By N. Todd Angkatavanich & Sean M. Aylward

Pre-liquidity Planning

Do it now

It has been 18 months since the collapse of Lehman Brothers and just over a year since the stock market touched its lows. Although the stock market has recovered a portion of the decline, values across most asset categories remain at significantly reduced levels when compared to pre-recession values. Despite the recent rally, uncertainty exists with respect to the strength of the recovery, both domestically and abroad. The unemployment rate remains high and the effect of the large federal deficits on the continued success of the recovery remains unclear. As a result, clients have adopted a cautious approach to business and wealth transfer planning. Many clients have stayed on the sidelines and have not considered, or have considered but not implemented, wealth transfer strategies during this period of economic uncertainty.

But a cautious approach may not be the best strategy. Rather, the current economic climate, with its combination of depressed asset values and low government hurdle rates, together with the likelihood of government action to restrict and/or eliminate certain planning techniques, makes this an ideal time to implement various wealth transfer strategies. To achieve the greatest tax benefits and to most efficiently leverage available exemption amounts, it is important that these transactions be considered and implemented prior to asset appreciation or gain recognition events—such as the sale or liquidation of assets. By exploring these wealth transfer strategies with your clients, you can seize the opportunity to help your clients take advantage of these unique circumstances.

N. Todd Angkatavanich, far left, is a partner of Withers Bergman LLP, in its Greenwich and New Haven, Conn. offices. Sean M. Aylward is a partner of Wolff & Samson, P.C., in its West Orange, N.J. office

What's Happening?

History shows that asset values are likely to rebound. It is not uncommon for a period of robust acquisition and consolidation to follow a period of recession. During this recession, many businesses, private equity firms and real estate investment funds suspended their acquisition/investment activities and instead opted to strengthen their balance sheets in advance of the recovery. As the economy continues to improve, businesses, private equity funds and real estate investment funds will likely become active and look to deploy their built-up capital. As a result, many individuals may be presented with the opportunity to dispose of assets or interests in closely held businesses in the near future.

It is important to consider and to implement wealth transfer strategies prior to a potential liquidity or sale event. If an individual waits to seek estate-planning advice until the receipt of a written offer or proposed letter of intent for the purchase of a closely held business or piece of commercial real estate, he may significantly reduce or eliminate the ability to implement wealth transfer strategies that rely on favorable valuations. Although letters of intent typically are non-binding, an appraiser generally must take into consideration all factors, including the proposed purchase price contained in the letter of intent, when preparing a fair market valuation of the interest.

In addition to the likely increase in investment activity, there are several factors that make this an ideal time to implement wealth transfer planning techniques. First, absent Congressional action, the federal estate tax will again be effective beginning Jan. 1, 2011. However, the exemption amount and tax rates will return to 2001 levels ($1 million exemption and estate tax rate

of 55 percent). Second, the Section 7520 rate,[1] which is the interest rate used by the Internal Revenue Service to determine the present value of term interests, life interests, annuities and remainder interests, and the applicable federal rate (AFR), which is the interest rate that must be charged on loans among family members to avoid a gift, are both near historic lows. In light of the increasing federal deficit, it's likely that both the Section 7520 rate and the AFR will increase in the near future, making estate-planning techniques that rely on these rates less effective. Finally, movement is afoot in Washington to (1) place substantial limitations on the use of valuation discounts in connection with family-controlled entities, and (2) implement certain restrictions on popular estate-planning techniques, such as the grantor retained annuity trust (GRAT).

These factors create an ideal opportunity to implement one or more wealth transfer strategies that would permit the potential appreciation of assets to pass in a transfer tax efficient manner to the next generation(s). In particular, an individual who believes that the economic turmoil has caused an unjustified decline in the value of his assets and/or the value of his assets is likely to increase, is a perfect candidate for implementation of certain wealth transfer strategies.

There are many planning options available to an individual who wants to take advantage of these unique circumstances. These options include (1) utilizing the annual gift tax exclusion (currently $13,000) and/or the lifetime gift tax exemption (currently $1 million), (2) making intra-family loans, and/or (3) implementing one or more estate "freeze" techniques, such as a GRAT, a sale to an intentionally defective grantor trust (gift/sale transaction), a charitable lead annuity trust (CLAT), or a preferred "freeze" partnership.[2]

Gifting Opportunities

A simple and effective way to take advantage of depressed asset values is to transfer assets to or for the benefit of the next generation(s) using the annual gift tax exclusion and/or the lifetime gift tax exemption. Such gifts can consist of cash, marketable securities, interests in closely held business or interests in real estate. In addition, it may be possible to leverage the benefit of the annual gift tax exclusion and/or the lifetime gift tax exemption by transferring interests that may be discounted to reflect lack of marketability and minority interest discounts. Due to the small annual gift tax exclusion amount, with clients with substantial assets, it is often difficult to achieve meaningful estate tax savings through the use of an annual gifting program. In addition, the annual exclusion is often unavailable because it is currently being used by clients in connection with other estate-planning techniques (for example, payment of insurance premiums on life insurance policies held in an irrevocable life insurance trust).

It is important when planning to use the lifetime gift tax exemption, to choose the assets to be transferred wisely. If the transferred assets decline in value or become worthless, the lifetime gift tax exemption will have been wasted. In addition, the recipient receives a carry-over basis in the asset transferred for income tax purposes. Accordingly, high basis assets are preferable candidates for transfer.

Intra-family Loans

An intra-family loan is an effective way to take advantage of the low AFR. To avoid incurring a gift tax, an intra-family loan must bear interest at the AFR, which the IRS publishes monthly. As mentioned above, the AFR is near its all time low. For example, in March 2010, the AFR for mid-term loans (loans with a term of more than three years but less than nine years) was 2.69 percent—significantly lower than the market rate for a similar loan. The recipient of the loan can use the proceeds to purchase a home, marketable securities, closely held business interests or commercial real estate. If the return on such investment exceeds the AFR, such excess effectively passes to the next generation(s) free of estate and gift tax.

Freeze Techniques

Transferring assets before appreciation occurs allows a taxpayer to remove such future appreciation from the taxable estate and put it in the hands of the younger generational family members or trusts for their benefit. The gift tax is imposed based upon the value of the assets on the date of transfer, and not on the future appreciation opportunity. If a taxpayer transfers assets when they have a relatively low value for gift tax purposes, the transfer

will be considered to have been made at that lower value, regardless of the magnitude of future appreciation.

With this objective in mind, estate-planning professionals typically use a number of different techniques which, in one form or another, are designed to freeze the taxpayer's estate by locking in the value of an asset at a current value while permitting the appreciation to inure to the benefit of the younger generation(s). These freeze techniques are particularly effective when it is anticipated that the actual rate of return on the assets transferred will significantly exceed the Section 7520 rate or the AFR. Freeze techniques provide an attractive alternative to the use of the lifetime gift tax exemption because, if structured properly, the techniques can be implemented with little or no use of the lifetime gift tax exemption, thereby reducing the potential downside risk of such techniques. Common freeze techniques include the GRAT, the gift/sale transaction, the CLAT, and the preferred freeze partnership (although the preferred freeze partnership involves a "hurdle" rate other than the Section 7520 rate or the AFR).

Gift/Sale Transaction

In a gift/sale transaction, the grantor sells an asset to a trust created for the benefit of his family in exchange for a promissory note. Typically, the grantor makes an initial contribution to a trust in an amount equal to 10 percent of the total value of the assets to be transferred (the seed gift). The trust is an irrevocable trust and the seed gift is a taxable gift. If the grantor has not utilized his lifetime gift tax exemption, then the amount of the seed gift will simply reduce his available lifetime gift tax exemption. The transfer to the trust is designed to be complete for gift and estate tax purposes, but is designed to be incomplete for income tax purposes. As a result, there is no gain recognized on the sale of the assets to the trust. In addition, the grantor continues to be responsible for the payment of all income taxes attributable to the assets held in the trust, as the trust is considered the same taxpayer as the grantor. This has the dual benefit of passing the assets to the trust beneficiaries on an after-tax basis and reducing the grantor's taxable estate by the amount of the income taxes paid by the grantor that are attributable to gains in the trust.

After the grantor contributes the seed gift to the trust, the grantor sells the asset to the trust in exchange for a promissory note. Often, the promissory note will be for a term of nine years, in order to take advantage of the mid-term AFR, although the promissory note can be structured to have a longer or a shorter term depending on the particular circumstances. Interest is imposed on the promissory note at the AFR. There is considerable flexibility when designing the payment terms of the promissory note. The promissory note can provide for straight amortization of principal and interest or it can provide for interest-only payments, with a balloon payment at the end of the note term, again depending on the particular circumstances. The promissory note received by the grantor is an asset of his estate. As such, the promissory note is subject to estate taxation at his death at its then outstanding balance; however, the transferred asset should not be included in the grantor's estate. In the case of an asset that appreciates in value after the sale, all of the appreciation will occur inside of the trust, which is outside of the grantor's estate. Additionally, if the asset sold to the trust is a non-controlling interest, the interest may be subject to discounts for gift and estate tax purposes, to reflect lack of marketability and minority interest discounts. Thus, the gift/sale transaction potentially reduces the value of the assets in the grantor's estate, and permits the grantor to generally freeze the value of his asset for estate tax purposes at the value of the asset on the date of sale, plus the interest earned on the promissory note.

A gift/sale transaction can, and typically is, structured to be multi-generational so that the assets can be preserved for several generations in a transfer tax efficient manner. To create generation-skipping transfer (GST) tax efficiency, the grantor would allocate all, or a portion, of his GST exemption to the trust in the amount of the seed gift. By allocating GST exemption on the gift tax return on which the seed gift is reported, the entire trust will become exempt from the generation skipping tax. If the trust is created to be a perpetual trust in states like Delaware, New Jersey, South Dakota or Alaska, the allocation of GST exemption to the trust will allow the trust assets to be held for multiple generations free of generation skipping, gift and estate taxes.

Planning with gift/sale transactions in 2010 brings some uncertainty in terms of allocation of GST exemption to the seed gift because GST tax and the corresponding ability to allocate GST exemption are not in effect

during 2010. Currently, it is unclear how these transactions will be treated in the future and whether a retroactive application of GST exemption will be permitted, and, if so, whether such exemption will apply to the value of the gift when made or the value when the exemption is applied (as in late GST allocation situations in prior years). In general, if it is expected that assets will increase substantially within the next year, the transaction should be completed in 2010, despite some uncertainty in terms of GST exemption. Nevertheless, completing the transaction in 2010 will provide the appreciation to at least pass from the grantor's estate to the next generation gift and estate tax-free; with assets expected to rapidly appreciate in value, the gift/sale transaction now still makes good sense. However, if it is anticipated that the assets will not greatly appreciate over the next year, and GST efficiency is a major concern, it may be more beneficial to wait until 2011 and the certainty that appreciation will pass gift, estate and GST tax-free, or until the issue is resolved, before implementing the transaction.

GRATs

A GRAT is a vehicle specifically authorized by Internal Revenue Code Section 2702. Generally, a GRAT involves a gift transfer by the grantor, with no sale component, to an irrevocable trust that provides for a stream of annuity payments to the grantor for a term of years. Upon the expiration of the annuity term, the balance of the assets held in the trust passes to the remainder beneficiaries of the trust (usually the grantor's children) gift tax free. If structured properly, the GRAT will result in little or no taxable gift upon creation.

The amount of the gift, if any, upon funding the GRAT is determined by calculating the present value of the remainder interest in the GRAT. Generally, the remainder interest is equal to the initial value of the assets contributed to the GRAT less the present value of the annuity payments that will be made to the grantor. The present value of the annuity payments is determined by using the Section 7520 rate.[3] It is possible, in the case of a zeroed-out GRAT, to structure the GRAT so that the present value of the annuity stream retained by the grantor roughly equals the value of the gift made to the trust, resulting in a gift of zero and thus, no gift tax upon creation.

As noted above, the Section 7520 rate is near its historic lows. The real benefit derived from the GRAT occurs in those circumstances where the underlying assets outperform the Section 7520 rate. In such circumstances, substantial value can be shifted from the grantor's estate in a gift tax-free manner. In light of the significantly depressed values of asset classes across the board and the historically low Section 7520 rate, the GRAT is a very attractive planning technique for individuals with assets that are likely to appreciate.

> It's critical that the selected annuity term of a GRAT be for a period that the grantor is likely to survive.

If the GRAT is structured properly, there is little risk if the assets do not appreciate as anticipated. In such event, the assets are returned to the grantor over the trust term and are available for contribution to a new GRAT. Importantly, with a zeroed-out GRAT, there is little or no impact on the lifetime gift tax exemption or estate tax exemption.

There are, however, some limitations to GRATs. First, the grantor must survive the stated annuity term to ensure that the assets in the trust are removed from his or her estate. If the grantor dies within the stated

ßannuity term, then a portion of the assets in the GRAT will be included in the grantor's estate and will be subject to estate taxation. Thus, it's critical that the selected annuity term be for a period that the grantor is likely to survive. This requires a balancing of the desire to lock in a low Section 7520 rate for an extended period and choosing a term that the grantor is likely to survive.

If the grantor is concerned about the prospects for surviving the annuity term, a series of short-term GRATs may be a more attractive alternative. This technique involves creating a series of short-term or rolling GRATs (usually a term of two years) in which each annuity payment from the earlier GRATs are used to fund a new two-year GRAT. This results in a reduction of the potential mortality risk by increasing the chance that the grantor will survive the term of each short-term GRAT. In addition, the short-term nature of each of the GRATs allows for an opportunity to lock-in the upside of the volatile market, while reducing the potential negative effects of the downside of a volatile market.

The current administration is seeking to impose significant limitations on GRATs. Recent proposals, if enacted, would require that (1) a GRAT have a minimum annuity term of 10 years, and (2) the remainder interest of a GRAT have a value greater than zero. The effect of these proposals, if adopted, would significantly increase the mortality risk of any GRAT, eliminate the short-term rolling GRAT, and eliminate the zeroed-out GRAT. It is unclear at this time if, when, and in what form, such restrictions will be adopted.

Another limitation is that it is generally not possible to create a GRAT with a multi-generational structure, which is exempt from the generation skipping tax. This is because of the estate tax inclusion period (ETIP) rule, which basically provides that the GST exemption cannot be allocated to a trust during its trust term if the assets would otherwise be included in the grantor's estate if he died during that term. If the grantor dies during the annuity term, a portion of the GRAT assets is includible in the grantor's estate. Thus, the ETIP rule would preclude the grantor from allocating GST exemption to the GRAT until after the stated annuity term. GST exemption may only be allocated based on the asset values at the time of the expiration of the annuity term rather than the asset values on the date of funding. At such time, if there has been significant appreciation, the assets may exceed the grantor's available GST exemption amount, which would preclude the trust from obtaining a zero GST inclusion ratio. If it is the grantor's desire for the remainder interest of the GRAT to pass to grandchildren and/or later generations, there may be a potential GST tax. Thus, a GRAT is generally an excellent vehicle to transfer assets to the next generation, but not to transfer assets in a multi-generational, generation skipping tax-exempt manner.

CLATs

If an individual is charitably inclined, a CLAT may be an attractive option. A CLAT is conceptually similar to a GRAT: The grantor makes a single contribution to a trust, which then makes annuity payments over a term of years, and once the annuity term expires, the remainder passes to the grantor's children. However, in a CLAT, the annuity payments are made to one or more charitable organizations rather than to the grantor. CLATs are generally structured to be zeroed-out such that the present value of the annuity payments based on the Section 7520 rate roughly equals the initial contribution and no gift tax on the remainder interest passing to the children is incurred. Thus, if the assets in the CLAT appreciate at a rate in excess of the Section 7520 rate, such excess appreciation will pass gift tax-free to the remainder beneficiaries. In contrast to a GRAT, however, the grantor does not have to survive the term of the CLAT in order for the assets, and any appreciation, to pass outside of the grantor's estate.

An additional benefit of a CLAT is that if the CLAT is structured as a grantor trust, the grantor has the potential for an income tax charitable deduction in an amount equal to the present value of the annuity payments in the year that the CLAT was settled. Because the grantor pays the income tax liability for the CLAT, it effectively grows income tax-free, thereby enabling more assets to pass gift tax-free to the grantor's children.

Preferred Freeze Partnership

A preferred freeze partnership (freeze partnership) is a statutorily blessed vehicle that, with the right assets, can provide a parent with fixed cash flow while at the same time shifting future growth out of the parent's taxable estate in a transfer tax efficient manner. Typically, a parent creates a freeze partnership by contributing

assets to a partnership (or a limited liability company) in exchange for a preferred interest. A child (or, better yet, a GST-exempt trust for the child's benefit) would contribute assets to the partnership in exchange for common partnership interests. (The parent could typically also contribute a small amount in exchange for a 1 percent common partnership interest in the partnership). Alternatively, the parent could initially own both preferred and common partnership interests and then transfer by gift or sale common partnership interests to or for the benefit of the child.

The parent's preferred partnership interest in the freeze partnership would be structured as a "qualified payment right" under IRC Section 2701 to ensure the parent doesn't have a deemed gift upon his contribution of assets to the freeze partnership under the Section 2701 zero valuation rule. The qualified payment right requires that the parent receive a fixed percentage payment return on his capital contribution, payable at least annually and on a cumulative basis. A valuation appraisal should be obtained from a qualified appraiser to determine what the proper preferred coupon to the parent will be. This valuation appraisal is critical; if the coupon paid to the parent is not sufficient, then the parent will be deemed to have made a partial taxable gift under the "subtraction method" of valuation.

In addition to the preferred coupon, the parent would also have a priority liquidation right, so that if the freeze partnership is ever liquidated, he will receive a return of his capital contribution before any return to the common partnership interest holders of their interests.

Because of these preferred rights that the parent will receive in the freeze partnership, he will receive none of the potential upside growth (that is, except for 1 percent common interest). The child, or trust for the child's benefit, will receive the upside growth potential in the common partnership interests above the amount needed to pay the preferred coupon. Over time, assuming that the freeze partnership assets are invested in a way so as to outperform the required coupon on the preferred partnership interest, the common partnership interest will appreciate in value thereby enabling all of the growth in the assets (above the preferred coupon) to be shifted to the next generation transfer tax-free. The parent's preferred interests, however, will be frozen for estate tax purposes. TE

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Endnotes

1. All references to the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended.
2. A detailed discussion of each technique is beyond the scope of this article.
3. The Section 7520 rate is equal to 120 percent of the applicable federal rate. Accordingly, there is potential that the grantor retained annuity trust will underperform the intentionally defective grantor trust.