

THE SILVER LINING REVISITED

Prologue

Given the stock market's dramatic losses, we understand that estate planning does not top the list of concerns for most clients. Nevertheless, history shows that investment-driven estate planning can be very profitable when implemented after dramatic market declines. Indeed, strategies like GRATs offer an opportunity to "make lemonade" when the market gives you lemons, even if you are not ready to commit more funds to equities.

In November 2001 we sent our clients an article entitled the "The Silver Lining." At that time, the Dow Jones Industrial Average was trading below 8,000 and the United States had only started mourning the deaths of almost 3,000 people following the terrorist attacks of September 11. Any optimism at that time certainly could have been questioned. However, with the benefit of hindsight, the topics discussed in that article were timely. We believe that in light of current market conditions, a similar time of opportunity may now be upon us.

During the last twelve months, we have experienced one of the most significant and painful declines in the history of the stock market. By way of reference, this is only the sixth time since 1871 that 10-year trailing returns on U.S. large-cap equities have fallen below 2%. After each of the prior occasions, returns over the following 10 to 20 years were extraordinarily positive. In fact, returns for the *first year* following a bear market usually have been substantial (averaging over 37%). Using history as a guide, it therefore would appear that the stock market's retreat presents an unusual opportunity for investors. While buying more stocks might entail risks that are all too familiar these days, the right estate planning strategies can take advantage of volatility without increasing investment risk.

We believe the time is ripe for what can best be described as investment-driven estate planning strategies. These strategies pass wealth to younger generations free of tax when investments produce returns in excess of a designated "hurdle rate." The hurdle rates for all strategies are determined monthly by interest rates set by the IRS. The precise calculation of a hurdle rate varies depending on the strategy employed. Because hurdle rates are tied to the general level of interest rates, many of which stand at all-time lows at the same time that equity prices are depressed, this would be a good time to consider implementing these strategies.

Political changes also suggest that now is the time to act. There is growing speculation that some long-standing planning opportunities may get repealed in the coming years. In many cases, the right strategy at this time could offer one last bite of the apple. Estate planners lack neither investment-driven strategies nor acronyms with which to label them. GRATs, GRITs, CLATs, SCINs and IDGTs are just some of the investment-oriented tools at the planner's disposal. Rather than drag our readers through this alphabet soup, we have chosen to describe the strategy we believe has the broadest application and can be most efficiently implemented.

GRATs

Grantor Retained Annuity Trusts (GRATs) can be a powerful way to transfer wealth to the next generation without incurring transfer taxes. There is no real downside to a well-planned GRAT (or series of GRATs) and the upside can be a tremendous savings in estate taxes.

A GRAT is an irrevocable trust that pays a set amount (an annuity) back to the grantor each year for a fixed term of years. If the grantor is still living when the GRAT expires, any assets left in the GRAT are distributed to a “remainderman,” which is most often a trust for the grantor’s children. The following diagram sets forth the basic mechanics of a GRAT. Over the past few years, the IRS has permitted individuals to create GRATs without paying any gift taxes or even using any part of one’s lifetime gift tax exemption. This is accomplished by setting the annuity high enough so there is virtually no taxable gift. (Tax attorneys and accountants call this “zeroing-out” the GRAT.) In other words, wealth will transfer to the next generation when the assets in the GRAT appreciate faster than the hurdle rate. If the assets in the trust do not appreciate fast enough to leave a remainder for the next generation, the grantor simply takes back all of the GRAT assets on a tax-free basis as the annuity is paid. Therefore, creating a zeroed-out GRAT is an attractive opportunity to transfer the excess appreciation on the assets contributed to the trust without taking on any risk of paying transfer taxes or wasting exemptions.



Asset Allocation and GRATs

It’s a basic tenet of investing that diversification is key to managing volatility and assuring long-term growth. A GRAT strategy should not alter a family’s overall diversification. Within one or more GRATs, however, a more concentrated approach makes sense. For example, rather than funding a GRAT with three different stocks, it makes sense to create three single-stock GRATs. If two of the three stocks produce strong returns but the third stock declines in value, using separate GRATs will have prevented the one poor performer from eroding the returns to be paid out on the two successful GRATs.

Managing “Success” During the Term of the GRAT

During this time of unprecedented volatility, monitoring and managing the stock in a GRAT is critical to its success. For example, let’s assume we funded a two-year GRAT with a large position of Microsoft (MSFT) in May 2006 (when our analysts believed the stock price was depressed relative to the company’s longer-term growth prospects). As you can see from the following chart, the stock was trading around \$24 per share at that time.

Microsoft (MSFT)

Stock Price from May 1, 2006 to May 1, 2008



Source: AOL Charts

Microsoft's stock price was modestly higher (about \$29) at the end of this two-year period but the volatility during that time remained high. There was a period of very strong performance followed by one of severe decline before settling at an annualized return of about 10% for the period. The beneficiaries would have received \$110,000 (in shares of Microsoft) if the stock had been held throughout the term of the GRAT. Instead, if the Microsoft shares had been sold or exchanged after the period of strong performance and replaced with a much less volatile asset class, like Treasuries, the beneficiaries would have received slightly over \$300,000 on a \$1 million initial contribution — and the grantor would have received the \$1 million back plus interest through the annuity payments.

As long-term investors, we are not apt to sell a stock like Microsoft simply because it has had some near-term success, but in managing GRATs we tend to be quite aggressive in "locking-in" a tax-planning success. GRATs typically contain "swap" provisions, which allow us to put appreciated stock back into the hands of the grantor in exchange for cash or bonds that the grantor swaps into the GRAT. Because the GRAT is treated as a grantor trust for income tax purposes, the grantor is treated as the owner of the assets in the trust. As a result, the grantor can substitute or swap assets without any income tax consequences. After executing a swap, we will often recommend a second GRAT and start the process all over again.

Other Optimization Strategies

There certainly are other optimization strategies available. A grantor can create multiple GRATs of varying lengths or could begin a program of establishing a series of short-term overlapping trusts. In addition, some lawyers advise selling the remainder interest in the GRAT to a dynasty trust (*i.e.*, a perpetual trust that permits the grantor to pass wealth to future generations without the burden of paying any transfer taxes), so that any assets remaining at the end of the term can be held for future generations. Each of these strategies can be highly effective but will further benefit from a close monitoring of the assets within the trust to capture gains or assess underperformance. We are constantly looking for opportunities to deliver the greatest amount of wealth to the next generation, which, of course, is the ultimate goal of a GRAT.

Conclusions

GRATs are a powerful, low-risk tool to pass assets tax-free to the next generation. During this period of uncertainty, we encourage our clients to consider basic and advanced planning measures to transfer wealth to the next generation without incurring a tax liability. The key person in evaluating the efficacy of this strategy for you and your heirs is your estate planner. We welcome the opportunity to work closely with your planner to offer thoughts on investments and administration to reach the best outcome for you and your family.

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