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## PERFECT TIME FOR ESTATE PLANNING

By Clay Stevens

For more than eight years, certain congressional Republicans have pushed unsuccessfully for complete repeal of the estate tax. While current law provides that the unified credit equivalent (the amount each person can transfer estate tax-free) increases to \$3.5 million in 2009 and is unlimited in 2010, in 2011 the credit returns to 2001 levels, or \$1 million. The estate tax rate for amounts over the credit, which is currently 45% (and effectively zero in 2010), also reverts to 55% in 2011. President Obama has proposed fixing the credit at \$3.5 million and the tax rate at 45%. In fact, Rep. Earl Pomeroy in the House of Representatives proposed legislation on January 9 to that effect. Although any future legislation is speculative, it is widely expected that changes will occur in 2009 and that Congress won't allow the one-year unlimited credit in 2010 to happen. Therefore, we can and should expect estate tax law changes this year—possibly in the first few months of the Obama administration.

Since the current law effectively reverts back to 2001 levels after 2010, President Obama's proposed plan is *not* revenue neutral. Whether the new legislation will include other estate tax provisions to offset the future revenue decrease, and what these provisions might be, is uncertain. However, since 1998, the legislative agenda of the IRS has included elimination of fractional interest discounts on family controlled entities. An increasing number of members of Congress also appear to favor legislation that would eliminate such discounts, so this area is a candidate to be included in the expected legislation. In fact, the proposed legislation issued on January 9 severely limits the ability to obtain such discounts on most types of property other than actively managed businesses.

Discounts of taxable values are often combined with estate planning transactions, such as Grantor Retained Annuity Trusts (GRATs), sales to Defective Grantor Trusts (DGTs) or outright gifts of Family Limited Partnership interests to achieve wealth transfer objectives. A GRAT is a trust to which the taxpayers transfers property and retains the right to be paid a fixed annual annuity from the trust. The taxable gift is reduced by the value of the annuity and often is set at an amount that reduces the taxable gift to zero. A DGT is similar to the GRAT except that the assets are transferred to the trust in exchange for a promissory note instead of an annuity. Both techniques are used to freeze the value of the property for estate tax purposes and pass the future appreciation to the taxpayer's heirs. These techniques will still be effective even without such discounts, but discounts do increase the likelihood of their achieving tax-advantaged transfers by increasing the size of the tax-advantaged gift.

Some commentators have suggested that Congress may go even further and change or eliminate some of these techniques itself. One change under

discussion would eliminate the ability of the taxpayer to “zero-out” the taxable gift on a GRAT and require the gift to be at least 10% of the original contribution. Although it is possible that any such changes may be made retroactive to January 1, it is more likely that they would be effective only after enactment. For example, the proposed legislation on January 9 provided an effective date for all transfers after the date of enactment. Therefore, the opportunity to use any of these techniques, especially if they are combined with family controlled entities, may be closing.

In any event, even if the law doesn't change, the time to act is especially opportune now. The potential benefits of entering into such planning increased significantly during the past few months. Aside from any discounting on family controlled entities, the two main factors that determine the effectiveness of these techniques are interest rates and valuation. The lower the interest rate required on any annuity or promissory note received in exchange for a transfer of property, the greater the wealth transfer benefits are for the family. For example, if \$5 million in property is transferred to a trust in exchange for a note bearing interest at 2% and the property appreciates at 8%, more than \$300,000 passes gift tax-free per year. The IRS publishes the minimum rates monthly and the rates in February 2009 are the lowest ever by almost 0.5% and almost 2% lower than just a year ago. In addition, with the market downturn, these estate planning techniques provide a great opportunity to “freeze” the value of the property at the current depressed value and to pass the upside to one's beneficiaries. Therefore, aside from any potential estate tax law changes, the current economic environment provides excellent opportunities for estate tax planning.

The downside to any family wealth transfer is the loss of access to the funds, especially given the recent uncertainty in the market and the global economy. However, much of this form of planning simply freezes the value of the estate and the transferor retains access to original value of the transfer through the annuity or promissory note payments. Additionally, flexibility can be built into the plan to discontinue future transfers if the desired wealth transfer has been achieved or the transferor would like to preserve more assets for himself or herself. Therefore, despite the market uncertainty, the likelihood of estate tax law changes along with the extremely favorable current wealth transfer environment makes this the ideal time for such planning. In fact, taxpayers facing a permanent exposure to estate tax of 45% on any amount over \$3.5 million (or \$7 million for a husband and wife)—assuming that's the final legislated amount—will probably never see a more appropriate opportunity than right now.

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