



Not Your Grandfather's Trust

NEW TRENDS IN ESTATE PLANNING

The world of estate planning is changing — and for the better.

A glimpse into most trusts would reveal traditional trust structures and investment assets. While these assets are still appropriate for many trusts, new trends are emerging.

Wealth structuring experts are embracing new methods and considering new asset classes.

For the individual, all of this means a more sophisticated and customized solution with a greater possibility of success.

- **The worlds of planning and investments are starting to be integrated.** Wealth structuring experts are beginning to think more holistically, combining sophisticated investment strategies and planning techniques to create original estate planning solutions.
- **Leveraged gifting strategies offer a potentially bigger “bang” for the gift-giving dollar** — particularly in a low-interest-rate environment — and can breathe new life into a tried-and-true structure, the Grantor Retained Annuity Trust (GRAT).
- **Some trusts are being structured for maximum gain potential.** New approaches to these trusts call for nontraditional portfolio management techniques.
- **Planners are expanding the sorts of investments they consider to include.**

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Estate Planning Finds the New Millennium

The world of estate planning is changing — and for the better. A glimpse into most trusts would reveal traditional trust structures and investment assets. While these assets are still appropriate for many trusts, new trends are emerging.

For example, wealth structuring experts are thinking more holistically than ever before. They are combining state-of-the-art planning techniques with sophisticated investment solutions. And alternative strategies are being used in structuring trusts.

As with many changes, there doesn't appear to be one single reason for the new trends, but rather a confluence of factors and a gradually increasing momentum. These investments may be particularly appropriate for certain types of trusts.

In the broadest sense, the migration of these vehicles into estate planning is simply part of their rapidly increasing popularity in general during the past decade. This coming of age has been driven by a combination of factors — a low-interest-rate environment, low anticipated returns from the so-called “traditional” asset classes, and generally greater investor and advisor knowledge and experience with these sorts of investments.

While estate planning has certainly been impacted by these trends, it has been with a noticeable lag. Traditionally, in many organizations one might find bright people in investments and bright people in estate planning, but the two groups have had little interaction with each other or knowledge of each other's work. The investment professional might have known little of planning; the planner might have focused on creating a solid structure that would meet the needs of the client from a flexibility and legal perspective. Beyond that, fitting the estate planning vehicle with the right sorts of investments has tended to be more of an afterthought.

But all of that is starting to change. True integration of planning techniques and investments is beginning to happen and, for the individual, all of this can mean a more sophisticated and customized solution.

The Goal of Estate Planning

One of the primary goals of estate planning is to transfer as much wealth as possible — usually from one generation of a family to another — with minimal (or possibly even zero) estate or gift tax implications.

Among the simplest forms of wealth transfer is an outright gift — taking an asset, giving it to somebody and hoping that the asset grows over time.

Outright gifts, whether to a trust or directly to one or more individuals, do have the advantage of simplicity. Once the gift is complete, its return, whether good or bad, is the recipient's. However, outright gifts have the distinct disadvantage of resulting in a gift tax once the gift exceeds the \$13,000 per recipient allowable to an individual each year (\$26,000 for married couples). Or at the very least, this gift would require using some or all of one's gift tax exemption, which means eating away at the \$1 million lifetime total that an individual can give away without having to pay transfer taxes. (An additional \$2.5 million exemption is available at death, bringing the total to \$3.5 million. These exemption amounts could change over the next several years.)

Better, more sophisticated gift-giving approaches are available: The use of leveraged gifting strategies, for instance, seems to offer a much bigger “bang” for the gift-giving dollar, particularly in a low-interest-rate environment. Among the more popular estate planning strategies that seek this sort of leverage is the Grantor Retained Annuity Trust, otherwise known as the GRAT.

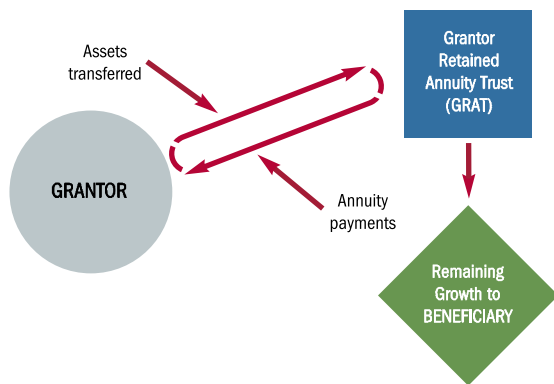
How the GRAT Works

While the GRAT is a fairly common estate planning technique, in recent years its use has been evolving in terms of structure, strategy and the sorts of investments routinely placed in it. In this way, the GRAT provides an excellent window into the current state of estate planning, particularly with regard to the integration of planning and investments.

First, though, a brief description of the basic GRAT structure and how it works:

A GRAT is an irrevocable trust into which the grantor (the person establishing the trust) transfers assets while “retaining” the right to two or more fixed annuity payments, depending on the term of the trust (the minimum is currently two years). Since the IRS is not interested in determining how each individual taxpayer’s assets will perform, it establishes return assumptions each month (based upon midterm interest rates) that must be used to determine the gift tax implications of a wealth transfer. This is commonly known as the “hurdle rate.”

THE GRAT IN ACTION



When establishing the trust, the goal is to transfer assets out of the grantor’s estate while minimizing the applicable gift tax. If the present value of all annuity payments (as calculated using the IRS hurdle rate) equals the amount put into the trust, the taxable gift will be “zeroed out” because the grantor’s retained interest (the annuity payments) will equal the value of the entire trust. As a result, there is no gift, and no gift tax will be due. (While most practitioners favor reducing the gift to zero, some are more cautious and prefer to create a modest gift.)

Now, this is where the GRAT becomes interesting. If the trust’s actual rate of return manages to exceed the hurdle rate, the positive balance, after all annuity payments, passes directly to the trust’s beneficiaries, and — importantly — does not trigger any gift taxes. In fact, this is the goal when establishing a GRAT — to exceed the hurdle rate and thereby transfer assets

without having to face gift taxes. The hurdle rate corresponds to interest rates. So when interest rates are low, the likelihood of exceeding the hurdle rate increases.

If the assets fail to outperform the hurdle rate, they are returned to the grantor, who may not have managed to transfer wealth but is generally no worse off than if a GRAT had never been created in the first place.

An example should help to make this clear:

Let’s say someone creates a \$2 million, two-year GRAT. If the IRS hurdle rate is 3.4 percent, then annuity payments would have to be \$1.05 million each, thus matching the IRS-assumed return, in order to zero out, or nearly zero out, the GRAT. In this case, if the rate of return on the trust’s assets turned out to be exactly the hurdle rate, then there would be no balance left in the trust, no wealth would be transferred, and the grantor would be no better or worse off than if the GRAT had never been created.¹

$$\text{\$2 million} = \frac{a}{(1+i)} + \frac{a}{(1+i)^2}$$

a = annuity payment
i = interest rate (IRS hurdle rate)

Interestingly, a GRAT can manage to outperform the IRS hurdle rate and still fail; this can occur when there is a severe drop in the value of the assets in the trust in the first year — even if followed by exceptional returns in the second year. When the loss is combined with the first year’s annuity payment, it can be extremely difficult for the few remaining assets in the trust to appreciate sufficiently to even make the second annuity payment, let alone have any remaining assets for wealth transfer.

In such a case, the average annual return might handily meet or even exceed the hurdle rate, but the GRAT would still go bust. No wealth would be transferred. (Such a situation actually argues for the creation of rolling GRATs, which we discuss later in this paper.)

But let’s return now to the successful GRAT. We’ll assume that our \$2 million GRAT manages to earn approximately 8 percent, and there is about \$150,000 left at the end of the two-year period. This is the leverage, the amount that is above the rate the IRS thinks you’ll earn,

¹ For illustrative purposes only. This hypothetical illustration does not reflect the performance of any specific investment. Actual rates of return cannot be predicted and will fluctuate. Your results may be more or less.

and it is a tax-free gift. The greater the outperformance, the greater the tax-free gift.

In the past, for many planners, that is essentially where the investment planning finished. Today, however, estate planning professionals are pushing further. They're moving beyond the concept of leveraged gifting and beginning to ask questions: Can we make these trusts even better? Can we improve results through different ways of structuring these trusts and the different types of investments with which we fund them? The inclusion of some investment instruments in the trust will vary depending on the structure of the trust, so it is critical to consider the trust structure and the investments the trust will hold at the outset.²

Structuring GRATs to Pursue Maximum Gain: Turning Diversification on Its Head

It's an investment axiom that portfolio diversification is important to managing risk and seeking long-term gains.³

Not so with some GRATs.

In fact, the opposite can be true. Let's reconsider our two-year, \$2 million GRAT example. This time, we'll assume that we have two stocks that we think are capable of growth well above the IRS hurdle rate; since that is our goal, we put \$1 million of each stock into the trust we're creating.

Fast-forward to the last year of the GRAT, just prior to the final annuity payment; one stock has not appreciated and is valued at \$475,000 (the initial \$1 million minus the first year's annuity payment of \$525,000); the other stock has appreciated and is worth \$550,000. Collectively, the trust holds \$1,025,000 and, after the final annuity payment, will leave no remaining assets to pass to the beneficiaries.

But what if we had taken those two stock positions and placed them into two separate trusts? In this case, the GRAT with the \$550,000 stock position would have been successful in creating a tax-free gift of about \$25,000. The other wouldn't have managed to transfer any wealth, but its failure would have been unable to taint the first GRAT's success.

If both investments had lost money, the separate trusts would not have helped, of course; but beyond the modest fees of establishing the additional trust, they would not have resulted in any additional losses.

How many GRATs could be created? It really depends upon the individual, but there is no statutory limit. The main issues involve the administration of numerous GRATs. For instance, annuity payments must be made on a timely basis or the validity of the GRAT could come into jeopardy. This is where working with sophisticated advisors who can handle and keep a careful eye on the details of trust administration can make an important difference.

	One GRAT	Two GRATs	
		GRAT 1	GRAT 2
		Stock A	Stock B
Inception	Stock A {\$1,000,000} + Stock B {\$1,000,000} = \$2,000,000	\$ 1,000,000	\$ 1,000,000
Appreciation	Stock A {0} + Stock B {\$75,000} = \$75,000	0	75,000
Year 1			
Annuity payment	\$ 1,050,000	525,000	525,000
Remaining in GRAT	1,025,000	475,000	550,000
Year 2			
Annuity payment	1,025,000	475,000	525,000
Remaining in GRAT	0	0	25,000

Illustration is for hypothetical purposes only. This hypothetical illustration does not reflect the performance of any specific investment. Actual rates of return cannot be predicted and will fluctuate. Your results may be more or less.

² To the extent that the grantor may look to another individual or a corporate fiduciary, such as U.S. Trust, to serve as trustee, thoughtful drafting of the trust document must be undertaken to enable the trustee to properly follow the grantor's intentions.

³ Diversification does not ensure a profit or guarantee against loss.

Long-Term, Short-Term and Rolling GRATs

The minimum length of a GRAT is two years, but there is no upper limit.⁴ Conventional investment advice has tended to argue that diversification and a long-term investment horizon are the two keys to investment success over time.

While this undoubtedly makes sense for certain types of investments and certain types of portfolios, when it comes to GRATs, it depends. While GRATs do tend to be shorter term, both short-term and long-term strategies can work well, and the optimal choice depends on a number of factors, including the grantor's age and health, risk profile, investment return objectives, liquidity needs and desire for complicated asset administration.

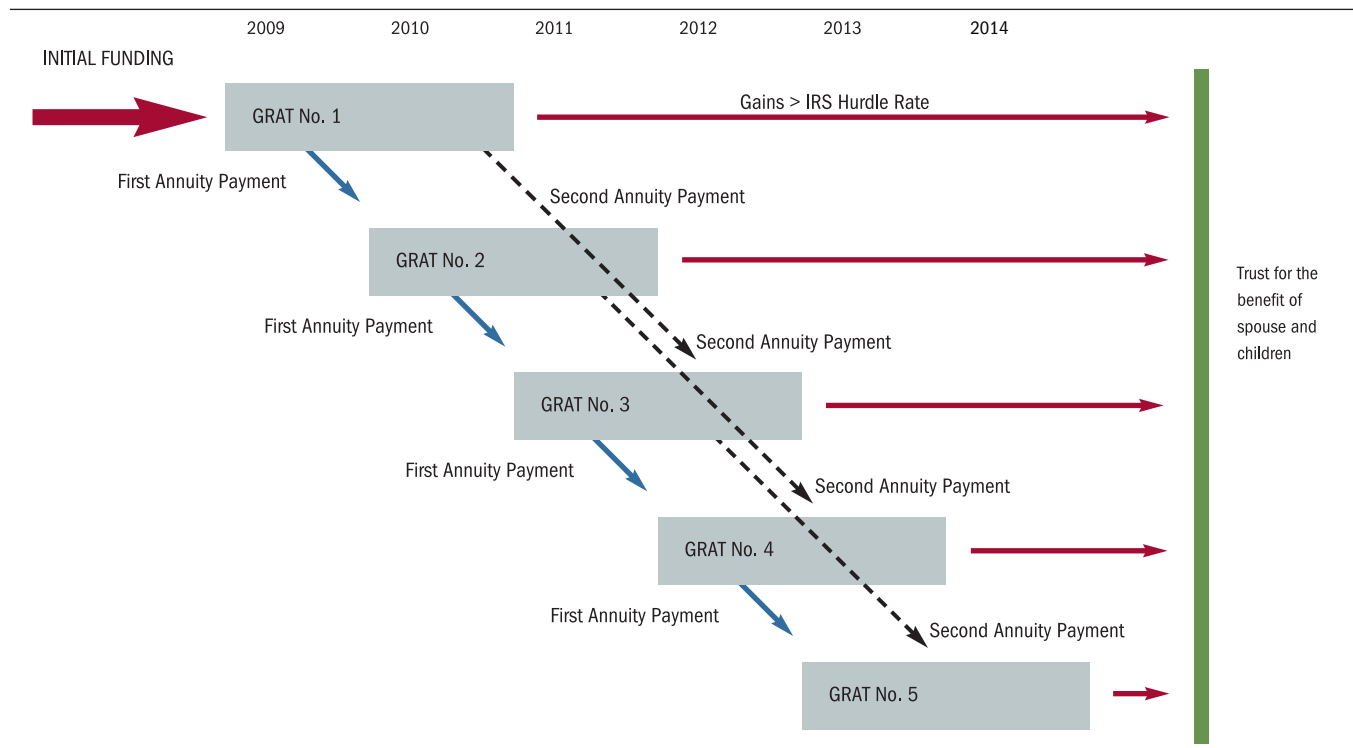
When it comes to more volatile asset classes, for instance, short term may well be better than long; or, rather, a series of short-term GRATs can often be preferable to one long-term GRAT. The two-year increments offer more opportunities to lock in short-

term spikes of strong performance. In addition, short-term GRATs increase the likelihood that the grantor will survive the GRAT term. (If the grantor dies before the GRAT terminates, the assets will generally be included in the grantor's estate).

To maximize the potential benefits over the long haul, an investor can create a series of GRATs, or rolling GRATs, in which received annuity payments are immediately rolled over into new two-year GRATs. This program ensures that as much value as possible is continually at work.

As we noted previously, the rolling GRAT structure would be especially useful if the GRAT suffered a severe drop in its first year and a dramatic gain in the second, causing the GRAT to "fail" even though the two-year average performance exceeded the IRS hurdle rate. If the first year's annuity payment were immediately placed, or "rolled," into another two-year GRAT, the first would still ultimately fail, but the second GRAT would benefit from the second year's big gain (actually, the second GRAT's first year), vastly increasing the likelihood of successful tax-free wealth transfer.

THE ROLLING GRAT



⁴The current administration's budget proposal includes a provision that would require a minimum length of 10 years, which, if adopted, will significantly modify GRAT planning.

In general, since investment returns can never be forecast with absolute precision, but rather within a range of probabilities, frequent short-term GRATs — particularly when invested in equities — appear to have a better chance of passing assets tax free than a single long-term GRAT.

Some assets behave differently from equities, however, and call for long-term GRATs. If the investment is not expected to be volatile but to increase in a more steady fashion — perhaps an ownership interest in a closely held business, particularly an interest in an S-corporation that makes periodic distributions — depending upon where we expect interest rates to go (since this is how the IRS creates the hurdle rate), a longer-term GRAT could make sense.

For a private equity GRAT, for instance, one might use a longer term in order to increase the likelihood that a liquidity event (or the expiration of a lock-up period on stock after a liquidity event) will take place during the term of the GRAT. We might also consider prefunding the first annuity payment with cash or a fairly liquid investment in order to allow the illiquid asset that is expected to appreciate the most to remain in the GRAT longer. With all of these strategies, there's always a risk that the gift at the end of the trust's term will be zero. Our goal is to lower that risk. With all of these strategies, there's always a risk that the gift at the end of the trust's term will be zero. Our goal is to lower that risk.

Managing the Successful GRAT

HARNESSING THE POWER OF THE GRAT MIDTERM

What happens when a GRAT achieves its goals before the end of its term? Let's walk through our \$2 million, two-year GRAT once again. This time, let's say we are one year into the trust's term, and the trust has experienced phenomenal growth — the \$2 million asset has doubled to \$4 million. The first annuity payment (say, \$1.05 million) is made, and \$2.95 million remains. We're looking ahead to another annuity payment of \$1.05 million. The GRAT has clearly been tremendously successful. What should happen now? Should the gains be locked in, or should the investment run for the second year, knowing any increase is all to the upside, but knowing also that the assets could drop in value?

What to do? One possible course of action would be for the grantor to swap assets — to substitute GRAT assets for his or her personal assets, so long as they are of equivalent value. In our example, the grantor could take back the \$2,924,000 asset and replace it with a more stable asset — say, cash or fixed income. Maybe it will only earn 4 percent or so, but then again the risk of loss has been greatly reduced. Moreover, the grantor hasn't had to sell the underlying asset to protect the gain and thereby diminish the success of the planning.

The move toward a more holistic, multidisciplinary approach to planning is...helping to create solutions customized to individual needs as well as increase the possibility of their longer-term success.

There is no income-tax impact from such a swap, since GRATs are taxed as grantor trusts. In other words, GRATs don't have a tax identity separate from the grantor and don't pay their own taxes; all items of income and expenses — dividends, capital gains — are picked up on the grantor's individual tax return. The appreciated stock swapped out of the GRAT in our example isn't actually bought or sold, so there's no taxable event.

Another way to approach the successful GRAT and lock in gains is simply to sell the asset. Here, the sale is tax free to the trust because the grantor pays any taxes associated with the sale.

Moving beyond midterm approaches to the GRAT, what happens if the trust has been “too” successful and it appears that the grantor is on track to transfer much more wealth than had been anticipated?

THE END OF THE GRAT — NOW WHAT?

When it comes to an especially successful GRAT at the end of its term, a grantor might not want the entire amount to simply transfer to, say, his or her children. Flexibility can be built into the structure of the trust. One way of dealing with this would be to name the

spouse as a potential beneficiary along with the children at the end of the trust's term. The remaining assets could then continue on in a different trust for the ultimate benefit of the children as well as the spouse after the GRAT's term ends and even beyond the grantor's death. These assets can now grow, not on the grantor's balance sheet, but on the balance sheet of the trust.

Such an approach is an effective way of preparing in advance for success and ensuring that the assets go where the grantor would like them to go at the end of the trust's term. The choices here are nearly limitless. Whatever is left in the trust can be given to family members, but more commonly the remaining assets transfer to long-term, flexible trusts for the benefit of family members. The continuing trusts could take the form of a single trust for the benefit of the grantor's spouse and/or all children, separate trusts for each family member or a combination.

The Risks?

Many people consider the main risks of a GRAT to be that the trust could fail to transfer wealth because the return is below the hurdle rate, causing the trust to run out of assets, or the grantor could die before the trust finishes its term. But what really is the potential downside? If the GRAT doesn't transfer any wealth, the grantor still has all the trust assets from the annuity payments. Factoring in fees associated with establishing the trust, the grantor is really no worse off than if the trust hadn't been established in the first place. The grantor can use the annuity payments to "re-GRAT" and try again.

And what if the grantor dies? The assets, while still in the GRAT, nonetheless usually would be fully included in the grantor's estate and would then be subject to estate taxes — which is, again, exactly the situation the grantor would have been in had a GRAT never been established. However, recent IRS rules may require only a portion of the trust to be included in the grantor's estate. Moreover, with proper drafting, that estate tax can be deferred through the use of the estate tax marital deduction.

A More Powerful Planning Solution

The move toward a more holistic, multidisciplinary approach to planning is evident. This is all to the good, in our view. No longer are investments merely finding a home in estate planning vehicles; now, estate planning vehicles are being "wrapped" around investments. We can add to this more thoughtful mindset the increasing sophistication of trust structures and strategies, the greater understanding of SEC rules and how they pertain to trusts and the newfound willingness of many planners to consider a wide variety of potential investments. All of these trends are helping to create planning solutions customized to individual needs as well as increase the possibility of their longer-term success.

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