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Memo

To: MDE Clients & Friends

From: Oleg Ikhelson, JD, CPA – VP of Tax Planning

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Re: Making Your Lemons Into Your Heirs' Lemonade

ARE YOUR LEMONS REALLY YOUR KIDS' LEMONADE?

At the time when real estate prices are plunging and most stocks are taking a heavy beating, it is not intuitive to think about maximizing tax savings. Yet, many estate planners agree that today may present rare wealth transfer opportunities. Most wealth transfer vehicles our clients employ depend on government interest rates and appreciation of underlying asset values. It appears that a combination of low applicable federal rates, and depressed stock prices in today's financial environment present a golden opportunity to turn the already proven techniques into even more successful wealth gifting tools. Take, for example, these three popular wealth shifting arrangements: family loans, intentionally defective grantor trusts, and grantor retained annuity trusts.

Family Loans

Wealthier family members have always been allowed to lend money to their relatives (e.g., children and grandchildren) at the government-set interest rates (so called *AFRs* or Applicable Federal Rates). Historically, these rates have been lower than prevailing bank rates, thereby saving the children significant interest costs with no gift tax ramifications. But today, the discrepancy between the *AFR* and APRs charged by the banks who survived the credit crisis is even more significant. For example, if you would loan some money to your relatives this month (November 2008), you will lock in an *AFR* as low as 1.63% (for short-term loans less than three years, 2.97% for loans three to nine years, and to 4.24% for loans with a maturity of nine years or longer), way below 6.5% or more currently charged by commercial banks.

If you have liquid cash on the sidelines awaiting reinvestment, it may be best to loan this cash to your children and allow them to make the investments at today's depressed equity levels. While they will have to pay you interest based upon the above rates, and will be subject to all the income tax on the investments, all appreciation will accrue to them free of any estate and gift tax.

Further, you can increase your heirs' profits and reduce their costs by utilizing the $12,000 ($24,000 for a married couple) annual exclusion by forgiving the part of the loan principal. In 2009, the exclusion is scheduled to increase to $13,000 ($26,000 for a married couple). In so doing, you will expedite the repayment schedule and reduce the annual interest cost.

Intentionally Defective Grantor Trusts (IDGTs)

The *IDGTs* (or *IDITs*, as some planners call them) are very popular trust strategies, albeit more expensive to set up and maintain. Under some circumstances, it might be the most successful and fastest way to get wealth out of your estate while minimizing the tax impact of the transfer. Success of this technique heavily depends on both probability of asset appreciation within the trust and interest rates. For instance, if the grantor has assets that have a high probability or

appreciation, the grantor sets up a trust (*IDGT*) and transfers these assets to the trust. However, the grantor must make an additional taxable gift to the trust equal to 10% of the transferred assets. With a long-term interest rate of less than 4.25% (or even lower for shorter terms as noted above), the trust will be self-sustaining as long as it can generate that much in annual income. Naturally, all appreciation is now out of the grantor's estate. This is why transferring depressed assets now present a unique chance for the heirs on the rebound.

The other beauty of the trust is that it is set up as a so called *grantor* trust, where the grantor pays income tax on any current income or recognized asset appreciation within the trust during its existence. Furthermore, the grantor does not pay income tax on interest payments he receives from the trust. Nor will he pay any tax on the "sale" of the assets into the trust, because of grantor trust gain recognition rules.

There is always a risk that this technique will not work, even under today's favorable circumstances, e.g., if the trust fails to generate sufficient income to pay the annual loan payment, or the value of the trust's assets decline further. Of course, these risks could be minimized with careful, conservative planning.

Grantor Retained Annuity Trusts (GRATs)

GRATs are another widely used tool in the arsenal of high-end tax professionals. The retained annuity trusts are considered somewhat safer by the estate planning community because they are creatures of the Tax Code and, unlike *IDGTs*, have received the blessing of the IRS. Even though they may result in smaller wealth transfers due to their generally shorter time frame and a 100% annuity going back to the grantor, they also allow the grantor to almost completely eliminate any gift tax. Instead of *AFR's*, the IRS uses so called section 7520 rates with respect to *GRATs*, which today are as low as 3.5%. The more your underlying assets appreciate within the trust, the more successful this technique becomes. Thus, any investments that you believe are on the verge of rebound or a rapid run-up are ideal candidates for inclusion. Arguably, such investments now are represented by market-undervalued public stocks.

As with any estate-planning vehicle, there are risks associated with *GRATs*. One of the more pronounced is the risk of not surviving the trust term. In such case, the assets revert back to the grantor and thus are included in his estate.

GRATs and IDGTs in Conjunction with Family Partnerships

In the recent years, some of our clients have established family limited partnerships (FLPs) holding marketable securities and subsequently gifted limited partnership interest to GRATs and IDGTs for the benefit of their children. This technique allowed a double leverage. These combined techniques not only allowed for the transfer of any upside asset appreciation, but also increased the donee's share in the trust by taking advantage of lack of control and lack of marketability discounts for assets contributed to the partnership.

Shifting Political Winds May Eliminate Some Benefits

Under the current administration, while the IRS has challenged some of the FLP transactions, they placed an emphasis on pursuing improperly structured or abusive transfers, not on the technique itself. However, things are likely to change under the new President. Barack Obama repeatedly stated during his campaign that he favors the economic substance doctrine, (i.e., "substance over form"). He has also promised to close what he calls "the abusive tax loopholes." Most of the sophisticated tax planning vehicles discussed above, even though technically compliant with the taxpayer-friendly rules of the Tax Code, are of the "heads-I-win-tails-I-don't-lose" variety. Thus, a growing number of tax experts predict that many, if not all, of these favorable laws will be amended as soon as the new President takes over. The current rumor mill is speculating that the discount on FLPs will be eliminated on all partnerships but those with demonstrable business purpose. Another rumor has GRATs and IDGTs subject to a minimum 10% gift. Historically, most tax law changes have been enacted in the first year of a new administration. Also, history teaches us that most of those changes were retroactive to the beginning of the first year in Office. This means that anything done today under today's law will probably be grandfathered in, but any transaction done starting 2009 is likely to be reviewed under the new rules.

Conclusion

As you see, the combination of low interest rates, beaten down investment values, and possible changes in federal tax laws creates a perfect inducement to take a fresh look at your estate plan and catch the last train of pre-Obama wealth transfer planning. As our country stands at the door step of potentially overwhelming changes affecting our political system and economic realities, we are anxiously awaiting news on the wealth transfer policies. Will the new President keep his word not to raise the estate tax and not to lower the exemption of $3.5 million currently written into law to take effect in 2009? Only time will tell. However, as we say good-bye to 2008, so too may we say good-bye to many of the tried and true planning techniques that have been the staple of estate planning for many years.

As I wrote to you in my October commentary, we do not know what is going to happen in the future. However, we take pride in our continued ability to provide you with the same level of proactive and creative financial and estate planning advice you have come to rely upon during these past years from MDE, *your family's most trusted advisor*.

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