

OCTOBER 18, 2008  
MONEY MATTERS

## Why Now Is the Time to Help Your Heirs

*Yes, your finances are likely taking a beating this year. Which means it's the perfect moment to transfer as many assets as you can.*

By ANNE TERGESEN

The economy is a mess, home prices are reeling, and stocks have plunged. But for those likely to become ensnared in the estate tax, there's a silver lining: These troubled times offer some of the best opportunities in years to transfer wealth to younger generations, without triggering much or any inheritance tax along the way.

"This is a great time to get your estate in order," says Jeff Baskies, partner at the law firm of Katz Baskies in Boca Raton, Fla.

### *Getting Your Estate in Order*

**JOURNAL PODCAST:** Holly Isdale, a managing director of Barclays Wealth, talks about simple steps you can take to get your estate in order, including giving \$12,000 a year to heirs and paying their tuition bills.

### *The Journal Report*



See the complete [Encore](#) report. set up another of these trusts in March.

Just a few years ago, the estate tax's days seemed numbered. Under the tax cuts President George W. Bush signed into law in 2001, the amount an individual can leave to someone aside from a spouse without paying federal estate tax has risen steadily, from \$1 million in 2002 to \$2 million today, en route to \$3.5 million next year. (You can transfer an unlimited amount to a spouse.) In 2010, the tax is supposed to disappear entirely.

But with the federal budget deficit growing, Republican presidential candidate John McCain has proposed allowing each individual to shield as much as \$5 million from the estate tax, while cutting the tax rate to 15%. Democratic rival Barack Obama is talking about a \$3.5 million exemption and leaving the tax rate at its current 45%. Meanwhile, several states impose their own inheritance taxes on estates smaller than those that are subject to the federal levy.



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Roger Roth

**THE ENCORE QUIZ** Think you're ready for life after the office? Here's your chance to prove it.

Just ask Tom Pedrick. The last time stocks were this depressed, the 53-year-old radiation oncologist was able to score outsized gains -- for his heirs. It wasn't hard: As stocks sank in 2002, Dr. Pedrick and his wife, Maureen, put their shares into a trust that funnels investment profits to heirs. When share prices rebounded soon after, the strategy paid off: The Columbus, Ohio, couple had succeeded in shifting to each of their three children -- tax-free -- many times the \$12,000 they otherwise would have been able to give away without triggering a 45% gift tax.

"We were so successful that we did it again," says the physician, who

With consensus growing that the estate tax won't fade away anytime soon, estate planners say families are getting serious about strategizing for the first time in years. Parents and grandparents are transferring to their heirs assets that they believe are temporarily depressed -- from real estate to stocks to stakes in family businesses -- reducing the size of their own estates and giving the heirs the chance to cash in on a rebound.

Families are also benefiting from today's low interest rates. Rather than hand down assets directly -- a move that would trigger a nasty gift-tax bill -- many instead put them into trusts or other arrangements that skim off a portion of the future profits for heirs. How much the heirs ultimately receive depends not only on whether

the investments soar or sputter. Interest rates also play a role, and the lower they are at a trust's outset, the more the heirs stand to gain.

"Today's low interest rates, plus beaten-up stock values, add up to a very high chance of success," says Charles Aulino, director of financial planning at Glenmede Trust Co. in Philadelphia.

Before calling your attorney, consider how much you can accomplish with a pen and checkbook. You and your spouse can give as much as \$12,000 each to a relative or friend every year before you'll owe a dime in gift tax. If you hold beaten-down stocks or mutual fund shares, consider giving shares you've made a profit on in lieu of cash.

You can also pay tuition and medical bills for grandchildren, with no tax consequences. Plus, over your lifetime, you can give away an additional \$1 million tax-free. While that \$1 million will reduce -- dollar for dollar -- the amount you can shield from the estate tax when you die, giving it away while you're still alive can make a lot of sense. In part, that's because if the assets appreciate, the gains will accrue on your heirs' balance sheets -- outside your estate.

Some of the arrangements described in what follows are relatively straightforward. They cost little or nothing to set up, and are specifically addressed in the Internal Revenue Service tax code. Others are more complicated and costly, and, particularly if structured in unusual ways, may expose you to an IRS challenge. Which options you choose will depend on factors including your age and health, the asset you plan to transfer, the amount of risk and complexity you can handle, and whether you want a charity or your grandchildren to have a cut.

### *Family Loans*

One of the most attractive wealth-transfer strategies is also one of the simplest -- a family loan. The IRS permits relatives to lend money to one another at what is called the Applicable Federal Rate, which the government sets monthly. With these, relatives can charge far less than a bank. For example, in August, when the average rate on a 30-year mortgage was 6.5%, the Applicable Federal Rates ranged from 2.5% to 4.5%, depending on the loan's maturity.

With banks tightening credit standards, the appeal of The Bank of Mom & Dad is obvious. But these loans and their super-low interest rates are also estate-planning opportunities. One reason: If the borrower (say, your child) invests the loan's proceeds wisely, he or she will have something left over after repaying the lender (say, you).

Roger Dunham is betting that will be the case with his daughter and son-in-law, whom he lent \$400,000 to purchase their Marietta, Ga., home. The couple was able to buy a "great house," Mr. Dunham says: a four-bedroom place in a good school district. Moreover, because the family was able to lock in an interest rate of just 2.97% over the next nine years, the couple will profit as long as the home appreciates by more than that amount annually.

To further reduce the cost of this loan, and put even more potential profits in his heirs' pockets, Mr. Dunham, a former consultant at Accenture, plans to use another estate-planning technique. He and his wife intend to use the \$12,000 each is able to give tax-free to their daughter and son-in-law every year to pay down the loan's principal.



John Kuczala

By reducing the size of the loan, this tactic will slash the total amount of interest the young couple will owe on this debt. By helping the couple retire its \$400,000 debt to him, Mr. Dunham will also reduce his estate by as much as \$400,000. That will cut his estate tax bill by some \$180,000, says Jeff Call, Mr. Dunham's adviser and the partner in charge of the wealth management practice at the Atlanta-based accounting and consulting firm Bennett Thrasher.

### *Intentionally Defective Grantor Trust*

A popular trust strategy, the sale of an asset to an Intentionally

Defective Grantor Trust, or IDGT, can also be complex and expensive to set up. Why bother? For one thing, the payoff is potentially greater than with other strategies. Moreover, these give you a tax-advantaged way to pass assets to grandchildren while keeping the value of what's in the trust outside of their estates, as well as yours.

"I don't think my children will ever need this money," says David Kleinhandler, whose New York-based firm, Kleinhandler Associates LLC, specializes in using insurance to solve estate-planning problems. "I want to do something to potentially benefit future generations."

While IDGTs can be complex, on a basic level the arrangement involves setting up a trust and then lending it money to buy an asset from you that has the potential to appreciate significantly. Many people use these to purchase family businesses or homes. Mr. Kleinhandler will sell to his trust shares he owns in private-equity funds and a real-estate limited partnership.

To buy the assets, the trust will need some cash. So, to start with, Mr. Kleinhandler plans to give it \$1 million. Why \$1 million? That's the amount he's allowed to give away free of gift tax during his lifetime. Because Mr. Kleinhandler wants this trust to endure for generations, he will have to either pay the so-called generation-skipping tax on this \$1 million transfer or use some of the \$2 million he's allowed to shelter from that tax. (He plans to do the latter.) Gifts of more than \$2 million to grandchildren or their descendants are subject to a generation-skipping tax of as much as 45%.

With that \$1 million in cash, plus a \$10 million loan from Mr. Kleinhandler, the trust will purchase assets valued at \$11 million. (That's the maximum debt level most advisers recommend these trusts take on.) The trust can use the Applicable Federal Rate, which for loans of 10 or more years was 4.5% when the trust was established in August.

Of course, the goal is for the trust's assets to gain enough to cover the loan, while leaving something more for Mr. Kleinhandler's children and grandchildren. Based on past performance, Mr. Kleinhandler expects his investments to appreciate at least 12% a year. That would be more than enough to make the 4.5% interest payments.

Over the next 20 years, he says, he expects that initial \$11 million to grow to around \$20 million.

Because these are so-called grantor trusts, Mr. Kleinhandler won't owe a dime of tax on the gains he realizes by selling his investments to the trust. Nor will he have to pay income tax on the interest payments he receives. "It's as if you've sold the asset to yourself," says Holly Isdale, a managing director of Barclays Wealth, a unit of Barclays PLC.

But there are plenty of caveats. Neither the tax code nor case law specifically addresses IDGTs -- and the IRS has been known to challenge them on occasion. To steer clear of problems, Ms. Isdale recommends such precautions as establishing the trust some time before selling it an asset.

Perhaps the biggest risk is that of the trust going bust. If its assets decline in value, it will have to come up with the cash to pay you back. It can always use the money you gave it -- the \$1 million, in Mr. Kleinhandler's case. But if it exhausts that sum, you will have to pay gift tax, and possibly generation-skipping tax, on the rest of the debt.

### *Grantor Retained Annuity Trusts*

With these trusts, heirs won't receive quite as much as they would with an IDGT. But grantor retained annuity trusts, or GRATs, are also less risky, in part because you can completely avoid any gift-tax consequences. Moreover, because the tax code sanctions them, there's virtually no risk of running afoul of the IRS.

In many ways, GRATs resemble loans. As with a loan, they mature within a specified number of years. Moreover, any money you put in will be returned to you by the time the trust expires. So, what's in it for your heirs? Assuming all goes well, a big chunk of the earnings will go to them, free of gift and estate taxes.

Because a successful GRAT is one that appreciates a lot, it's best to select an asset you think is on the verge of a rapid run-up. The classic example: shares in a privately held company that's likely to go public. These days, beaten-down shares are also good candidates, says Daniel Roe, chief investment officer at Budros Ruhlin & Roe in Columbus, Ohio. On Mr. Roe's advice, Dr. Pedrick in Ohio put most of his stocks into a GRAT a few months ago.

"If there's going to be a better than average gain, we thought it was worthwhile to transfer that to our kids," Dr. Pedrick says.

Adele Virden, 54, recently put one-third of her Montrose, Colo., cattle ranch into one of these trusts. So that no gift taxes would be due, Ms. Virden agreed to take back the approximately \$3 million of value she put into the trust, in equal annual installments. She will also receive a little extra -- an annual interest payment designed to make sure she takes back what the IRS assumes her ranch will be worth in 10 years, when the trust expires. To estimate the rate at which investments in these trusts will grow, the IRS uses the so-called "7520" rate the government sets monthly. At 4.8% when Ms. Virden set up her GRAT, it has since declined to 3.8%.

If Ms. Virden's ranch appreciates by more than the 4.8% annual hurdle rate, the excess profits will remain in the trust and eventually go to her two children. So far, she figures, the property's value has risen by just a bit more. But even if it were to decline, there's little downside. True, Ms. Virden could have saved herself the approximately \$3,000 she paid an attorney to set up the trust. But the GRAT will simply pay her back what's left of her investment by the time it expires -- no one is required to make up for a shortfall, says her adviser, Mark Brown of Brown & Tedstrom in Denver.

If you have more than one type of asset you want to put into a GRAT, it's best to use a separate trust for each. Brent Kessel, founder of Abacus Wealth Partners in Pacific Palisades, Calif., recently advised a client to set up three \$1 million GRATs -- one composed of U.S. small-cap stocks, another of commodities, and a third of emerging-markets stocks. Had the client instead combined these three volatile investments into a single GRAT, he would have run a risk that losses on one might offset gains on another, Mr. Kessel says.

Many advisers favor limiting GRAT terms to as few as two years -- the minimum allowed. That way, if a particular investment soars, you'll be able to get the gains out of the GRAT before your luck changes.

As with IDGTs, GRATs are grantor trusts. As such, they allow you to pay capital-gains and income taxes on the investments in the GRAT on behalf of your heirs. Because the IRS doesn't consider such tax payments a gift, they are another way to transfer wealth to the next generation free of gift and estate taxes.

But there are drawbacks. Because GRATs have to pay you higher rates than short-term and medium-term family loans, they pass along slightly less to your heirs. The biggest risk is that you might die before your trust ends. In that situation, it's as if the GRAT never existed: Its entire value -- including returns -- is generally included in your estate and subject to tax.

### *Charitable Lead Annuity Trusts*

Similar to GRATs, these trusts can pass most of their investment gains to heirs, while reducing or eliminating gift and estate taxes. But whereas a GRAT returns interest and principal to you, a charitable lead annuity trust, or CLAT, typically gives everything away. Annual income payments, for example, must go to charity. What's left is generally earmarked for heirs. Of course, it makes little sense to set one up unless you are charitably inclined. But if you are, these "can be better than giving it away outright, because you preserve something for your heirs," says Vaughn Henry, a Springfield, Ill., charitable gift and estate planner.

There are many ways to structure a CLAT. The tax treatment, for example, can vary, depending on whether you elect to receive an upfront charitable deduction on your income tax. That was important to Dan Ritchie, 61, who contributed \$450,000 to a CLAT in 2002. The \$209,428 deduction he earned in the process went a long way toward offsetting the

income-tax bill he triggered earlier that year when he exercised stock options after retiring from Wells Fargo.

A CLAT, says Johnne Syverson, Mr. Ritchie's adviser at Syverson Strege & Co. in West Des Moines, Iowa, was an appropriate choice for Mr. Ritchie because "Dan had newfound cash he didn't need to live off of and he also regularly contributes to charity." Unlike Mr. Ritchie, most CLAT owners forgo the income-tax deduction. That relieves them of responsibility for covering the taxes these trusts incur on the income or capital gains they earn.

Some -- most famously Jacqueline Onassis -- leave instructions to create these trusts after death. But those who set them up while alive have a big advantage: They can select the most opportune moment to act. "When rates are down, they are very attractive," says Mr. Henry. One of Mr. Henry's clients recently put his \$1.2 million equity portfolio into a CLAT. Over a 14-year term, the trust will pay charity 5%, or \$60,000, a year. The client, says Henry, "is already making \$60,000 a year in charitable contributions, so having the trust make those gifts for him wasn't a difficult transition."

Thanks to today's low interest rate, the client was able to pay far less in gift tax than he would have had he set up his trust even a year ago. Here's why: When the IRS estimates how much is likely to remain in one of these trusts for heirs, it uses an interest rate -- the 7520 rate -- as a proxy for the trust's projected investment returns. With the 7520 rate at just 3.8%, this formula assumes the trust won't even grow enough to cover its 5% annual payment to charity. Of course, if the trust has to dip into its principal to make its charitable contributions, the estimate of what will remain for heirs will fall -- and so will the gift-tax bill.

In the end, Mr. Henry's client paid gift tax on the \$557,760 the IRS estimates is destined for his heirs. But if his beaten-down portfolio earns an 8% annual return over the next 14 years, his heirs will receive \$2.07 million instead -- tax-free. To set one up, expect to spend from \$3,000 to \$10,000, depending on the trust's complexity. And remember: Once you put money into one of these trusts, you can't get it back.

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