Private Bank

Using margin and securities backed finance in your US wealth transfer strategy

Jason Britton
Margin and Securities Backed Finance

Lee Garsson
Trust & Wealth Planning

Contents

Changes to wealth taxes and near-term levies to support increased government spending are likely in multiple jurisdictions

The US is no exception to such legislative headwinds affecting the wealthy. Recent political developments suggest that Grantor Retained Annuity Trusts (or "GRATs"), which often form an essential part of US ultra-high net worth individuals' wealth transfer plans, could also be impacted.

In these uncertain times, margin and securities backed finance (MSBF) loans could offer a potential longer-term solution to GRATs. However, before delving into MSBF strategies, it is worth touching on what might be on the US legislative horizon and the inner workings of GRATs.

> On March 25, 2021, Senators Bernie Sanders (I-VT) and Sheldon Whitehouse (D-RI) introduced a tax proposal entitled, For The 99.5 Percent Act (the "Proposed Act")[1], with possible major ramifications for wealth succession.

If enacted, the Proposed Act – which may take effect on January 1, 2022 – would lower current federal estate, gift, and generation-skipping transfer tax exemption amounts to levels not seen since 2009, while imposing higher tax rates.

> On May 28, 2021, the Biden Administration released its fiscal year 2022 tax and revenue proposals (the "Biden Proposals").

[1] S.994 - For the 99.5 Percent Act, 117th Congress (2021-2022) https://www.congress.gov/bill/117th-congress/senate-bill/994
Neither Citigroup nor any of its affiliates provide tax or legal advice.

One of the Biden Proposals would cause a donor of an appreciated asset to realize a capital gain at the time of the gift. The realized gain amount would be the amount by which the asset's fair market value on the date of the gift exceeds the donor's basis in that asset. Transfers of appreciated property into, and distributions in kind from, a trust (other than a revocable grantor trust) would be treated under this proposal as recognition events. This proposal has certain exclusions and would apply to transfers and distributions occurring after 2021.

POTENTIAL TRANSFER TAX CHANGES UNDER THE PROPOSED ACT AND THE BIDEN PROPOSALS (THE "POTENTIAL CHANGES")

Our review of the proposals in the public domain points to the following:

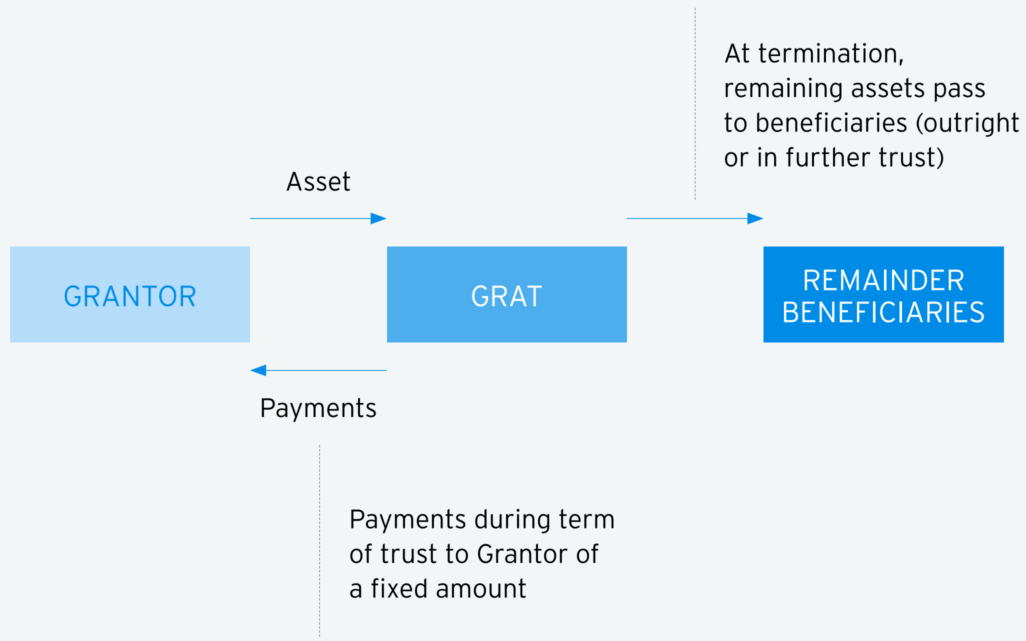
- The lifetime gift tax exemption amount would be reduced to $1 million per individual ($2 million for married couples), with no inflation adjustments.
- The estate tax exemption amount would be reduced to $3.5 million per individual ($7 million for married couples), with no inflation adjustments. Akin to the current law, an individual's estate tax exemption amount would be reduced, dollar for dollar, by the gift tax exemption amount used during such individual's lifetime.
- The Potential Changes would eliminate or roll back the use of popular estate planning strategies such as GRATs.

Furthermore, the Potential Changes are unlikely to be the only sources of legislative framework. In fact, they may be the first of several proposals introduced or released this year that may modify the current transfer tax laws and certain wealth transfer strategies. Even though passage of the Potential Changes is far from certain, it serves as a strong reminder that there may be a short window of opportunity to explore and implement certain wealth transfer strategies before new legislation goes into effect.

Deep dive into GRATs

A GRAT is a wealth transfer strategy where an individual (the "Grantor") transfers assets to the trustee of an irrevocable trust, with the Grantor retaining the right to receive an annuity payment for a fixed number of years. This annuity payment is based on:

- The initial fair market value of the GRAT's assets;
- The selected term of years; and
- An "IRS interest rate" determined at the time the GRAT is funded.



Neither Citigroup nor any of its affiliates provide tax or legal advice.

Under current tax law, the Grantor can fund the GRAT in a manner that results in a nominal gift or no gift, preserving the Grantor's remaining gift tax exemption amount, if any, for other wealth transfer strategies.

Structuring the GRAT so the Grantor makes a nominal gift, or no gift, is known as a "zeroed-out" GRAT. When the GRAT term ends and the final annuity payment is made to the Grantor, assets left in the trust can pass either outright to family members (or other beneficiaries) or stay in trust for their benefit.

THE "FORMULA" FOR A SUCCESSFUL GRAT REQUIRES:

- The Grantor must survive the selected term of the GRAT;
- The actual return (income, gains, and appreciation) on the GRAT's assets must outperform the IRS interest rate (that was used for determining the annuity payment) – looking over the entire term of the GRAT;
- The GRAT agreement must contain all required statutory provisions; and
- The trustee must properly follow the provisions of the GRAT.

Under current law, a Grantor may establish a GRAT with a short term – even two years is acceptable. The GRAT technique can be an effective strategy to shift the trust's income and appreciation in excess of the IRS interest rate to family members (or other beneficiaries) with minimal or no gift tax consequences. Since the IRS interest rate is based on mid-term bond rates, GRATs produce more favorable wealth transfer results in a low interest rate environment.

During the GRAT term, the Grantor will report all of the trust's income, gains, deductions, and losses on his or her personal tax returns (federal and state), because the GRAT is a "grantor trust." Under current law, the Grantor will not be treated as making an additional gift to the GRAT if the Grantor pays (from his/her own assets) any income taxes attributable to the income or gains generated by the GRAT.

For transfers made after the date of enactment, the Proposed Act would require a GRAT to have:

- A minimum term of 10 years; and
- A "remainder interest" with a value for gift tax purposes equal to at least 25 percent of the value of the assets contributed to the GRAT or $500,000, whichever is greater (but no more than the value of the assets contributed) – requiring the Grantor to use up some or all of the Grantor's remaining gift tax exemption amount and/or trigger the payment of gift taxes.

It is unclear whether and to what extent GRAT-related transfers and distributions of appreciated assets after 2021 would trigger a realization of capital gains under the Biden Proposals. The types of GRAT-related transfers and distributions that may (or may not) be impacted by the Biden Proposals include (i) the initial funding of the GRAT with appreciated assets, (ii) an in-kind distribution of an asset with a built-in gain to the Grantor in order to satisfy the required annuity payment, (iii) distributing appreciated assets to the remainder beneficiaries either outright or in further trust when the GRAT term ends, and (iv) the Grantor reacquiring assets from the GRAT by substituting other assets of equivalent value.

Possible risks to wealth transfer benefits of GRATs posed by the Potential Changes

In the event of the passing of the Potential Changes, we see the following risks to the wealth transfer benefits of GRATs:

Market risk

If a minimum term of 10 years is required, it may be challenging to capture upside volatility in the GRAT, and more active management of the GRAT may be required.

Mortality risk

A 10-year minimum term also increases the possibility that the Grantor does not survive the annuity term, causing some or all the GRAT's remaining value to be included in the Grantor's estate for estate tax purposes. The Grantor is more likely to survive a two to three-year term as compared to a minimum term of 10 years.

Reverse leverage risk

The Potential Changes would eliminate the ability of the Grantor to establish a zeroed-out GRAT by requiring the Grantor to make a sizable taxable gift (of the remainder interest) at the time the Grantor transfers assets to the GRAT. This will effectively limit the number of GRATs that a Grantor could create without paying gift taxes. In addition, if the transferred assets produce a rate of return that is below the IRS interest rate, some or all of the gifted "remainder interest" in the transferred property will have to be used to pay the required annuity to the Grantor – resulting in a waste of some or all of the Grantor's gift tax exemption amount (used to establish the GRAT) or requiring the Grantor to pay gift taxes with little or no economic benefit passing to the remainder beneficiaries.

Realization event risk

A transfer of appreciated assets into a GRAT and/or a distribution of appreciated assets from a GRAT might trigger a realization of capital gains.

IMPACT OF THE POTENTIAL CHANGES ON ROLLING GRATS

Currently, most GRATs are designed as zeroed-out GRATs with a shorter term (typically 2 or 3 years) of making annuity payments to the Grantor. A rolling GRAT program involves the creation of a series of consecutive short-term GRATs where the Grantor's annuity payments from older GRATs are reinvested into newer GRATs. A rolling GRAT approach can help minimize mortality risk and take advantage of a fluctuating market.

A rolling GRAT program can effectively pass wealth to the remainder beneficiaries even if only a few of the GRATs are successful (i.e., the assets' income, gains, and appreciation exceed the IRS interest rate). It also ensures that the Grantor's investments remain in a GRAT at almost any given time.

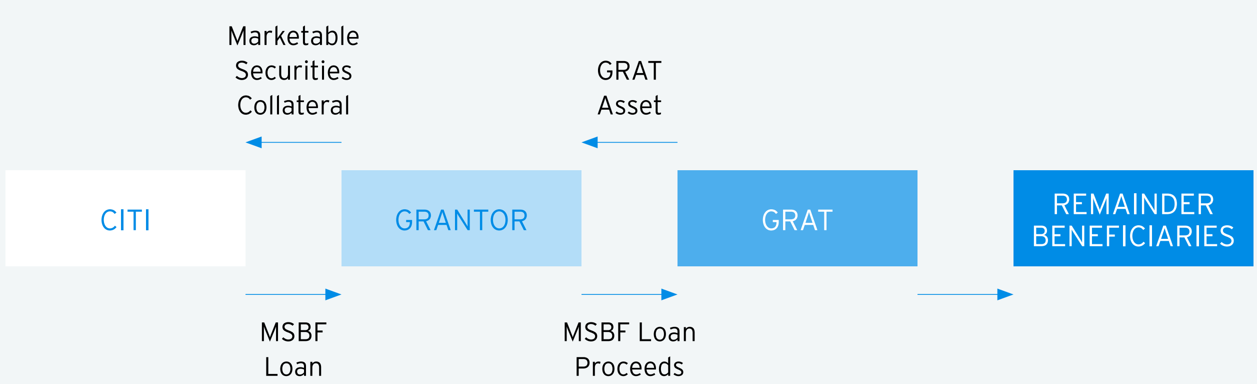
However, the Potential Changes could disrupt existing rolling GRAT strategies or severely hamper plans for a future rolling GRAT strategy. First, with each new GRAT established, the Grantor would be required to make a gift equal to the greater of $500,000 or 25% of the value of the assets transferred to the new GRAT. Second, the 10-year term minimum would increase the risk that the Grantor does not survive the GRAT term. Third, capital gains might be realized if the Grantor transfers an asset with a built-in gain to a new GRAT or if the trustee of the GRAT distributes an asset with a built-in gain to the Grantor when making the annuity payment.

Exploring MSBF as a solution[2]

There is a flexible way to access liquidity from financial assets without selling investments, thus retaining the full upside potential of your investments. MSBF is an extension of credit which uses financial assets as collateral. Its costs are often lower than other lines of credit.

> An MSBF loan could potentially be established at GRAT inception with minimal cost, and loan proceeds can be used to fund a GRAT.

GRAT Immunization - exchanging the higher volatility assets held in a GRAT for cash or cash equivalents through a MSBF loan - can: (i) protect the GRAT's value from future market declines; (ii) limit the GRAT's value from exceeding future market appreciation expectations; and (iii) avoid the need for an asset sale.



[2] All credit products are subject to credit approval
Neither Citigroup nor any of its affiliates provide tax or legal advice.

Furthermore, assets exchanged out of the GRAT can be either part of the MSBF collateral or transferred to a new GRAT structure (rolling GRAT strategy). We believe MSBF could complement GRAT strategies, allowing the Grantor to lock in the value of appreciated assets at any time before expiration by exchanging the value of the GRAT asset with MSBF loan proceeds in the form of cash.

The MSBF loan can also provide flexibility as to when the appreciated value is locked in. At GRAT termination, the cash proceeds can be transferred to the remainder beneficiaries at the locked-in value with no built-in gain, or the loan proceeds could be exchanged back out for the underlying asset. Without an exchange, beneficiaries could receive the underlying asset with built-in gains.

Qualified Citi Private Bank clients may be able to borrow at competitive rates against a range of financial assets, including stocks, bonds, cash and cash equivalents, exchange traded REIT shares, structured notes, mutual funds, ETFs, separately managed accounts, and hedge funds. Typically, there are no commitment fees and interest is payable only if the MSBF loan is drawn down.

Our experienced Wealth Planners and MSBF specialists can offer planning considerations and provide guidance on what you can potentially achieve in 2021 before new tax legislation takes effect. Contact your Private Banker for more information. Before implementing a wealth plan, consult your independent legal and tax advisors in the relevant jurisdictions regarding the appropriate strategy to achieve your objectives.

About the authors

JASON BRITTON
SENIOR VICE PRESIDENT
MSBF INVESTMENT FINANCE TRANSACTOR

Jason Britton is a Senior Vice President and MSBF Investment Finance Transactor, assisting ultra-high net worth individuals and family offices by structuring tailored liquidity solutions secured by financial assets held with Citi Private Bank. These MSBF solutions provide Citi Private Bank clients a cost-effective and flexible way to consolidate debt, bridge financing, purchase real estate, meet tax obligations, and create general liquidity for other uses.

Prior to joining Citi Private Bank, Jason worked at Morgan Stanley Private Bank as a Regional Lending Advisor to provide subject matter expertise for ultra-high net worth borrowers and their Financial Advisors and Private Bankers, covering the Pacific Northwest, Southern California, Texas, and the Bay Area regions.

Jason received a BA from the University of Utah and an MBA from Westminster College.

LEE GARSSON
DIRECTOR
WEALTH PLANNER

Lee Garsson is a Director and Wealth Planner, assisting ultra-high net worth individuals and families with their sophisticated estate planning needs. Lee provides guidance on estate, gift, generation-skipping transfer and income tax planning, and works with clients to develop solutions for their philanthropic, business succession, and wealth transfer goals.

Prior to joining Citi Private Bank, Lee worked at Bank of America Private Bank as a Wealth Strategist assisting high net worth clients with estate, tax, and financial planning. Prior to Bank of America, Lee worked at a full-service law firm in San Antonio, Texas where he practiced estate planning and tax planning.

Lee received a BBA from the University of Texas at Austin, a JD from Southern Methodist University School of Law, and an LLM in Taxation from New York University School of Law.

Neither Citigroup nor any of its affiliates provide tax or legal advice.

Important information

Citi Private Bank is a business of Citigroup Inc. ("Citigroup"), which provides its clients access to a broad array of products and services available through bank and nonbank affiliates of Citigroup. Not all products and services are provided by all affiliates or are available at all locations.

The views or opinions expressed herein in this white paper are those of the author and do not necessarily reflect the views of Citigroup Inc. or its affiliates. This document is for informational purposes only. All opinions are subject to change without notice. Opinions expressed herein may differ from the opinions expressed by other businesses of Citigroup Inc., are not intended to be a forecast of future events or a guarantee of future results. Although information in this document has been obtained from sources believed to be reliable, Citigroup Inc. and its affiliates do not guarantee its accuracy or completeness and accept no liability for any direct or consequential losses arising from its use.

Citigroup Inc. and its affiliates do not provide tax or legal advice. To the extent that this material or any attachment concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Any such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

For US clients, trust services are provided by one of the following entities: Citibank, N.A.; Citicorp Trust South Dakota; or Citicorp Trust Delaware, N.A.

For clients who are neither residents nor citizens of the US, trust services are provided by one of the following entities: Cititrust Private Trust (Cayman) Limited, Cititrust Private Trust Zurich GmbH, Cititrust (Bahamas) Limited, Cititrust (Cayman) Limited, Cititrust (Jersey) Limited, Cititrust (Singapore) Limited, Cititrust (Switzerland) Limited or Citicorp Trust Delaware, N.A.

Cititrust (Jersey) Limited, whose contact details are P.O. Box 728, 38 Esplanade, St. Helier, Jersey JE4 8ZT, Channel Islands, telephone number + 44 1534 608000 is licensed by the Jersey Financial Services Commission for the conduct of Trust Company Business.

The service providers are referred to collectively as "Citi Trust". Neither Citigroup nor any of its affiliates provide tax or legal advice.

This document is made available for general guidance only. The information contained herein is not intended to be a comprehensive discussion of legal or tax advice of the strategies or concepts described. Interested clients should consult their tax and/or legal advisors. This document contains a summary of rules and planning techniques that are complex and subject to change. Citigroup companies may compensate their affiliates and representatives for providing products and services to clients.

The risk of loss in financing a transaction by deposit of collateral is significant. Citibank, N.A. ("Citi") will be your lender for this financing and you may sustain losses in excess of your cash and any other assets deposited as collateral with Citi or Citi's agent. Market conditions may make it impossible to execute contingent orders, such as "stop-loss" or "stoplimit" orders. You may be called upon at short notice to make additional margin deposits or interest payments. If the required margin deposits or interest payments are not made within the prescribed time, your collateral may be liquidated without your consent. Moreover, you will remain liable for any resulting deficit in your account and interest charged on your account. You should therefore carefully consider whether such a financing arrangement is suitable in light of your own financial position and investment objectives. You are not entitled to choose which securities or other assets in your account(s) are liquidated or sold to meet a margin call. The firm can increase its margin requirements at any time and is not required to provide you advance written notice. You are not entitled to an extension of time on a margin call. Citi has the right to demand repayment of a demand facility at any time, for any reason or no reason.

In Canada, Citi Private Bank is a division of Citibank Canada, a Schedule II Canadian chartered bank. References herein to Citi Private Bank and its activities in Canada relate solely to Citibank Canada and do not refer to any affiliates or subsidiaries of Citibank Canada operating in Canada.

In the United Kingdom, Citibank N.A., London Branch (registered branch number BR001018), Citigroup Centre, Canada Square, Canary Wharf, London, E14 5LB, is authorised and regulated by the Office of the Comptroller of the Currency (USA) and authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. The contact number for Citibank N.A., London Branch is +44 (0)20 7508 8000.

Citibank Europe plc (UK Branch), is a branch of Citibank Europe plc, which is authorised by the European Central Bank and regulated by the Central Bank of Ireland and the European Central Bank (reference number is C26553). Citi bank Europe plc (UK Branch) is also authorised by the Prudential Regulation Authority and with deemed variation of permission. Citibank Europe plc (UK Branch) is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details of the temporary permissions regime, which allows EEA-based firms to operate in the UK for a limited period while seeking full authorisation, are available on the FCA's website. Citibank Europe plc (UK branch) is registered as a branch in the register of companies for England and Wales with registered branch number BR017844. Its registered address is Citigroup Centre, Canada Square, Canary Wharf, London E14 5LB. VAT No.: GB 429 6256 29. Citibank Europe plc is registered in Ireland with number 132781, with its registered office at 1 North Wall Quay, Dublin 1. Citibank Europe plc is regulated by the Central Bank of Ireland. Ultimately owned by Citigroup Inc., New York, USA.

Citibank Europe plc, Luxembourg Branch is a branch of Citibank Europe plc with trade and companies register number B 200204. It is authorised in Luxembourg and supervised by the Commission de Surveillance du Secteur Financier. It appears on the Commission de Surveillance du Secteur Financier register with company number B00000395. Its business office is at 31, Z.A. Bourmicht, 8070 Bertrange, Grand Duchy of Luxembourg. Citibank Europe plc is registered in Ireland with company registration number 132781. It is regulated by the Central Bank of Ireland under the reference number C26553 and supervised by the European Central Bank. Its registered office is at 1 North Wall Quay, Dublin 1, Ireland.

In Jersey, this document is communicated by Citibank N.A., Jersey Branch which has its registered address at PO Box 104, 38 Esplanade, St Helier, Jersey JE4 8QB. Citibank N.A., Jersey Branch is regulated by the Jersey Financial Services Commission. Citibank N.A. Jersey Branch is a participant in the Jersey Bank Depositors Compensation Scheme. The Scheme offers protection for eligible deposits of up to £50,000. The maximum total amount of compensation is capped at £100,000,000 in any 5 year period. Full details of the Scheme and banking groups covered are available on the States of Jersey website www.gov.je/dcs, or on request.

Citibank, N.A., Hong Kong / Singapore organised under the laws of U.S.A. with limited liability. This communication is distributed in Hong Kong by Citi Private Bank operating through Citibank N.A., Hong Kong Branch, which is registered in Hong Kong with the Securities and Futures Commission for Type 1 (dealing in securities), Type 4 (advising on securities), Type 6 (advising on corporate finance) and Type 9 (asset management) regulated activities with CE No: (AAP937) or in Singapore by Citi Private Bank operating through Citibank, N.A., Singapore Branch which is regulated by the Monetary Authority of Singapore. Any questions in connection with the contents in this communication should be directed to registered or licensed representatives of the relevant aforementioned entity. The contents of this communication have not been reviewed by any regulatory authority in Hong Kong or any regulatory authority in Singapore. This communication contains confidential and proprietary information and is intended only for recipient in accordance with accredited investors requirements in Singapore (as defined under the Securities and Futures Act (Chapter 289 of Singapore) (the "Act")) and professional investors requirements in Hong Kong(as defined under the Hong Kong Securities and

Futures Ordinance and its subsidiary legislation). For regulated asset management services, any mandate will be entered into only with Citibank, N.A., Hong Kong Branch and/or Citibank, N.A. Singapore Branch, as applicable. Citibank,N.A., Hong Kong Branch or Citibank, N.A., Singapore Branch may sub-delegate all or part of its mandate to another Citigroup affiliate or other branch of Citibank, N.A. Any references to named portfolio managers are for your information only, and this communication shall not be construed to be an offer to enter into any portfolio management mandate with any other Citigroup affiliate or other branch of Citibank, N.A. and, at no time will any other Citigroup affiliate or other branch of Citibank, N.A. or any other Citigroup affiliate enter into a mandate relating to the above portfolio with you. To the extent this communication is provided to clients who are booked and/or managed in Hong Kong: No other statement(s) in this communication shall operate to remove, exclude or restrict any of your rights or obligations of Citibank under applicable laws and regulations. Citibank, N.A., Hong Kong Branch does not intend to rely on any provisions herein which are inconsistent with its obligations under the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, or which mis-describes the actual services to be provided to you.

Citibank, N.A. is incorporated in the United States of America and its principal regulators are the US Office of the Comptroller of Currency and Federal Reserve under US laws, which differ from Australian laws. Citibank, N.A. does not hold an Australian Financial Services Licence under the Corporations Act 2001 as it enjoys the benefit of an exemption under ASIC Class Order CO 03/1101 (remade as ASIC Corporations (Repeal and Transitional) Instrument 2016/396 and extended by ASIC Corporations (Amendment) Instrument 2021/510).

Private Banking for Global Citizens

Private Bank citi®