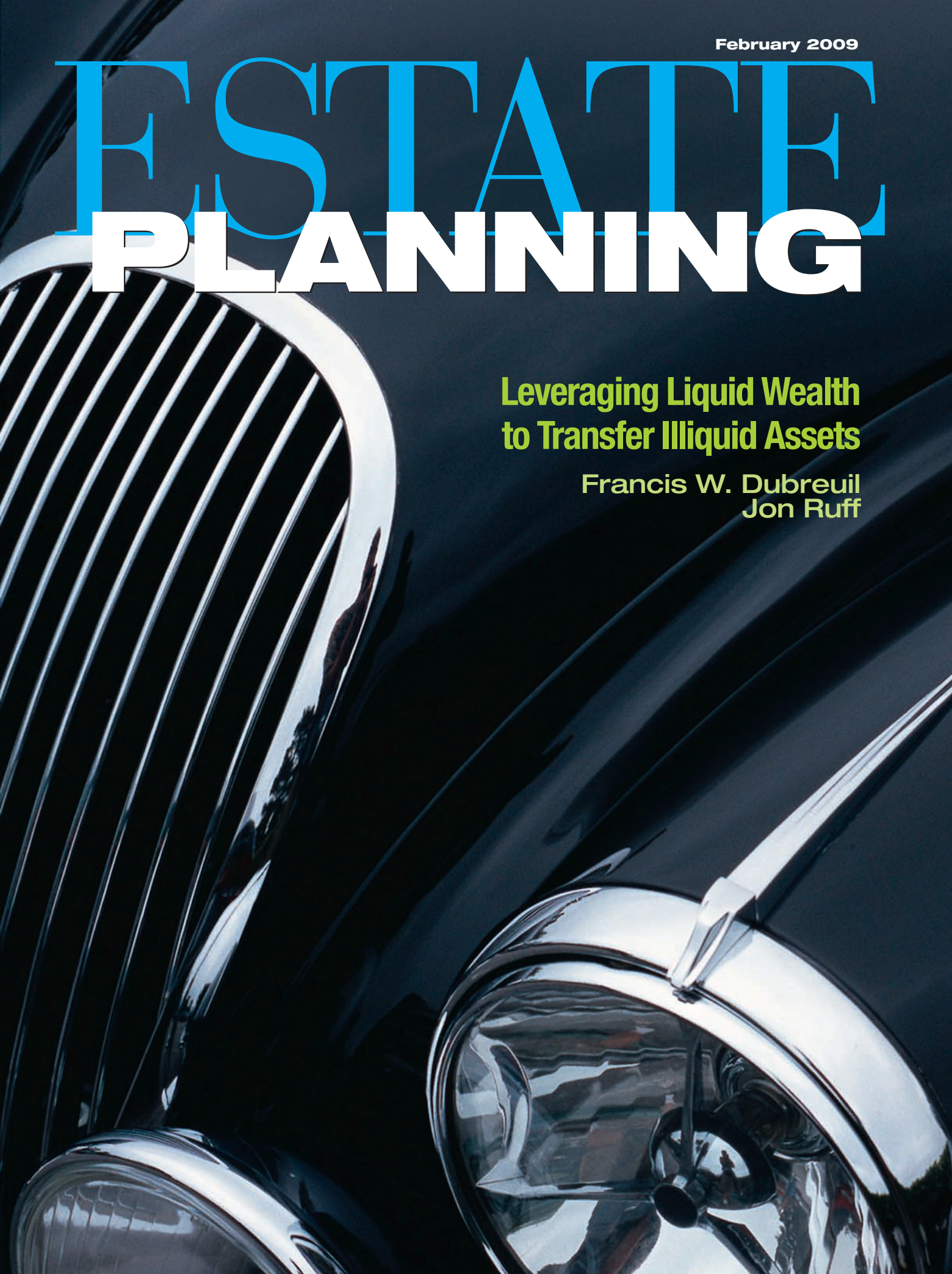


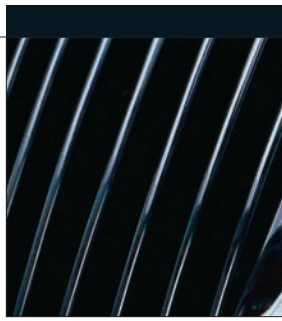
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ESTATE PLANNING

**Leveraging Liquid Wealth
to Transfer Illiquid Assets**

Francis W. Dubreuil
Jon Ruff





Leveraging Liquid Wealth to Transfer Illiquid Assets

Rolling grantor retained annuity trusts and intentionally defective grantor trusts provide a powerful synergy that either alone or in combination with installment sales can leverage liquid wealth to achieve a family's illiquid asset transfer goals.

FRANCIS W. DUBREUIL AND JON RUFF

Illiquid assets, such as real estate or closely held business interests, present attractive lifetime wealth transfer planning opportunities, but they pose challenges as well. Strategies used to transfer liquid assets can also work well with illiquid ones—for example, direct gifts, intentionally defective grantor trusts (“IDGTs”),¹ and grantor retained annuity trusts (“GRATs”).² And because the value of illiquid assets that are gifted or sold can be discounted, it's possible to leverage the amount of property transferred. Often, however, sizable transfers of illiquid assets are constrained because the gift tax exclusions available are insufficient to directly shelter them from taxation or to facilitate other planning.

An installment sale of illiquid assets to an IDGT³ is a classic example of the constraints that can be encountered. Such a sale is made in exchange for a promissory note that obligates the trust to pay the principal amount plus interest to

the grantor. The wealth transfer payoff comes if the assets sold to the IDGT produce an investment return that exceeds the interest payable under the note—in which case the excess return is captured by the trust without gift tax consequences. To ensure that the strategy is respected for tax purposes, most planners recommend that prior to the transaction the trust already hold assets whose value equals at least 10% of the assets to be purchased.⁴ If sufficient property isn't already held in the trust, the grantor will usually make an initial “seed” gift to support a leveraged purchase of assets by the trust.

FRANCIS W. DUBREUIL is a National Managing Director, and JON RUFF is a Director, of the Wealth Management Group, at Bernstein Global Wealth Management. The authors are resident in the firm's San Francisco office. Bernstein Global Wealth Management (“Bernstein”), a unit of AllianceBernstein L.P., does not provide tax, legal, or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

The grantor's ability to shelter the seed gift from gift tax is limited by the grantor's (and possibly his spouse's) available lifetime gift tax exclusion.⁵ As a consequence, installment sale planning is often “capped” at \$20 million (or less) of illiquid assets (ten times the maximum \$2 million seed gift to the trust that can be sheltered from gift tax by the grantor and his spouse's combined lifetime gift tax exclusions). A donor wishing to eventually make larger sales could use some portion of his liquid assets to fund a “rolling” GRAT strategy, couple that strategy with an IDGT (new or existing), and thus set the stage for effective future transfers of illiquid assets for the benefit of younger generations. Such a hybrid transfer strategy—leveraging liquid wealth to transfer illiquid assets—can provide an elegant, flexible, and effective solution that families with substantial illiquid holdings may want to consider.

Combining rolling short-term GRATs and IDGTs

“Rolling” short-term GRATs funded with marketable securities can add significant power to any multi-generational wealth transfer plan. In a basic GRAT, the grantor transfers assets to the GRAT and retains the right to a specified annuity payment from the GRAT each year during its term. If the grantor structures the GRAT so that it is “zeroed-out” (in other words, the annuity payments are calibrated so that their present value when the GRAT is funded—discounted by the Section 7520 rate—is equal to the value of the assets contributed to the GRAT), any growth in the value of GRAT assets beyond the total amount required to fund the annuity payments will be transferred to the GRAT remainder beneficiaries free of gift tax.

In a rolling GRAT strategy, the grantor creates a short-term GRAT (say, one with a two-year term), funds the GRAT with marketable securities, and uses each year’s annuity payment to fund a new GRAT. The grantor can keep doing this for as many years as he wants, but let’s say he continues the process for

ten years. During this time, he will have created nine two-year GRATs (the final one expires in year 10).

Applying Bernstein’s wealth forecasting model to simulate 10,000 market scenarios across a wide range of asset classes and likely Section 7520 rates, we are able to show how much wealth is transferred in the median case by a rolling GRAT strategy that passes the assets remaining in any successful GRAT to an IDGT.⁶ The total wealth reflected by each bar in Exhibit 1 comprises the aggregate value of the assets received by the IDGT from successful GRATs, the subsequent growth of those assets, and the portion of that growth that is attributable to the grantor’s payment of the income taxes on the income from those assets.⁷

Assuming a \$10 million commitment to the rolling GRAT strategy (and sufficient other grantor assets from which to pay the income taxes on the income of the assets in the GRATs and IDGTs), a grantor could expect to move \$8 million of inflation-adjusted wealth out of his estate in ten years’ time in typical markets. The longer the strategy continues, the more powerful it becomes: In two decades, the strategy passes

\$22 million to the next generation in typical markets, and in three decades, a total of \$46 million—more than four times the amount committed to the strategy.

Rolling GRATs take advantage of the long-term upward trend in the value of publicly traded stocks, and in effect make market volatility your friend. The key is that over time, a number of GRATs during some periods will likely capture stock price increases for the benefit of the GRAT remainder beneficiary, free of offsetting stock price declines in other periods. Even if markets are poor and stock returns are relatively flat (or even down), over any particular stretch of time there are likely to be several shorter periods when stock prices move up.

A case in point: The Biltmores

Let’s see how this strategy might be put into practice. Consider a family that we’ll call the Biltmores, who have about \$100 million in real estate equity and \$30 million in liquid assets. The family is headed by a developer and his spouse, who are both 60 years old. The next generation is also involved in the business.

¹ Assets held in an intentionally defective grantor trust (“IDGT”) are excluded from the grantor’s estate for estate tax purposes, but the income generated by the assets is taxable to the grantor. Because the grantor is legally responsible for the payment of the tax, that payment is not considered a gift. See Rev. Rul. 2004-64, 2004-2 CB 7. There are a number of interests in, or powers over, a trust that a grantor may have that will cause it to be classified as an IDGT. One common provision used by planners is for the IDGT to give the grantor or a nonadverse person the power, acting in a nonfiduciary capacity, to reacquire the trust principal by substituting other property of equivalent value. See Section 675(4). The IRS recently confirmed that the possession of such a power by a grantor will not cause the inclusion of trust assets in the grantor’s estate under Section 2036 or 2038. Rev. Rul. 2008-22, 2008-16 IRB 796. See Madden, Hayes, and Baldino, “Current Tax Developments: Power to Substitute Trust Assets Does Not Cause Estate Tax Inclusion, Rules IRS,” 35 ETPL 34 (Sept. 2008).

² A grantor retained annuity trust (“GRAT”) refers to a trust in which the grantor retains a qualified annuity interest within the meaning of Reg. 25.2702-3. Although the Regulations allow GRAT annuity payments to increase

by 20% each year, the analysis here assumes constant payments. See Reg. 25.2702-3(b)(ii).

³ Because the assets of an IDGT are treated as owned by the grantor, transactions between the IDGT and the grantor are ignored for income tax purposes. See Rev. Rul. 85-13, 1985-1 CB 184.

⁴ Under prevailing practice, 10% appears to be the general rule. However, no tax or legal authority expressly sanctions 10% as a necessary or sufficient amount.

⁵ In the case of a trust that is not intended to be exempt from generation-skipping transfer (“GST”) tax, additional seed gift tax shelter might be obtained by granting Crummey powers to take advantage of the gift tax annual exclusion. See Section 2503(b). A number of recently issued private letter rulings concluded that the original grantor continued to be treated as the “owner” of all the trust under the grantor trust rules despite the existence of a Crummey power under the trust. Ltr. Ruls. 200729005, 200729007, 200729008, 200729009, 200729010, 200729011, 200729013, 200729014, 200729015, 200729016, and 200730011.

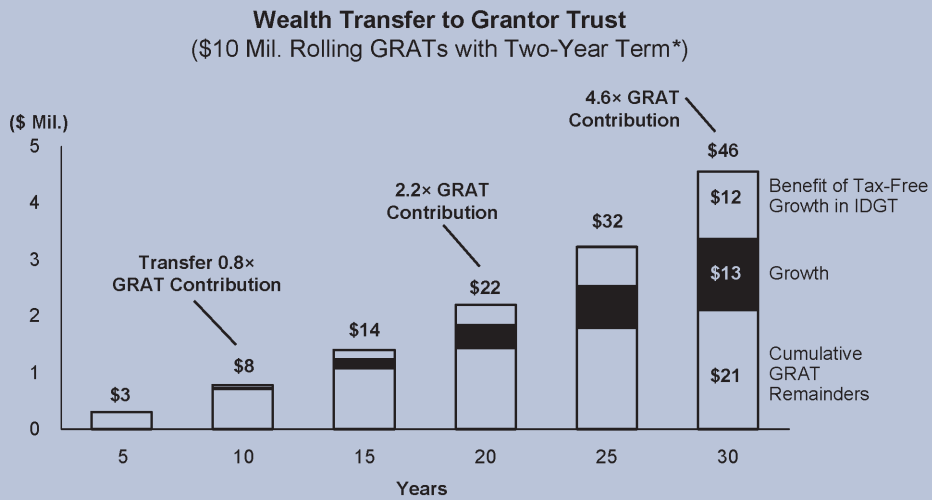
⁶ Bernstein’s analyses use a Monte Carlo model that simulates 10,000 plausible future paths of returns for each asset class and inflation, and produces a probability distribution of out-

comes. (Bernstein’s model also simulates 10,000 plausible paths for the Section 7520 rate.) However, the model does not randomly draw from a set of historical returns to produce estimates for the future. Instead, forecasts (1) are based on the building blocks of asset returns, such as inflation, yields, yield spreads, stock earnings, and price multiples; (2) incorporate the linkages that exist among the returns of various asset classes; (3) take into account current market conditions at the beginning of an analysis; and (4) factor in a reasonable degree of randomness and unpredictability. See the material on Bernstein’s Wealth Forecasting Analysis in note 14, *infra*.

⁷ GRATs are generally not used in conjunction with generation-skipping trusts, because during the annuity term all or a portion of the GRAT is subject to inclusion in the grantor’s estate. This period thus constitutes an “estate tax inclusion period” (subject to the “ETIP rule”) during which GST exemption may not be allocated to the GRAT. See Section 2642(f) and Reg. 26.2632-1(c)(2). However, the grantor can allocate GST exemption to the GRAT remainder upon termination of the GRAT, thereby making it possible for the grantor to make use of his full GST exemption during life without payment of gift tax.

EXHIBIT 1
Value and Growth of Assets

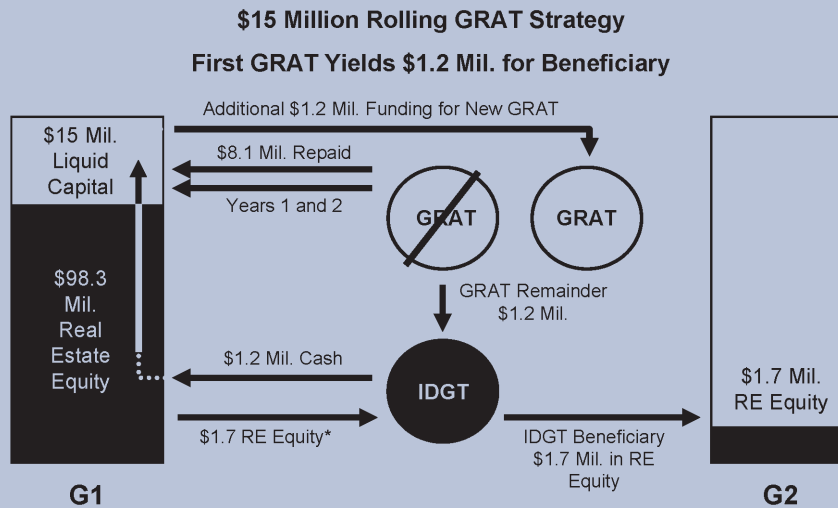
The Role of Rolling GRATs: Scaling Up the Transfer:
 Rolling GRATs and a Grantor Trust



*Median results; after inflation. All accounts are invested in 100% globally diversified equities. Based on Bernstein estimates of the range of returns for the applicable capital markets over the next 30 years. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting at the end of this presentation for further details.

EXHIBIT 2
GRAT Remainder Passes to IDGT

Rolling GRATs Fund IDGT To Make Iterative Purchases of Real Estate



Assumes 7520 rate of 5%, 10% return each year on the GRAT's assets, and A 30% discount in transfer valuation

First among the senior Biltmores' goals is to keep the real estate in the family. At the same time, they want to reduce estate taxes to the extent possible lest the family's liquid capital be depleted to cover the tax or they be forced to sell properties—again, something they don't want to do.

The senior Biltmores have already used their combined \$2 million lifetime gift tax exclusions to help their children purchase personal residences. They also make annual exclusion gifts to their children and grandchildren. They have heard of using an installment sale to an IDGT as a means of transferring illiquid real estate interests, but they understand that an IDGT would have to be funded with a gift that would entail their paying gift tax, which they aren't eager to do. Because their liquid assets are substantial and they are willing to commit a portion of them to help transfer illiquid assets to the next generation, they consider combining a rolling GRAT strategy with an IDGT as part of their planning.

Bridging illiquid and liquid assets

With liquid wealth to draw on, the Biltmores could use a rolling GRAT strategy to transfer marketable securities to one or more IDGTs, which could set the stage for effective wealth transfer of illiquid assets to younger generations. The trustee of the IDGT could use the liquid wealth transferred to the IDGT from successful GRATs to buy fractional interests in the real estate (or non-controlling interests in one or more entities through which the real estate is owned) from the Biltmores with-

out income tax consequences.⁸ And because the assets the IDGT is purchasing are illiquid, they are likely to be subject to a valuation discount—say, 30%—thereby increasing the share of the assets the IDGT could purchase.⁹ The Biltmores could then take the liquid assets received as payment for the purchase and start the process over again, using those assets to fund more rolling GRATs.

Assume the Biltmores commit \$15 million to a rolling GRAT strategy when the Section 7520 rate is 5%; that means they must get back an annuity payment each year of \$8.1 million in order to “zero out” an initial two-year GRAT. The rolling GRAT strategy takes advantage of market volatility, so it typically requires time to succeed. But let's assume for preliminary discussion purposes that the Biltmores' initial GRAT assets grow by 10% each year. In that case, the remainder amount at the termination of the GRAT would be about \$1.2 million, which would pass to an IDGT (see Exhibit 2).

The trustees of the IDGT would then purchase a fractional interest in the Biltmore real estate at a 30% discount, meaning that \$1.2 million would fund a purchase by the IDGT of \$1.7 million in underlying value of the property, all free of transfer tax. At the same time, the Biltmores could take the \$1.2 million in liquid assets they receive as payment from the IDGT and plow that back into the next series of GRATs established, increasing the amount committed to the strategy and thereby accelerating the pace of transfer. The Biltmores can then continue the strategy, following each GRAT annuity payment with the funding of another two-year GRAT until the desired amount of real estate is bought by the IDGT at a discount.

What does this strategy achieve over time? When we ran the numbers, based on a range of 10,000 possible paths of return for the marketable

securities contributed to the GRAT¹⁰ (instead of the hypothetical 10% return assumed in the prior example), and looked at the probable outcomes over different time spans, we saw that in 15 years, in median market conditions, the IDGT could purchase about \$33 million of inflation-adjusted real estate from the Biltmores. Over 20 years, the IDGT could purchase more than \$50 million in median markets (see Exhibit 3).

If markets were poor (say, at the bottom decile of forecasted returns), those numbers would be different (\$13 million passed in 15 years, and \$23 million over 20 years)—but still impressive in terms of the amount of property transferred. Indeed, if the value of the Biltmores' real estate portfolio grew in line with inflation for those 20 years, they'd have moved the *entire value of the properties* out of their estate, in median markets, without paying a dollar in gift tax.

World enough and time: Leveraging the strategy

Now, the senior Biltmores are only 60 years old, so it's likely that they would have enough time to move all, or a significant portion, of the real estate out of their estates through such repetitive purchases. However, mortality is nonetheless an important consideration, and multiple unleveraged purchases of real estate interests over time will almost certainly entail higher valuation costs and other transaction costs as well as greater complexity.

To accelerate the pace of transfer, the Biltmores could increase the amount committed to the rolling GRAT strategy above \$15 million. As Exhibit 1 indicates, an attractive feature of the strategy is its scalability. So, for example, doubling the value of marketable securities committed to the strategy will double the projected value of successful GRAT remainders—and thus the cumulative value of real estate that

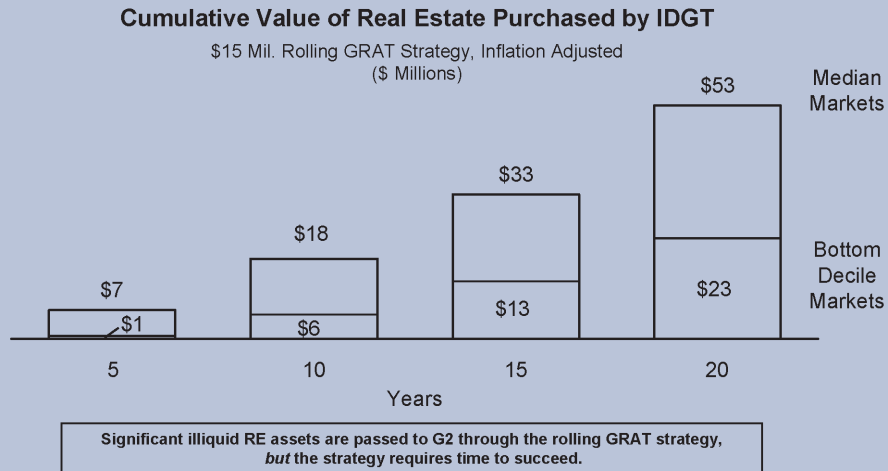
⁸ See note 3, *supra*.

⁹ The appropriate valuation discount, if any, applicable to an asset must be determined by a qualified professional appraiser. Bernstein is not a valuation advisor; if appropriate, consult a qualified appraiser.

¹⁰ Assets are invested in globally diversified equities (35% U.S. value, 35% U.S. growth, 25% developed foreign markets, and 5% emerging markets).

EXHIBIT 3 IDGT's Purchase of Real Estate

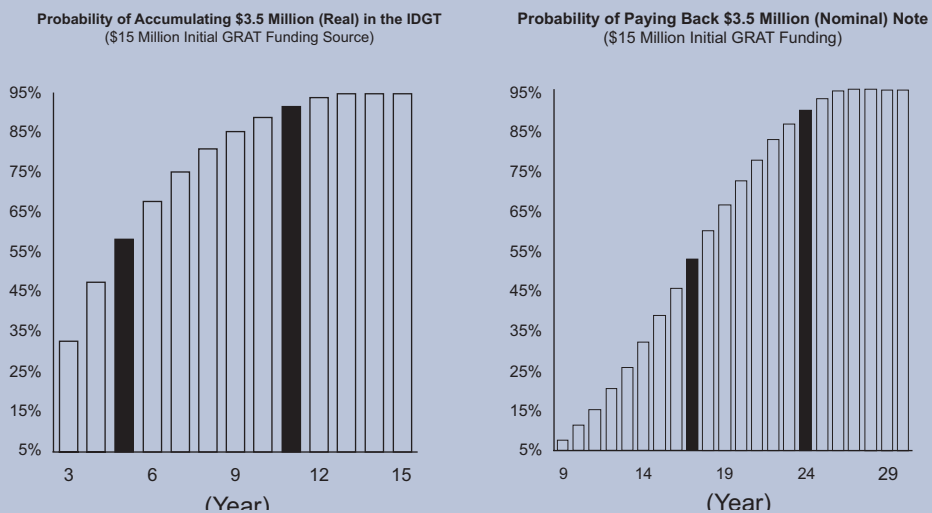
The Next Generation's Stake in the Family Business Grows over Time



Liquid assets received by the IDGT as remainders from successful GRATs are immediately used to purchase real estate from the senior generation, and then are recommitted to the rolling GRAT strategy. Assumes the senior generation has sufficient liquid assets to pay taxes from additional assets that were not committed to the rolling GRAT strategy. Assumes 30% discount on initial transfer of RE equity to IDGT.

EXHIBIT 4 Leveraging the Strategy

GRATs Can Seed IDGT and Fund Payment of Note Principal



*Range of outcomes is based on Bernstein's long-term forecasts of capital markets, does not represent any past performance, and is not a promise of actual future results. Please refer to Notes on Wealth Forecasting System for further details.

can be purchased by the IDGT on a fully funded basis—and will shorten the time required to accumulate the initial target amount.

The Biltmores could also use the rolling GRAT strategy in conjunction with an installment sale to the IDGT. For example, they might implement such a sale as soon as the value of remainders from successful GRATs accumulated in the IDGT provides sufficient seed funding to support a leveraged purchase of a 50% noncontrolling interest in an entity that owns the Biltmore real estate, at a total purchase price of, say, \$35 million (once again, assuming a 30% discount from the \$50 million fair market value of a proportionate share of the underlying real estate). As the left side of Exhibit 4 indicates, with a commitment of \$15 million to the rolling GRAT strategy, there is a 50% probability of accumulating at least \$3.5 million of seed funding (inflation adjusted)¹¹ within five years of the strategy's implementation—and a 90% probability of doing so in 11 years.

A key benefit of the installment sale is that the senior Biltmores would *immediately* reduce their estates by approximately \$15 mil-

lion—the discount in valuing the noncontrolling interest in the underlying property purchased on a financed basis. That is ten times the amount (\$1.5 million) that would be removed immediately from their estates if they instead used liquid assets to purchase property on a fully funded basis. In addition, post-sale appreciation and income attributable to the larger financed property purchase would be excluded from their estates rather than only that attributable to the smaller amount of property that could be purchased on a fully funded basis. Transaction costs also would be reduced since fewer purchases of real estate interests would be required.

Following the installment sale, liquid assets distributed to the IDGT from successful GRATs could also be used to fund payments on the installment note and then could be committed to the rolling GRAT strategy.¹² Again, in the case of a \$15 million commitment to the rolling GRAT strategy and a \$35 million installment note purchase (see Exhibit 4, right side), there is a better than 50% probability that the continuing rolling GRAT strategy could itself fund payment of the nominal amount

of principal due under the note within 17 years of the installment sale, and a 90% probability within 24 years, assuming that the combination of the initial liquid seed funding of the IDGT and cash flow from the underlying real estate interests fund annual interest payments, but not principal.¹³ And if necessary to achieve fully the Biltmores' ultimate wealth transfer goals, further leveraged purchases of additional interests in the Biltmores' real estate, and possibly other illiquid assets, could be made by the IDGT at whatever future point in time the net equity owned by the IDGT (as a result of the combination of note payments and real estate cash flow and appreciation) would support them.

Conclusion

Comprehensive wealth transfer planning is a complicated exercise, and when that wealth includes significant illiquid assets, it is even more so. Rolling GRATs and IDGTs provide a powerful synergy that either alone or in combination with installment sales can leverage liquid wealth to effectively achieve a family's illiquid asset transfer goals.¹⁴ ■

¹¹ To support the purchase of \$35 million of real estate (inflation adjusted).

¹² The law is unclear regarding the income tax consequences if the grantor dies while the note is outstanding. For example, it is possible that the IRS would take the position that the grantor's death results in capital gain recognition by the grantor or his estate. For that reason, payment of the note in full during the grantor/payee's life is desirable.

¹³ Some planners structure the note so that interest is capitalized rather than paid each year and the IDGT makes no payouts until the note term expires.

¹⁴ Notes on wealth forecasting analysis. The Bernstein Wealth Forecasting AnalysisSM ("WFA") is designed to assist investors in making a range of key decisions, including setting their long-term allocation of financial assets. The WFA consists of a four-step process: (1) Client Profile Input: the client's asset allocation, income, expenses, cash withdrawals, tax rate, risk-tolerance goals, and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, such as which vehicles are best for intergenerational and philanthropic giving, what his/her cash-flow stream is likely to be, whether his/her portfolio can beat inflation long term,

when to retire, and how different asset allocations might affect his/her long-term security; (3) The Capital Markets Engine: our proprietary model, which uses our research and historical data to create a vast range of market returns, taking into account the linkages within and among the capital markets (not Bernstein portfolios), as well as their unpredictability; and (4) A Probability Distribution of Outcomes: based on the assets invested pursuant to the stated asset allocation, 90% of the estimated returns and asset values the client could expect to experience, represented within a range established by the 5th and 95th percentiles of probability. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes. Further, we often focus on the 10th, 50th, and 90th percentiles to represent the upside, median, and downside cases. Asset-class projections used in this publication are derived from the following: U.S. value stocks are represented by the S&P/Barra Value Index, with an assumed 20-year compounding rate of 8.2%, based on simulations with capital market conditions as of 12/31/07; U.S. growth stocks by the S&P/Barra Growth Index (compounding rate of 8.1%); developed international stocks by the Morgan Stanley Cap-

ital International ("MSCI") EAFE Index of major markets in Europe, Australasia, and the Far East, with countries weighted by market capitalization and currency positions unhedged (compounding rate of 8%); emerging markets stocks by the MSCI Emerging Markets Index (compounding rate of 6.6%); taxable bonds by diversified securities with seven-year maturities (compounding rate of 5.4%); real estate investment trusts ("REITs") by the NAREIT Index (compounding rate of 5.3%); a single stock with a beta of 1.0, volatility of 30%, and a dividend yield of 0% (compounding rate of 5.3%); and inflation by the Consumer Price Index (compounding rate of 2.5%). Expected market returns on bonds are derived taking into account yield and other criteria. An important assumption is that stocks will, over time, outperform long-term bonds by a reasonable amount, although this is by no means a certainty. Moreover, actual future results may not be consonant with Bernstein's estimates of the range of market returns, as these returns are subject to a variety of economic, market, and other variables. Accordingly, this analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.

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