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Bonds and the original issue discount: Easy does it

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SCINs, GRATs and IDGTs: Acronyms that present planning opportunities in a low-interest environment

By Jesse T. Coyle

With interest rates at historical lows, several wealth transfer techniques offer high net worth individuals an excellent opportunity to transfer wealth to their descendants at a minimal cost. These techniques benefit from low interest rates. Two sophisticated estate planning techniques that benefit from a low interest rate environment are the SCIN and the GRAT.

SCINs

A self-cancelling installment note, or "SCIN," is a promissory note that is cancelled on the death of the holder of the note, thereby terminating all additional payments due to the holder and creating a windfall for the maker. SCINs may be structured to repay income and principal on a level platform, or to pay interest only with a balloon at the end of the term. An interest only SCIN is generally structured so that interest payments are made to the holder over the term of the SCIN, with a balloon payment of the balance at the end of the SCIN term. If the holder dies before the balloon payment is due, then the balloon payment is cancelled, eliminating the payment of the balloon and any other interest payments from the estate of the holder. As a general rule, a low interest rate will allow for a reduced income interest to the holder and a larger forgiveness to the maker of the note, if the holder dies before the SCIN term.

GRATs

A grantor retained annuity trust, or "GRAT," is a trust (generally with a short duration, i.e.

2 to 3 years) to which a grantor transfers assets and retains the right to be paid an annuity from the trust for a certain number of years. The annual annuity amount is based on the initial fair market value of the assets transferred to the trust and the § 7520 interest rate (or "hurdle rate"). At the time the trust is created and the annual annuity payment is calculated, the size of the gift to the remainder beneficiaries is calculated. At the end of the term, and if the grantor outlives the GRAT, the assets remaining in the trust after all of the annuity payments are made pass outright to (or in trust for) the trust's remainder beneficiaries. If the assets in the GRAT appreciate faster than the § 7520 interest rate, more assets will remain in the GRAT than originally calculated. These assets will pass on to the remainder beneficiaries gift tax free.

In a low interest rate environment, the required annual annuity is decreased and the § 7520 hurdle rate is easier to surpass. This means that there is a greater likelihood that the assets in the GRAT will appreciate at a rate higher than the § 7520 rate, leaving a surplus of assets in the GRAT at termination and increasing the remainder persons' interest. The GRAT may be used for many types of assets, but it is best utilized for assets that will experience a growth spike, or will receive a valuation discount, such as limited interests or restricted interests. The following demonstrates the unique historic opportunity provided by the current interest rate environment:

The SCIN-IDGT Technique

Substantial wealth can be transferred gift tax free through the dual implementation of both a SCIN and an IDGT. There are several

steps to this complex and often confusing technique. These steps are explained below, with a diagram to follow:

Step 1: Fund the IDGT

First, an individual (the "grantor") must create and fund an intentionally defective grantor trust ("IDGT"). The trust is referred to as "defective" as even though it is effective for estate and gift tax purposes, it is defective for income tax purposes. Thus, the grantor pays the income tax on the trust. This is a windfall for both the grantor (as the grantor decreases his or her estate by paying the income tax on the trust) and the trust beneficiaries (as the trust is able to grow income tax free) retain the value of the assets.

The IDGT should be funded with the remaining Gift Tax Exclusion Amount available. We will presume for the purpose of this illustration that no lifetime gifts have been made and the IDGT is therefore funded with the full \$1M Gift Tax Exclusion Amount. Additionally, when funded, the estate tax and generation skipping transfer tax ("GSTT") exemption should be allocated to the trust. This ensures that the assets will grow in the trust estate GSTT free and will remain Estate and GSTT free when later distributed. Thus, the IDGT also becomes a "Dynasty Trust" that can benefit several generations and will be referred to as such from this point forward.

Step 2: Sell to the Dynasty Trust in Exchange for a SCIN

Second, the grantor sells assets to the Dynasty Trust. Ideally the assets sold to the Dynasty Trust will be assets that receive a valuation discount (i.e. FLP units discounted for lack of marketability and control). The discount allows assets to be sold to the trust at

a bargain price. With the proper use of leverage, the Dynasty Trust can use its \$1M seed money to purchase assets from the grantor totaling \$8M after discount (so possibly up to \$12M of assets pre-discount). In exchange, the grantor will receive an interest-only SCIN. The grantor is now temporarily also the "holder" of the SCIN. At current interest rates, depending on the term of the SCIN, the Dynasty Trust will only have to make relatively small annual interest payments to the holder and then will make a large balloon payment to the holder years later. Thus, if the SCIN holder dies before the balloon payment is due, then the balloon payment will not be canceled, terminating that loan repayment to the estate of the holder.

Step 3: Give the SCIN to the LLC, Receive LLC Interests

Third, the grantor creates a limited liability company ("LLC") and funds it with the SCIN. The LLC is now the "holder" of the SCIN. In exchange for transferring the SCIN to the LLC, the LLC transfers LLC interests back to the grantor (usually 99 percent non-voting and 1 percent voting). The grantor is then able to transfer the non-voting LLC interests while retaining the voting interest, and thereby retaining control of the LLC even though the grantor possesses only a minimal (1 percent) financial interest in the LLC.

Step 4: Give LLC Interests to a GRAT, Get an Annuity

Fourth, the grantor creates a GRAT and funds it with the non-voting LLC interests (at a discount) in exchange for an annuity. The value of the annuity is determined at the time the GRAT is created and funded with consideration given to the § 7520 interest rate. Ideally, the total value of all annuity pay-

ments should be calculated so as to leave no remainder for the trust's remainder beneficiaries (the trust should be "zeroed-out"). If the GRAT is properly zeroed-out, then no gift tax will result from the creation of the GRAT.

Because current interest rates are so low, it is likely that the GRAT's assets will appreciate at a rate that surpasses the § 7520 interest rate. And if the assets do appreciate at a higher rate than the § 7520 interest rate, the value of the GRAT's assets will be greater than the annuity payments, and the remainder interest will pass on gift tax free to the trust's remainder beneficiaries.

Step 5(a): GRAT Remainder to the Beneficiaries

As noted above, if the grantor outlives the GRAT and the GRAT's assets appreciate at a rate higher than the § 7520 interest rate, there will be remainder assets in the GRAT that will pass on to the GRAT's remainder beneficiaries free of gift tax. Generally after the termination of the GRAT, the remainder passes into a trust held for the remainder beneficiaries (the "Remainder Trust") and then at some future date the Remainder Trust later divides into identical separate trusts, each holding an equal share for each beneficiary. But how much ultimately passes to the Remainder Trust depends on whether the grantor survives the SCIN term. Let's examine the following fact patterns:

(1) The Grantor Outlives the SCIN:

If the grantor outlives both the GRAT and the SCIN, the Remainder Trust will benefit. This is because the grantor funded the LLC with the SCIN, making the LLC the SCIN holder. In exchange the grantor received LLC interests. Second, the LLC interests were transferred to the GRAT. Third, after the ter-

mination of the GRAT, the LLC interests remaining in the GRAT were transferred to the Remainder Trust. Thus, when the SCIN term ends and the large balloon payment is made to the LLC (the holder of the SCIN), the value of the LLC increases, which in turn increases the value of the LLC interests now held by the Remainder Trust.

(2) The Grantor Does Not Outlive the SCIN:

If the grantor dies before the SCIN term the Dynasty Trust benefits. The Dynasty Trust was funded with \$1M and purchased \$10M in discounted assets from the grantor in exchange for an interest-only SCIN. The SCIN, initially held by the grantor, called for a large balloon payment at its termination. The SCIN was transferred by the grantor to the LLC. Thus, the LLC was the holder and would receive the balloon payment. But by dying before the balloon payment is due to the LLC, the balloon payment is cancelled, and the value of the balloon payment (likely substantial) remains in the Dynasty Trust. Additionally, the Remainder Trust still benefits, though to a lesser degree. Arguably, the second scenario is the most valuable scenario as the Estate and GSTT exempt Dynast Trust receives the largest benefit, but the Remainder Trust also some benefit as well.

Step 5(b): The Grantor Does Not Outlive the GRAT

If the grantor dies before the SCIN term ends and also before the GRAT term ends, then all subsequent future payments to the SCIN holder (the LLC) are cancelled. In this situation, the Dynasty Trust benefits from the cancellation of the balloon payment, but because the grantor does not outlive the GRAT, the GRAT fails, and nothing is transferred to the Remainder Trust. ■

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