SUCCESSFUL ESTATE PLANNING TECHNIQUES MAY CEASE TO EXIST

Estates & Trusts Alert
July 27, 2009

Practices & Industries

Trusts & Estates

July 27, 2009

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Two transfer-tax techniques that have been extremely successful for certain clients may be legislated out of existence this year. Hodgson Russ urges clients whose estate plans may benefit from these techniques to consider implementing either or both before legislation now being considered in Congress takes effect. Clients who we believe should consider this kind of planning are those who meet the following descriptions:

- An estate valued at over $3.5 million, or $7 million if married
- A significant portion of their estate is closely held or non-publicly traded business or investment interests, or they have a substantial portfolio of publicly traded securities they expect to appreciate over the near term (two years)
- These interests are expected to appreciate, perhaps because of an eventual liquidity event, such as a sale
- A desire to maximize value to family members

Both techniques are sometimes called “estate freezes” because they freeze the value of the estate, passing all appreciation above a certain hurdle rate to family members free of gift or estate tax.

The first technique is a sale of part or all of the closely held interests to a grantor trust in exchange for cash (previously gifted to the trust) and a promissory note. The effectiveness of this technique may be diminished by legislation that would eliminate discounts in valuing the interests being transferred. These discounts, which can run as high as 40 percent, make this technique effective even if the transferred interests appreciate less than expected. Sales to grantor trusts are disregarded for income tax purposes and do not cause recognition of gain. Debt service payments on the promissory note are also disregarded and do not give rise to capital gains or interest income during the grantor’s life. Interest on the promissory note can be set at today’s extraordinarily low rates — 2.76 percent in July 2009 for a nine-year note — which means that all appreciation above the interest rate will escape taxation in the grantor’s estate and benefit family members who are the trust beneficiaries.

The second technique is the short-term Grantor Retained Annuity Trust (GRAT). Short-term GRATs have the advantage of little downside risk. Transfers to GRATs can be “zeroed-out,” which means they use no lifetime gift tax credit. If the GRAT fails — that is, if its assets do not return more than the hurdle rate — the grantor simply gets the assets back and is no worse off than if the GRAT technique had never been employed. The "hurdle rate" for June is 3.4 percent. If the GRAT succeeds, all of the return above the hurdle rate passes to the beneficiaries without gift tax. Unlike sales to grantor trusts, GRATs involve a mortality risk. If the grantor does not survive the term of the GRAT, its assets are subject to estate tax in the grantor's estate. Legislation has been introduced to impose a 10-year minimum term on GRATs. If enacted, this rule would reduce the attractiveness of GRATs by raising the mortality risk, requiring assets to be tied up for at least 10 years and eliminating the use of a series of short-term GRATs in which assets that fail to beat the hurdle rate during the GRAT term come back to the grantor, while those that outperform pass to the beneficiaries.

If you believe that your estate plan would benefit from either of these techniques, please call your Hodgson Russ lawyer without delay. No one can tell for certain what the effective date of legislative changes may be, but starting soon and building in flexibility should minimize the risk of missing the window of opportunity.