Private Wealth

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AN ESTATE PLANNING TUNE-UP

The market downturn and the shift in political winds make this a perfect time to revisit wealth transfer plans.

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IT SEEMS LIKELY THE FEDERAL ESTATE TAX IS HERE TO STAY NOW that the Democrats rule the White House and Congress. Couple this with the turbulent economy and an increased desire by families to preserve their wealth, and the need for advisors to "tune up" their clients' estate plans is clear.

Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the federal estate and generation skipping transfer tax exemptions went from $2 million to $3.5 million this year. The highest federal estate and gift tax rates remains at 45%. However, on January 1, 2010, the federal estate tax will be "repealed." Exactly a year later, the federal estate tax rate is scheduled to revert back to prior law and return to a confiscatory 55% with a $1 million exemption (the generation skipping transfer tax exemption becomes $1.12 million, subject to further inflation adjustment).

President Obama and the Democratic majority in Congress agree that new federal legislation is required. Obama recently proposed freezing the federal estate tax exemption at $3.5 million, with a top estate tax rate of 45%.

While the law remains in flux, it is a particularly advantageous time for planning wealth transfers. Individuals who have been waiting on the sidelines should take action to ensure their estate plans are in order. Determine the disposition of the assets in light of current goals and objectives and in light of life events and recent changes to wealth. Determine where assets are distributed based on your current balance sheet and asset ownership. Assess potential estate tax liability and how that might be funded. Further, evaluate whether the planned disposition is tax-efficient and incorporates current law. Clearly, if the current plan does not represent your objectives, make appropriate revisions and be mindful to make any necessary changes.

Remember, estate planning is not exclusive to taxable estates above the $3.5 million threshold. There is a universal need that varies based on goals, age, wealth, health and many other factors. A well thought-out plan should protect, preserve and ensure the distribution of assets. Planning for incapacity and the appropriate care for one's self and assets, should such situations arise, is also incredibly important. For this reason, powers of attorney for property and health care, as well as health care directives and living wills, should be reviewed.

Take note of any increases to exemption amounts since your estate plan was last updated. With the increase to the estate and generation skipping transfer tax (GST) exemption, it is particularly important to review your plan in light of two items: retirement assets and state estate tax.

For individuals whose balance sheet consists predominantly of retirement assets, it is important to ensure that these assets aren't allocated to the estate tax exemption and incurring income tax unnecessarily. The many recent developments with retirement plan asset tax rules should not be overlooked.

For clients who live in one of the many states that assess a separate estate tax, it is important to consider that state's exemption. Many states have exemptions that are lower than the federal amount. An estate that is not taxable for federal purposes could be still subject to a state estate tax. Domicile planning, as part of the estate plan, is important.

Don't neglect the benefits of wealth transfer "gifts" from the IRS. These include the annual exclusion amount of $13,000 a year per individual, including the front-loading of 529 plans with five years of the annual exclusion. Also, each person may give $1 million during their life without incurring a gift tax. Finally, gifts for the direct payment of medical and education expenses do not count against annual exclusion gifts. Taking advantage of these freebies avoids the gift tax and may significantly reduce one's taxable estate over time.

Market Losses Offer Opportunity

Deep market declines offer a tremendous estate planning opportunity. Several strategies incur little or no gift tax that, with a market recovery, can successfully transfer wealth to heirs. Strategies such as grantor retained annuity trusts (GRATs), charitable lead annuity trusts (CLATs), intrafamily loans, installment sales to intentionally defective grantor trusts (IDGTs) and statutory freeze strategies transfer to heirs the appreciation on these temporarily depressed asset values above a statutory interest rate—often referred to as the "hurdle rate." In most cases, so long as you outlive the term established, the appreciation is removed from your estate. With asset values and interest rates at historic lows, conditions favor implementing one or more of these strategies.

A GRAT allows taxpayers to transfer future appreciation to beneficiaries. The GRAT returns an annual annuity for a term of years, designed so that the present value of those payments, calculated using the hurdle rate, equals the initial funding amount. The current rates applicable for

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2009 are at historically lowest levels.

If the assets appreciate more than the hurdle rate during the term of the trust, at the end of the term the appreciation will be transferred to the remainder beneficiaries, such as your children or a family trust, resulting in a wealth transfer with an estate tax savings.

The CLAT is based upon the same principles as the GRAT, except that during the initial term the annuity payments go to a charity, such as a family foundation, designated by the grantor. Just like the GRAT, at the end of the CLAT term, appreciation in excess of the hurdle rate passes tax-free to the designated beneficiaries. For the charitably inclined, a CLAT is very advantageous.

An intrafamily loan permits loans to family members using statutory interest rates without gift tax implications. Assuming the loan principal is invested and appreciates more than the interest rate charged, currently 1.94% for 9 years, the appreciation above this interest rate is owned by the borrower with no gift tax and generates an estate tax savings. The lender gets back the original principal plus the annual interest payments.

An IDGT is similar to the intrafamily loan except that the loan is made to finance the purchase of property from the lender. Moreover, the note is made between the lender and a grantor trust structured to avoid income taxes with the sale of the property. The amount of appreciation above the stated interest rate in the note is transferred to heirs, the beneficiaries of the grantor trust. This sophisticated strategy requires some homework and compliance to yield the favorable tax results.

For the large estate, the "statutory freeze," a complex strategy based on corporate and partnership law, should be considered. The statutory freeze allows senior family members to contribute assets in exchange for units with younger family members participating in the investment results. Typically, the senior generation retains general management control over the entity and receives a fixed, cumulative annual return and a fixed value on liquidation with their managing and preferred units.

The junior family members receive units that provide that the excess return, after satisfying the managing unit's interest and the preferred return, is theirs. Although these residual units provide less security, all capital, income and appreciation above the hurdle rate, which is returned to the senior generation transfers the investment gains to the junior family members without incurring gift tax and removes this "excess" appreciation from the senior generation's estate. Low asset values and low interest rates make this strategy particularly attractive for the high-net-worth family.

One often-overlooked strategy is a qualified personal residence trust (QPRT), in which a homeowner transfers an interest in a personal residence to a trust and retains the right to live in the home for a specified term. The homeowner may continue to live in the home after the end of the term pursuant to a lease agreement providing for fair market rental to the successor owners, who are typically the children.

Unlike the previous strategies, QPRTs tend to incur a larger gift tax upon establishment in a low-interest environment. Therefore, QPRTs tend to be used less as interest rates decline. However, given the likelihood the estate tax will continue to be assessed and in a climate of depressed home values, a review of its application is in order.

For individuals whose portfolios have lost significant value, there may be reluctance to consider wealth transfers of their business or investment assets until they see market recovery and have comfort their lifestyle needs are met. A second residence or vacation home with a depressed value may be an asset ripe for wealth transfer through a QPRT. Although there is a gift tax assessed, the tax would be paid based on current depressed values. Paying the tax on today's lower value is more beneficial than paying the estate tax on the future appreciated value.

Conclusion

The time is right for a thoughtful review of clients' estate plans, including a review of health care, property management and tax issues in light of the current economic landscape. Estate plans should be continually monitored and adjusted as life events occur and laws change. Estate planning is a dynamic process requiring continued attention and diligence to realize the best results. Now is an opportune time to act.

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