monetizing” Collars – Advantages & Disadvantages

- Advantages
  - Same protection as a protective put
  - No current capital gain (further deferral if cash settled)
  - No current cost because selling the call pays for the put
  - Collared shares can be used as collateral to borrow and diversify—can borrow up to 50% of value for this purpose
  - Retain ownership of stock (keep voting rights and rights to dividends)
- Disadvantages
  - Lose upside potential on long position above call strike price
  - Price band on collar can’t be too tight or there is a constructive sale
  - No net cash inflow
  - May produce unfavorable tax consequences- (e.g., straddle rules may apply)

Variable Forward Sale

- Investor receives cash (generally 70-90% of stock FMV) at outset
- Investor agrees to deliver some or all of underlying shares at end of transaction (depending on stock price at the time of closure) or opt for cash settlement if investor wants to keep the stock
- Embedded “collar” provides ceiling and floor on number of shares to be delivered
- Economically the same as a collar + borrowing against the underlying stock
  - Same 15% minimum band between put and call strike to avoid a constructive sale as for a collar

Variable Forward Sale – Advantages & Disadvantages

- Advantages:
  - No gain recognition until expiration of contract + further deferral if cash settled
  - Monetize 70 – 90% of stock value to provide funds for diversification
  - Downside protection below floor price
  - No restrictions on use of up-front proceeds—don't have to be repaid

- Disadvantages:
  - Lose upside potential on stock above cap price
  - Profit for counter party
  - Unfavorable tax straddle rules apply
  - Short-term capital gains treatment
  - Fees may be higher than with a collar

Exchange Fund

- Investor and other stock owners contribute shares of stock to a private placement limited partnership
- Pool shares with those of other investors who may also have concentrated positions
- Entitled to a prorated portion of the portfolio after 7 years
- No tax until stock is sold

Exchange Fund – Advantages & Disadvantages

- Advantages:
  - Immediate diversification without recognition of gain on low-basis stock
  - Full monetization of after-tax proceeds
  - Retain all upside potential in stock
- Disadvantages:
  - Premature withdrawals could result in penalties
  - Fund produces little or no current income
  - No downside protection
  - No shareholder control over assets contributed by and distributed to other partners
  - High management fees

Gift & Estate Tax Planning in a Volatile Market

Opportunities & Disasters in a Volatile Market

- Gift & Estate Tax Planning
  - Taxable and Tax-free Gifting
  - Trust Distributions to Minimize GST Liability
  - Late Allocation of GST Exemption
  - Distributions and Sales from a Taxable Estate to capture the Alternative Valuation Date
  - Grantor Trust Asset Substitution under § 675(4)(c)
  - Funding GRATs
  - IDGT Sales
  - Refinancing Existing Notes
  - Split-dollar strategies

Taxable and Tax-free Gifting

Specific Down Market Strategy

- The amount of gift tax exemption used and the amount against which gift tax is accessed is based on the fair market value of the gifted asset

- Assets which are undervalued in down market are efficient gifts:
  - Low transfer tax cost
  - No further appreciation of the estate from the down market value
  - High appreciation for recipients

Taxable and Tax-free Gifting

Basis in Property Acquired by Gift

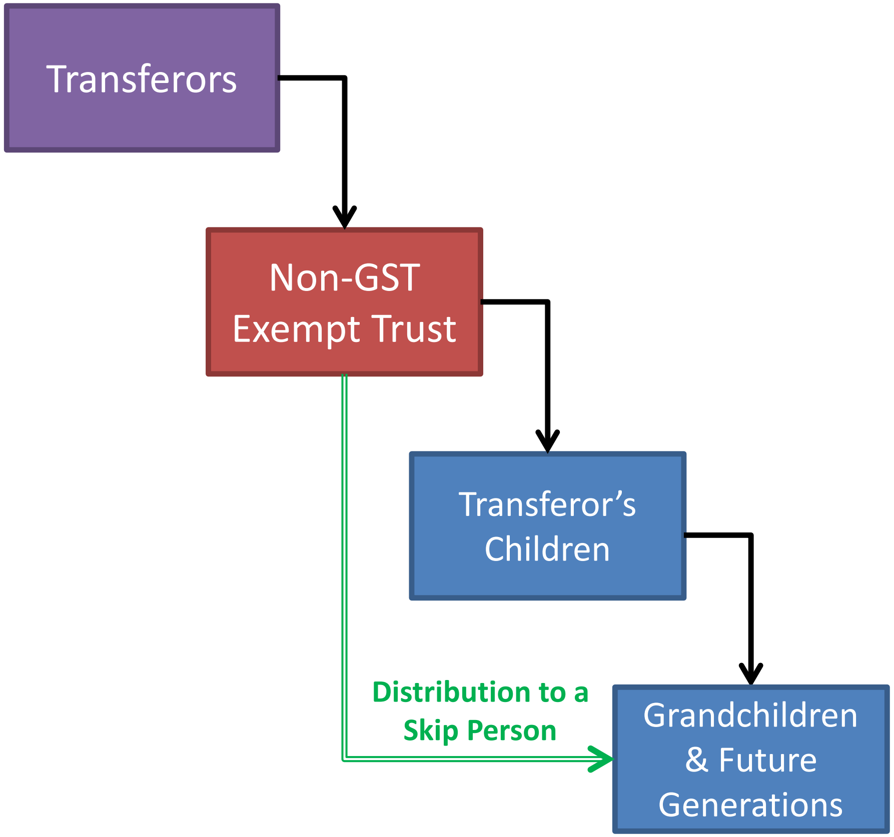
- Donee’s basis for computing gain is the same as the donor’s basis

- Donee’s basis for computing loss is the lesser of—
  - Donor’s basis, or
  - FMV of property on date of gift (Reg. § 1.1015-1(a)

Taxable Trust Distributions

Minimizing GST Tax

- GST Tax is imposed on trust distributions to skip persons
- A common situation might be as follows:
  - Transferors fund a trust with a taxable gift on which they do not wish to incur GST tax
  - The trust is for the benefit of children, grandchildren, and future generations
  - The trustee makes a distribution to a grandchild to help buy a car while the middle generation is still alive
  - **GST tax is owed on the fair market value of the distribution**



Late Allocation of GST Exemption

Minimizing GST Tax

- Timely allocation permits use of date-of-gift value for purposes of allocation

- Late allocation requires use of values as of date return is filed
  - Special first of the month rule
  - Treas. Reg. Sec. 26.2642-2(a)(2)
  - **Example:** David makes a $100,000 gift to a dynasty trust in 1999 but did not allocate GST exemption on the gift tax return. David files a gift tax return in March 2020 in order to allocate GST exemption to the trust. He must use the value of the trust on March 1, 2020 to fully allocate GST exemption to the trust.

IRC § 2032 Alternative Valuation

Minimizing Estate Tax

(A) GENERAL The value of the gross estate may be determined, if the executor so elects, by valuing all the property included in the gross estate as follows:

(1) In the case of property distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date of distribution, sale, exchange, or other disposition.

(2) In the case of property not distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date 6 months after the decedent's death.

(3) Any interest or estate which is affected by mere lapse of time shall be included at its value as of the time of death (instead of the later date) with adjustment for any difference in its value as of the later date not due to mere lapse of time.

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IRC § 675(4)(c) Grantor Trust Asset Substitution

Maximizing Basis & Growth Potential

- Grantors will generally hold a Power of Substitution over the assets in a grantor trust (aka Swap Powers).
- This is perhaps the most common way drafters confer grantor trust status.
- The power allows the grantor to swap assets in the trust of equal value owned directly by the grantor.
- Market volatility presents opportunities to use this power; for example a grantor could swap assets primed for growth into the trust in exchange for assets with a lower growth potential or low basis

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Disasters in a Volatile Market

Example

- On March 7, 2000 Proctor & Gamble's share price decreased from $43.72 to $30.50 in a single trading day, losing over 30% of its value.
- At the time, our team had many clients who were P&G employees who we're devastated
- Protecting vulnerable clients from such events is important from not only a finance, but also a tax standpoint

Disasters in a Volatile Market

Example – Cont.

- Consider, for example, if a client died on March 6 with $1,000,000 of P&G stock and faced a 55% estate tax rate
- By the end trading at March 7, the value of the stock decreased to about $697,621 but the client still was required to report $1,000,000 of value on their 706
- Thankfully, the Alternative Valuation Date Election could prevent this result

Disasters in a Volatile Market

Example – Cont.

- However, consider if the client died on March 1 and the estate bought a Put at $44 per share before March 7.
- The client could use the stock price of $30.06 on the alternative valuation date of September 1
- The client would owe estate tax on the $30.06 price
- However, the spread of $13.94 ($44-30.06) would not be subject to estate tax

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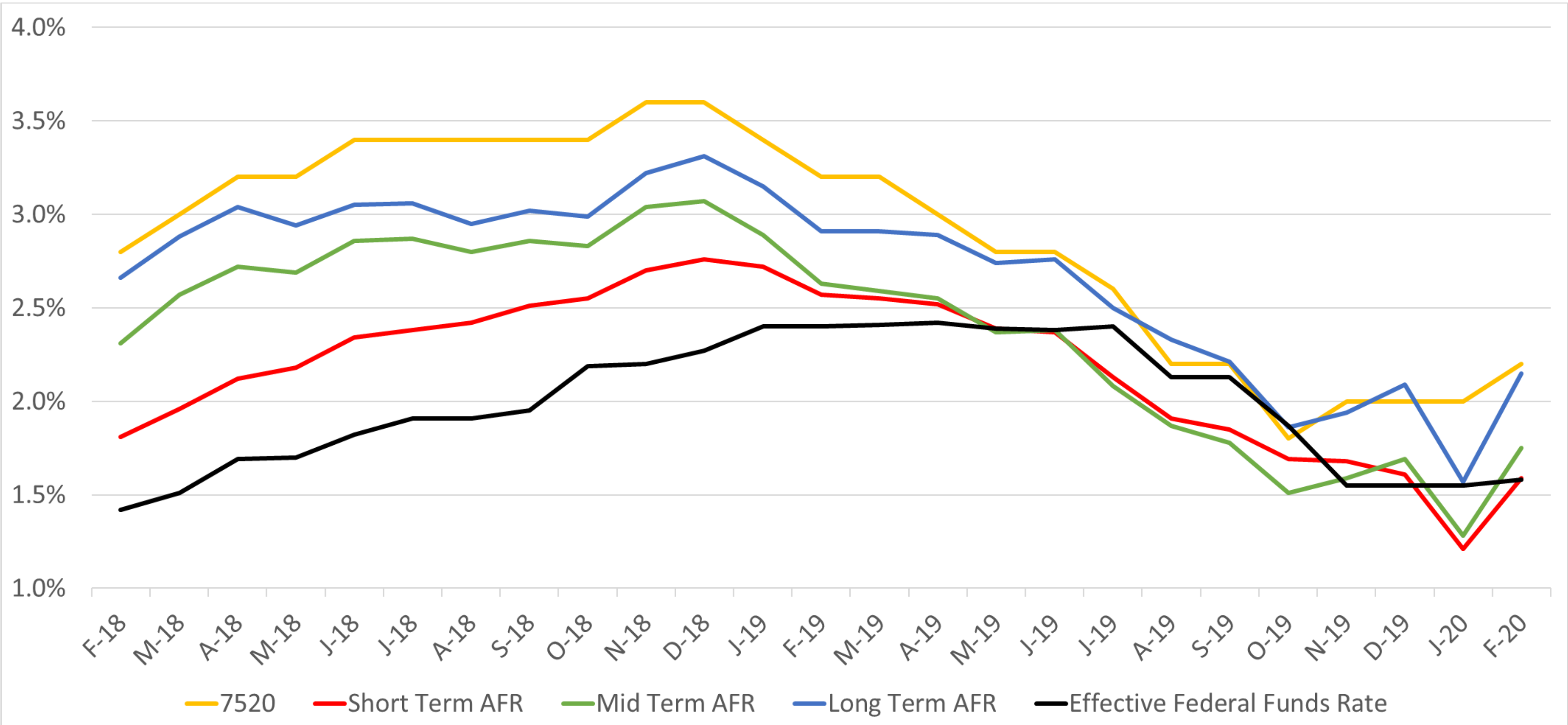
Low Interest Rate Planning

- Low interest rates are advantageous to many common estate tax planning techniques
- Those who expect a taxable estate may be prudent to act when rates are low

- Democratic proposals to significantly strengthen the estate tax, such as from Senator Sanders, increase the impetus to act

Low Interest Rate Planning



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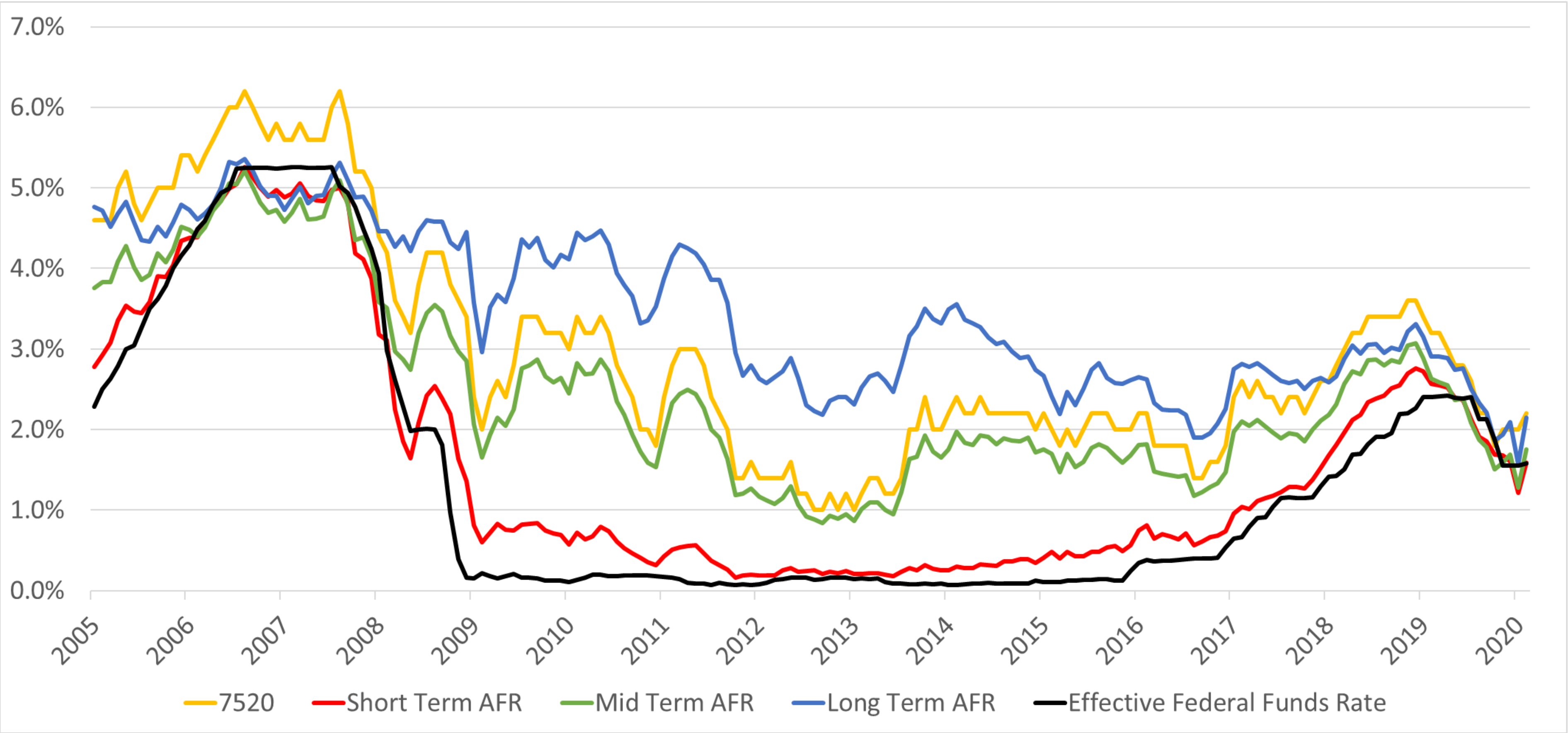
Low Interest Rate Planning



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7520 Rate Computation

- The 7520 rate is 120% of the applicable federal mid-term rate (mid-term AFR) rounded to the nearest two-tenths of one percent

Valuation Month	120% of Applicable Federal Midterm Rate	Section 7520 Interest Rate
Jan-19	3.47	3.4
Feb-19	3.15	3.2
Mar-19	3.1	3.2
Apr-19	3.06	3.0
May-19	2.85	2.8
Jun-19	2.86	2.8
Jul-19	2.5	2.6
Aug-19	2.24	2.2
Sep-19	2.13	2.2

Long-term AFR
3.15
2.91
2.91
2.89
2.74
2.76
2.50
2.33
2.21

Note the inversion

Tax Planning & Rates

Lower Rates Favor

- GRATs
- IDGTs Sales
- § 453 Installment Sales between related parties
- CLATs
- Private Annuities
- Split-dollar Life Insurance, Loan Method

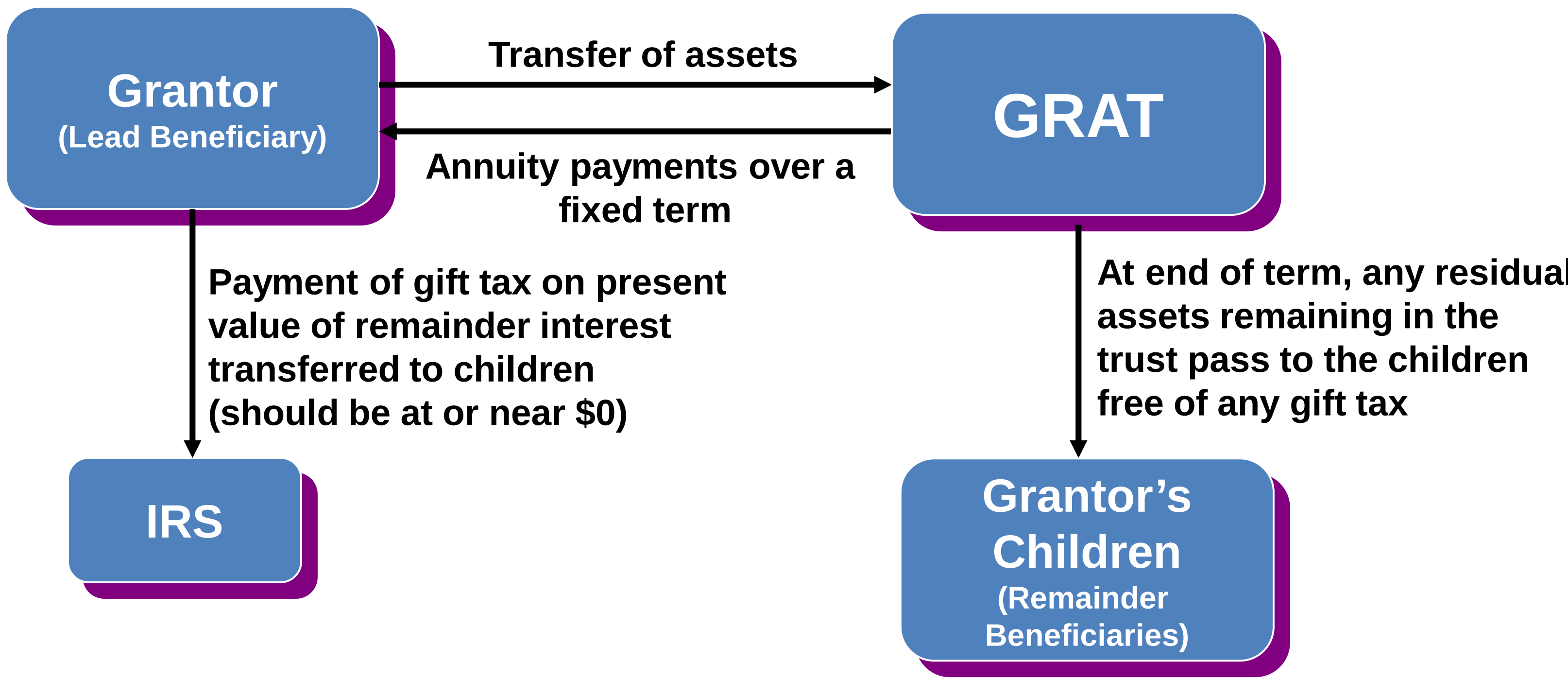
Higher Rates Favor

- QPRTs
- GRITs
- CRATs
- Graegin Loans
- Farmland alternative valuation

Generally Neutral

- CRUTs
- CLUTs

Grantor Retained Annuity Trust (GRAT)



*** Instead of naming the children as outright remainder beneficiaries of the GRAT, a grantor trust could be used (thus producing a greater estate tax benefit)**

GRAT

Why a GRAT Works

§ 7520 Rate 2.4%

Year		Beginning Balance		Taxable Income 10.00%	$	Annuity Payment 795,680		Ending Balance
1	$	10,000,000	$	1,000,000	$	(795,680)	$	10,204,320
2	$	10,204,320	$	1,020,432	$	(795,680)	$	10,429,072
3	$	10,429,072	$	1,042,907	$	(795,680)	$	10,676,299
4	$	10,676,299	$	1,067,630	$	(795,680)	$	10,948,248
5	$	10,948,248	$	1,094,825	$	(795,680)	$	11,247,393
6	$	11,247,393	$	1,124,739	$	(795,680)	$	11,576,452
7	$	11,576,452	$	1,157,645	$	(795,680)	$	11,938,417
8	$	11,938,417	$	1,193,842	$	(795,680)	$	12,336,578
9	$	12,336,578	$	1,233,658	$	(795,680)	$	12,774,556
10	$	12,774,556	$	1,277,456	$	(795,680)	$	13,256,331

BENEFIT: $13,256,331 Transferred to Beneficiaries Tax-Free

* Assuming a $7,000,000 (after valuation adjustments) initial contribution

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GRAT

Why a GRAT Works – Rate Differential

§ 7520 Rate 2.4%

Year		Beginning Balance		Taxable Income 2.40%	$	Annuity Payment 1,136,686		Ending Balance
1	$	10,000,000	$	240,000	$	(1,136,686)	$	9,103,314
2	$	9,103,314	$	218,480	$	(1,136,686)	$	8,185,108
3	$	8,185,108	$	196,443	$	(1,136,686)	$	7,244,864
4	$	7,244,864	$	173,877	$	(1,136,686)	$	6,282,055
5	$	6,282,055	$	150,769	$	(1,136,686)	$	5,296,138
6	$	5,296,138	$	127,107	$	(1,136,686)	$	4,286,559
7	$	4,286,559	$	102,877	$	(1,136,686)	$	3,252,751
8	$	3,252,751	$	78,066	$	(1,136,686)	$	2,194,131
9	$	2,194,131	$	52,659	$	(1,136,686)	$	1,110,104
10	$	1,110,104	$	26,642	$	(1,136,747)	$	-

Year		Beginning Balance		Taxable Income 10.00%	$	Annuity Payment 1,136,686		Ending Balance
1	$	10,000,000	$	1,000,000	$	(1,136,686)	$	9,863,314
2	$	9,863,314	$	986,331	$	(1,136,686)	$	9,712,959
3	$	9,712,959	$	971,296	$	(1,136,686)	$	9,547,569
4	$	9,547,569	$	954,757	$	(1,136,686)	$	9,365,640
5	$	9,365,640	$	936,564	$	(1,136,686)	$	9,165,518
6	$	9,165,518	$	916,552	$	(1,136,686)	$	8,945,384
7	$	8,945,384	$	894,538	$	(1,136,686)	$	8,703,237
8	$	8,703,237	$	870,324	$	(1,136,686)	$	8,436,874
9	$	8,436,874	$	843,687	$	(1,136,686)	$	8,143,876
10	$	8,143,876	$	814,388	$	(1,136,686)	$	7,821,577

BENEFIT: $7,821,577 Additional Wealth Transferred to Beneficiaries Tax-Free (of which $1,640,473 is due to taxes paid to grantor)

GRAT

Why a GRAT Works – Valuation Adjustments

§ 7520 Rate 2.4%

Year	Beginning Balance	Taxable Income 10.00%	Annuity Payment $ 1,136,686	Ending Balance
1	$ 10,000,000	$ 1,000,000	$ (1,136,686)	$ 9,863,314
2	$ 9,863,314	$ 986,331	$ (1,136,686)	$ 9,712,959
3	$ 9,712,959	$ 971,296	$ (1,136,686)	$ 9,547,569
4	$ 9,547,569	$ 954,757	$ (1,136,686)	$ 9,365,640
5	$ 9,365,640	$ 936,564	$ (1,136,686)	$ 9,165,518
6	$ 9,165,518	$ 916,552	$ (1,136,686)	$ 8,945,384
7	$ 8,945,384	$ 894,538	$ (1,136,686)	$ 8,703,237
8	$ 8,703,237	$ 870,324	$ (1,136,686)	$ 8,436,874
9	$ 8,436,874	$ 843,687	$ (1,136,686)	$ 8,143,876
10	$ 8,143,876	$ 814,388	$ (1,136,686)	$ 7,821,577

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1	$ 10,000,000	$ 1,000,000	$ (795,680)	$ 10,204,320
2	$ 10,204,320	$ 1,020,432	$ (795,680)	$ 10,429,072
3	$ 10,429,072	$ 1,042,907	$ (795,680)	$ 10,676,299
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8	$ 11,938,417	$ 1,193,842	$ (795,680)	$ 12,336,578
9	$ 12,336,578	$ 1,233,658	$ (795,680)	$ 12,774,556
10	$ 12,774,556	$ 1,277,456	$ (795,680)	$ 13,256,331

BENEFIT: $5,434,754 Additional Wealth Transferred to Beneficiaries Tax-Free

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GRAT

Why a GRAT Works – Grantor-Paid Taxes
§ 7520 Rate 2.4%

Year	Beginning Balance	Taxable Income 10.00%	Annuity Payment $ 795,680	Less: Taxes @ 40.00%	Ending Balance
1	$ 10,000,000	$ 1,000,000	$ (795,680)	$ (81,728)	$ 10,122,592
2	$ 10,122,592	$ 1,012,259	$ (795,680)	$ (86,632)	$ 10,252,539
3	$ 10,252,539	$ 1,025,254	$ (795,680)	$ (91,829)	$ 10,390,284
4	$ 10,390,284	$ 1,039,028	$ (795,680)	$ (97,339)	$ 10,536,292
5	$ 10,536,292	$ 1,053,629	$ (795,680)	$ (103,180)	$ 10,691,062
6	$ 10,691,062	$ 1,069,106	$ (795,680)	$ (109,370)	$ 10,855,117
7	$ 10,855,117	$ 1,085,512	$ (795,680)	$ (115,933)	$ 11,029,016
8	$ 11,029,016	$ 1,102,902	$ (795,680)	$ (122,889)	$ 11,213,349
9	$ 11,213,349	$ 1,121,335	$ (795,680)	$ (130,262)	$ 11,408,742
10	$ 11,408,742	$ 1,140,874	$ (795,680)	$ (138,078)	$ 11,615,858

Year	Beginning Balance	Taxable Income 10.00%	Annuity Payment $ 795,680	Less: Taxes @ 40.00%	Ending Balance
1	$ 10,000,000	$ 1,000,000	$ (795,680)	$ -	$ 10,204,320
2	$ 10,204,320	$ 1,020,432	$ (795,680)	$ -	$ 10,429,072
3	$ 10,429,072	$ 1,042,907	$ (795,680)	$ -	$ 10,676,299
4	$ 10,676,299	$ 1,067,630	$ (795,680)	$ -	$ 10,948,248
5	$ 10,948,248	$ 1,094,825	$ (795,680)	$ -	$ 11,247,393
6	$ 11,247,393	$ 1,124,739	$ (795,680)	$ -	$ 11,576,452
7	$ 11,576,452	$ 1,157,645	$ (795,680)	$ -	$ 11,938,417
8	$ 11,938,417	$ 1,193,842	$ (795,680)	$ -	$ 12,336,578
9	$ 12,336,578	$ 1,233,658	$ (795,680)	$ -	$ 12,774,556
10	$ 12,774,556	$ 1,277,456	$ (795,680)	$ -	$ 13,256,331

BENEFIT: $1,640,473 Additional Wealth Transferred to Beneficiaries Tax-Free

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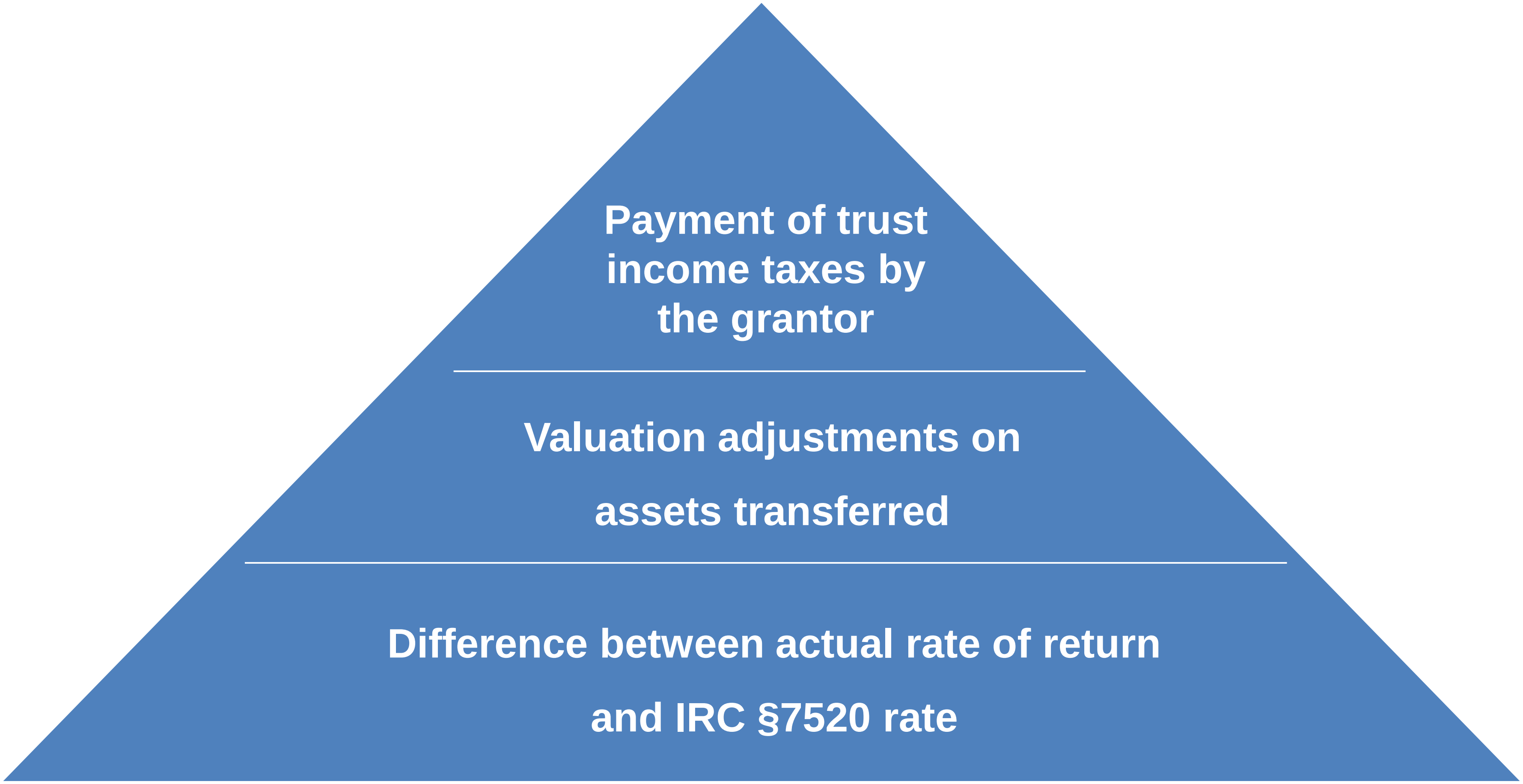
GRAT

Why a GRAT Works – Summary
§ 7520 Rate 2.4%

Reasons for Total Wealth Transferred		
Differential Between Rates of Return	$	6,181,104
Valuation Adjustment		5,434,754
Income Taxes Paid by Grantor		1,640,473
Total Wealth Transferred	**$**	**13,256,331**

GRAT

Why a GRAT Works – Summary



GRAT

Advantages

- Annuity payments provide income stream to the grantor
- Ability to make gifts of substantial amounts of property tax-free
- Grantor pays income tax on trust income, leaving more assets in the GRAT for remainder beneficiaries
- Reduces the taxable estate of the grantor
- Valuation adjustments increase effectiveness of sale for estate tax purposes; A *Wandry*-clause can substantially reduce or eliminate the risk of valuation adjustments on audit

GRAT

Disadvantages

- If the grantor dies before the end of the GRAT term, the assets in the GRAT are included in the grantor's estate
- The remainder beneficiaries will have the same basis in the property transferred to the GRAT as the grantor had at the time the property was transferred (no step-up in basis)
- Risk that rate of return will not exceed interest rate resulting in no assets being transferred to remainder beneficiaries
- GST allocations to GRATs are ineffective until the end of the Estate Tax Inclusion Period (ETIP); i.e. The sole beneficiaries cannot be skip persons

GRAT

Rate Based Efficacy

GRAT										
7520 Rate		**1.00%**		**2.00%**		**3.00%**		**4.00%**		**5.00%**
Rate of Return		7.00%		7.00%		7.00%		7.00%		7.00%
Principal	$	1,000,000	$	1,000,000	$	1,000,000	$	1,000,000	$	1,000,000
Term (years)		8		8		8		8		8
Annuity (annual)	$	130,690	$	136,510	$	142,456	$	148,528	$	154,722
Remainder	$	377,330	$	317,623	$	256,612	$	194,320	$	130,771
Estate Tax Savings (40%)	$	150,932	$	127,049	$	102,645	$	77,728	$	52,308

GRAT

Valuation at Death During the Inclusion Period

- Inclusion can be reduced by termination and returning to the grantor the actuarial value of the retained interest.
- Otherwise, inclusion is based on the dollar value of the assets required to satisfy the annuity computed at the current 7520 rate

GRAT

99-year GRAT

99-YEAR GRAT					
7520 Rate @ Funding	**2.00%**	**2.00%**	**2.00%**	**2.00%**	**2.00%**
Principal	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000
Term (years)	99	99	99	99	99
Death Year	5	5	5	5	5
Annuity (annual)	$ 23,277	$ 23,277	$ 23,277	$ 23,277	$ 23,277
7520 Rate @ Death	**1.00%**	**2.00%**	**3.00%**	**4.00%**	**5.00%**
Computed Inclusion	$ 2,327,729	$ 1,163,865	$ 775,910	$ 581,932	$ 465,546
Maximum Inclusion	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000
Estate Tax Savings Due to 7520 Rate Change (40%)	**$ -**	**$ -**	**$ 89,636**	**$ 167,227**	**$ 213,782**

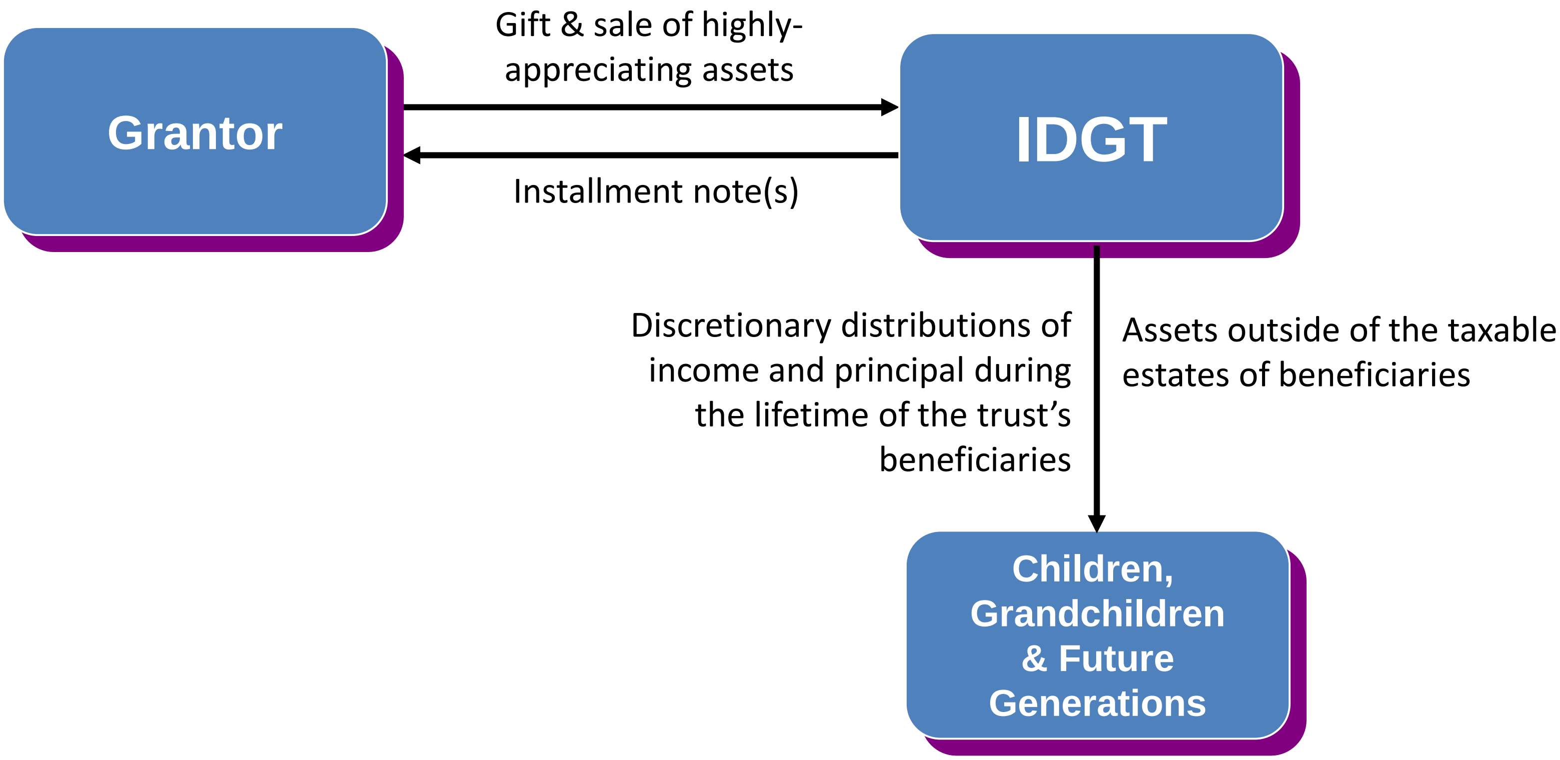
See Rev. Ruls. 82-105, 1982-1 C.B. 133, 76-273, 1976-2 C.B. 268, TAM 200210009 (Nov. 19, 2001)

Intentionally Defective Grantor Trust (IDGT) Sale

- An IDGT sale is a transaction whereby a grantor sells a highly-appreciating asset to an IDGT in exchange for an installment note.
- To the extent that the growth rate on the assets sold to the IDGT is greater than the interest rate on the installment note taken back by the grantor, the "excess" is passed on to the trust beneficiaries free of any gift, estate and/or GST tax.
- No capital gains tax is due on the installment sale to the trust because the trust is "defective" for income tax purposes.
- Interest income on installment note is not taxable to the grantor because the trust is "defective" for income tax purposes.

IDGT Sale

Overview



IDGT Sale

Why an IDGT Sale Works

§ 7520 Rate 3.66%

Year	Beginning Balance	Taxable Income 10.00%	Annual Payment	Ending Balance
1	$ 10,000,000	$ 1,000,000	$ (256,200)	$ 10,743,800
2	$ 10,743,800	$ 1,074,380	$ (256,200)	$ 11,561,980
3	$ 11,561,980	$ 1,156,198	$ (256,200)	$ 12,461,978
4	$ 12,461,978	$ 1,246,198	$ (256,200)	$ 13,451,976
5	$ 13,451,976	$ 1,345,198	$ (256,200)	$ 14,540,973
6	$ 14,540,973	$ 1,454,097	$ (256,200)	$ 15,738,871
7	$ 15,738,871	$ 1,573,887	$ (256,200)	$ 17,056,558
8	$ 17,056,558	$ 1,705,656	$ (256,200)	$ 18,506,014
9	$ 18,506,014	$ 1,850,601	$ (256,200)	$ 20,100,415
10	$ 20,100,415	$ 2,010,041	$ (7,256,200)	$ 14,854,256

BENEFIT: $14,854,256 Transferred to Beneficiaries Tax-Free

* Assuming a $7,000,000 (after valuation adjustments) interest only, balloon payment feature installment note with a 3.66% annual interest rate (long-term AFR)

IDGT Sale

Why an IDGT Sale Works – Rate Differential

Long-term AFR 3.66%

Year	Beginning Balance	Taxable Income 3.66%	Installment Payment $ 366,000	Ending Balance
1	$ 10,000,000	$ 366,000	$ (366,000)	$ 10,000,000
2	$ 10,000,000	$ 366,000	$ (366,000)	$ 10,000,000
3	$ 10,000,000	$ 366,000	$ (366,000)	$ 10,000,000
4	$ 10,000,000	$ 366,000	$ (366,000)	$ 10,000,000
5	$ 10,000,000	$ 366,000	$ (366,000)	$ 10,000,000
6	$ 10,000,000	$ 366,000	$ (366,000)	$ 10,000,000
7	$ 10,000,000	$ 366,000	$ (366,000)	$ 10,000,000
8	$ 10,000,000	$ 366,000	$ (366,000)	$ 10,000,000
9	$ 10,000,000	$ 366,000	$ (366,000)	$ 10,000,000
10	$ 10,000,000	$ 366,000	$ (10,366,000)	$ -

Year	Beginning Balance	Taxable Income 10.00%	Annuity Payment $ 366,000	Ending Balance
1	$ 10,000,000	$ 1,000,000	$ (366,000)	$ 10,634,000
2	$ 10,634,000	$ 1,063,400	$ (366,000)	$ 11,331,400
3	$ 11,331,400	$ 1,133,140	$ (366,000)	$ 12,098,540
4	$ 12,098,540	$ 1,209,854	$ (366,000)	$ 12,942,394
5	$ 12,942,394	$ 1,294,239	$ (366,000)	$ 13,870,633
6	$ 13,870,633	$ 1,387,063	$ (366,000)	$ 14,891,697
7	$ 14,891,697	$ 1,489,170	$ (366,000)	$ 16,014,866
8	$ 16,014,866	$ 1,601,487	$ (366,000)	$ 17,250,353
9	$ 17,250,353	$ 1,725,035	$ (366,000)	$ 18,609,388
10	$ 18,609,388	$ 1,860,939	$ (10,366,000)	$ 10,104,327

BENEFIT: $10,104,327 Additional Wealth Transferred to Beneficiaries Tax-Free (of which $ 5,971,931 is due to taxes paid to grantor)

IDGT Sale

Why an IDGT Sale Works – Valuation Adjustments

Long-term AFR 3.66%

Year		Beginning Balance		Taxable Income 10.00%	$	Annuity Payment 366,000		Ending Balance
1	$	10,000,000	$	1,000,000	$	(366,000)	$	10,634,000
2	$	10,634,000	$	1,063,400	$	(366,000)	$	11,331,400
3	$	11,331,400	$	1,133,140	$	(366,000)	$	12,098,540
4	$	12,098,540	$	1,209,854	$	(366,000)	$	12,942,394
5	$	12,942,394	$	1,294,239	$	(366,000)	$	13,870,633
6	$	13,870,633	$	1,387,063	$	(366,000)	$	14,891,697
7	$	14,891,697	$	1,489,170	$	(366,000)	$	16,014,866
8	$	16,014,866	$	1,601,487	$	(366,000)	$	17,250,353
9	$	17,250,353	$	1,725,035	$	(366,000)	$	18,609,388
10	$	18,609,388	$	1,860,939	$	(10,366,000)	$	10,104,327

Year		Beginning Balance		Taxable Income 10.00%	$	Annuity Payment 256,200		Ending Balance
1	$	10,000,000	$	1,000,000	$	(256,200)	$	10,743,800
2	$	10,743,800	$	1,074,380	$	(256,200)	$	11,561,980
3	$	11,561,980	$	1,156,198	$	(256,200)	$	12,461,978
4	$	12,461,978	$	1,246,198	$	(256,200)	$	13,451,976
5	$	13,451,976	$	1,345,198	$	(256,200)	$	14,540,973
6	$	14,540,973	$	1,454,097	$	(256,200)	$	15,738,871
7	$	15,738,871	$	1,573,887	$	(256,200)	$	17,056,558
8	$	17,056,558	$	1,705,656	$	(256,200)	$	18,506,014
9	$	18,506,014	$	1,850,601	$	(256,200)	$	20,100,415
10	$	20,100,415	$	2,010,041	$	(7,256,200)	$	14,854,256

BENEFIT: $4,749,929 Additional Wealth Transferred to Beneficiaries Tax-Free

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IDGT Sale

Why an IDGT Sale Works – Grantor-Paid Taxes

Long-term AFR 3.66%

Year	Beginning Balance	Taxable Income 10.00%	Annuity Payment $ 256,200	Less: Taxes @ 40.00%	Ending Balance
1	$ 10,000,000	$ 1,000,000	$ (256,200)	$ (297,520)	$ 10,446,280
2	$ 10,446,280	$ 1,044,628	$ (256,200)	$ (315,371)	$ 10,919,337
3	$ 10,919,337	$ 1,091,934	$ (256,200)	$ (334,293)	$ 11,420,777
4	$ 11,420,777	$ 1,142,078	$ (256,200)	$ (354,351)	$ 11,952,304
5	$ 11,952,304	$ 1,195,230	$ (256,200)	$ (375,612)	$ 12,515,722
6	$ 12,515,722	$ 1,251,572	$ (256,200)	$ (398,149)	$ 13,112,945
7	$ 13,112,945	$ 1,311,295	$ (256,200)	$ (422,038)	$ 13,746,002
8	$ 13,746,002	$ 1,374,600	$ (256,200)	$ (447,360)	$ 14,417,042
9	$ 14,417,042	$ 1,441,704	$ (256,200)	$ (474,202)	$ 15,128,344
10	$ 15,128,344	$ 1,512,834	$ (7,256,200)	$ (502,654)	$ 8,882,325

Year	Beginning Balance	Taxable Income 10.00%	Annuity Payment $ 256,200	Less: Taxes @ 40.00%	Ending Balance
1	$ 10,000,000	$ 1,000,000	$ (256,200)	$ -	$ 10,743,800
2	$ 10,743,800	$ 1,074,380	$ (256,200)	$ -	$ 11,561,980
3	$ 11,561,980	$ 1,156,198	$ (256,200)	$ -	$ 12,461,978
4	$ 12,461,978	$ 1,246,198	$ (256,200)	$ -	$ 13,451,976
5	$ 13,451,976	$ 1,345,198	$ (256,200)	$ -	$ 14,540,973
6	$ 14,540,973	$ 1,454,097	$ (256,200)	$ -	$ 15,738,871
7	$ 15,738,871	$ 1,573,887	$ (256,200)	$ -	$ 17,056,558
8	$ 17,056,558	$ 1,705,656	$ (256,200)	$ -	$ 18,506,014
9	$ 18,506,014	$ 1,850,601	$ (256,200)	$ -	$ 20,100,415
10	$ 20,100,415	$ 2,010,041	$ (7,256,200)	$ -	$ 14,854,256

BENEFIT: $5,971,931 Additional Wealth Transferred to Beneficiaries Tax-Free

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IDGT Sale

Why an IDGT Sale Works – Summary

Long-term AFR 3.66%

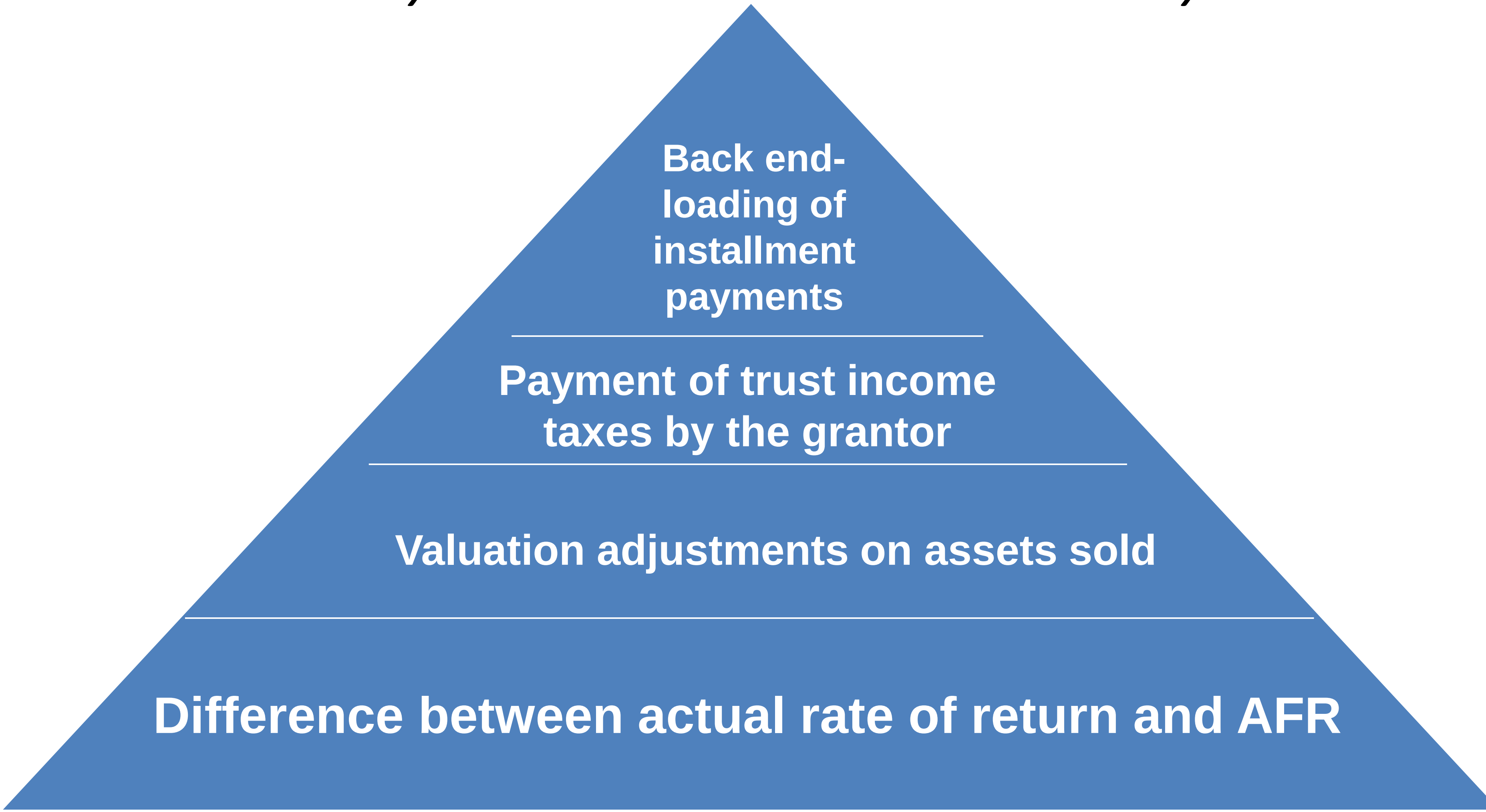
Reasons for Total Wealth Transferred		
Differential Between Rates of Return	$	4,132,396
Valuation Adjustment		4,749,929
Income Taxes Paid by Grantor		5,971,931
Total Wealth Transferred	**$**	**14,854,256**

IDGT Sale

Why an IDGT Sale Works – Summary

IDGT Sale

Why an IDGT Sale Works – Summary



IDGT Sale

Advantages

- Freezes value of appreciation on assets sold in the grantor's taxable estate at the low interest rate on the installment note payable
- No capital gains tax due on installment sale and interest income on the installment note is not taxable to the grantor
- Grantor pays income tax on trust income, leaving more assets in the IDGT for remainder beneficiaries
- The sale can be made efficiently to a GST exempt trust (unlike a GRAT)
- Valuation adjustments increase effectiveness of sale for estate tax purposes; A *Wandry*-clause can substantially reduce or eliminate the risk of valuation adjustments on audit

IDGT Sale

Disadvantages

- Estate inclusion of note if grantor dies during term of the installment note
- No step-up in basis at grantor's death
- Trust income taxable to grantor during his/her life could cause a cash flow problem if there is not sufficient income earned by the seller/grantor
- Possible gift and estate tax exposure if insufficient assets are used to fund the trust
- Possible taxable gift for amount of loan

IDGT Sale

Self Canceling Installment Notes

- Cancellation-at-death feature added to note
- Premium must be paid, either in the form of additional principal or increased interest rate to compensate for the cancellation-at-death feature

OBJECTIVE: Reduction of estate tax if premature death occurs

IDGT Sale

Self Canceling Installment Notes – Sample Premiums

SINGLE LIFE				JOINT LIFE				
Age	SCIN Risk Premium	AFR	Total Interest Rate	Age 1	Age 2	SCIN Risk Premium	AFR	Total Interest Rate
53	0.870%	2.970%	3.840%	53	53	0.067%	2.970%	3.037%
58	1.346%	2.970%	4.316%	58	58	0.153%	2.970%	3.123%
63	2.042%	2.970%	5.012%	63	63	0.332%	2.970%	3.302%
68	3.183%	2.970%	6.153%	68	68	0.742%	2.970%	3.712%
73	5.115%	2.970%	8.085%	73	73	1.675%	2.970%	4.645%
78	8.211%	2.970%	11.181%	78	78	3.554%	2.970%	6.524%

***Assumptions**	
Term of Note	10
AFR	2.97%
Payment Frequency	Annually
Type of Note	Interest Only with Balloon Payment

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IDGT Sale

Self Canceling Installment Note - Example

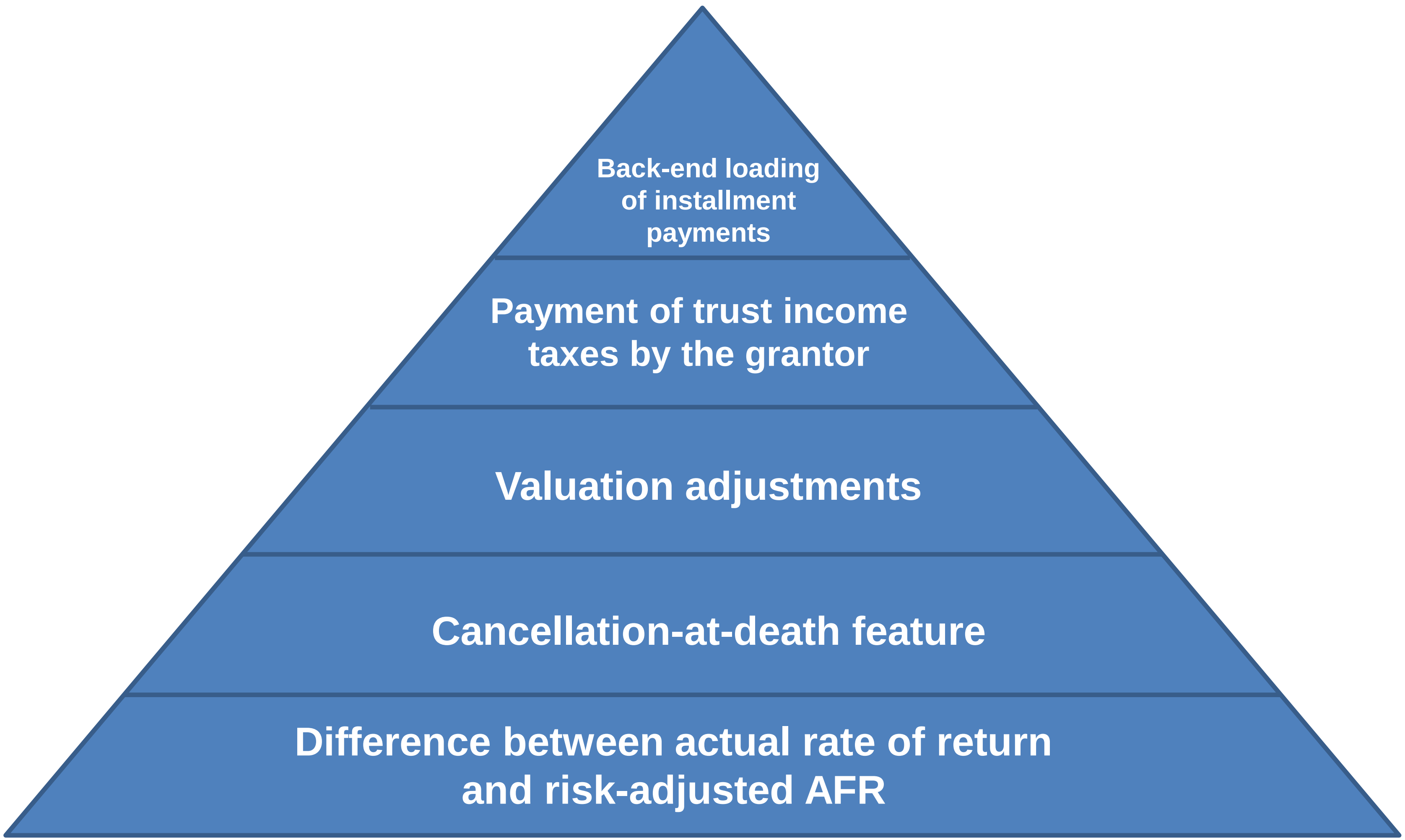
Year	Beginning Balance	Taxable Income 10.00%	Annual Payment	Ending Balance
1	$ 10,000,000	$ 1,000,000	$ (700,140)	$ 10,299,860
2	$ 10,299,860	$ 1,029,986	$ (700,140)	$ 10,629,706
3	$ 10,629,706	$ 1,062,971	$ (700,140)	$ 10,992,537
4	$ 10,992,537	$ 1,099,254	$ (700,140)	$ 11,391,650
5	$ 11,391,650	$ 1,139,165	$ (700,140)	$ 11,830,675
6	$ 11,830,675	$ 1,183,068	$ (700,140)	$ 12,313,603
7	$ 12,313,603	$ 1,231,360	$ (700,140)	$ 12,844,823
8	$ 12,844,823	$ 1,284,482	$ (700,140)	$ 13,429,165
9	$ 13,429,165	$ 1,342,917	$ (700,140)	$ 14,071,942
10	$ 14,071,942	$ 1,407,194	$ (7,700,140)	$ 7,778,996

BENEFIT: $7,778,996 transferred to beneficiaries estate/gift tax-free

***NOTE: Assuming a 78-year-old seller and a $7,000,000 (after valuation adjustments) interest only, balloon payment feature installment note with a 10.0020% annual interest rate (2.2% + 7.8020% mortality risk premium)**

IDGT Sale

Why an IDGT SCIN Sale Works – Summary



IDGT Sale

Why an IDGT SCIN Sale Works – Advantages

- Future appreciation above the note interest rate, including the risk premium, is removed from the grantor's estate
- Asset not included in grantor's estate in case of premature death during SCIN term
- Value of assets transferred out greatly exceeds value of payments coming back into the estate of the grantor if he/she passes away prematurely
- No gain or loss on sale
- Trust income taxable to grantor allows for greater appreciation to inure to future generations, thereby creating an additional tax-free gift
- Valuation adjustments increase effectiveness of sale for estate tax purposes

IDGT Sale

Why an IDGT SCIN Sale Works – Disadvantages

- Complex calculation of risk premium
- Possible gift tax exposure if SCIN risk premium is inadequate
- Possible gift tax exposure if trust is insufficiently funded
- Possible taxable estate inclusion under *Karmazin* (retained life estate)
- No step-up in basis at grantor's death
- Possible acceleration of capital gain at grantor's death
- Trust income taxable to grantor during his/her life could cause a cash-flow problem if there is there is not sufficient income earned by the grantor
- Possible upstream transfer if the grantor survives the term of note or lives a significant portion of the term

IDGT Sale v. GRAT

IDGT Sale

- Greater flexibility
  - Rates vary by term
  - Balloon note possible
  - Early repayment possible
  - Refinance opportunities
- Less inclusion in the event of early death compared to a GRAT
- Greater opportunities to maximize GST exemption

GRAT

- Basically, risk free from an estate-tax perspective
- Allows for a taxable gift of zero whereas the IDGT sale generally requires a “seed” gift
- Specifically addressed in the IRC whereas the IDGT sale is not

IDGT Sale v. GRAT

The GRAT is Estate Tax Risk-Free

- Consider a $10,000,000 tech-stock portfolio with a difficult to ascertain future value:
  - Value may increase 100%
  - Value may decrease 50%

- The client's life expectancy and other factors calls for a Five-year GRAT or IDGT sale

IDGT Sale v. GRAT

GRAT: Value Increases 100%

Year		Beginning Balance		Appreciation (Depreciation)		Annuity 2.20%		Ending Balance
1	$	10,000,000	$	1,486,984	$	(2,133,915)	$	9,353,069
2	$	9,353,069	$	1,390,786	$	(2,133,915)	$	8,609,940
3	$	8,609,940	$	1,280,284	$	(2,133,915)	$	7,756,310
4	$	7,756,310	$	1,153,350	$	(2,133,915)	$	6,775,745
5	$	6,775,745	$	1,007,542	$	(2,133,915)	$	5,649,373

$5,649,373 TO CHILDREN FREE OF TRANSFER TAX

GRAT: Value Decreases 50%

Year		Beginning Balance		Appreciation (Depreciation)		Annuity 2.20%		Ending Balance
1	$	10,000,000	$	(1,294,494)	$	(2,133,915)	$	6,571,591
2	$	6,571,591	$	(850,689)	$	(2,133,915)	$	3,586,988
3	$	3,586,988	$	(464,334)	$	(2,133,915)	$	988,739
4	$	988,739	$	(127,992)	$	(860,748)	$	-
5								

GRAT FAILS - NO FURTHER NEGATIVE CONSEQUENCES

Note, to fairly compare the GRAT to an IDGT sale a modeling a series of rolling-GRATs would be necessary, but that is beyond the scope of the example.

IDGT Sale v. GRAT

IDGT SALE: Value Increases 100%

Year	Beginning Balance	Appreciation (Depreciation)	Balloon Note 1.78%	Ending Balance
1	$ 10,000,000	$ 1,486,984		$ 11,486,984
2	$ 11,486,984	$ 1,708,096		$ 13,195,079
3	$ 13,195,079	$ 1,962,087		$ 15,157,166
4	$ 15,157,166	$ 2,253,846		$ 17,411,011
5	$ 17,411,011	$ 2,588,989	$ (10,922,253)	$ 9,077,747

$9,077,747 TO GRANDCHILDREN FREE OF TRANSFER TAX

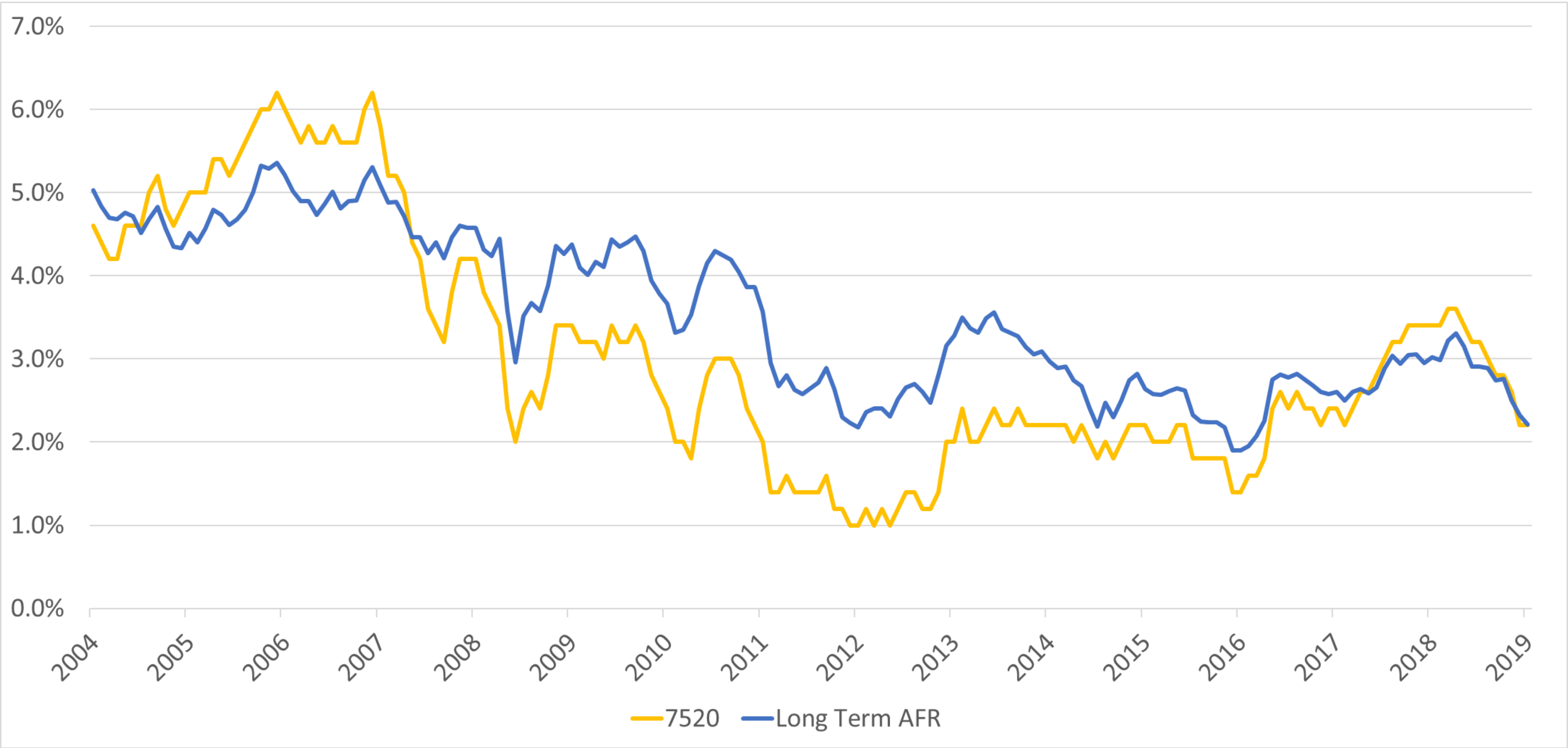
IDGT SALE: Value Decreases 50%

Year	Beginning Balance	Appreciation (Depreciation)	Balloon Note 1.78%	Ending Balance
1	$ 10,000,000	$ (1,294,494)		$ 8,705,506
2	$ 8,705,506	$ (1,126,923)		$ 7,578,583
3	$ 7,578,583	$ (981,043)		$ 6,597,540
4	$ 6,597,540	$ (854,048)		$ 5,743,492
5	$ 5,743,492	$ (743,492)	$ (10,922,253)	$ (5,922,253)

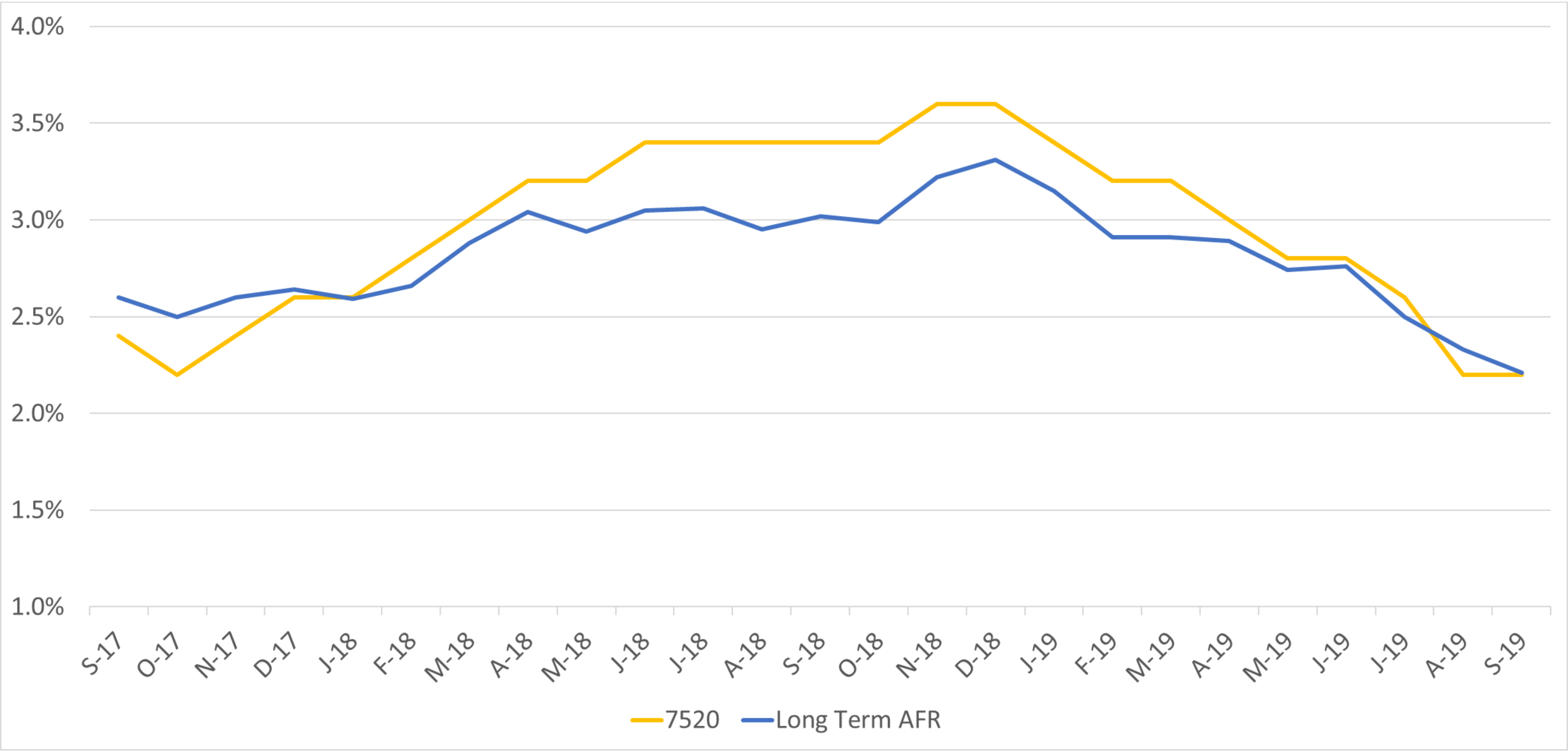
IDGT SALE FAILS - UPSTREAM TRANSFER OF $5,922,253

The trust must pay the grantor or estate far more than the property is worth thereby increasing the taxable estate.

IDGT Sale v. GRAT



IDGT Sale v. GRAT



Installment Sales

Overview

- IRC § 453 allowed for deferral of taxation on Installment Sales
  - $5,000,000 annual limitation
  - $10,000,000 annual limitation for married couple
- Gain is generally deferred until payment occurs (exception: depreciation recapture)

Two-Year Installment Sales

Overview

- Sale from taxpayer to a non-grantor trust or a child receives a basis increase
- IRC § 453(e)(2) provides a sale by a related party within two years results in realization of the original deferral
- Therefore, the original buyer must wait at least two years and one day to sell the asset to a third-party – No realization of the original gain if the sale is at least two years and one day later

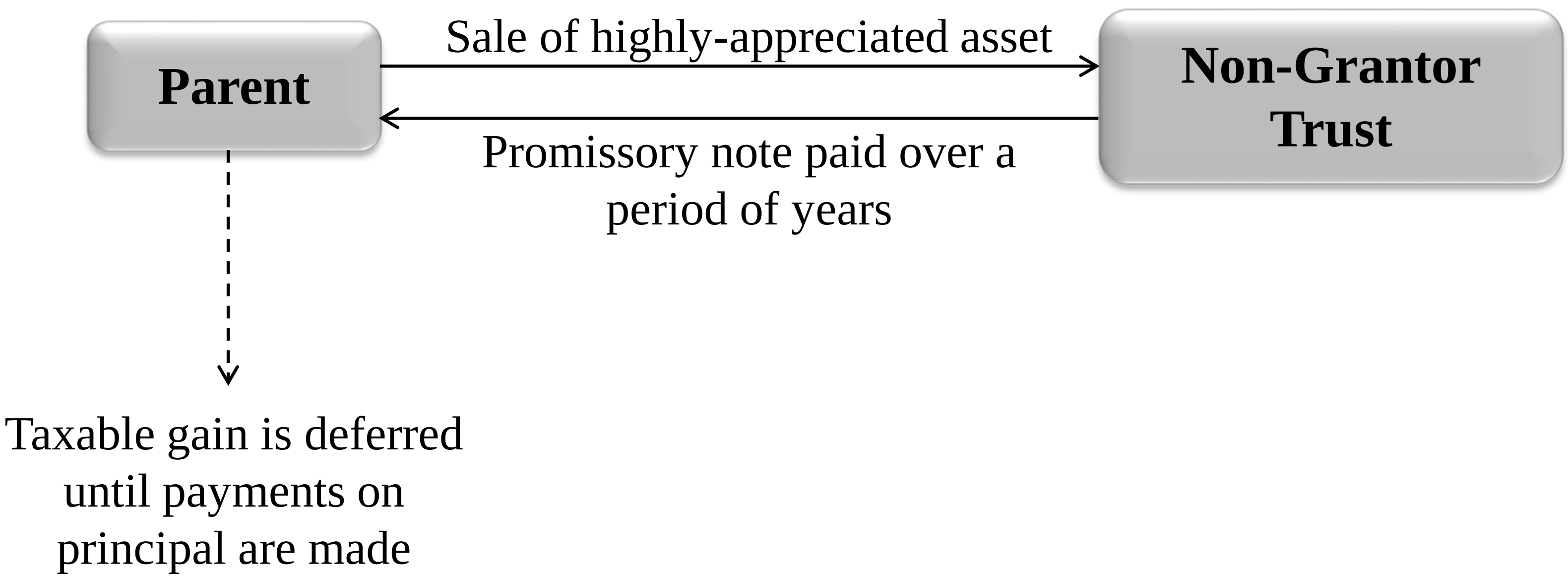
Two-Year Installment Sales

Strategy

- Parent has an asset with a large capital gain
- Parent sells it to a nongrantor trust for the benefit of his or her children and takes back an installment note
- The trust receives a stepped-up basis in the asset
- Two years and one day later the trust sells the asset, recognizing little, if any, gain
- Trust makes payments to Parent who spreads the gain out over the period of the installment note

Two-Year Installment Sales

Strategy



Two-Year Installment Sales

Current Opportunity: Volatility & Rates

1. Low Rates – increase wealth transfer by limiting the amount of interest paid to the seller which will be subject to estate tax

2. Rate Increase – should rates increase the value of the note to the seller will decrease thereby decreasing the taxable value of the estate

3. Volatility – provides an opportunity to time sale

Two-Year Installment Sales

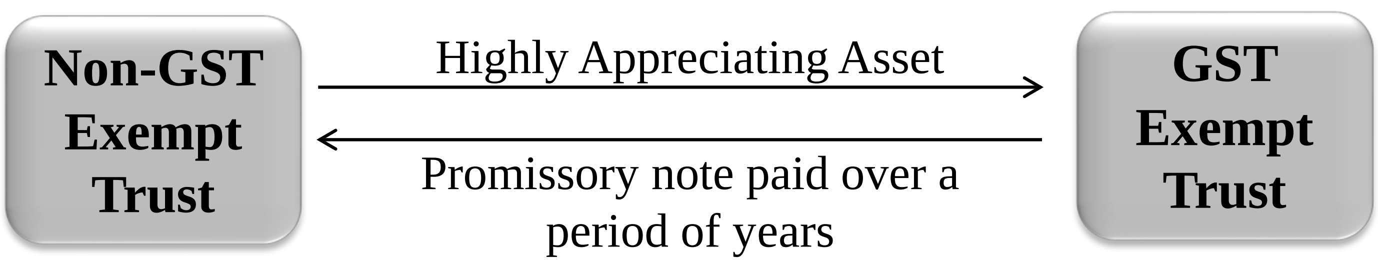
Valuation of Installment Note

453 Installment Sale					
Long Term AFR @ Funding	**2.50%**	**2.50%**	**2.50%**	**2.50%**	**2.50%**
Principal	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000
Term (years)	20	20	20	20	20
Death Year	5	5	5	5	5
Annuity (annual)	$ 64,147	$ 64,147	$ 64,147	$ 64,147	$ 64,147
Long-Term AFR @ Death	**2.00%**	**2.50%**	**3.00%**	**3.50%**	**4.50%**
Note Value	$ 824,243	$ 794,230	$ 765,784	$ 738,809	$ 688,911
Estate Tax Savings Due to 7520 Rate Change (40%)	**$ (12,005)**	**$ -**	**$ 11,378**	**$ 22,168**	**$ 42,128**

Installment Sales Between Trusts

Overview

- A non-GST exempt trust can sell highly appreciating assets to a GST exempt trust thereby increasing the wealth transfer to skip-persons



Installment Sales Between Trusts

Current Opportunity: Volatility & Rates

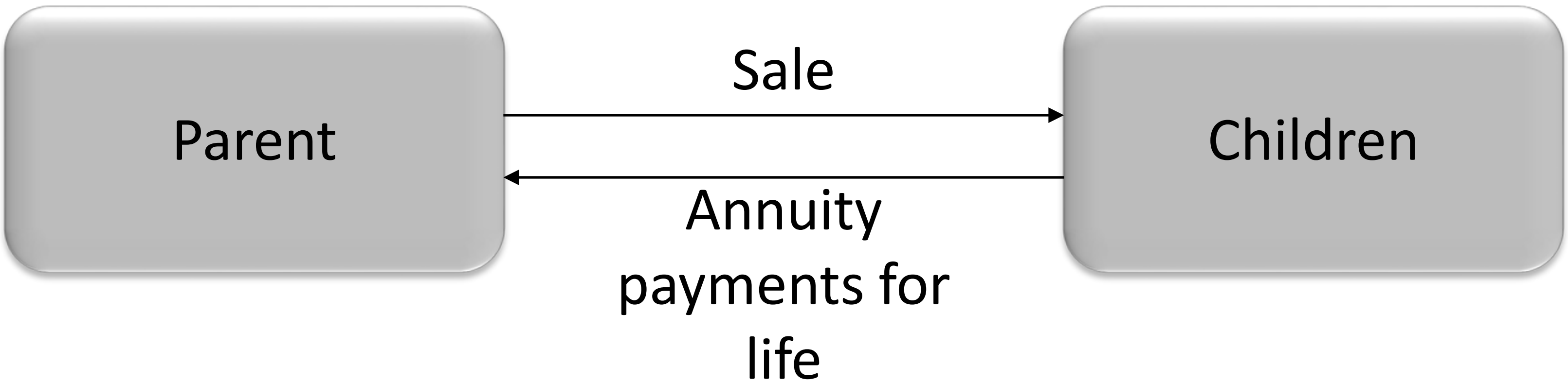
1. Low Rates – increase wealth transfer by limiting the amount of interest paid to the seller thereby decreasing future GST taxation

2. Rate Increase – should rates increase the value of the note to the seller will decrease which could allow for a tax-efficient termination or distribution

3. Volatility – provides an opportunity to time sale

Private Annuity

Overview



The seller's age and the current IRC §7520 rate are used for purposes of determining the amount of the annuity

Provided that the annuity is calculated correctly, the future value of the assets sold less the future value of the payment stream retained by the seller inures to the buyer (beneficiaries) free of transfer taxes, thus effectively freezing the growth of assets at the IRC §7520 rate

Private Annuity

Actually Computed Annuity Sample

Age	Private Annuity Amount
53	$ 357,054
58	$ 405,032
63	$ 468,660
68	$ 555,608
73	$ 680,351
78	$ 860,331

***Assumptions**

Value of Assets Sold	$7,000,000
IRC §7520 Rate	2.20%
Payment Frequency	Annually
Timing of Payment	End of Period

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Private Annuity

Example

Year	Beginning Balance	Growth 10.00%	Annual Payment	Ending Balance
1	$ 10,000,000	$ 1,000,000	$ (860,331)	$ 10,139,669
2	$ 10,139,669	$ 1,013,967	$ (860,331)	$ 10,293,305
3	$ 10,293,305	$ 1,029,330	$ (860,331)	$ 10,462,304
4	$ 10,462,304	$ 1,046,230	$ (860,331)	$ 10,648,204
5	$ 10,648,204	$ 1,064,820	$ (860,331)	$ 10,852,693
6	$ 10,852,693	$ 1,085,269	$ (860,331)	$ 11,077,632
7	$ 11,077,632	$ 1,107,763	$ (860,331)	$ 11,325,064
8	$ 11,325,064	$ 1,132,506	$ (860,331)	$ 11,597,239
9	$ 11,597,239	$ 1,159,724	$ (860,331)	$ 11,896,632
10	$ 11,896,632	$ 1,189,663	$ (860,331)	$ 12,225,964

Benefit: $12,225,964 Transferred to Beneficiaries Tax-Free

* Assuming a 78-year-old seller and a $7,000,000 (after valuation adjustments) sale price

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Private Annuity

Advantages

- Provides an income stream to the seller for life
- Asset not included in seller/grantor’s estate in case of premature death during the annuity term
- Value of assets transferred out of the seller’s estate greatly exceeds value of payments coming back if he/she passes away prematurely
- Valuation adjustments increase effectiveness of sale for estate tax purposes

Private Annuity

Disadvantages

- Under the Proposed Treasury Regulations, an immediate gain would be recognized by the seller
- The buyer's payments are not deductible as "interest," thus causing more ordinary income to be recognized (double taxation)
- Potential upstream transfer if seller lives for a long period of time → Especially if the seller lives longer than his/her life expectancy
- If assets are sold to a trust, possible gift tax exposure could occur if the trust has inadequate assets to support the payments

Grantor Retained Income Trust (GRIT)

- An irrevocable grantor trust where the settlor receives all income from the assets generated by the trust for a period of time, annually or more frequently, and the balance of the corpus passes to beneficiaries estate and gift tax-free.

- The trust terminates:
  - After a term of years
  - Or at the death of the grantor if earlier

- A GRIT is very effective, however Chapter 14 of the IRC, the anti-freeze rules, basically eliminated the effectiveness of the GRIT for transfers between related parties.

GRIT

Rate Based Efficacy

GRIT										
7520 Rate		**1.00%**		**2.00%**		**3.00%**		**4.00%**		**5.00%**
Rate of Return		7.00%		7.00%		7.00%		7.00%		7.00%
Principal	$	1,000,000	$	1,000,000	$	1,000,000	$	1,000,000	$	1,000,000
Age at Funding (single)		75		75		75		75		75
Term (years)		5		5		5		5		5
Taxable Gift	$	748,940	$	712,940	$	679,000	$	646,980	$	616,750
Nontaxable Gift	$	251,060	$	287,060	$	321,000	$	353,020	$	383,250
Nontaxable Appreciation	$	402,552	$	402,552	$	402,552	$	402,552	$	402,552
Estate Tax Savings (40%)	$	261,445	$	275,845	$	289,421	$	302,229	$	314,321

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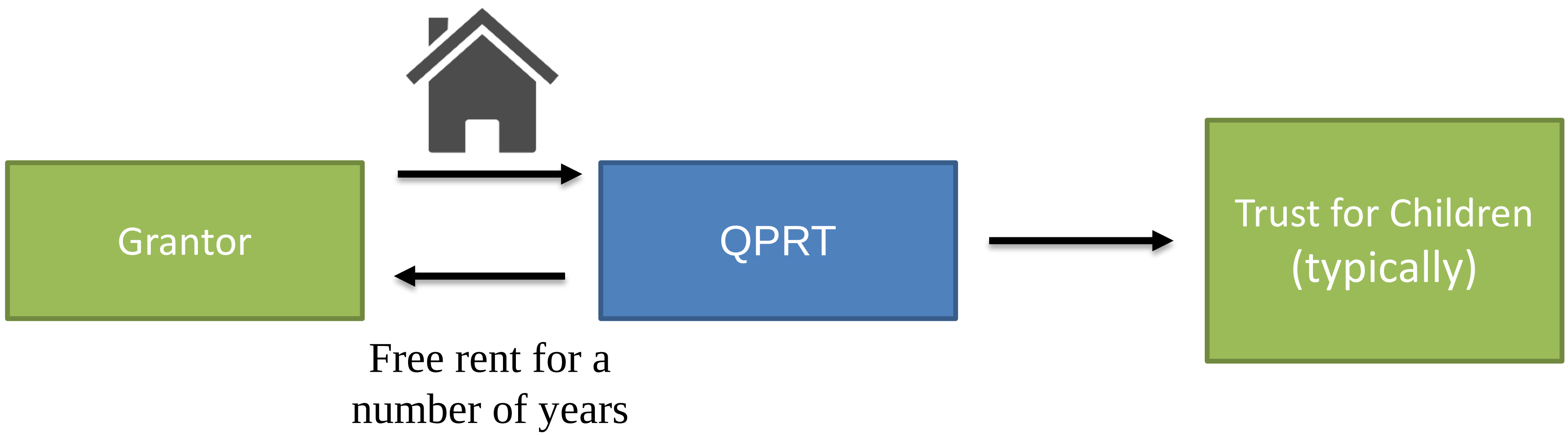
Qualified Personal Residence Trust (QPRT)

- A QPRT allows a grantor to transfer their personal residence out of their estate at a lower value for gift tax purposes
- Grantor retains the right to live in the house for a number of years rent free, which reduces the value of the gift
- Grantor pays rent after the remainder beneficiaries are vested

QPRT



Grantor
QPRT
Trust for Children (typically)
Free rent for a number of years

QPRT

Rate Based Efficacy

QPRT					
7520 Rate	**1.00%**	**2.00%**	**3.00%**	**4.00%**	**5.00%**
Rate of Return	4.00%	4.00%	4.00%	4.00%	4.00%
Principal	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000
Age at Funding (single)	75	75	75	75	75
Term (years)	5	5	5	5	5
Taxable Gift	$ 748,940	$ 712,940	$ 679,000	$ 646,980	$ 616,750
Nontaxable Gift	$ 251,060	$ 287,060	$ 321,000	$ 353,020	$ 383,250
Nontaxable Appreciation	$ 216,653	$ 216,653	$ 216,653	$ 216,653	$ 216,653
Estate Tax Savings (40%)	$ 187,085	$ 201,485	$ 215,061	$ 227,869	$ 239,961

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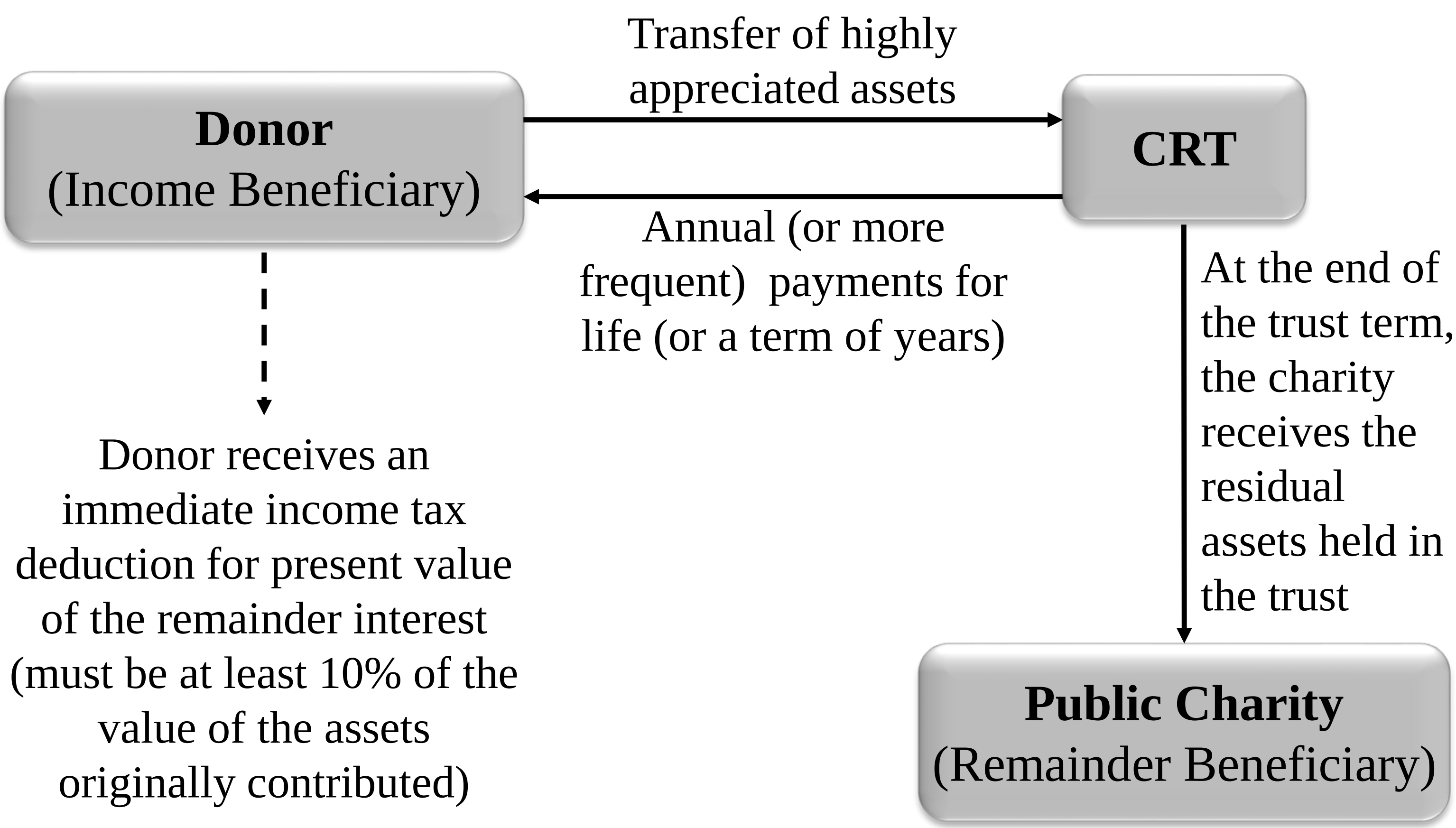
Charitable Remainder Trust (CRT)

- Charitable remainder trusts can be used to reduce or avoid incremental capital gains tax rates by smoothing out income
- CRTs are particularly useful when a taxpayer has a large capital gain
- Generally, the donor will NOT realize gain or loss when property is transferred to the trust or when the property is later sold by the CRT

CRT

Substantial Sale CRT



CRT

CRAT – Annuity Trust Payments & Rates

Rate Based Efficacy

CRAT					
7520 Rate	**1.00%**	**2.00%**	**3.00%**	**4.00%**	**5.00%**
Rate of Return	7.00%	7.00%	7.00%	7.00%	7.00%
Principal	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000
Term of Years	20	20	20	20	20
Tax Deduction	*	$ 100,019	$ 165,372	$ 237,584	$ 300,871
Annuity (annual)	$ 50,000	$ 55,040	$ 56,100	$ 56,100	$ 56,100
Annuity PV	$ 529,701	$ 583,095	$ 594,324	$ 594,324	$ 594,324
Remainder Interest (FV)	$ 1,819,910	$ 1,613,293	$ 1,569,837	$ 1,569,837	$ 1,569,837

*If the 7520 rate is 1% the CRAT cannot pass the "10% test"

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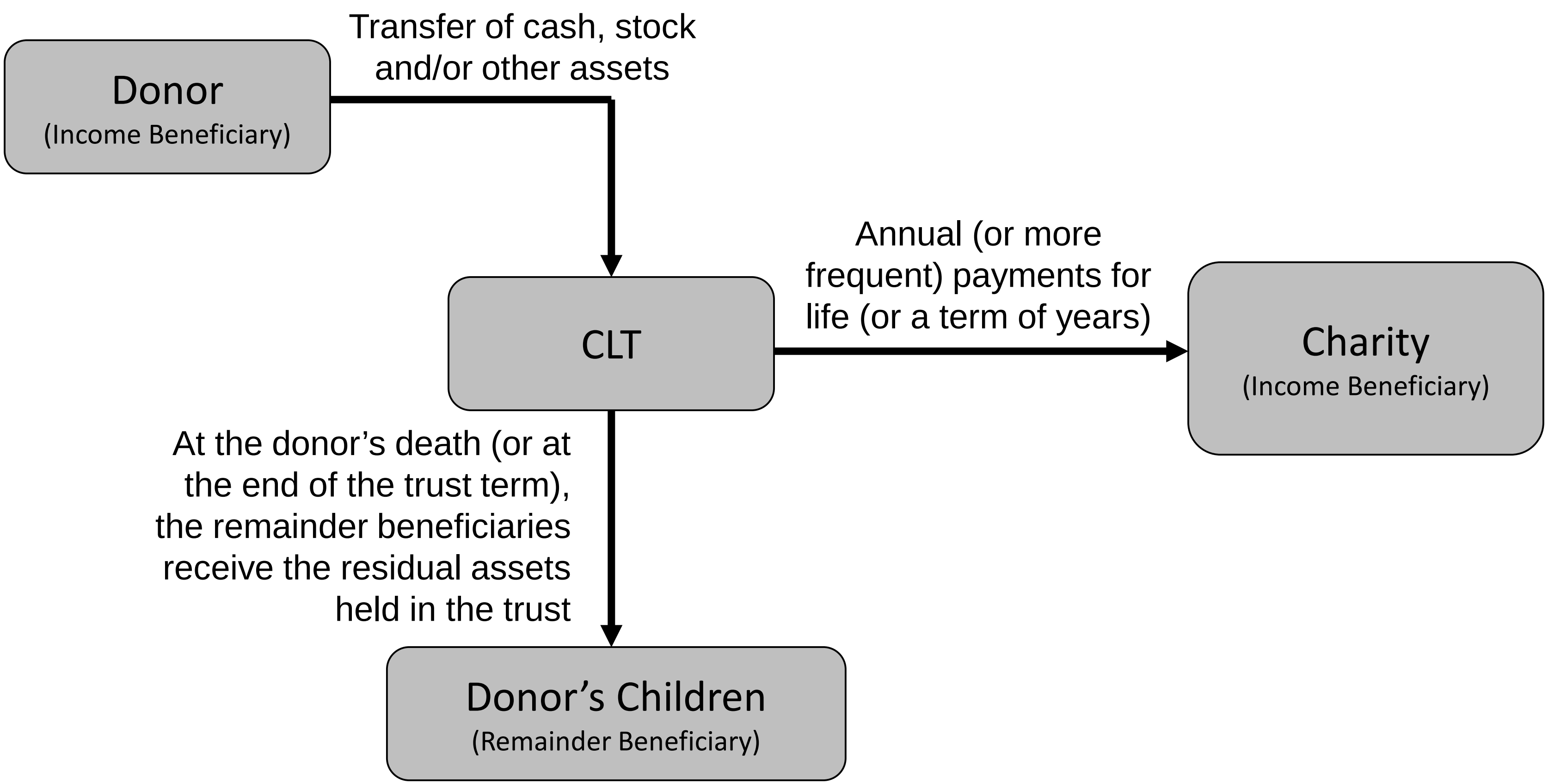
Charitable Lead Trust (CLT)

- A Charitable Lead Trust (CLT) is a split interest trust consisting of an income interest and a remainder interest.
- During the term of the trust, the income interest is paid out to a named charity.
- At the end of the trust term, the remainder (whatever is left in the trust) is paid to non-charitable beneficiaries (e.g. children of the donor) that have been designated in the trust document.

CLT


Donor
(Income Beneficiary)
Transfer of cash, stock and/or other assets
CLT
Annual (or more frequent) payments for life (or a term of years)
Charity
(Income Beneficiary)
At the donor's death (or at the end of the trust term), the remainder beneficiaries receive the residual assets held in the trust
Donor's Children
(Remainder Beneficiary)

CLT

CLAT – Annuity Trust Payments & Rates

Rate Based Efficacy

CLAT					
7520 Rate	**1.00%**	**2.00%**	**3.00%**	**4.00%**	**5.00%**
Rate of Return	7.00%	7.00%	7.00%	7.00%	7.00%
Principal	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000
Term of Years	20	20	20	20	20
Annuity (annual)	$ 55,420	$ 61,160	$ 67,220	$ 73,580	$ 80,250
Annuity PV	$ 587,120	$ 647,930	$ 712,130	$ 779,508	$ 850,170
Remainder Interest (FV)	$ 1,597,714	$ 1,362,400	$ 1,113,967	$ 853,236	$ 579,796
Estate Tax Savings (40%)	$ 639,086	$ 544,960	$ 445,587	$ 341,294	$ 231,918

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Split Dollar

A type of premium financing arrangement in which two or more private parties (e.g. employer/employee, corporation/shareholder) choose to split the economic benefits of a life insurance policy whereby one party pays for all or a portion of the annual premium.

Split Dollar

- **Employment benefit**
- **Estate planning**
  - **Irrevocable Life Insurance Trust (ILIT)**
  - **Estate liquidity**
- **Business succession planning**
  - **FASB 150 – stock redemptions**

Split Dollar

Current Methods of Reporting Split-Dollar
(Final Regulations – Post 9/17/2003 Arrangements)

- Economic Benefit Method
  - Employer/company ("owner") owns the policy and endorses the policy death benefit to the employee/shareholder ("non-owner")
  - "Non-owner" does not have an investment or an ownership interest in the policy
- Loan Method
  - Employee/shareholder ("owner") owns the policy and the employer/company ("non-owner") is entitled to recover its cumulative premiums advanced to the employee/shareholder
  - The cumulative premiums advanced are secured by the policy cash value

Conclusion