



Estate Planning Articles

New Dynamics for Trust Investments

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Investment science can be applied to the precise objectives of a given trust. Assets and techniques can be selected to complement current economic conditions and tax rules. Flexibility can be incorporated into arrangements in anticipation of the ongoing changes that we face. Let's review the current planning context and several investment techniques that are currently being used or proposed for trusts.

Dynamic Planning

The context of decisions is always important and change is often the only constant; the economy and the tax code are in a continual process of evolution. But consider how much more uncertainty currently exists in the areas of taxation, economic growth, and stock market investments.

Taxation: For tax purposes, several possible tax scenarios lie before us over the next two decades. The estate tax will be phased out in 2010 but will return automatically in 2011 unless Congress makes the repeal permanent.

Meanwhile, tax cuts intended to stimulate the economy have arrived. Congress has lowered tax rates on income, capital gains, and dividends. In light of the nation's growing deficit, the need for tax revenues may catch up with us. That scenario could mean the return of the estate tax and higher income tax rates. Reductions in the taxation of capital gains and dividends is also temporary.

Uncertainty on a Strict Schedule:
Tax Evolution 2001 - 2011

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
INCOME TAX TOP RATE	39.1%	38.6%	35%	35%	35%	35%	35%	35%	35%	35%	39.6%*
CAPITAL GAINS	20% and 10%	20% and 10%	15% and 5% (after 5/5/03)	15% and 5%	15% and 5%	15% and 5%	15% and 5%	15% and 0%	20% and 10%	20% and 10%	20% and 10%
DIVIDENDS	Taxed as ordinary income	Taxed as ordinary income	15% and 5%	15% and 5%	15% and 5%	15% and 5%	15% and 5%	15% and 0%	Taxed as ordinary income	Taxed as ordinary income	Taxed as ordinary income
GIFT TAX TOP RATE	55%+	50%	49%	48%	47%	46%	45%	45%	45%	35%	55%+*



Uncertainty on a Strict Schedule: Tax Evolution 2001 - 2011

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GIFT TAX EXEMPTION	\$675,000	\$1 million	\$1 million	\$1 million	\$1 million	\$1 million	\$1 million	\$1 million	\$1 million	\$1 million	\$1 million
ESTATE TAX TOP RATE	55%+	50%	49%	48%	47%	46%	45%	45%	45%	0%	55%+*
ESTATE TAX EXEMPTION	\$675,000	\$1 million	\$1 million	\$1.5 million	\$1.5 million	\$2 million	\$2 million	\$2 million	\$3.5 million	N/a	\$1 million
BASIS AT DEATH	Stepped up basis	Stepped up basis	Stepped up basis	Stepped up basis	Stepped up basis	Stepped up basis	Stepped up basis	Stepped up basis	Stepped up basis	Carry Over Basis**	Stepped up basis*
STATE DEATH TAX CREDIT	FULL CREDIT	Credit Reduced 25%	Credit Reduced 50%	Credit Reduced 75%	NO CREDIT~	NO CREDIT~	NO CREDIT~	NO CREDIT~	NO CREDIT~	NO CREDIT~	FULL CREDIT*

+ = In addition to the 55% rate, a 5% surtax applied to certain estates exceeding \$10 million.

* = In 2011, item reverts to 2001 level unless Congress enacts further legislation.

** For carryover basis in 2010 (and beyond if extended by Congress) a limited stepped-up basis would continue to apply to the first \$1.3 million of capital gains transferred to a nonspouse and the first \$3 million of capital gains transferred to a spouse.

~ = After 2004, there will be no federal credit provided for state death taxes. However, amounts paid will be deductible. This will not benefit most estates.

Economy: The economic climate is equally dynamic. America's economy expanded during the third quarter of 2003 at 7.2%, the fastest rate since 1984. Technology companies have rebounded and manufacturing growth has been unusually high. However, celebration may be premature since this level of activity was recorded during the peak of mortgage refinancing, the lowest interest rates in 45 years, and the one-time child-credit-tax rebate. While it is very unlikely for growth of 7% to be sustained beyond one quarter, things are looking up. The potential for 4% growth during 2004 was noted by one economist. Somewhat more optimistic, the Conference Board projects 5.7% growth for 2004, the fastest growth rate in 20 years.

Not everyone is convinced that the technology sector is entirely healthy. And not all technology companies will share the same future. Lawrence Ellison, founder of Oracle, points out that the high-tech sector is now in a maturing phase and predicts a shakeout. "We think there's at least 1,000 Silicon Valley companies that need to go bankrupt," says Ellison. He predicted Oracle would be one of the survivors, along with Microsoft and IBM, and noted that they are among only five technology companies that account for almost all of the profits in the industry.



Financial Markets: The technology sector appears to be recovering and the economy has improved. But how safe is the investment environment? Past growth spurts in manufacturing have been followed by periods of stock market decline. The time to invest is before everyone else knows that there's a party going on. There is also a psychological factor that is very hard to predict. Wars, disasters, and shifts in the global economy can change the complexion of the market overnight.

For example, the Dow Jones Industrial Average has crossed the 10,000 mark several times and has great psychological significance to investors. Only a few years ago, getting beyond 10,000 was a great step forward that had optimists predicting the Dow at 15,000, 20,000, and beyond. When the tech stock "bubble" burst, the Dow lost much of its recent gains and remained below 10,000 for 18 months; it hit a five-year low of 7,286 on October 9, 2002. In December, the Dow closed above 10,000 for the first time since May 24, 2002. During the next period of economic instability and the Dow falls below 10,000, the loss of investor confidence may make it harder for the market to "find the bottom" and regroup.

Dividend Déjà Vu

Once upon a time, before we became enlightened about long-term equity growth and total return investing, investors thought highly of dividends and many companies provided them. It was a different time. In the past, the stock market looked like a flat line compared with the steep ascent it has traveled over the past two decades. Suddenly, the dividend is not only rediscovered but is the object of our desires. This is no coincidence. Consider the factors contributing to the dividend phenomenon:

- ▣ Having been burnt in the stock market, investors need to have assets that will provide reliable returns to the portfolio-and the dividend certainly fits that description.
- ▣ The high-profile status of corporate scandals and excessive corporate salaries is prompting a movement toward accountability and the sharing of profits with corporate stockholders in the form of a dividend.
- ▣ Dividends are more valuable by reducing the tax consequences of receiving most dividends. Under JGTRRA, dividends are taxed much like long-term capital gains, i.e., at 15% and 5% with pre-JGTRRA levels, taxed as ordinary income, after 2008.
- ▣ Microsoft has set the standard by declaring a new dividend policy and then quickly announcing that dividend would be doubled. Microsoft had amassed \$50 billion of cash. This development is expected to be highly influential.

Investment Strategies

All investors must evaluate their tolerance for risk. When is security more valuable than the potential for higher returns? The approaches that are summarized below are by no means the only options, nor are they necessarily recommended. Rather, they are intended as a representative sampling of the investment strategies that are currently under consideration for purposes of estate and trust planning.



It is possible that a moribund portfolio is so conservative that assets are not generating adequate returns. For example, there are an estimated \$8 billion in U.S. savings bonds that no longer earn income. A portfolio may also include stocks that need to be liquidated and certificates of deposit with extremely low rates of return. There are alternative investments such as annuities and highly rated bonds that can provide safe investments with reasonable returns.

Pooling assets to provide a diversified mix of investments that includes growth stocks, especially those providing reliable dividend payments, is another useful approach. A pool of assets has the added advantage of coordinating investments and distributions under professional supervision.

Tweaking GRATs

Investments that complement estate tax plans can be more valuable than those which generate larger returns that are ultimately exhausted on tax liabilities. Nor can any investor assume that the repeal of the estate tax eliminates the need to plan ahead. Estate tax consequences remain relevant for those persons dying prior to completion of the estate tax repeal and for everyone else who lives to see whatever form the estate tax takes when it is reimposed.

A grantor-retained annuity trust (GRAT), a private annuity, and/or a sale of assets to defective grantor trust, have been identified as low-risk ways of removing future appreciation of assets from a taxable estate.¹

These techniques take advantage of the difference between actual and assumed rates of return on investments for purposes of valuing assets—generally 120% of the applicable federal rate (AFR).

Similarly, charitable trust arrangements (discussed below) also exploit the discrepancy between actual and assumed rates of return. For example, the remainder interest in a grantor-retained annuity trust (GRAT) is valued based on the total value of trust assets when the trust is created and the present value of the annuity interest retained by the grantor. If the grantor's interest is large enough, the remainder passes free of transfer taxes. And if the annuity is growing faster than the assumed rates for tax purposes, additional appreciation will accumulate and make the remainder that much larger.

One way of making a GRAT more effective is with derivatives, particularly, if the GRAT contains a large holding of a particular stock. While the use of a "put option" (the right to sell a stock) or a "call option" (the right to buy a stock) is generally associated with speculative techniques and higher risks, these investment tools can also be utilized to reduce risks.

For example, a "collar" arrangement involves an investor selling a call option and buying a put option on the same stock. This limits the potential losses in an investment at minimal cost. There are a number of additional put and call techniques that can enhance the security and/or performance of investments.²

Charitable Trusts

Charitable trusts are able to satisfy both personal and charitable objectives. When structured as a charitable remainder trust (CRT), the donor retains an interest for life or a period of years, after which the remainder of the trust goes to charity. The opposite approach is the charitable lead trust (CLT), which provides a current income interest in a trust to a charity for a period of time, after



after which the remaining assets of the trust revert to the grantor's beneficiaries. CRTs and CLTs can be established as annuity trusts or unitrusts. All of these variations result in a host of acronyms: CRATs, CRUTs, CLATs, and CLUTs.

Let's focus on the charitable lead annuity trust (CLAT) for the moment. A charity will benefit immediately and for a period of years. The trust instrument describes the annuity as either a fixed amount or a fixed percentage of the initial fair market value of the assets in the trust. So a \$5-million trust paying an annual annuity of 8% would pay \$400,000 to the named charity each year.

The donor would get a charitable deduction to be used to offset gift or estate tax. That deduction is based on the present value of what the charity is entitled to. The present value is determined by how long the charity will continue to receive payments and applicable interest rates under Section 7520.

It is possible to structure a "zero-out CLAT," i.e., a CLAT that provides a charity with an interest that is sufficiently long to create a present value equal to the entire trust. As a result, the remainder can reach the donor's beneficiaries with zero transfer tax consequences.

The ability to structure a zero-out CLAT may involve paying an annuity to a charity for 20 or more years. During this time, appreciation that exceeds the growth anticipated under §7520 will accumulate inside the trust. This can be a considerable amount that remains inaccessible to beneficiaries for an extended period of time. There are several potential remedies for this. Having so much wealth deferred to a future time can be offset by having other assets distributed at the time of death. The guaranteed annuity payments can be prepaid, i.e., the beneficiary satisfies the amount the charity anticipated and keeps the rest. There are also creative laddering or cascading arrangements where annuities with staggered termination dates would create a new flow of assets to beneficiaries every few years.

Another theoretical (but as yet unproven) technique would be to fund a CLAT with a note. In theory, excess appreciation could be transferred to beneficiaries each year. What makes the entire arrangement work begins with a revision to the grantor's will or trust. A CLAT is established with interests in a limited partnership. At the grantor's death, the beneficiaries are given an opportunity to acquire the partnership utilizing a note. Thereafter, the partnership pays the beneficiaries, the beneficiaries make the note payment to the CLAT, the CLAT pays the charity. To the extent the partnership assets appreciate in value beyond the note payments, that value can be paid to the grantor's beneficiaries.³

Foundation Investments

A private foundation is subject to specialized investment parameters. Under self-dealing rules, transactions with "disqualified persons" can trigger a 5% excise tax. "Disqualified persons" include major contributors and foundation officers. Foundation managers also trigger penalties if they jeopardize investments. But, but can still target investments in a manner that complements the grantor's goals.⁴



TECHNICAL REFERENCES

¹ Champine, "Planning Despite Potential Repeal", 142 *T&E* 4, p. 27 (April, 2003).

² Goldsbury, "Increasing a GRAT's Effectiveness with Derivatives", 30 *Estate Planning* 6, p. 278 (June, 2003). Regarding the use of a stock "collar," if the stock is worth \$100 and a \$90 put option is purchased, the investor has purchased the right to sell the stock at \$90 even if it falls below that price. That limits the potential risk in the investment. Because put options cost money, one approach is to offset the cost by selling a call option with a strike price of \$120. If the stock rises above \$120, the purchaser would be able to exercise the option and the original investor would be forced to sell the stock at the \$120 price. The net effect is that the investor limits the potential losses and gains on the stock with little or no cost, thereby making the ultimate sale price of the stock more reliable.

³ Madsen, "Funding a CLAT with a Note", 30 *Estate Planning* 10, p. 495 (Oct., 2003). This approach relies in part on an estate administration exception to the self-dealing rules under Reg. 53.4941(d)-1(b) (3).

⁴ See IRC §§4940 - 4945. Halperin and Harris, "Investment Guidelines for Private Foundation Managers", 30 *Estate Planning* 11, p. 542 (Nov., 2003). Recent rulings reveal how much latitude philanthropic investments may enjoy. For example, where a foundation's grantor and sole trustee owned more than 35% of the general partner of a hedge fund, he sought IRS permission to invest most of the foundation's assets in the hedge fund. Although the general partner of the hedge fund was a disqualified person for purposes of foundation transactions, the IRS permitted the investment because 1) no disqualified person would benefit from the transaction; 2) none of the limited partners in the hedge fund would have control over the foundation's investment decisions; and 3) the structure was beneficial to the foundation by providing an investment on favorable terms. Let. Rul. 200318069.

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