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Carpe Diem!
Estate Planning Opportunities in Uncertain Times

By: Quincy Cotton and Stuart J. Gross

Seizing Upon Current Market Conditions To Achieve Estate Planning Objectives

It is not clear what action the newly elected President and Congress will take with respect to the Federal estate tax, but outright repeal seems unlikely. This means that minimizing the estate and gift tax cost of transferring wealth to future generations continues to be an important goal for many clients. While perhaps not exactly a "silver lining," current market conditions that combine depressed asset values and low interest rates may provide a unique opportunity to accomplish estate planning objectives.

Here are four techniques the senior generation ("Senior") may be able to use to transfer assets to the junior generation ("Junior").

1. Sell Assets to a Defective Grantor Trust

Suppose Senior owns an asset with a current fair market value that Senior believes is temporarily below its "true" value. Senior can create a so-called "defective grantor trust" for the benefit of Junior and sell the asset to the trust for its current fair market value. The trust must have some equity (preferably 20%), which Senior can provide by making a gift to the trust. Senior may gift up to $1,000,000 (cumulative, total lifetime gifts in excess of "annual exclusion" gifts) during her lifetime without incurring gift tax. If Senior's spouse consents to gift-splitting, Senior may also use some or all of her spouse's $1,000,000 gift exemption amount. The balance of the purchase price of the asset is paid by a promissory note from the trust.

The trust is structured so that Senior's gift to fund its equity is a completed gift for gift tax purposes and therefore the trust's assets are not included in Senior's estate at her death. However, Senior nonetheless continues to be treated as the owner of the trust's assets for income tax purposes. The advantage here is that Senior's sale to the trust is not recognized for income tax purposes (not a taxable transaction) and the same is true of the trust's payments of interest on its note to Senior (not treated as interest income to Senior). Any income earned on the trust's assets (e.g., dividends) are taxable to Senior as if she continues to own the assets of the trust.

Finally, when the trust later sells the asset (to an unrelated party) after its value has bounced back, the gain realized on the sale is taxable to Senior (not the trust). This means that the trust is

able to repay its loan owed to Senior from the sales proceeds (unreduced by income tax) and to keep the balance of the proceeds for reinvestment or distribution to the beneficiaries, pursuant to the terms of the trust. Thus, the difference between the temporarily depressed value and the "true" value is transferred to Junior without gift or estate tax, and the income tax on the trust's income is paid by Senior, further reducing Senior's estate and increasing the value in the trust.

2. Fund the Younger Generation's Purchase of the Asset

We do not give investment advice, but we know some of our clients are watching for opportunities to buy marketable securities and other assets at temporarily depressed (bargain) prices. Suppose Senior wishes to acquire an asset at a value that Senior believes is below its "true" value. Instead of buying the asset directly, Senior can make that opportunity available to Junior (or Junior's trust) and can fund Junior's purchase of the asset by making a loan at the IRS safe harbor rate – the December 2008 rate is 2.85% for a loan with a term of 3 to 9 years. A recourse loan to Junior (assuming he is an adult) for 100% of the purchase price is perfectly acceptable. As noted above, if the loan is to Junior's trust, the trust must have some equity. When the asset bounces back to its "true" value, Junior (or Junior's trust) alone benefits from that appreciation.

It may also be that Senior previously created a defective grantor trust which owns assets acquired in prior transactions. Depending upon its current net equity, this existing trust may be able to support additional debt from Senior, to fund the purchase of the new asset.

If any existing trust (or family member) is obligated under prior loans, a review of those loans is appropriate to consider whether refinancing is desired. Senior may have made loans to Junior (or Junior's trust) when rates were higher, and may be willing to refinance at current (lower) rates (for example, in connection with a partial repayment of principal).

3. Create a Grantor Retained Annuity Trust ("GRAT")

Suppose Senior has used her entire gift exemption amount or desires to retain it for other gifts and therefore cannot provide the equity (gift) for the sale to a defective grantor trust. Another way to take advantage of the current depressed value of Senior's asset is to transfer it to a GRAT in exchange for a fixed dollar payment (annuity) for a term of years. This transfer constitutes a gift for gift tax purposes. The amount of the gift is equal to the present value of the remainder interest (any value remaining after the annuity term), based on the IRS rate for GRATs. At the end of the annuity term, the remaining assets in the trust pass to the beneficiaries (in trust or outright) previously designated by Senior in the GRAT agreement. During the annuity term, the GRAT is considered a grantor trust for income tax purposes. (If there is a post-annuity trust, that too may be structured as a grantor trust.)

A Zeroed-Out GRAT

The annuity rate under a GRAT may be set to "zero-out" the value of the remainder interest. This means that the value of the retained right to the annuity payments is approximately equal to the value of the asset transferred to the GRAT, and therefore the value of the remainder interest is approximately zero. The GRAT rate for December, 2008 is a very low 3.4%. (By way of comparison, the rate was 5% in November 2001 and 8.6% in November 1991.) If the assets transferred by Senior to the GRAT out-perform the IRS interest rate, there will be value remaining in the GRAT at the end of the annuity

term and that value will pass to the remainder beneficiaries free of gift tax and with no absorption of Senior's gift-tax exemption amount.

Here is an example of how this would work. Suppose Senior owns a block of shares now worth $1 million and previously (in the recent past) worth much more. Senior expects the shares to revert to their prior value when the markets calm down and the economy recovers. Senior transfers the shares to a 2-year GRAT, retaining the right to receive approximately $525,000 on each of the first and second anniversary dates of the transfer. This annuity rate approximately "zeros out" the gift at the 3.4% interest rate (there will be a small gift, which Senior will report on her gift tax return). Assuming no dividends, each of the two annuity payments will be made by transfer to Senior of that number of shares with a value of $525,000 at the time the annuity is paid. All appreciation in excess of the annuity payments remains in the trust for the benefit of the remainder beneficiaries.

If the shares double in value during the annuity term, significant value will remain when the term ends. Senior will have transferred this "excess" value at no gift or estate tax cost. If the shares fail to appreciate, Senior will receive them back (as her annuity payment) and will be no worse off than if she had not created the GRAT.

There is a timing issue in any GRAT. If, in the foregoing example, the shares double in value during the first year of the annuity term (before the first annuity payment), substantially more value will remain at the end of the 2-year period than if the shares double in value during the second year. If the shares fail to appreciate before the first annuity payment (or if Senior thinks there may be further appreciation), Senior may "roll over" the annuity payment into a new GRAT. (The gift tax consequences of the new GRAT will be determined at the time it is funded, based on the IRS rate then in effect.) If the shares appreciate in year 2 (which is year 1 of the second GRAT), the second GRAT will benefit from that appreciation. Senior may continue to roll over every annuity into a new GRAT, if she so desires.

Given the current low GRAT rate, some clients are asking why not create a longer-term GRAT and lock in the current low rate for a longer period. There are two potential disadvantages to doing this. First, the GRAT's best results are achieved only if Senior outlives the annuity term; the longer the term, the greater the risk of death during the term. In the above example, if Senior had created a 4-year GRAT and died in year 3, essentially all of the assets of the GRAT would be included in her estate for estate tax purposes. The second potential disadvantage of the longer-term GRAT relates to the effect of market volatility on the overall performance of the GRAT. If there are market swings during the annuity term, the longer term gives rise to a greater risk that the down-swings will wipe out the up-swings and the GRAT's performance may be mediocre overall. Historically, the shorter-term GRAT has increased the likelihood that the appreciation in the "up" years is captured and transferred to the remainder beneficiaries.

For some assets, however, a longer-term GRAT that locks in the low current rate might work very well. If Senior's depressed-value asset is an interest in real estate, for example, it may be possible to structure the GRAT (and the ownership of the real estate) so that the required annuity payments, over the appropriate term, are funded entirely from the net cash flow generated by the property.

4. Use a Freeze Transaction

Some assets are not good candidates for a short-term GRAT. Suppose Senior's depressed value asset is an interest in an LLC that owns real property. A transfer of this asset to a short-term GRAT may raise valuation issues for each annuity payment. Moreover, Senior may have a very low basis (and "negative capital account") and be interested in the basis step-up that occurs at death, if she owns the asset at that time. A transaction that may work well on these facts is a "freeze."

In a freeze transaction, Senior contributes her low value LLC interest to a freeze partnership in exchange for a preferred interest, entitling Senior to a cumulative preferred interest-like return, and a liquidation preference. Junior contributes assets to the freeze partnership, in exchange for the junior "common" or "residual" interest, which entitles Junior to cash flow above the preferred return and appreciation above the preferred interest's liquidation preference. The face amount of the preferred interest is based upon the appraised value of the LLC interest contributed by Senior to the freeze partnership. The appraised value of Senior's LLC interest starts with the current low value of the real estate and may be reduced further by discounts for lack of control and marketability, and the like. Senior's contribution to the freeze partnership can be accomplished without any income tax cost (even if Senior has a negative capital account in the LLC interest she contributed).

One of the features of the freeze is that Senior retains a preferred ("frozen") interest in the asset. At her death, assuming the preferred interest is included in her estate for estate tax purposes, the income tax basis of the preferred interest will be "stepped up" to its fair market value (likely the same as its face amount). If Senior's basis is low (particularly if Senior has a negative capital account) the basis step-up provides a significant benefit.

Current State of the Estate Tax

You may recall that under President Bush's 2001 tax cuts (the "2001 Act"), the estate tax exemption amount phased up and estate tax rates phased down. The Federal estate tax exemption amount is $2,000,000 in 2008 and increases to $3,500,000 in 2009; the Federal estate tax rate is 45% for both years. Under current law, if no changes are made, the estate tax is repealed in 2010, and certain "carry-over basis" provisions (above a threshold amount) apply in lieu of the step-up in basis provisions now in effect. In 2011, the estate tax law reverts to the law in effect prior to the 2001 Act: $1,000,000 exemption amount and 55% top rate.

Prior to the 2001 Act, a credit against the Federal tax was available for state estate taxes paid. The 2001 Act phased out the credit and replaced it with a deduction.

Many states (including New York, New Jersey and Connecticut) do not to conform to the 2001 Act. The New York exemption amount is $1,000,000. The New Jersey exemption amount is $675,000. The Connecticut exemption amount is $2,000,000, but an estate over that amount is taxed in its entirety, in effect losing the full benefit of the exemption.

Depending upon the state, the effective (combined Federal and state) estate tax rate may be significantly above the Federal rate. For example, a New York domiciliary subject to the highest New York rate (16% for estates above approximately $10,000,000) will be subject to estate tax at an effective rate of 53.8%.

The lifetime gift tax exemption amount remains at $1,000,000. Gifts in excess of $1,000,000 (even when the estate tax exclusion amount is $2,000,000 or $3,500,000) are subject to gift tax at rates ranging from 41% to 45% once the taxpayer's cumulative lifetime gifts exceed $1,000,000.

Legislative action on the estate tax in 2009 seems likely, in view of the otherwise scheduled repeal in 2010 and reversion in 2011 to pre-2001 law. We continue to believe that full repeal of the estate tax is unlikely. A likelier scenario is a permanent increase in the exemption amount and reduction in the top rate from 2001 levels. One of a number of proposals would make permanent the 2009 exemption amount and top rate: $3,500,000 and 45%, respectively. The lifetime gift exemption has not been proposed to be increased.

Because it is likely that the estate and gift taxes are here to stay, tax-efficient methods of transferring wealth to the next generation remain important. The best estate tax savings are achieved by transferring assets prior to death or, even better, arranging for the junior generation to acquire them in the first place. If Senior is a New Yorker, New York tax on the transfer is entirely avoided, because there is no New York gift tax.

Our Estate Planning Practice Team

Stuart J. Gross
Mark David Rozen
Quincy Cotton
JoAnn Luehring
Sanford H. Goldberg
Lionel Etra
Stanley S. Weithorn
Debra G. Kosakoff