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YEAR-END INSIGHTS
(Estate and Gift Tax Planning)

As a holiday gift to our clients and friends, we are pleased to provide a select number of unique year-end insights for you to consider as 2010 closes. In this second part of our series, we address estate and gift tax planning.

GIFT TAX PLANNING

It may be counterintuitive to make significant gifts in the current financial climate. Actually, depressed asset values and current ultra-low interest rates make certain gift tax techniques particularly attractive. In particular, falling U.S. Treasury interest rates have forced an important rate used in estate and gift tax planning -- the "applicable federal rate" or "AFR" -- down to a historical low. Taking advantage of techniques that are keyed to low interest rates can lower the risks and costs of giving.

1. Inter-family Loans

Among other uses, the AFR determines the interest rate that a loan must carry in order to avoid classification as a gift. This means that family members may make loans to others at extremely low rates right now. For example, a parent may loan his or her child money to buy a house. A thirty-year loan made in December must carry interest of only 3.53% to be ignored for gift tax purposes. If the child is able to buy a home at a depressed value, the parent's loan is of even greater worth.

Shorter-term loans can bear even lower rates. A loan with a term that is less than three years must pay only .32% annually. The rate for a three-to-nine-year loan is just over 1.5%. If your child uses the loan to invest in property with a higher return, you have essentially transferred value to your child without any gift tax cost.

HINT*: *Low interest rates and depressed values make it a good time to transfer investment opportunities to your family. Rather than making a new investment, loan the purchase price to your family members or trusts for them. The value will grow in their estates instead of yours.

2. Sales to Grantor Trusts for Family Members

Consider establishing an "intentional grantor trust" for the benefit of your family. This is a trust that is not yours for estate tax purposes, but is still treated as your property for income tax purposes. You therefore pay any income tax due on the trust's behalf, and the trust can grow tax-free for your family's benefit.

You may also sell any asset you believe will appreciate to such a trust for cash or a promissory note. This is another "giving" technique that avoids gift taxes. As long as the appreciation on the asset beats the interest rate on the note -- the so-called "hurdle rate," the technique moves value to your heirs without incurring a taxable gift.

> ***HINT*: Because a grantor trust is the same as you for income tax purposes, you can sell an appreciated asset to your trust without triggering immediate capital gain. Also, interest paid to you under a promissory note from the trust is ignored on your return so no taxes are due on the interest.**

3. Grantor Retained Annuity Trusts

To establish a "GRAT," you would transfer assets that you believe will appreciate to a trust. The trust would pay a fixed amount back to you in every year of the trust, and at the end of that term any remaining property would pass to your beneficiaries. Your taxable gift is equal to the value of the property you transfer to the GRAT, reduced by the value of your right to the annuity. Under current law, a GRAT can be "zeroed out," so that the value of the property is equal or nearly equal to your annuity right. Under that circumstance, you can transfer significant value to your beneficiaries with little or no gift tax cost.

In order to successfully transfer significant value to your beneficiaries without gift or estate tax costs, two things must occur. First, you must survive to the end of the GRAT term, and second, the investment return on the assets in the GRAT must equal or exceed the implied present value interest rate on the retained interest.

> ***HINT*: Because of the effectiveness of GRATs, there have been several legislative proposals, not yet passed, that would curtail their use. If this is an attractive technique, it is best to act immediately.**

4. Charitable Lead Annuity Trusts

"CLATs" are similar to GRATs as a leveraged gifting device, except that the annuity payments go to charity rather than back to you, as grantor. Your family can therefore share the benefits by obtaining appreciating property at conclusion of the CLAT, while the charity receives an annual annuity payment from the CLAT. Like a GRAT, under current law, a CLAT can be zeroed out, so that the value of the property you transfer to the trust is equal to the value of the charitable annuity interest. This results in no taxable gift for the transfer of the property, but if the assets outperform the extremely low assumed IRS interest rate, your family will receive property nonetheless.

> ***HINT**: With proper planning, a CLAT established during your life or under your Will at death can be used to endow a foundation or donor advised fund controlled by your family, providing you and your family with a legacy.*

5. Annual Gifts

Each person may give $13,000 per year to any other person or persons, and to certain trusts, without gift tax consequences. This basic mechanism is low-cost, and low-risk or no-risk.

> ***HINT**: You can increase the effectiveness of your annual giving by transferring an asset that is depressed in value, if you expect the value ultimately to recover.*

ESTATE TAX LEGISLATION

The future of the estate tax is a highly politicized issue and is impossible to predict. Under EGTRRA, the 2001 tax reform act, the amount of the estate tax exemption increased over time from $675,000 in 2001 to $3.5 million in 2009. EGTRRA also repealed the estate tax, but because of budget limitations the repeal applies to 2010 only. Many planners believed the year of repeal would never come to pass. Nonetheless, Congressional inaction in 2009 meant that, barring retrospective legislation, the estates of persons dying in 2010 are not subject to estate tax but instead are subject to complicated income tax rules that carry over the basis of inherited assets.

The estate tax is once again the subject of intense Congressional debate. If Congress fails to act, EGTRRA will sunset, and the estate tax will be restored according to 1997 law. Under that regime, each taxpayer's estate will have a $1 million exemption, and the top tax rate will be 55%. There are three main factions in Congress that propose different legislative reforms:

1. Return to 2009 Law

This weekend saw the Senate defeat H.R. 4853, which included the "Middle Class Tax Cut Act of 2010," introduced by Senator Max Baucus (D-Mont), Chairman of the Senate Finance Committee. This bill would have made the Bush income tax cuts permanent only for individuals making under $250,000 per year. It also would have restored the estate tax in essentially its 2009 form:

- The bill included a $3.5 million estate tax exemption, indexed for inflation.
- The top estate tax rate would be 45%.
- The estate and gift tax exemptions would be made consistent, meaning that taxpayers could give away $3.5 million at death or during life.
- A family farm would be exempted from estate tax, if it was kept in the family and retained as a working farm.
- This bill included provisions to limit the use of GRATs, as mentioned above.

2. Increase in Exemption; Decrease in Rates

The second Congressional faction would retain the estate tax, but apply it in an even more limited way. The estate tax exemption would become $5 million, and the top tax rate would drop to 35%. The $5 million exemption means that the estate tax would affect only a tiny fraction of decedent's estates -- about 0.14%.

This group is led by Republican John Kyl of Arkansas and Democrat Blanche Lincoln, who was defeated in the November election. Mitch McConnell (R-Ky) also introduced legislation to this effect in September.

3. Repeal

Finally, a significant bloc of legislators strongly advocates full and permanent repeal of the estate tax. These lawmakers view the estate tax as fundamentally unfair and destructive to family farms and businesses. Republicans Mike Pence, of Indiana, on the House side, and Jim DeMint, of South Carolina, in the Senate, introduced a new repeal bill in late November.

***HINT*: This week, President Obama and the Congressional Republicans generally agreed to the principles of faction No. 2 above, to apply for two years. It still remains to be seen whether the Democrats in Congress will support the principles. Even if Congress does enact the reduction in rates and increase in exemption, it is probable that the states, hurting badly from the "Great Recession," will pick up the slack left behind by the Federal government**

and increase their local rates. For that reason, gift tax planning that takes advantage of current low values and current low interest rates, and minimizes estate taxes, is wise.

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