Advanced Planning Strategies

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The tax policy proposed by President-Elect Obama garnered significant attention prior to the election, particularly after the encounter with Joe the Plumber. The worsening economic condition has caused some debate about the timing of any proposed changes. In a press conference announcing the appointment of his economic team, he did not back off of the proposal to reduce taxes for 95 percent of workers and increase taxes for those earning at least $250,000. The timing of the changes is certainly important to the individuals who are affected.

There are some implications in the choice of words used to describe the policy. First, reducing taxes for 95 percent of workers appears to refer to earned income. Unearned income (this is a technical tax term and not a value judgment on our part), such as dividends, interest, and capital gains, is not covered in his statement. We are aware of the scheduled expiration of the lowered dividend and long-term capital gains rates, but these rates could be increased sooner.

Our next letter should be available on or before the inauguration. We will detail the tax changes from the Bush administration that are scheduled to expire. The initial tax changes in the Obama administration will be included in an expected stimulus package. We'll obviously be on top of any developments that occur.

Although the economy is on everyone's mind at the moment, there are some estate-planning opportunities that are created by an environment of low interest rates and reduced asset valuations. If assets are reduced in value, the conventional wisdom is to consider the possibility that increases in value might be in the future. This is certainly not an investment newsletter and our primary focus is tax and estate planning. One immediate thought is that it is most appropriate to make gifts of assets with future appreciation potential since the appreciation that occurs after the completed gift is not subject to gift or estate taxes. Low interest rates enhance specific methods of gifting or other forms of transfer. For more information, read the inside report.

Knowledge is not power. Only knowledge in use is power.

THE IMPACT OF LOW INTEREST RATES ON ESTATE PLANNING TECHNIQUES

Asset values in the United States have been challenged in recent times, to say the least. The real estate sector hit its most recent peak in 2006 or 2007, depending on location. Although location is always critical with real estate, there has been some reduction in virtually all geographic areas, with steep reductions in some specific markets. At the time this letter was written, the stock market was off approximately 47 percent from its peak in fall 2007. The Federal Reserve has lowered interest rates to attempt to stimulate the economy and create liquidity in the commercial lending market.

What does all this have to do with estate planning? There are some opportunities created by these circumstances for individuals who have the resources to consider making lifetime transfers to family members. With the election of Senator Obama to President and a Congress to be controlled by the Democratic Party for a minimum of two years, it is apparent that there will be significant federal estate taxes into the foreseeable future. Making lifetime gifts may be indicated as part of a cohesive estate planning strategy.

ASSET VALUATION AND INTEREST RATES

What do interest rates and the reduction in asset values have to do with estate planning techniques? First, it is generally best to transfer assets with the greatest appreciation potential. Second, the interest rate is used in actuarial valuation methodology and can have a profound impact on charitable giving and other estate planning techniques. Since May 1989, Congress has mandated the use of specified current interest rates and mortality tables in valuing asset transfers through some popular estate planning techniques (IRC Code Sec. 7520). The interest rates are updated monthly by the IRS. The mandated mortality rates must be updated every 10 years (the next update will be May of next year). The interest rate is 120 percent of the federal midterm rate compounded annually (rounded to the nearest 2/10ths of one percent). The interest rate has fluctuated significantly during the time these rules have been in effect, reaching a high of 11.6 percent in 1989 and a low of 3 percent in July 2003. For December, this rate will be 3.4 percent. It seems quite possible that the rate may be lower in the near future.

The interest rate and mortality tables (where necessary) are used for valuing partial interests in property for tax purposes. For example, the interest and mortality tables are used to determine (1) the income, gift, and/or estate tax deductions for charitable lead or remainder trusts, (2) the gift tax value of transfers to qualified personal residence trusts, grantor-retained annuity trusts, and (3) the annual payment for a private annuity transaction. Since the interest rate is at its all-time low, this discussion is to provide you with basic guidance for selecting planning techniques that benefit from low interest rates.

WHAT TECHNIQUES BENEFIT?

Charitable Lead Annuity Trusts (CLATs). Charitable lead trusts (CLTs) are the reverse of the more commonly known charitable remainder trusts (CRTs). That is, the donor creates a trust and the charity receives a donation of a temporary annual annuity (a fixed amount) or unitrust (a stated percentage of the annual value of principal) payments from the CLT. The remaining principal is distributed to a noncharitable beneficiary at the termination of the trust term. Any appreciation that occurs after the property is contributed to the CLT is transferred to the remainder beneficiaries without gift or estate taxes. Thus, the charitable income, gift, and/or estate tax deductions are based on the actuarial value of the temporary annuity or unitrust rights donated to the charity. Due to the nature of the actuarial calculation, the lead unitrust donation is not significantly affected by changes to the interest rate. However, the charitable lead annuity trust will perform significantly better in a period of low interest rates.

Example: Suppose Phil Enthropic creates a CLAT and places $1 million of principal in the trust. The trust will pay his favorite charity $80,000 per year for 10 years with the remainder distributable to his children. Under the

current 3.4 percent interest rate, his charitable deduction is $668,696, and the value of the remainder (for gift tax purposes) given to his children is only $331,304. This gift tax cost is fixed, regardless of how the assets held by the trust perform. The greater the return, the more that will be available to the beneficiaries after the charitable lead interest ends. Just for comparison, under an 11.6 interest rate (the highest rate ever in effect), the tax deduction would have been limited to $459,520, and the size of the taxable gift would have been $540,480.

Private Annuities. The typical private annuity could be described as a sale of property between family members. In accordance with estate planning goals, a parent (or grandparent) sells family property to a child (or grandchild). Instead of paying a purchase price today, the buyer promises to make annual payments to the seller for the rest of the seller's life (i.e., a life annuity). The payments are fixed in amount at the time of the sale. The size of the annual payments is based on the seller's life expectancy, the current valuation interest rates, and the amount of the purchase price. The estate planning goal of a private annuity often is to sell property to the next generation for as little as possible. Thus, it is usually desirable to hold down the size of the required annuity payments. Recent IRS regulations removed some of the advantages of the private annuity. The impact of the regulations is the immediate imposition of the capital gains tax at the time the property is transferred. Here again, timing is everything. Currently reduced asset valuations in some property might have reduced or eliminated built-in capital gains. Second, the long-term capital gain rate is 15 percent and it is quite possible that this rate may be increased within the next two years. It might be preferable to incur some capital gains tax at the current 15 percent rate and allow the future appreciation to benefit the next generation. Let's look at the impact of the new low interest rate on private annuities.

Example: Suppose Mary Matriarch is 60 years old and owns investment real estate (a duplex apartment) worth $500,000, 20 percent below its value in 2006. The two rental units currently generate $3,500 per month ($42,000 annually) in rental income. Mary would like to reduce her otherwise substantial estate and eventual estate taxes. Under the current 3.4 percent interest rate, she can sell the real estate to her child for a private annual annuity payment of only $35,855. These annuity payments will continue for the rest of Mary’s life. If Mary is unhealthy, but she has a greater than 50 percent likelihood of surviving one year, the regulations will still allow the use of these valuation methods to determine the required annual annuity payment. If Mary dies before her life expectancy determined by the tables, the technique will have greater wealth transfer leverage. In addition, the appreciation on the real estate benefits her child. Again for comparison, under the highest (11.6 percent) interest rate in effect under these rules, the required payment would have been $70,690, an amount well in excess of the property's current income and certainly a less favorable estate planning scenario for Mary and her child.

Grantor-Retained Annuity Trusts (GRATs). A grantor-retained annuity trust is an irrevocable trust that is funded with any appropriate investment by the grantor, who will retain a temporary fixed annual annuity followed by a gift of the remainder interest to the GRAT’s remainder beneficiaries. The GRAT is a very interest-rate-sensitive planning technique and performs well in an environment of low interest rates, as the example below indicates.

Example: Ernest Estateplanner, aged 60, transfers $1 million in marketable securities to a GRAT. The same portfolio might have been worth $1.8 million about 1 year ago. He retains the right to an annual annuity payment of $50,000 for 10 years, and the remainder will be distributed to a trust for his children. The size of his taxable gift is the actuarial value of the remainder, allowing for his 10-year annuity. Under the current 3.4 percent rate, he will make a taxable gift of $582,065, well under his $1 million lifetime exemption for taxable gifts. Again, for comparison, under an 11.6 percent rate, his taxable gift would have been $712,800. What’s more, if the trust principal grows at 6 percent (1 percent higher than the 5 percent required annual annuity payment to Ernest), the remainder beneficiaries will receive a principal sum of $1,131,808 when the trust terminates. This sum was transferred by using only $582,065 of Ernest’s unified credit! Again the greater the

actual return on the GRAT's invested principal, the larger the wealth transfer.

WHAT TECHNIQUES SUFFER FROM LOWER INTEREST RATES?

Without providing the same detailed analysis, the lower interest rates provide a smaller tax benefit for qualified personal residence trust (QPRTs) and charitable remainder annuity trusts (CRATs). QPRTs work most effectively when the real estate appreciates in value during the term of the trust, so the impact on the gift tax cost of making the gift must be balanced with the grantor's feelings about the growth potential of his or her residence. The more common type of charitable remainder trust, a charitable remainder unitrust (CRUT) is only marginally affected by the interest rate and will remain viable in a lower interest rate environment.

SUMMARY

Although the federal estate tax is scheduled to be repealed in 2010, most now believe that the tax will be continued indefinitely and lifetime transfers by gift or sale to family members remain important estate-planning techniques. As the examples above clearly demonstrate, interest rate swings can have a profound effect on many estate planning techniques. When interest rates are low, charitable lead annuity trusts, private annuities, and grantor-retained annuity trusts are more favorable. The benefits of these techniques are markedly enhanced when the property appreciates in value after the gift or sale is completed. Although it is easy to be drawn into the pessimism created by the current economic forecasts, it is important to consider the opportunities that are available.

RECENT CASES AND RULINGS

IRS Examines Gift Tax Implications Of Grantor Substitution Power In A GRAT

The grantor created a GRAT and retained an annuity for a term of years. After the termination of the GRAT, the remaining trust funds were distributed to a family trust. It was represented that the value of the remainder exceeded 10 percent of the amount contributed. Her husband was named as trustee of both trusts and had the power to determine distributions from the family trust. The grantor retained the power to take property from the GRAT and replace the property with new property of equal value, based on fiduciary standards. The GRAT was funded with publicly traded stocks and cash.

The IRS ruled (Ltr. 200846001) that (1) the power to substitute did not disqualify the annuity interest from the definition of a "qualified annuity" under the requirements for a GRAT; (2) the exercise of the power to substitute would not constitute an additional gift to the GRAT; and (3) the exercise of the power to substitute would not be a taxable event for either the grantor or the GRAT. The last ruling verified that the GRAT was a "defective" grantor trust under the income tax rules.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.
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