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Allocating assets during the distribution phase of your financial life

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For most of us, it holds true that as our wealth grows, our financial objectives change. These changes commonly manifest themselves during three different lifecycle phases: asset accumulation, asset conservation, and asset distribution. Marked by increased gifting, the distribution phase generally occurs when assets exceed financial needs. During this phase, it is critically important to align your financial strategy with your objectives for distributing wealth to posterity or charity.

Weigh assets against core capital needs

In building a sound financial strategy for the distribution phase, it is important to first understand your core capital needs. Core capital needs—the wealth required to survive a lifetime—can be predicted within reason by carefully analyzing expenses and employing financial modeling techniques.

The assets required to meet core capital needs are known as core capital assets. These assets may or may not include emergency reserves, but should ultimately be sufficient to weather economic troubles and outlive your life expectancy. Any assets that exceed core capital needs should be targeted for transfer to posterity or charity. Failure to do so prior to death will result in a significant wealth transfer to the government through estate taxes.

Although the benefits of transferring excess wealth are considerable, many remain uncomfortable with the concept. One common reason is that these individuals do not have a firm grasp of their financial needs. There is a second reason: Many are often reluctant to cede control of their assets. Working closely with an experienced advisor can help these individuals better understand their core capital needs and identify which assets are candidates for distribution.

Allocate assets with beneficiaries in mind

Too often, allocations are not appropriately adjusted to account for assets that will be distributed to posterity or charity. For this reason, asset allocations that occur during the distribution phase can be overly conservative.

The allocation of excess assets should be determined based on the time horizon, risk tolerance, and tax situation of the intended recipients. If a 60-year-old man intends to leave his assets to his grandchildren, for example, the asset allocation should be based on the time, horizon, and tax situation of the grandchildren—not on the 60-year-old man himself. This analysis should be performed and applied to each group of assets. The end result: a sound strategy with very clear investment objectives.

Discuss transfer options

The method of asset transfer is an important factor to consider. There are many options to choose from, including Grantor Retained Annuity Trusts (GRATs), Intentionally Defective Grantor Trusts (IDGTs), Irrevocable Life Insurance Trusts (ILITs), private foundations, and outright gifts.

Traditionally, asset transfers attempt to maximize return while minimizing

volatility. This is accomplished by selecting asset classes that are not highly correlated and combining them into one portfolio. Yet this may not always be the best strategy. For a GRAT, a better strategy might be to select certain highly correlated assets from an otherwise diversified portfolio. Doing so would satisfy required distributions without decreasing the efficiency of the overall portfolio, which will ultimately be distributed to the beneficiaries.

Each strategy for transferring wealth includes unique attributes—for example, the low tax rate of a private foundation or the need for current income to make premium payments in an ILIT. These unique attributes should be considered carefully, as they will help determine which transfer option best suits your financial needs.

In summary

During the distribution phase, it is important to obtain a firm grasp of core capital needs and to develop a sound financial strategy for distributing excess wealth. This strategy should incorporate principles for asset allocation that take into account the intended recipients of the assets, as well as the method that will be used to transfer those assets.

GRATs: Making the most of wealth transfer planning

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Today's low interest rates and asset values make one gift tax planning technique extremely attractive: the Grantor Retained Annuity Trust (GRAT).

The Basics

A GRAT allows an individual (or grantor) to transfer property to another individual by placing those assets in a fixed-term trust. This enables the assets to appreciate and produce income. Throughout the term of the trust, the original value of the property plus stated interest is returned to the grantor through annuity payments. At the end of the term, the trust dissolves and any remaining value, resulting from a return on investment that exceeds the stated interest, remains with the trust's designated beneficiaries.

Contributing assets to a GRAT triggers a gift tax transaction. To determine the gift amount, the fair market value of the transferred assets must be reduced by the present value of the required annuity payment stream, which is calculated using IRS stated interest rates. The IRS stated interest rate is 120% of the mid-term federal rate, also known as the 7520 rate.

This September, the interest rate for a GRAT will be relatively low: 4.2%. The lower the interest rate, the less the income interest is worth. By setting up a GRAT now, a grantor can lock in the opportunity to transfer to his beneficiaries any appreciation in excess of the 4.2% rate. Please note that, as with any grantor trust, the income tax ramifications of the trust are imposed on the grantor.

Advantages

Using a GRAT to transfer wealth offers several advantages. For gift tax purposes, the value of the remainder interest at the funding of the trust can be reduced by adjusting the annuity amount. If the value of the interest retained by the grantor equals the value of the assets transferred to the trust plus the IRS stated interest rate, the calculated gift amount is zero.

If a GRAT is set up so that there is no gift, any appreciation of the property in excess of the federal mid-term interest rate is transferred to the beneficiaries—gift-tax free. In addition, the remainder interest at the end of the trust's term will be excluded from the grantor's estate.

Disadvantages

Although GRATs are excellent wealth transfer vehicles, they are not optimal in every circumstance. There are at least four considerations to keep in mind. First, the timing of a GRAT is critical to its success; asset growth rates must remain higher than the stated IRS interest rate for a GRAT to prove worthwhile. A second hurdle: The IRS requires GRATs to use 120% of the mid-term federal rate, while other wealth transfer vehicles are permitted to use the actual rate.

A third consideration hinges on how a GRAT functions. Because gifts are established when the trust is first funded, they are considered future interests and therefore do not qualify for annual exclusion. If the calculated gift amount is greater than zero, the amount can be offset by the grantor's lifetime gifting exemption. For this reason, using a GRAT to plan

generation skipping is inappropriate, as the exemption for generation skipping cannot be allocated until the end of the GRAT's term. At the end of the GRAT's term, the full value of the property would be subject to the generation skipping transfer tax, thereby eliminating the benefit previously obtained by using a GRAT for gift tax purposes.

Finally, it is important to consider that a qualifying GRAT requires the grantor to outlive the annuity term. If the grantor does not outlive the annuity term, a portion of the assets in the GRAT (up to 100%) will be included in the grantor's estate.

Supercharging your GRAT

Although using a GRAT involves certain risks, many of these risks can be mitigated by employing the proper strategy. For example, the risk that the growth rate of the assets in the GRAT might not exceed the interest rate set by the IRS can be mitigated by using a rolling GRAT. The concept of a rolling GRAT is straightforward: As the assets are distributed from the GRAT to the grantor of the trust, the grantor contributes those assets to a new trust with similar terms.

Rolling GRATs are flexible for two primary reasons: (1) Their terms can be as brief as two years, and (2) the grantor retains the right to stop rolling the annuity at any time. Rolling GRATs also have limited downside because all of the assets contributed to the GRAT are ultimately returned to the grantor. If the grantor chooses to terminate the rolling GRAT, he only forfeits future appreciation. A rolling GRAT strategy enhances the chances that, even in down markets, the grantor will be able to transfer assets to the beneficiaries.

For a long-term GRAT, the risk that assets could be included in the estate can be mitigated by selling the retained interest in the trust. As long as the retained interest is sold more than three years prior to the grantor's death, no portion of the GRAT will be included in the grantor's estate.

In Summary

GRATs can be valuable wealth transfer vehicles if the timing, structure, and circumstances are appropriate. Using a GRAT to transfer marketable securities, family limited partnership interests, or family-owned businesses, for example, can be very effective.

Low stated interest rates and depressed asset values make this a good time to consider your options for estate planning and wealth transfer. Please consult your PwC tax and financial planning advisor to discuss whether establishing a GRAT is right for you.

Going green puts more green in your pocket

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Green. Was there ever a color so popular? These days, you hear about "going green" everywhere, and media coverage only seems to be increasing. But what does going green really mean, and why should you be concerned with it? Going green means being environmentally conscious and acting in ways that minimize your negative impact on the environment. Every company—big and small, local and international—should care about the environment. Looking at your business through an environmental lens creates opportunities to cut costs, reduce risks, drive revenues, and enhance your public image. In today's business world, the environment may be the key to gaining a competitive advantage.

Causes for concern

In their book *Green to Gold*, Daniel Esty and Andrew Winston explain that current environmental concerns are being fueled by two main sources of pressure. First, the resources available in the natural world are limited. Unless alternative resources are obtained, businesses—and the entire planet—will be in danger.

Running out of key natural resources like oil and industrial metals, however, is not the only concern. With greenhouse gas emissions on the rise, pollution is disrupting essential ecosystems that provide fresh water, breathable air, a stable climate, and productive land. This means an increased risk of extreme weather events such as hurricanes and drought, a decrease in the availability of fresh water, and serious food shortages in many parts of the world.

The second source of pressure stems from increased public awareness. In recent years, people have become more concerned with the environment and have placed greater demands on businesses and their efforts to protect the planet. Companies that choose not to heed the public's call for greater corporate responsibility risk tarnishing their public image. Many consumers prefer to buy eco-friendly products, and many employees prefer to work for companies with strong environmental values.

The business reasons for going green are overwhelming, and no company can afford to ignore them. Today, CEO performance is measured not just by profits and market share, but by social and environmental results as well. Companies that handle hazardous materials or operate in heavily regulated industries, such as utility providers, automakers, and electronic manufacturers, are likely to face more stringent environmental regulations. And companies in the service sector will need to stay on top of environmental issues to retain competitive talent, since the new work force values a company's commitment to the environment. Smaller companies will be affected too; they may need to increase their positive contribution to the environment in order to keep customers happy and remain competitive.

Investors think green

In his book *Go Green, Live Rich*, David Bach contends that "investing in green will be to the twenty-first century what investing in technology was to the twentieth century." Increasingly, a company's environmental strategy is a key factor in the decisions made by many fund managers. Public demand has prompted the creation of green mutual funds, which consist of companies that have been screened for environmental responsibility. Institutional investors are also looking for green investment options; many of these large investors have already contributed billions of dollars to growing environmental companies and technologies.

Going green: key business considerations

What steps can companies take to become more environmentally responsible? First, a company should trace its carbon footprint, the negative impact of its activities on the environment, by capturing data and creating metrics. An action plan aimed at reducing that carbon footprint should be implemented, and a CEO statement committing the company to environmental values and goals should be released.

Next, a company should track its performance and build an environmentally minded corporate culture. This can be accomplished by creating accountability and project ownership, and should be reinforced regularly through relevant internal and external communications. In the long term, environmental thinking needs to be embedded deep into the overall business strategy; this may require a

reexamination of existing products or markets and increased attention to shareholder concerns.

When making any changes, be sure that customer needs, including nonenvironmental ones, remain a top priority. Control costs, and remember that green attributes rarely stand alone; a product or service must provide value in other ways, as well.

Taking personal responsibility

Businesses are not the only ones with a responsibility to conserve the environment. In your everyday life, you can take meaningful steps to reduce your carbon footprint. You can purchase green housing or get a green mortgage. You can shop green by buying organic produce, bringing your own bag, or buying recycled paper products. You can become energy smart by using solar power, planting trees, or switching to compact fluorescent bulbs. Both at home and at work, you can conserve energy by simply turning off the lights and computer when they are not in use.

You can go green on the road, too. By keeping your tires inflated and driving slower, you can get better gas mileage and protect the environment, while saving at the pump. If we each become more environmentally conscious in our own lives, we can save billions in energy costs and prevent millions of tons of CO2 emissions from being released into the air.

Government incentives

A number of federal tax incentives are currently available to environmentally focused businesses and individuals. For businesses, these incentives include deductions for energy efficient commercial buildings (up to $1.80 per square foot), credits for renewable electricity (up to two cents per kilowatt hour), credits for energy-efficient new homebuilders (up to $2,000 per home), tax credits for equipment used to generate alternative fuel sources, and 50% bonus depreciation for eligible renewable-energy systems. Personal tax credits are available for solar heating and fuel cells.

Most of these incentives are set to expire on December 31, 2008; however, green legislation is quickly gaining popularity, and extensions or new legislation may well be enacted in the near future. It is prudent to learn more about your state and city's green tax incentives, which may yield additional, significant tax savings.

Think green, get ahead

Environmental challenges create opportunities. For the most part, green companies are more innovative and entrepreneurial than their competitors, and their creativity often leads to higher revenues and lower operational costs. Kermit the Frog may have said, "It's not easy being green," but in today's environment it's not easy *not* being green.

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