

**PLANNING WITH
UNDERWATER ESTATE
PLANNING STRATEGIES
(GRATS, INSTALLMENT
SALES, ETC.)**

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Jones Day

September 25, 2009

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UNDERWATER GRATS AND ISGTS

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UNDERWATER GRAT

- Client Grantor has previously created a GRAT
- Assets in “Old GRAT” have dropped in value
- Old GRAT will likely fail, and client would have to wait to receive annuity payments to “re-GRAT”

UNDERWATER

“OLD GRAT”

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Funded with \$10M in July of
2008

Old GRAT owes client
graduated annuity for two
years: ~\$4.84M payable
7/09, and ~\$5.81M payable
7/10 (totaling ~\$10.65M)

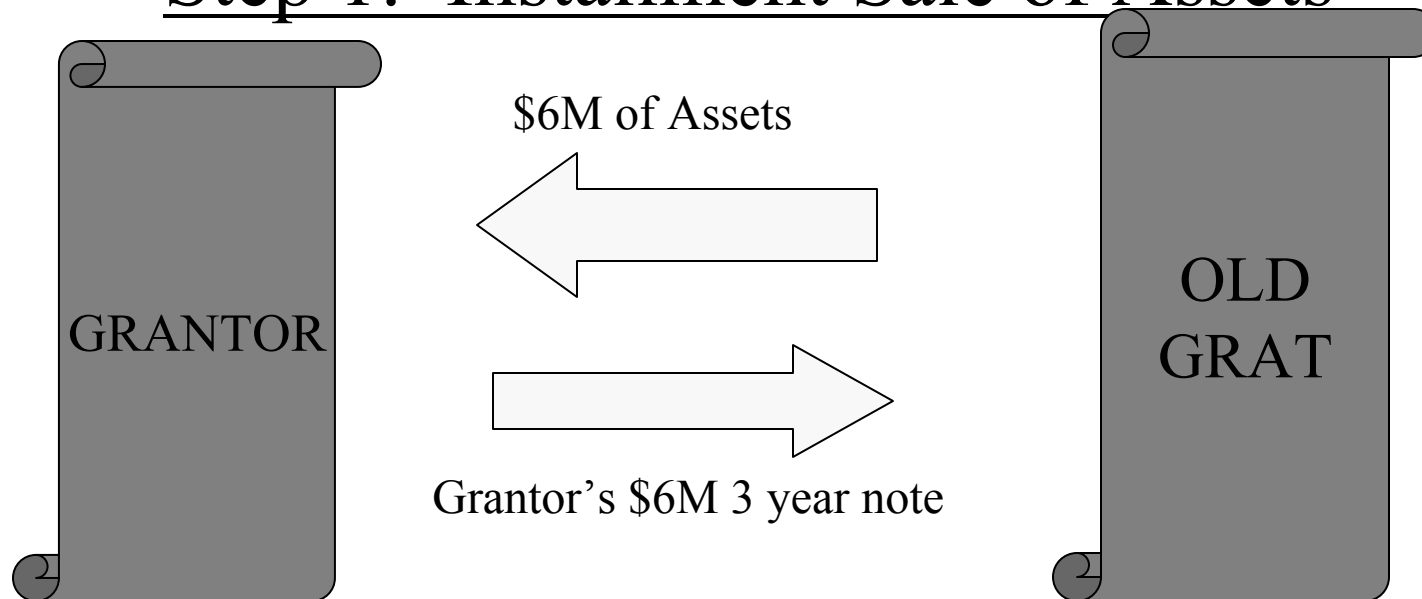


\$6M – May 2009 value of
assets

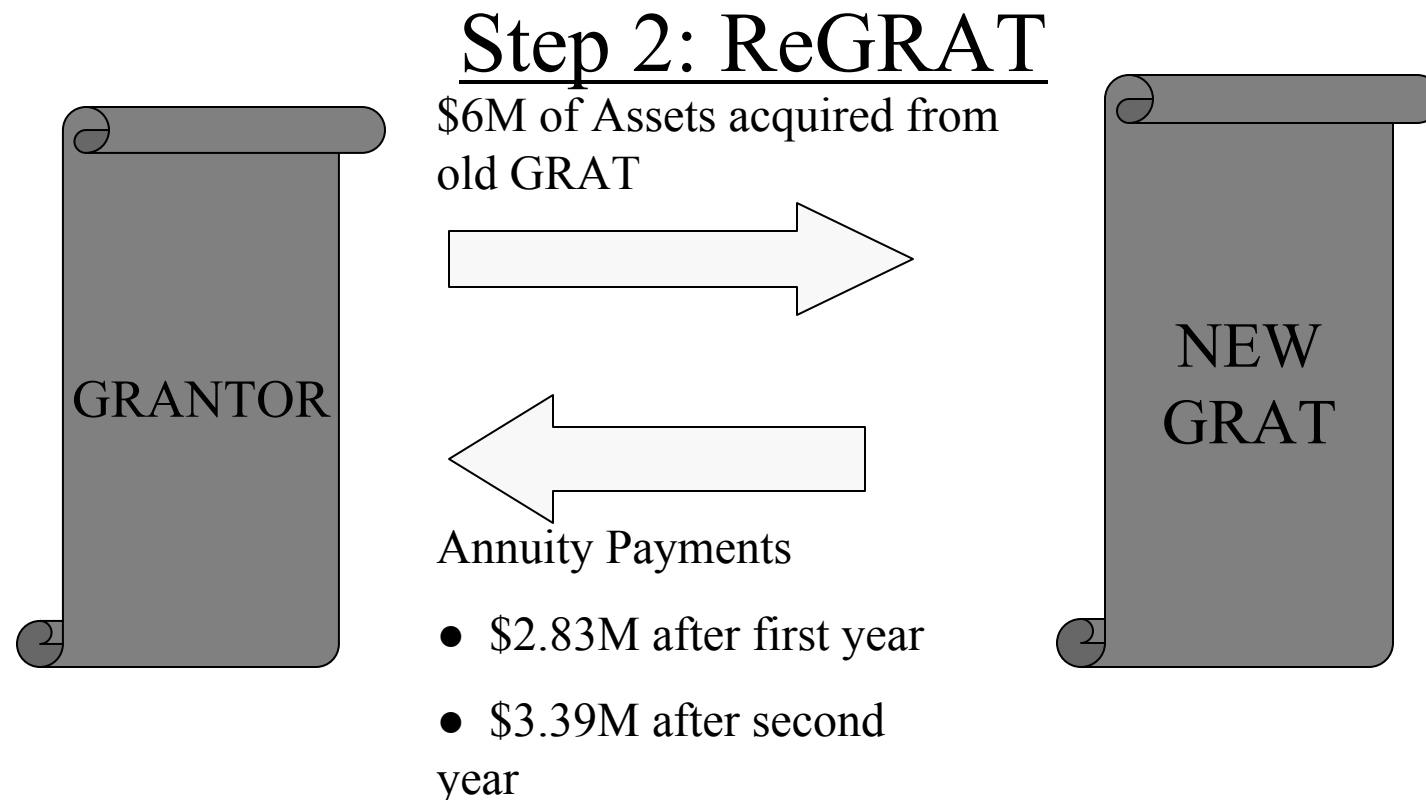
UNDERWATER GRAT
OPTION 1:
INSTALLMENT SALE OF
OLD GRAT ASSETS
AND
REGRAT

INSTALLMENT SALE OF OLD ASSETS AND REGRAT

Step 1: Installment Sale of Assets



INSTALLMENT SALE OF OLD ASSETS AND REGRAT



The annuity payments are based on the 2.4% Code § 7520 rate in effect for May, 2009.

INSTALLMENT SALE OF OLD GRAT ASSETS AND REGRAT

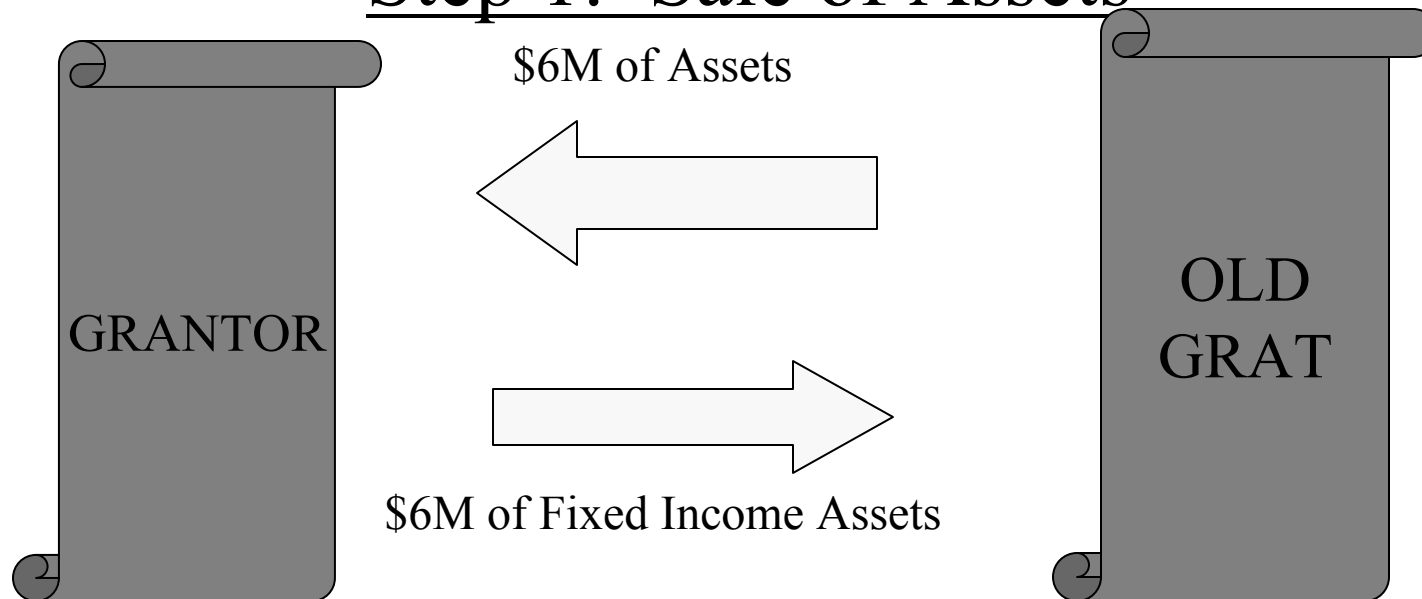
Concerns

- Possible commutation problem if installment note is disregarded as lacking economic substance or otherwise or if too little is paid for Old GRAT's assets. See Reg. § 25.2702-3(d)(5).
- Possible constructive contribution to GRAT contrary to Reg. § 25.2702-3(b)(4) if too much is paid for Old GRAT's assets.
- Possible concern that use of grantor's debt obligation runs afoul of Reg. § 25.2702-3(d)(6), but this regulation appears to bar only notes issued by the Old GRAT trustee, not those payable to the trustee.
- Possible Section 16b securities concerns for grantor who is an insider in regard to issuer of publicly traded stock held by Old GRAT.

UNDERWATER GRAT
OPTION 2:
SALE OF OLD GRAT ASSETS
AND
REGRAT

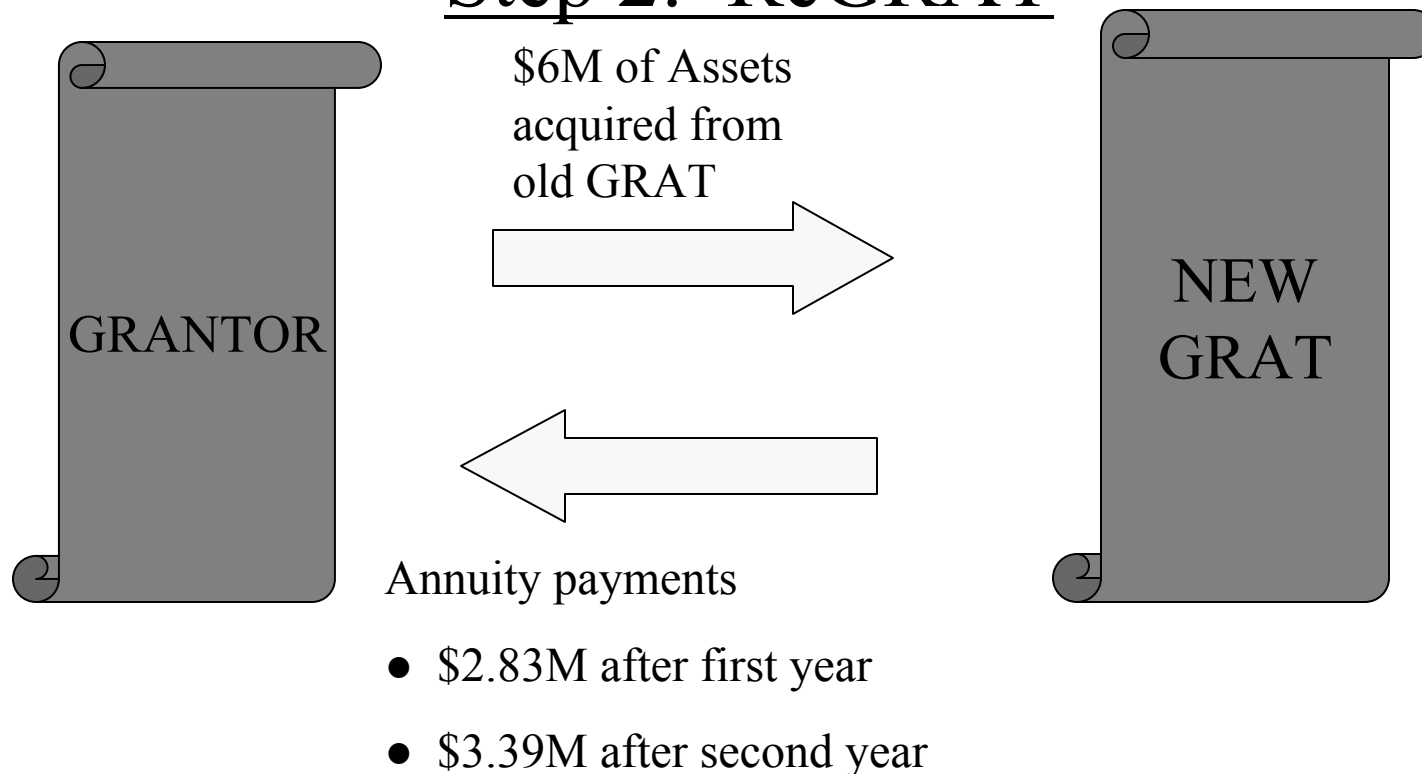
SALE OF OLD GRAT ASSETS AND REGRAT

Step 1: Sale of Assets



SALE OF OLD GRAT ASSETS AND REGRAT

Step 2: ReGRAT



The annuity payments are based on the 2.4% Code § 7520 rate in effect for May, 2009.

SALE OF GRAT ASSETS AND REGRAT

Concerns

- Insufficient fixed income or other assets to effect swap
- Potential undervaluation or overvaluation of Old GRAT's assets
- Possible Section 16b securities concerns for grantor who is an insider in regard to issuer of publicly traded stock held by Old GRAT

UNDERWATER GRAT OPTIONS 1 AND 2:

INSTALLMENT SALE OF OLD GRAT
ASSETS AND REGRAT

SALE OF OLD GRAT ASSETS AND REGRAT

Failure of Old GRAT

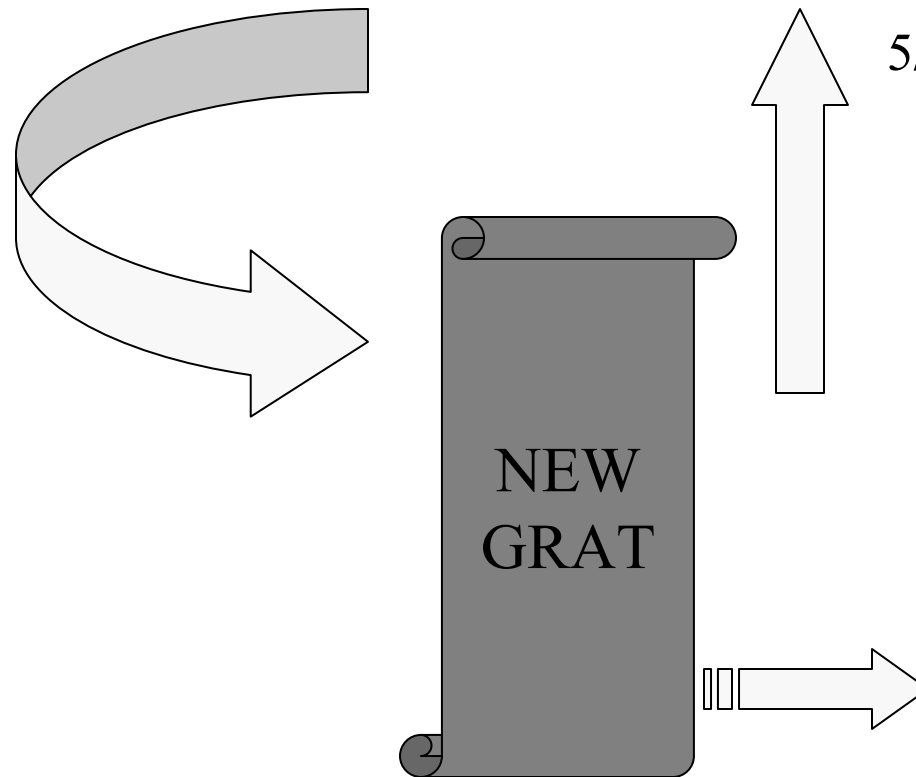
(i.e., all of Old GRAT's assets are distributed to
Grantor, with nothing left for remainder)

UNDERWATER GRAT OPTION 3:

**“GAP GRAT”
(Grantor Annuity Payments GRAT)**

“GAPGRAT”

Funded with annuity interest in
Old GRAT (\$6M fmv)

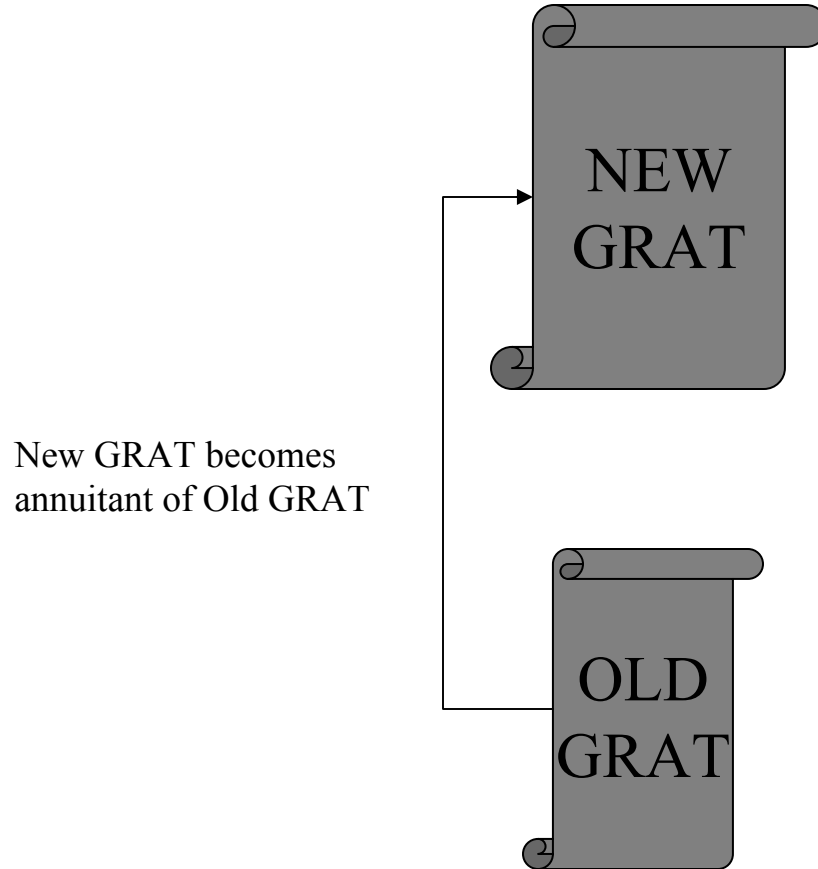


GRAT pays client
graduated annuity for two
years: ~\$2.83M payable
5/10, and ~\$3.39M payable
5/11 (totaling ~\$6.22M)

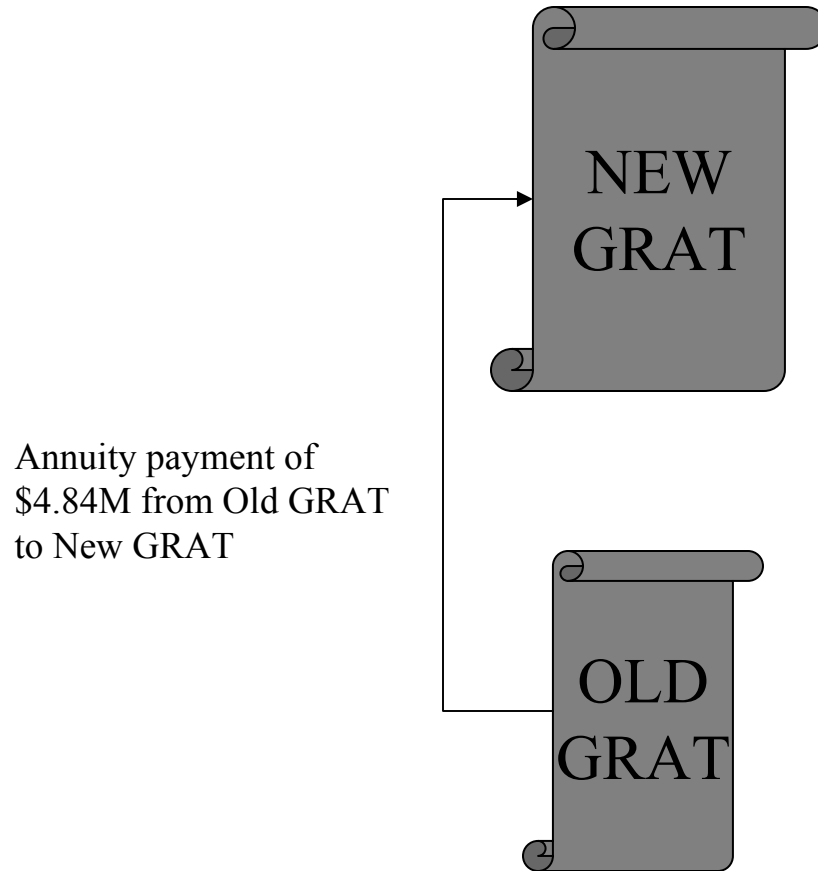
Any assets remaining in
GRAT after two years to
be paid to remainder
beneficiaries (or held in
trust for their benefit)

These calculations are based on the 2.4% Code § 7520 rate in effect for May, 2009.

“GAPGRAT” – After New GRAT



“GAPGRAT” – Annuity Paid from Old GRAT – July 2009



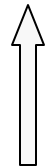
“GAPGRAT” - *10% Growth*

After 1 year

Annuity payment of
~\$2.83M to client

*(Satisfied from \$4.84M paid from Old
GRAT)*

\$6,600,000



10% growth

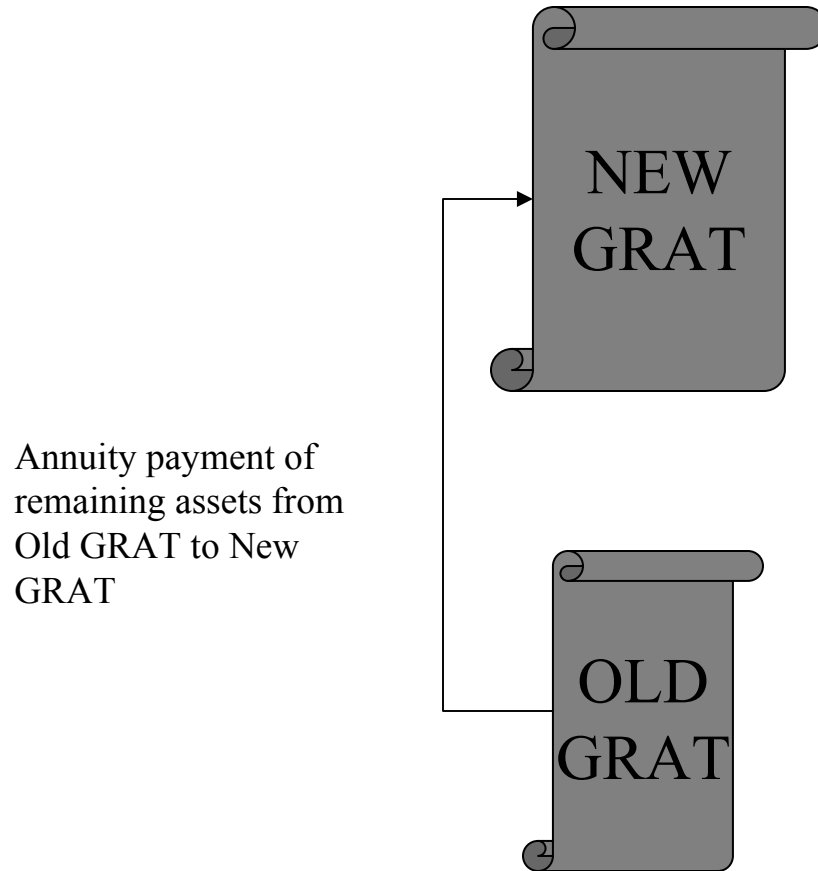
\$6,000,000



~\$3.77M remains

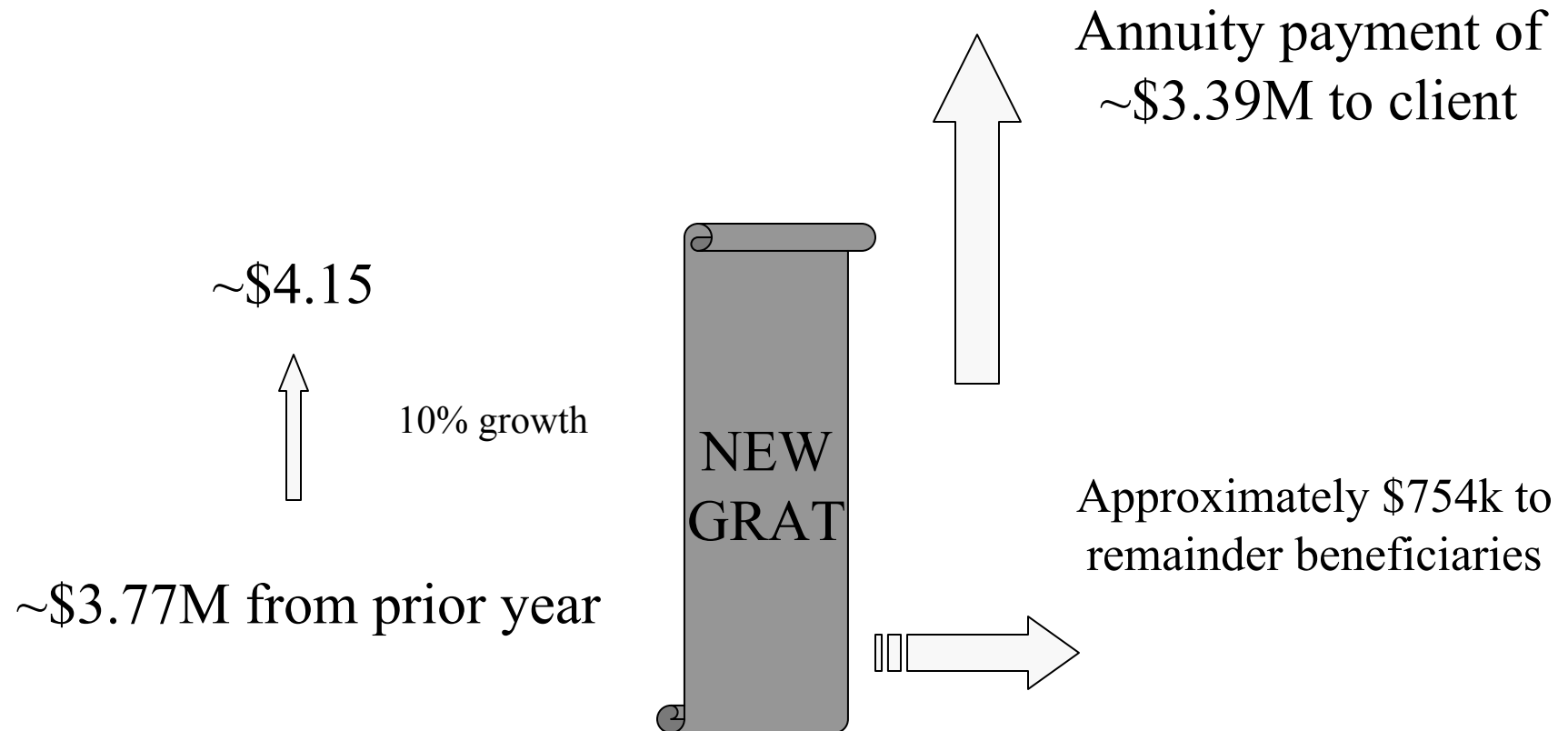
*(Consisting of \$2.01M from Old
GRAT, plus remaining annuity
interest in Old GRAT)*

“GAPGRAT” – Annuity Paid from Old GRAT – July 2010



“GAPGRAT”

After 2 years - trust termination



“GAPGRAT”

Concerns

- Valuation – the value of the Old GRAT annuity payments should not exceed the value of the assets in the Old GRAT. See Reg. § 25.7520-3(b)(2)
- Assignment of the annuity interest – depending upon the terms of the Old GRAT, the annuity interest generally should be assignable

UNDERWATER GRAT
OPTION 3:
“GAPGRAT”

Probable failure of old GRAT absent
extraordinary return

**UNDERWATER OPTIONS 1, 2 AND 3
 INSTALLMENT SALE OF OLD GRAT ASSETS AND REGRAT
 SALE OF OLD GRAT ASSETS AND REGRAT
 GAPGRAT**

After 2 years - trust termination - \$6 million funding

| <u>Annual Return</u> | <u>Remainder Value</u> |
|----------------------|------------------------|
| <=2.4% | \$0 |
| 6% | \$348k |
| 10% | \$754k |
| 20% | \$1.851M |
| 30% | \$3.068M |

All amounts are based on the 2.4% Code § 7520 rate in effect for May, 2009 and are rounded and approximate. Actual results *will* vary.

UNDERWATER ISGT

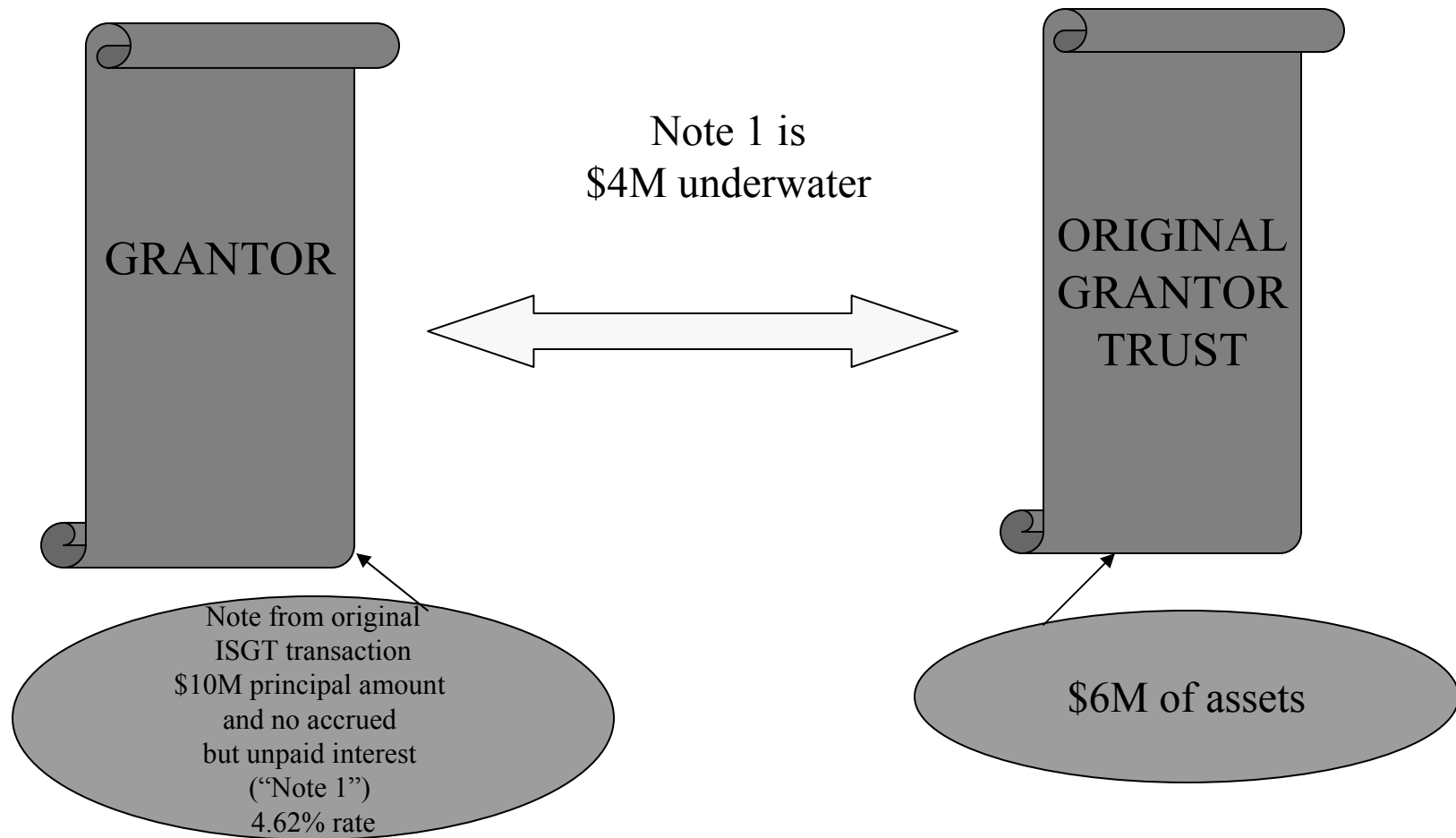
- Client/Grantor previously sold assets to a grantor trust on an installment basis, taking back a note from the trust
- The assets held by the grantor trust decline in value and are worth less than the amount then owed under the installment note

UNDERWATER ISGT

Example

- Terms of ISGT installment note dated May 1, 2007
 - 9 year term
 - \$10M stated principal amount
 - 4.62% per annum interest payable annually, which equaled the mid-term AFR then in effect
 - Balloon payment on April 30, 2016
- May 1, 2009 Facts
 - Unpaid stated principal remains \$10M
 - No accrued but unpaid interest
 - Value of trust's assets have declined to \$6M -- the trust is \$4M under water

UNDERWATER ISGT



UNDERWATER ISGTS POSSIBLE RENEGOTIATION OPTIONS

Interest rate reduction?

Principal reduction?

UNDERWATER ISGT

OPTION 1:

INTEREST REDUCTION

Example

- Grantor proposes to drop the interest rate from the 4.62% provided in the installment note to the 2.05% rate in effect for May, 2009, the mid-term AFR for that month.
- Assuming sufficient trust assets:
 - May, 2009 present value of note yielding 2.05% interest: \$10M
 - May, 2009 present value of note yielding 4.62% interest: approximately \$11M
 - Query: would interest reduction result in approximately \$1M taxable gift?
- But trust only holds assets with a \$6M fmv

UNDERWATER ISGT OPTION 1:

INTEREST REDUCTION

Considerations

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- **Reg. § 25.2512-4 and Prop. Reg. § 1.7872-3(c)(3), Example (5)(iii) seem to indicate that a rate reduction to the appropriate AFR for the month of the reduction does not result in a gift loan even if the loan is not underwater. *See also* Blattmachr, Crawford, and Madden, “How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note,” 109 Journal of Taxation 22 (July, 2008).**
- ***See also* Prop. Reg. § 20.7872-1, an estate tax provision, which seems to indicate that the cap on transfer tax value of the installment note is the unpaid stated principal plus accrued interest.**
- **The value of the assets in the grantor trust, plus any guarantees, should cap the transfer tax value of the installment note if the value of such assets, plus any guarantees, is less than the unpaid stated principal plus accrued interest. The extent to which the note is underwater should thus provide an added gift tax cushion.**
- **Would the absence of a prepayment right increase the chances of a gift? Prop. Reg. § 1.7872-10(a)(3) may offer some comfort that a prepayment provision is not required.**

UNDERWATER ISGT

OPTION 2:

PRINCIPAL REDUCTION

Example

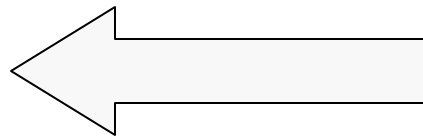
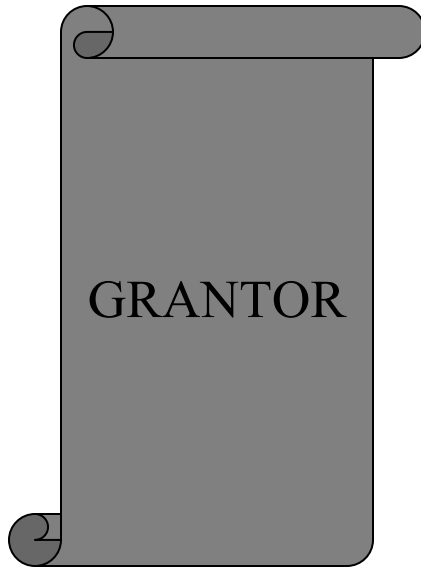
- Unpaid stated principal amount: \$10M
- Proposed reduced principal amount: \$6M -- the same as the fmV of the grantor trust's asset
- Issues: Is the reduction a taxable gift, and if so how much?
The reduction should not be a taxable gift.

UNDERWATER ISGT

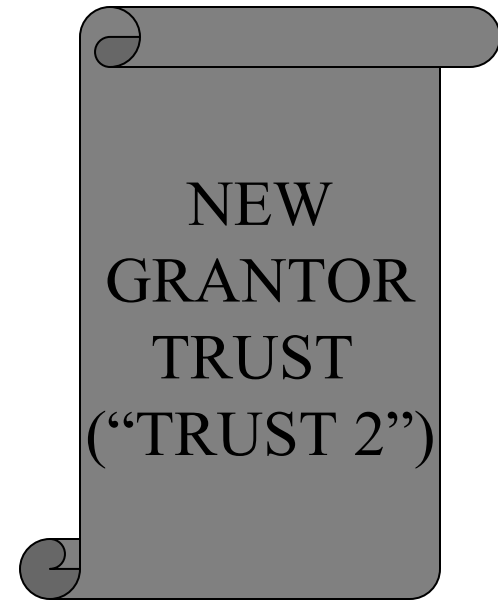
OPTION 3:

SECOND ISGT

Note 1 (\$10M principal balance yielding 4.62% but \$4M underwater)



\$6M installment note (Note 2) yielding 2.05%

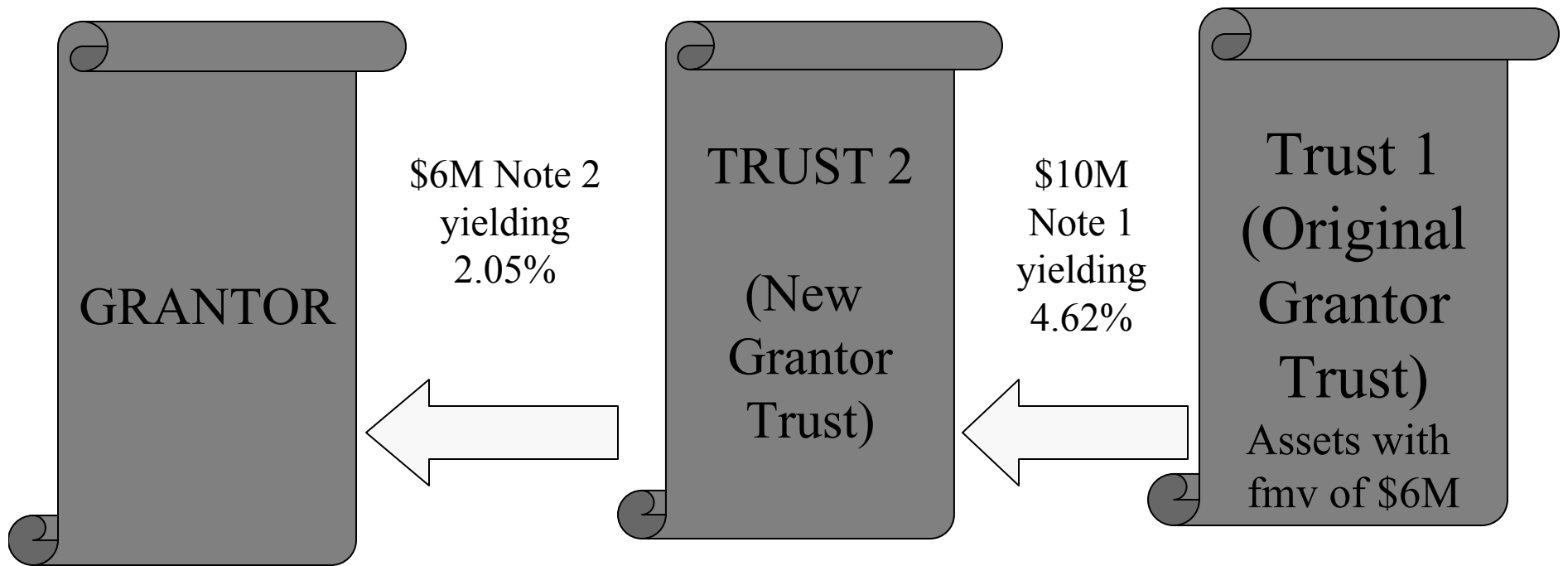


Query: Should the remainder beneficiary be Trust 1?

UNDERWATER ISGT

OPTION 3: SECOND ISGT

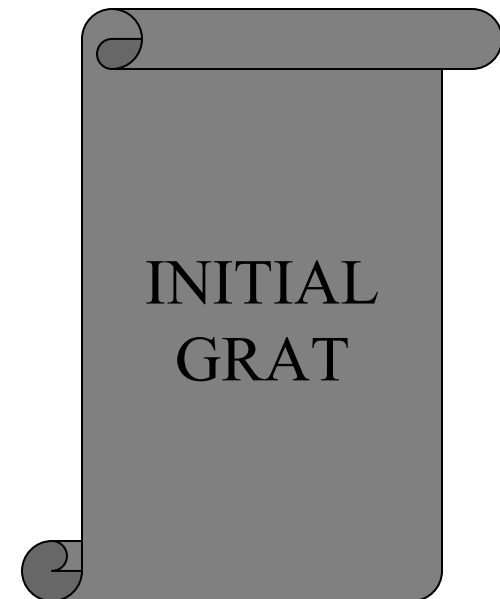
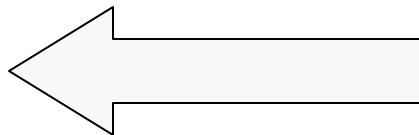
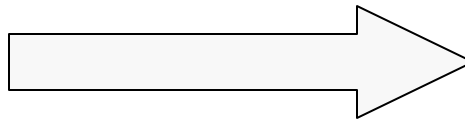
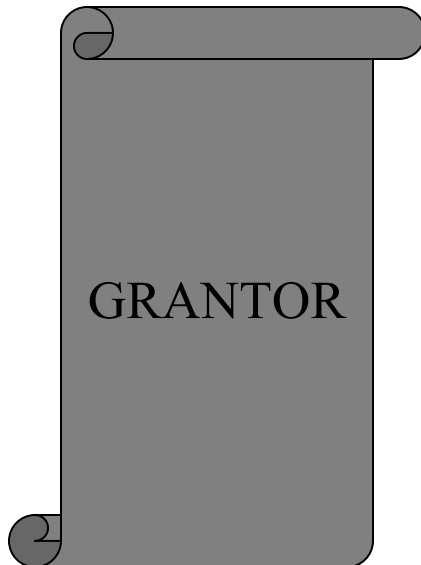
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UNDERWATER ISGT

OPTION 4: ROLLING GRATS

Note 1 (\$10M principal
balance yielding 4.62% but
\$4M underwater)

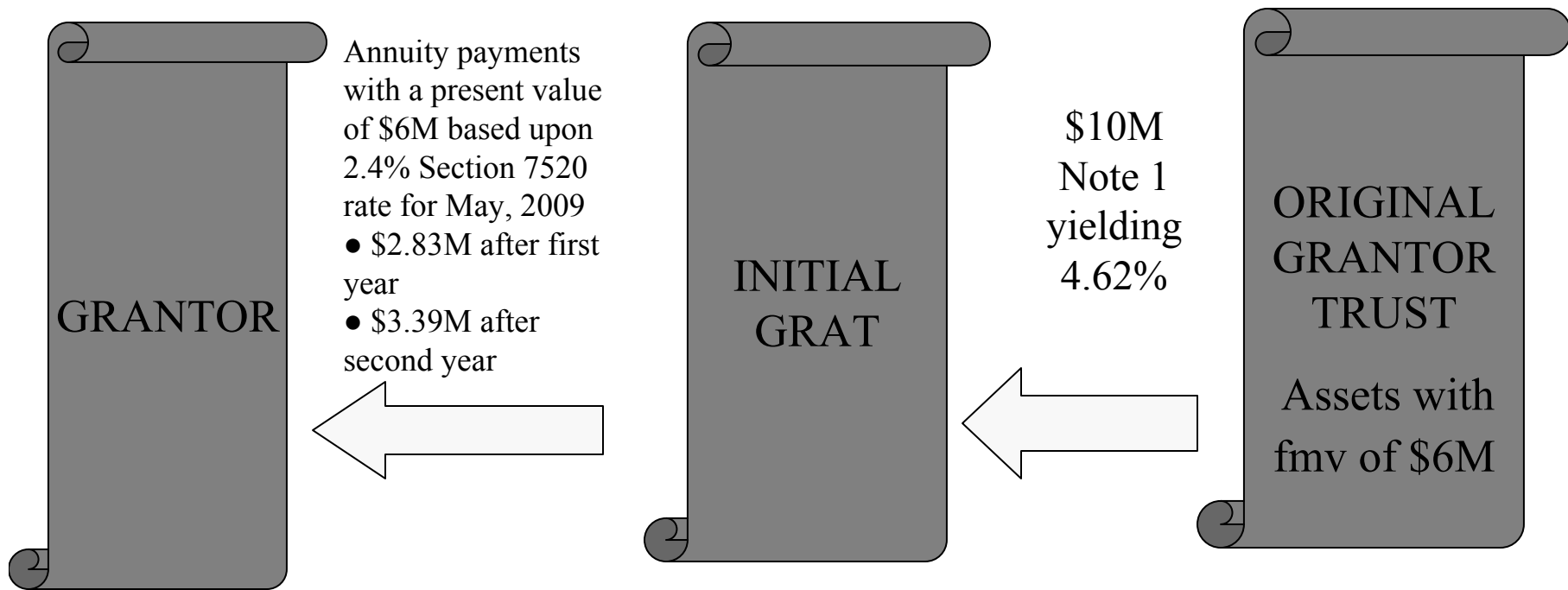


Annuity payments with a
present value of \$6M based
upon 2.4% Section 7520 rate
for May, 2009

- \$2.83M after first year
- \$3.39M after second year

UNDERWATER GRAT

OPTION 4: ROLLING GRATS



**ALTERNATE VALUATION DATE
 (“AVD”)
MAXIMIZATION IN A DECLINING
MARKET**

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AVD MAXIMIZATION IN A DECLINING MARKET MARITAL BEQUEST DISCLAIMER

Example

Terms of Will

- Pecuniary bequest marital amount or fractional marital share
- Residuary credit shelter trust

Date of death value: \$10M

Alternate valuation date value: \$6M

**AVD MAXIMIZATION IN A
DECLINING MARKET
PECUNIARY MARITAL BEQUEST DISCLAIMER**

No Disclaimer

| |
|------------------------------|
| <u>Marital Share</u> \$6M |
|------------------------------|

| |
|--|
| <u>Residuary Credit Shelter Trust</u> 0 |
|--|

\$1,000 Disclaimer and AVD Election

| |
|-------------------------------------|
| <u>Marital Share</u> \$2,499,000 |
|-------------------------------------|

| | |
|---------------------------------------|--------------------|
| <u>Residuary Credit Shelter Trust</u> | |
| Credit shelter amount | \$3,500,000 |
| Disclaimed amount | 1,000 |
| Estate Taxes | (450) |
| Net Amount | <u>\$3,500,550</u> |

**AVD MAXIMIZATION IN A
DECLINING MARKET
FRACTIONAL MARITAL SHARE DISCLAIMER**

No Disclaimer

| |
|----------------------|
| <u>Marital Share</u> |
| \$3,900,000 |

| |
|-----------------------------|
| <u>Credit Shelter Trust</u> |
| \$2,100,000 |

\$1,000 Disclaimer and AVD Election

| |
|----------------------|
| <u>Marital Share</u> |
| \$2,499,000 |

| | |
|-----------------------------|--------------|
| <u>Credit Shelter Trust</u> | |
| Credit shelter share | \$3,500,000 |
| Disclaimed amount | 1,000 |
| Estate Taxes | <u>(450)</u> |
| Net Amount | \$3,500,550 |

AVD MAXIMIZATION: POST-DEATH ENTITY EARNINGS DISTRIBUTION

Example

100% owned LLC

\$10M date of death value

\$6M AVD value

\$1M of net income between date of death and AVD election



AVD MAXIMIZATION:
POST-DEATH ENTITY EARNINGS DISTRIBUTION

No AVD Distribution

Reg. § 20.2032-1(d)
Included Property
LLC \$7M

Reg. § 20.2032-1(d)
Excluded Property
0

\$1M AVD Distribution

Reg. § 20.2032-1(d)
Included Property
LLC \$6M

Reg. § 20.2032-1(d)
Excluded Property
Distribution \$1M