CLEARY
GOTTLIEB

NEW YORK WASHINGTON PARIS BRUSSELS LONDON MOSCOW FRANKFURT COLOGNE ROME MILAN HONG KONG BEIJING

Memorandum Regarding Estate Planning Techniques in a Low-Interest Rate Environment

New York
November 19, 2008

In this environment of historically low interest rates, three techniques for intra-family transfers of wealth may be particularly effective:

- Loans to family members and loans or sales to "grantor trusts"
- Gifts to grantor retained annuity trusts ("GRATs")
- Gifts to charitable lead annuity trusts ("CLATs")

These techniques are designed to "freeze" the value of the senior family member's assets by shifting appreciation on investment assets in excess of the published Treasury rate to children or other beneficiaries without any gift tax.

Each technique has its own risks and benefits, and, depending on an individual's risk tolerance, the intended beneficiaries and the assets to be transferred, a technique that is appropriate for one person may not be appropriate for another. This memorandum will briefly discuss the three techniques, their respective risks and benefits and the different variables affecting each technique.

Intra-Family Loans and Loans to Grantor Trusts

The most basic of the three techniques is the intra-family loan. Intra-family loans may be used to transfer to children, other family members or a trust, on a gift-tax-free basis, the total return on the transferred assets in excess of the interest rate charged on the loan.

The simplest form of intra-family loan would be for a parent to lend funds to a child at the lowest interest rate allowable under the Treasury Department's safe harbor rates for loans, known as the applicable federal rate ("AFR"). The AFRs for the month of November, 2008 are as follows:

- Short-term loans (up to 3 years) 1.63%

- Mid-term loans (more than 3 years and up to 9 years) 2.97%
- Long-term loans (more than 9 years) 4.24%

The parent would report interest payments as income and, generally speaking, the child would be able to deduct the interest payments for income tax purposes if the loan is made in connection with the acquisition of a residence or an investment that produces taxable income.

If the total return on the funds loaned to the child exceeds the AFR, the excess growth will belong to the child, without gift tax. Unlike a GRAT or a CLAT, described below, the converse must also be considered. If the total return is less than the interest rate on the note, repayment of the loan must be made from the child's financial resources.

A low interest rate loan may also be made by a donor to a new or existing trust for children or other family members, including a so-called generation-skipping trust that is designed to benefit multiple generations. The trust should hold sufficient assets other than the loan proceeds so that the transaction will be respected as a loan and not recharacterized as a gift.

The trust would typically be structured as a "grantor trust". If a trust is structured as a grantor trust, the trust is invisible for income tax purposes, and all income and capital gains are reported on the donor's income tax return. Because the donor pays the income taxes on trust income, without reimbursement from the trust, the donor is able to provide an additional benefit to the trust without the imposition of a gift tax. Further, a loan by the donor to the trust will have no income tax consequences, so that the donor will not report the interest as income and the trust will not deduct the interest.

A variation on this theme arises if a parent has established, or wants to establish, a family investment company for commingled investments. Interests in the family investment company would be sold to the grantor trust in exchange for a note bearing interest at the applicable federal rate. The sale of a family investment company can be particularly effective if the interest purchased is valued at a discount because of its lack of marketability and the purchaser's lack of control.

Grantor Retained Annuity Trusts

A GRAT, although more complicated than an intra-family loan, may be an effective technique for certain individuals. A GRAT may be used to transfer to children, on a gift-tax-free basis, the total return on assets placed in the GRAT in excess of the appropriate AFR. The AFR for a GRAT is equal to 120% of the mid-term Treasury rate (3.6% for the month of November, 2008).

Under a GRAT, the donor establishes a trust where the donor retains a fixed annuity for a term of years that is designed to return to the donor the entire amount of the initial gift, plus interest at the AFR. At the end of the term of years, any remaining property in the trust passes to children or to trusts for their benefit. If the donor dies before the end of the GRAT term, the trust property is includible in the donor's taxable estate, and there is no tax benefit (or tax cost) associated with the gift.

The discounted present value of the children's remainder interest is a taxable gift. The value of the gift equals the value of the assets transferred to the trust less the present value of the donor's retained annuity. The annuity is set so that its value absorbs almost the entire value of the property given to the GRAT. As a result, the present value of the children's remainder interest is close to zero, and the taxable gift has a minimal reportable value. Further, because the annuity is stated as a percentage of the value of the assets transferred to the trust, if the value of those assets is increased on audit, the donor's retained annuity will also increase so that the remainder interest continues to have only minimal value for gift tax purposes. Therefore, the risk of an unexpected gift tax is minimal.

A GRAT can transfer significant assets to children without a gift tax cost. If the total return on the trust property over the GRAT term exceeds the AFR, the excess return passes to children at the end of the term, free of transfer taxes. Because the GRAT is a grantor trust, so that, as discussed above, the donor pays the income taxes on trust income, the trust will grow income-tax free. If the total return on the trust property equals or is less than the AFR, all of the property will return to the donor, but at no cost to the donor, other than any administrative costs in setting up the trust and administering it during its term.

The annuity amount payable to the donor need not be a level amount over the term of the GRAT. Instead, it may be set by a formula so that it increases by up to 20% of the previous year's annuity. A graduated annuity adds leverage to a GRAT by maximizing the funds available for investment by the GRAT in the early years.

GRATs may also be used to take advantage of the donor's exemption from the generation-skipping transfer tax (the "GST Exemption"). Although the GST Exemption may not be allocated to a GRAT upon the formation of the GRAT, the GST Exemption may be allocated at the end of the GRAT term to any amounts passing to the remaindermen of the GRAT. If a donor wishes to allocate his GST Exemption to the amounts being paid out at the end of the GRAT term, the remainderman of the GRAT should be a trust designed to benefit grandchildren and younger generations. Because the GST Exemption will be increasing to $3.5 million in 2009 while the exemption from the Federal gift tax (the "Gift Tax Exemption") will remain at $1 million, a GRAT may be an effective way for a donor to utilize the portion of the GST Exemption that exceeds the Gift Tax Exemption without the imposition of a gift tax.

There are two key variables that a donor should consider when establishing a GRAT: the length of the GRAT term and the property used to fund the GRAT. With respect to the first variable, while a longer-term GRAT locks in the current low interest rate, a series of short-term GRATs may be more effective if the rate of investment return is not expected to be constant.

With respect to the type of property used to fund the GRAT, generally, a donor should fund a GRAT with property that the donor believes will appreciate at a rate that exceeds the AFR. Given the current state of the market, a donor may wish to consider transferring a portion of his or her equity holdings to a GRAT.

Isolating different securities (or a collection of similar securities) in separate GRATs is a way to maximize the likelihood of a successful GRAT. When securities are isolated in separate GRATs, if one stock (or group of stocks) performs well and another does not, the GRAT with the performing stock will succeed, and the stock with the declining value will simply be returned to the donor without canceling out the positive performance of the successful GRAT.

The following chart illustrates the future value of the remainder interest that would pass to children at the end of a $1 million GRAT after ten years, depending on the AFR at the time of funding and the total rate of return over the ten-year period. For purposes of this illustration, we have assumed a graduated annuity and a constant rate of return.

Future Value of Remainder for Children
Under a $1 million Ten-year GRAT

	6% total return	**9% total return**	**12% total return**
3.6% AFR (Nov. rate)	$251,000	$664,000	$1,216,000
5% AFR	108,000	506,000	1,040,000
7% AFR	- 0 -	263,000	771,000

Charitable Lead Annuity Trusts

A CLAT operates in a similar manner to a GRAT, except that the annuity is paid to charity instead of to the donor. The annuity may take the place of part of all of the donor's regular charitable gifts.

As in a GRAT, the CLAT annuity is stated as a percentage of the initial value of the property transferred to the CLAT and is fixed as of the date that the CLAT is created. Like the annuity payable to the donor in a GRAT, the charitable annuity in a CLAT is set by a formula designed so that the discounted present value absorbs almost the entire value of the property given to the CLAT. Charity will receive over the CLAT term the entire amount of the initial gift to the CLAT, plus interest at the appropriate AFR, which is equal to 120% of the mid-term Treasury rate (3.6% for the month of November).

If the trust's investment performance during the charitable term exceeds the AFR, there will be property in the trust to pass to the children at the end of the charitable term but there will be no reportable gift. Because the charitable annuity is fixed at the time of the initial gift to the CLAT, investment performance in excess of the AFR accumulates for the benefit of the children.

If the trust investments do not outperform the AFR, the entire principal of the trust will be depleted by the charitable annuity paid out during the trust term, and there will be nothing remaining at the end of the term to pass to the children. However, the children will not be any worse off than if the property used to fund the CLAT had been given directly to charity.

Like the annuity payable to the donor in a GRAT, the CLAT annuity payable to charity need not be a level amount over the term of the CLAT. Instead, it may be set by a formula so that it increases by a percentage of the previous year's annuity. A graduated annuity adds leverage to a CLAT by maximizing the funds available for investment by the CLAT in the early years and thus maximizing the potential spread ultimately payable to children.

For the typical CLAT, the donor receives no charitable income tax deduction on the transfer of property to the CLAT, and the CLAT is subject to its own income taxes, after the allowance of a charitable deduction for its payment of the annuity to charity. The charitable deduction by the CLAT for its annuity payment is not subject to the percentage limitations applicable to individual taxpayers and may be accelerated under certain conditions to the previous tax year of the CLAT.

Another type of CLAT is designed as a grantor trust. In this case, the donor may take a charitable income tax deduction for the discounted present value of the charitable annuity (that is, the entire value of the property given to the CLAT) upon the formation of the CLAT. This charitable income tax deduction may be carried forward for up to five years. The donor, however, must report all CLAT income on the donor's individual income tax returns in each year of the CLAT term, with no charitable income tax deductions for the payments of the charitable annuity. If the donor dies during the CLAT term, the initial income tax deduction will be "recaptured" and the trust will continue as a separate income taxpayer, with a charitable deduction for each annuity payment.

Because a CLAT operates in almost an identical manner to a GRAT, the future value of the remainder interest that would pass to children at the end of a $1 million CLAT after ten years is identical to the values in the GRAT table above. Additionally, the same variables that a donor should consider when establishing a GRAT (*i.e.*, the property used to fund the trust and the length of trust term) should be fully evaluated by a donor establishing a CLAT.

* * * *

Each of these techniques has its own benefits and drawbacks. If you would like to discuss any of these techniques, please contact one of the attorneys in our Private Clients and Charitable Organization Practice Group.

Steven M. Loeb (212) 225-2620 sloeb@cgsh.com	Judith Kassel (212) 225-2062 jkassel@cgsh.com	Heide H. Ilgenfritz (212) 225-2358 hilgenfritz@cgsh.com
Catherine A. Borneo (212) 225-2292 cborneo@cgsh.com	Ruth Z. Plave (212) 225-2094 rplave@cgsh.com	Amanda T. Oberg (212) 225-2388 aoberg@cgsh.com
Chi-Yu L. de Tray (212) 225-2333 cdetray@cgsh.com	Leslie Bogart Geller (212) 225-2145 lgeller@cgsh.com	Michele Leibson (212) 225-2166 mleibson@cgsh.com

CLEARY GOTTLIEB STEEN & HAMILTON LLP

CLEARY GOTTLIEB

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax