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Strategic Wealth Transfer Planning in Volatile Times

Low asset valuations and financing costs are providing a compelling opportunity for affluent families to execute wealth transfer strategies.

By Christopher Zander
Partner & Wealth Advisor
Evercore Wealth Management LLC

After a year of extreme market volatility, many affluent individuals have turned their attention away from wealth transfer planning. At Evercore Wealth Management (EWM), we believe that the current challenging economic environment offers a compelling opportunity for clients to execute a variety of wealth transfer planning initiatives. Most significantly, we believe that depressed valuations for real property, financial assets and business interests – combined with current low interest rates – present an historic opportunity for families to transfer assets to younger generations at a discount to their future expected value.

Today's environment

The overall economic and market disruption of the past year has caused a considerable decline in valuations for most assets, including – perhaps most obviously – publicly traded securities. The deleveraging of financial institutions and resulting lower availability of credit has also reduced the value of many private businesses as well as prices for commercial and residential real estate. Private equity and venture capital funds are at their lowest valuations in several years.

At the same time, the Internal Revenue Service's interest rate schedule – which is published monthly and used to set the terms for various wealth transfer strategies – remains at a relatively low level based on historical data.

Creating a strategic wealth transfer plan

Before implementing any strategy, it is essential that families understand their long-term wealth planning objectives and how they correspond to their current and projected financial asset base and liquidity needs. At EWM, we analyze our clients' personal financial objectives and assess their short- and long-term liability streams as well as their need for liquidity at various points in time. This wealth planning analysis helps us determine the optimal amount of wealth to transfer to future generations. It also allows us to remain confident that our clients will be able to fund their desired lifestyle, as we have seen too many parents and grandparents come to us after suffering financial hardship from overly aggressive wealth transfer plans.

Implementing appropriate strategies

Once our clients have their wealth plans in place and they have utilized their full federal gift tax exemption, we recommend considering strategies to freeze the current value of the assets in their estates and to transfer the future appreciation of those assets – above a certain fixed rate of return – to the next generations. Grantor Retained Annuity Trusts, intra-family loans and installment

sales to defective grantor trusts are all popular strategies that may be particularly attractive in today's environment of depressed asset valuations and low interest rates.

Grantor Retained Annuity Trusts. A GRAT is an effective strategy for transferring assets to a family member with minimal gift or estate taxes. A GRAT is created by transferring assets into an irrevocable trust and retaining the right to annuity payments for a fixed term of years. At the end of the trust's term, the remaining assets in the trust go to the "remainder" beneficiaries named in the trust, free of estate and gift taxes after all annuity payments have been made. However, if the grantor dies within the term of the trust, then all of the assets may potentially revert back to the grantor's estate.

By adjusting the term of the trust as well as the annuity payments, the present value of the taxable gift amount can be substantially reduced. The interest rate used by the IRS to calculate the annuity payment and taxable gift is governed under IRC §7520. The current IRC §7520 rate is 3.4% for July 2009 transactions. Although higher than June's 2.8% rate, these rates remain favorable for GRATs.

By selecting assets that have the potential to outperform the IRS interest rate within the term of the GRAT, individuals can transfer a significant portion of the appreciation of the trust assets to their beneficiaries. Also, the annuity payments can be satisfied with property in-kind or cash. By combining liquid and illiquid assets, the discounted value of the illiquid property can stay in the trust for a longer period of time to help maximize the overall return while the more liquid, readily marketable securities can be used for the annuity payments.

Since a GRAT is a grantor trust (where the grantor pays the income taxes), the grantor can substitute higher basis assets for appreciated assets within the GRAT without causing a taxable event for income tax purposes. This effectively "locks in" the success of the GRAT prior to its termination and also increases the tax basis of the assets passing to the beneficiaries.

It is important to note that President Obama's revenue proposals for the 2010 budget may limit GRATs to a 10-year minimum term, which may reduce the benefits of the strategy by eliminating short-term GRATs and extending mortality risk. Also, the GRAT is not an ideal vehicle for transferring assets to grandchildren because the Generation Skipping Transfer Tax (GSTT) exemption cannot be applied until the end of the term of the GRAT, thereby nullifying the potential success of the strategy for GSTT purposes.

For affluent families who wish to efficiently transfer their wealth, the careful use of a GRAT – or multiple GRATs – with a variety of investment and business assets offers an attractive alternative to retaining the assets and having all future appreciation be subject to estate taxes. If the assets in the GRAT fail to outperform the IRS discount rate, the grantor is in roughly the same position he or she was prior to the transfer.

Intra-family loans and installment sales. Affluent individuals who have successfully navigated the last few years of market volatility may see investment opportunities in today's depressed valuations. Given the low interest rate environment, it may be beneficial for them

to lend funds to a child or grandchild – or a trust for their benefit – to make the investment. In doing so, grantors create an “estate freeze” where they receive fixed principal and interest payments while the loan recipient benefits from any appreciation from the transaction.

If the transaction is done with an intentionally defective grantor trust, there is no income tax impact as the grantor is the deemed taxpayer on the trust. Existing intentionally defective grantor trusts may also purchase assets from the grantor in return for an installment note.

Both of these strategies involve freezing the asset value in the client’s estate while transferring upside to the next generations. Also, a loan and/or installment sale to a defective grantor trust is an effective way to make a transfer to grandchildren, from a transfer tax perspective.

To avoid creating a taxable gift, interest rates on the installment note or intra-family loan must be no less than the current month’s IRS Applicable Federal Rate (governed under IRC Sec. 1274) for that time period. In July, for loans of three years or fewer, the annual interest rate is 0.82%. For loans of more than three years but not more than nine years, the annual interest rate is 2.76%. For loans longer than nine years, the annual interest rate is 4.32%. These are attractive financing terms for families to consider when structuring investments to minimize estate taxes.

It is important to note, however, that these transactions use leverage and are similar to investing on margin. Clients must realize that a significant decline in the investments after the transaction is made could cause the transaction to fail for the intended beneficiary. As a result, it may be appropriate for the advisor to construct a diversified portfolio that includes an allocation to less risky assets.

Selecting appropriate assets

In most cases, the performance of the underlying asset is the biggest driver of success in a wealth transfer strategy. Therefore, we recommend utilizing assets with high return potential to execute these strategies. In some cases, the ideal asset to transfer could be a privately owned business or privately managed commercial real estate, both of which may be able to benefit from significant valuation discounts for gift tax purposes.

For client families that instead have a diversified portfolio of financial assets, we must determine which assets should be utilized – and in what combination – in a comprehensive, multi-generational wealth transfer program. For example, a client at EWM with a balanced risk/reward profile may have a portfolio invested as follows:

- 5% cash equivalents
- 30% defensive assets (e.g., high-quality municipal bonds)
- 7.5% inflation and dollar hedging assets (e.g., TIPs, commodities and gold)
- 50% liquid growth assets (e.g., global equities, higher yielding corporate bonds and MLPs)
- 7.5% illiquid growth assets (e.g., distressed debt, private equity and real estate)

Because the strategies discussed involve transferring the future appreciation of assets beyond a fixed rate of return, the client must select assets that have the potential to outperform that fixed rate of return. Assets solely invested in cash equivalents and defensive assets do not likely fall into that category. However, we believe that a diversified portfolio invested in inflation and dollar hedges, liquid growth assets and illiquid growth assets will have a return in excess of the fixed rate of return – with a commensurate amount of risk – thereby giving the wealth transfer strategy a better chance of succeeding for the family.

For GRATs, selecting a high-performing asset – or portfolio of assets – merits consideration because, if the transaction fails, the grantor is in roughly the same position that he or she was before executing the transaction. When contemplating intra-family loans or installment sales to defective grantor trusts, the grantor should consider the risks of leverage on the transaction and construct a portfolio with a higher level of diversification and, quite possibly, a defensive asset component to lessen overall portfolio and transaction risk. Clients may also wish to pursue an even more conservative transaction in which they invest the proceeds in a high-quality fixed income security that yields a modest spread above the low financing costs on a loan of similar maturity.

Clients that are willing to accept a greater level of administrative complexity may also choose to utilize individual GRATs for specific asset classes or individual investments with greater potential. This will help ensure that an underperforming asset in one GRAT does not negatively impact a successfully performing one in another, for wealth transfer purposes.

Planning for future growth

During times of economic prosperity, affluent families spend a great deal of time and energy on estate planning. The most successful strategies, however, tend to be implemented when asset values and financing costs are low. As a result, we advocate considering wealth transfer opportunities today in advance of hopefully better economic times down the road.

Christopher Zander joined Evercore Wealth Management as a founding partner in 2008 with 16 years of experience in providing comprehensive advice to high-net-worth individuals and families on their complex, multi-generational wealth management and planning needs.

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