

CLIENT ADVISORY

TAKING ADVANTAGE OF THE PERFECT STORM: WEALTH TRANSFER STRATEGIES FOR TURBULENT TIMES

Not long ago the commercial real estate market was flying high. An individual who sold commercial real estate ran the risk of being hit with a large capital gains tax bill. A senior family member who made a gift of real estate as part of his overall estate planning was hard pressed to avoid using at least part of his US\$1 million lifetime gift tax exemption.

Times have changed. Declining real estate values, low interest rates, low long-term capital gains tax rates, and underwater securities portfolios have converged to create a “perfect storm” for transferring wealth to younger generations at minimal income and transfer tax cost. Intra-family sales, transfers to grantor retained annuity trusts (GRATs), and installment sales to intentionally defective grantor trusts (IDGTs) are three simple strategies for using the current economic environment to your advantage. Steps taken today have the potential to create value for your family for generations to come.

I. INTRA-FAMILY SALES

Perhaps the simplest way to take advantage of the current environment is for a senior family member to sell undervalued real estate to a younger family member.

Here’s how an intra-family sale works: A senior family member and younger family member enter into a purchase and sale agreement. The senior family member accepts as payment a promissory note bearing interest at the applicable federal rate (AFR) in effect for the month of sale (The use of the AFR avoids negative gift tax consequences). The note is structured as an interest-only note with a balloon payment upon expiration of the term of the loan.

Example. In December 2008, Grandfather sells to Granddaughter a 40% interest in a limited liability company (LLC) that owns income-producing real estate. In today’s depressed market, the fair market value of the real estate owned by the LLC is US\$5 million. Yet, the real estate produces income at the annual rate of 8%. Due to applicable valuation discounts for minority status and lack of marketability, the fair market value of the LLC interest is not 40% of US\$5 million

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(i.e., US\$2 million), it is substantially less. Assuming an overall valuation discount of 35%, the 40% interest in the LLC has a value of US\$1.3 million.

Grandfather sells to Granddaughter the 40% LLC interest and accepts as payment an interest-only promissory note with a face value of US\$1.3 million and a term of nine years. The safe harbor midterm AFR for December 2008 is 2.83% (The midterm rate is used for loans with a term equal to or longer than three years and equal to or less than nine years). No principal is due until the expiration of the nine-year term.

The property generates US\$400,000 per year (underlying value of US\$5 million multiplied by 8% rate of return), 40% of which (i.e., US\$160,000) is payable to Granddaughter). Granddaughter uses this revenue to pay the interest on the note. But, the amount of interest due each year is only US\$37,050—far less than the amount of revenue generated.

Moreover, by the time principal becomes due, the storm clouds over the commercial real estate marketplace likely will have passed, and the property owned by the LLC may be worth more, say US\$7.5 million. Granddaughter pays Grandfather US\$1.3 million (the amount of the principal on the note). The source of the repayment could be a refinancing of the real estate. Now Granddaughter owns a 40% interest in an LLC that in turn owns real estate worth US\$7.5 million. Grandfather has succeeded in transferring substantial wealth to Granddaughter at zero gift tax cost and minimal, if any, income tax cost.

Grandfather realizes capital gain on the difference between the sales price of the LLC interest and his basis in the interest. It is likely, however, that Grandfather can fully offset this capital gain with losses on marketable securities. Even if Grandfather does not have enough losses to offset the gain, the 15% capital gains tax rate now in effect will reduce the tax bill substantially. But the rate will not be this low for long. It is set to increase to 20% on January 1, 2011.

II. GRANTOR RETAINED ANNUITY TRUST

In the event capital gains consequences make the intra-family sale a non-starter, a transfer of commercial real estate to a GRAT is an attractive alternative. However, for technical tax reasons relating to the generation-skipping transfer tax, a GRAT is not the optimal strategy for transferring wealth to grandchildren and more remote descendants.

Here's how it works: A senior family member makes a gift of property to an irrevocable trust for the benefit of younger family members and, pursuant to the terms of the trust agreement, retains the right to receive an annuity payment for a fixed term of years. At the end of that term (typically two or three years), the property remaining in the trust (after all retained annuity payments are made to the senior family member) are distributed to younger family members. If the property transferred to the GRAT appreciates at a rate (or produces income at a rate) that is higher than the Internal Revenue Code 7520 rate (the "hurdle" rate) to which the retained annuity payments are pegged, that appreciation passes—completely free of gift tax—to the younger family members. The lower the 7520 rate, the higher the likelihood of passing wealth free of gift tax to younger family members.

It is possible to structure the transfer of property to a GRAT as a "zeroed out" gift. This is achieved by setting the actuarial value of the senior family member's retained interest at a value equal to the fair market value of the property transferred to the GRAT.

Example. In December 2008, when the 7520 rate is 3.4%, Father transfers US\$1 million worth of commercial real estate to a GRAT for the benefit of Son. The GRAT has a term of three years. Assuming an 8% growth in the property and assuming that the property produces income at the rate of 8%, the amount transferred *free of gift tax* to Son at the end of a three-year GRAT term would be US\$321,183.

III. INSTALLMENT SALE TO AN INTENTIONALLY DEFECTIVE GRANTOR TRUST

A third strategy is an installment sale to an irrevocable trust that is treated as a “grantor” trust for income tax purposes. This strategy is particularly attractive if, save for capital gains considerations, an intra-family sale would have been the option of choice.

Here is how this strategy works: A senior family member creates an irrevocable grantor trust for the benefit of younger family members and funds the trust with an amount of cash equal to or greater than 10% of the value of the property to be sold to the trust. The senior family member and the trustees of the trust then enter into a purchase and sale agreement pursuant to which the trustees agree to purchase the property in exchange for a promissory note that bears interest at the AFR in effect for the month of sale.

Because the trust is structured as a grantor trust, the sale of the property is ignored for income tax purposes and does not result in the realization of capital gain by the senior family member.

Attorneys at Arnold & Porter LLP have extensive experience in customizing these and other strategies to meet clients' specific needs. If you have further questions about any of the wealth transfer strategies discussed above, please contact your Arnold & Porter attorney or:

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