

Rare Opportunities To Save Estate Taxes—The Perfect Storm



By Graham D. Holding

Rare opportunities are available today for you to save estate taxes by transferring more wealth to family members at reduced or no gift tax cost. You should give serious consideration to these opportunities if you anticipate that the value of your estate at the time of your death will be greater than the federal estate tax exemption amount.

Under current law, the federal estate tax exemption is \$3,500,000 for decedents dying this year, which means that the IRS will not impose an estate tax on those estates valued at \$3,500,000 or less. The estate tax is scheduled to be repealed in 2010 and then be reinstated in 2011 with a \$1,000,000 exemption. However, it appears likely, but by no means certain, that Congress will enact legislation this year making the estate tax permanent and fixing the exemption amount at \$3,500,000. The value of assets in excess of that amount would be taxed at a rate of 45%. The Obama administration supports this approach, which has been proposed in Senate Bill 722 introduced in March of this year.

Right now, there are three circumstances that, considered together, present a window of opportunity to remove more assets from your taxable estate at a lower cost than will likely be available in the future. One commentator has referred to the convergence of these three circumstances as “the perfect storm.” First, the values of stock, real estate and other assets are currently depressed, although there is some evidence that they are bottoming out. Second, federal interest rates used in determining the present value of certain gifts in trusts and the interest rate charged on loans among family members are at historic lows. Finally, there may be only a limited time to make use of valuation discounts on gifted assets because of threatened legislation and IRS regulations that may restrict or prohibit the use of these discounts.

The Advantage of Depressed Market Values

The advantage of gifting assets with depressed market values that may rebound in the future is obvious: more assets can be transferred to family members within the federal gift tax annual exclusion of \$13,000 per recipient and the \$1,000,000 federal lifetime gift tax exemption. A gift of the annual exclusion amount and any appreciation

in value from the date of that gift would be completely removed from the taxable estate at death. The value of gifts in excess of the annual exclusion amount are sheltered from gift tax by the \$1,000,000 lifetime gift tax exemption but are added to the taxable estate at death. However, any appreciation in the value of these gifts would also escape estate taxes at death.

The Advantage of Low Federal Interest Rates

The advantage of making use of low federal interest rates to save gift and estate taxes is less obvious.

1. The 7520 rate. This rate is used to determine the present value of a fixed amount payable at regular intervals to a trust beneficiary during the term of the trust. It changes monthly. The rate is 2.4% in May, an historic low. The 7520 rate, combined with depressed market values, make two estate planning techniques particularly attractive — the grantor retained annuity trust (“GRAT”) and the charitable lead annuity trust (“CLAT”).

A GRAT is an irrevocable trust sanctioned by the IRS regulations to which you, as the grantor of the trust, transfer property while retaining the right to receive a fixed amount payable at least annually for a term of years. At the end of the term any property remaining in the trust (the remainder interest) goes to family members.

The 7520 rate for the month in which the gift is made is used to determine the present value of the annuity interest retained by you. The gift tax value of the remainder interest is determined by subtracting the present value of your annuity interest from the value of the property transferred to the trust. You can select a fixed annuity amount that will result in the present value of your retained interest being equal to the value of property transferred to the trust so that the taxable gift of the remainder interest is zero.

The present value of your retained annuity assumes a yield during the term of the trust equal to the 7520 rate. Thus, the GRAT can result in gift and estate tax savings if property transferred to the GRAT produces an actual rate of return during the term in excess of the 7520 rate. The greater the spread between the 7520 rate and the trust’s actual rate of return, the more assets will pass gift tax free to family members at the end of the term.

If you are charitably inclined, you should consider a CLAT. To establish a CLAT you transfer funds to a trust that pays a fixed amount at least annually to the charity of your choice for a term of years with any property remaining at the end of the term (the remainder interest) passing to family members.

The 7520 rate is used to determine the present value of the annuity payments to the charity. The gift tax value of the remainder interest is determined by subtracting the present value of the charitable annuity interest, which is deductible by you for gift tax purposes, from the value of the property transferred to the trust. As with the GRAT, the remainder interest can be “zeroed out” if you select a fixed annuity amount payable to charity that has a present value equal to the value of the assets transferred to the trust.

Again as with the GRAT, because the present value of the annuity interest assumes a rate of return equal to the 7520 rate, the lower the 7520 rate the more assets will pass gift tax free to family members at the end of the trust term if the assets transferred to the CLAT produce an actual rate of return over the term greater than the 7520 rate.

2. The AFR. The “applicable federal rate” (AFR) is used to determine the interest that must be charged for loans among family members to avoid having the loan characterized as gifts. It is also at an historic low. The AFR ranges from less than 1% to 3.5% depending on the duration and type of loan.

The low AFR makes direct loans to family members particularly appealing now. The lower the AFR the less interest the family member will have to pay and the greater the probability that the total rate of return on the

proceeds of the loan will exceed the AFR and pass gift tax free to the family member to whom the loan is made .

An installment sale to an “intentionally defective grantor trust” (IDGT) makes a more sophisticated use of the AFR. In this technique you sell assets to an irrevocable trust for the benefit of family members in exchange for a promissory note of the trustee payable to you with an interest rate equal to the AFR in effect at the time of sale. The amount by which the total rate of return of the trust assets exceeds the interest rate on the note (the AFR) goes gift tax free to the trust beneficiaries. Because the trust is designed as a “grantor trust,” which means the grantor is treated as the owner of the trust for income tax purpose, no capital gains or losses are realized on the sale of the property to the trust.

Threatened Discontinuance of Discounts

In addition to taking advantage of the current depressed market values and favorable low federal interest rates, there may be a limited timeframe to obtain valuation discounts. Valuation discounts can currently be taken on the value of gifts of limited partnership interests in family limited partnerships, nonmanager interests in LLCs, minority stock in corporations and fractional interests in real estate. The value of gifts of these interests is discounted for lack of control of the underlying asset and/or lack of marketability. Discounts typically range from 15% to 50%. There is a potential for a “homerun” in estate planning when discounted interests are transferred to a GRAT or to an IDGT.

Unfortunately, House Bill 436, introduced in 2009, threatens to eliminate discounts on transfers of nonbusiness assets and restrict the use of discounts in other contexts. We also understand that the IRS, which has resisted the use of valuation discounts in some situations, will “soon” propose regulations on the use of discounts. Thus, there may be only a short period of time to continue to take advantage of valuation discounts.

Conclusion

The current depressed market values, favorable federal low interest rates, and the potential for restriction or elimination of valuation discounts makes the present time an ideal one for lifetime planning to reduce estate taxes. If you think your estate may be subject to estate taxes at your death, you should consider taking advantage of this perfect storm that may never be seen again.

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