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# Hedging Techniques in Estate Planning

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ABSTRACT

In dealing with various forms of calculated risk, understanding how to play the probabilities can allow a transaction to be successful, or at least to avoid an untoward result. The key point for the estate planner to consider is that hedging can permit strategies based on opposite premises to complement each other.

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Diversification is a sacred tenet in the investment world. As much as professional investors strive for logical rationales and empirical evidence in forming investment strategies, unpredictable shifts and turns occur as they will. So, the investment manager allocates funds to large or small cap companies; and to domestic and foreign companies, with international investments further divided between emerging markets and the most developed foreign economies. At the core of the strategy based on diversification is the thought that if one of these investments doesn't work, the others will bail me out. So, if stocks take a breather and the equity averages drop, bonds may remain a steady source of income and also offer greater principal protection.

Similar uncertainties pervade the world of tax planning. Depending upon the technique, uncertainty may come along not only from investment results; mortality, business vicissitudes, and the IRS may all be factors to be assessed. However, hedging strategies may be followed to support tax saving techniques, as well as investment plans. In dealing with various forms of calculated risk, understanding how to play the probabilities can allow a transaction to be successful, or at least to avoid an untoward result.

## Reducing Mortality Risk

A sale of assets to an irrevocable grantor trust (IGT), a transfer to a grantor-retained annuity

trust (GRAT), or a gift of a remainder interest in a residence to a qualified personal residence trust (QPRT) all permit the grantor who makes the transfer to select a time period. A longer period enables the transferred asset to attain substantial growth in value. The antidote to a premature death may be the purchase of an insurance policy on the grantor's life, held by an irrevocable trust. The duration of the coverage may be measured against the time needed for the trust to realize growth. A 10-year term insurance policy may go a long way to reaching the wealth transfer objective of the client. A permanent policy might be better if the client is older or the planning period is longer. For most policies, the internal rate of return generated by the death benefit paid to an irrevocable trust will provide an impressive investment return, at least until the insured reaches an advanced age. Of course, attaining a longer life span can help the IGT, the GRAT, or the QPRT to perform heroically with growth compounded over many years. Projections can be made to compare the growth of the assets set aside in trust at a given point in the future with the return represented by the insurance proceeds at the same point.

A gift made to a GRAT or a QPRT may prove to be an "all or nothing" proposition if the grantor dies within the period he or she selects. Assets may be transferred in a series of separate transactions. For example, a transfer of a residence to a QPRT for a 10-year period can be successful to reduce estate taxation if the grantor survives for more than 10 years. However, the game is lost if the grantor doesn't survive the period. The transfers of fractional interests can be laddered so as to have partial success if the grantor survives some, but not all, of the designated durations. For example, the grantor might transfer a one-third interest in a residence to a QPRT which has a 5-year term, a one-third interest to a QPRT which has an 8-year term, and the final third to a 10-year QPRT. If the grantor lives for 9 years, two-thirds of the value is excluded from the grantor's estate for federal estate tax purposes, rather than full inclusion if a 10-year trust had been utilized. In addition, the staged transfers permit gifts of fractional interests to be made. A discount for lack of marketability can be taken in reporting the value of each fractional interest. Sales to an IGT or gifts to a GRAT can be structured in a similar manner over various periods of the grantor's choosing. If minority interests or nonvoting stock of an S corporation are transferred in stages, the probability of success is enhanced (compared to a single transfer for the longest period), with accompanying discounts for lack of marketability and lack of control.

## Private Annuity with Sale to IGT

A sale of investment assets for a private annuity can be a very effective means of removing value for estate tax purposes. The transfer of assets for a private annuity typically involves a commitment by the recipient of the assets to make annuity payments for the transferor's lifetime. As a result, a private annuity transaction is virtually always arranged between family members. Morbid as it sounds, it is a transfer that has its greatest success if the transferor doesn't survive for very long after the transfer. Conversely, the prospect that the transferor may live beyond life expectancy may make the transaction a daunting prospect. Typically, the persons obligated to make the annuity payments are the children of the transferor-annuitant. The private annuity is often employed when the transferor is elderly and has a limited life expectancy. The expectancy should not be too limited. In order to be able to use the IRC Section 7520 rate to set the amount of the annuity and to project the transferor's life expectancy according to the actuarial standards permitted by the tax law, the annuitant should have a better than 50 percent chance of surviving for at least one year. In structuring the transaction, it is best to obtain a written statement from the transferor's physician that the transferor, more likely than not, will survive for at least a year.

By basing the payment obligation on the transferor's prospects for survival, the thought is that an-

nual payments can end if an earlier death occurs. Rather than have the success of the planning with a private annuity solely defined by an early death, the private annuity can be hedged by other planning measures. First, the annuity payments may be used to make cash gifts to family members other than those obligated to make the annuity payments. For example, annuity payments may be made by children to a parent, who, in turn, transfers all or a portion of the payments to grandchildren as annual exclusion gifts. As wealth is shifted from parent to child by virtue of the asset transfer made for the annuity payments, the gifts to grandchildren provide an efficient means of reducing the estates of both the grandparent and parent of the recipients of the gift. Of course, the grandparent has no obligation to make the gifts; no reference to any gifts would be made in the private annuity agreement; and the transferor who receives the annuity payments may keep them or use them as he or she sees fit.

## Other Wrinkles

The annuity payments may also be deferred for one or more years from when they would otherwise be due. Given that the annuity may be structured so that the first annual payment is due at the end of the year after the agreement is effective, a deferral of one year would effectively be 2 years if payments were made at the end of each year. Each year for which payments are deferred would cause the amount of the annual annuity payment to increase. Deferral beyond a year or two is not likely to be worthwhile because the amounts ultimately due would be so much more. However, adding a year or two of deferral permits investment funds to accumulate until payments must be made. While the IRC Section 7520 rate is not as low as the midterm Applicable Federal Rate (AFR), both rates are low enough for even modestly successful investments to exceed. The Section 7520 rate applicable to private annuities in November 2014 was 2.2 percent. The November 2014 midterm AFR applicable to IGT sales was 1.9 percent.

A sale of assets to an IGT offers a very appropriate hedge to the private annuity transaction. The hurdle rate to measure the IGT's success as an investment proposition is the midterm AFR (1.9 percent annually in the example mentioned above) if the payment term is between 3 and 9 years. In most midterm time frames, it should not be difficult to produce investment results well in excess of 1.9 percent annually. Of course, to allow the funds held in the trust to compound significantly after interest payments on a promissory note are made, the transferor must survive for several years. So, the hedging presents a balancing act between the ongoing private annuity payments over the transferor's lifetime and the growth of the IGT assets over a fixed period selected by the transferor.

The "die to win" mentality of the private annuity operates in stark contrast to the prospect of ever-increasing value in the IGT during the transferor's lifetime. In many instances, if everything else is equal, an early exit that ends the private annuity may be more financially beneficial than an extended survival period that produces greater growth of the IGT assets. A projection of outcomes for an elderly client can be made when the private annuity and IGT sale are reviewed side by side. An important point to remember with any hedged planning techniques is that they need not be equally weighted. Asset values and time periods can be evaluated with an expectation that one outcome or another may be more likely. The key point for the estate planner to consider is that hedging can permit strategies based on opposite premises to complement each other.

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