

Depressed Stock Market Offers Unique Estate Planning Opportunities

By Victor J. Ferguson

The recent volatility of the stock market and widespread economic turmoil have left many people worried about the value of their assets and the future of their wealth.

But for those with estates subject to the federal estate tax (estates over \$3.5 million in 2009), the depressed market offers a unique opportunity to implement strategies that reduce the value of an individual's estate and save estate taxes by making tax-free gifts and utilizing grantor retained annuity trusts, also known as GRATs.

One simple way to save estate taxes is to make gifts of the "annual exclusion" amount to children, grandchildren and others each year. The exclusion is the amount that each U.S. citizen may give to any person each year free of the federal gift tax. In 2009, the cap is \$13,000. However, rather than gifting \$13,000 in cash, if investors have depressed securities that are expected to rebound from the financial crisis, now is an ideal time to gift them to heirs. In the future, if the gifted securities appreciate in value, the recipient will benefit and it will be outside the donor's estate.

Each U.S. citizen can gift an additional \$1 million during his or her lifetime—the so-called "lifetime gift tax exemption." While such gifts will reduce dollar for dollar the amount that can pass tax-free at death, using all or a portion of the lifetime exemption to gift depressed securities to heirs may be very beneficial.

Keep in mind that each individual can utilize his or her annual exclusion amount and lifetime gift tax exemption. Thus, married couples have double the opportunity to transfer a significant amount of wealth.

GRAT Growth

Investors also can reap the rewards of the current low interest rates by transferring depressed securities into a GRAT. A GRAT is an irrevocable trust in which the grantor retains an annual, specified distribution expressed as a percentage of the initial fair market value of the assets placed

into the GRAT for a term of years. An irrevocable remainder interest (after the specified payments are made to the grantor for the fixed term) is then distributed to the designated remainder beneficiary or beneficiaries.

A GRAT typically is structured so that the value of the interest retained by the grantor is equal to the fair market value of the property transferred to the GRAT. Hence, the present value of the remainder interest, and the taxable gift, is valued at zero. This is known as a "zeroed out" GRAT.

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To estimate the growth of GRAT assets, the IRS uses the so-called 7520 rate set monthly by the federal government. At the end of the GRAT term, any earnings in excess of the 7520 rate will be distributed to the remainder beneficiary free of federal gift and estate taxes. Historically low 7520 rates coupled with depressed securities make GRATs an especially appealing option because of the potential for the securities to appreciate above the 7520 rate.

For example, if a grantor transfers securities valued at \$1 million to a two-year, zeroed out GRAT while the 7520 rate is 3.4 percent, and the securities appreciate 10 percent each year during the two-year term, the grantor would receive a payment of \$478,583 at the end of year one and a payment of \$574,300 at the end of year two. Significantly, at the end of year two,

the \$109,258 balance would be distributed to the remainder beneficiary free of federal gift and estate taxes. The major advantage is that the \$109,258 would be distributed without using any of the grantor's lifetime gift tax exemption.

In May 2009, the U.S. Treasury Department released a set of tax proposals endorsed by the Obama administration for fiscal year 2010. One would require that any new GRAT have a minimum term of 10 years. The Obama administration perceives that GRATs are being abused because they can be established for short periods of time, typically two years.

But there are two reasons to utilize a short timeframe. First, GRATs are generally funded with assets that are expected to increase in value over the short term. If a GRAT is required to last for at least 10 years, there is a risk that even if the assets do increase in value over the short term, they may subsequently decline in value, leaving less to the remainder beneficiary. Second, if the grantor dies during the term, all of the trust assets generally must be included in the grantor's estate for tax purposes, thereby eliminating any tax benefit. A shorter GRAT term minimizes that risk. Accordingly, those considering establishing a GRAT should do so now before the window of opportunity closes.

Gifting securities and GRATs are just two components of a comprehensive estate plan that may allow investors to maximize their opportunities in a volatile market. However, anyone desiring to establish a gifting program or utilize a GRAT should first consult an estate planning professional. ♦

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