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Low Interest Rates and A Down Market — An Estate Planning Silver Lining

With the stock and real estate markets down and rates of return falling, people may feel less inclined to make gifts. Yet, this coincidence of low values and low interest rates makes now a particularly favorable time to implement tax-motivated gift techniques. The success of many of these techniques depends on investment performance that beats the IRS assumed rates of return in effect on the date the planning is implemented. Accordingly, the implementation of those techniques when values are depressed and interest rates are at historical lows significantly increases the likelihood that they will result in significant tax-free transfers to the donor's designated beneficiaries.

Low Interest Rate Loans to Family Members and Trusts

Low interest rate loans to children or other loved ones, or to trusts for their benefit, are a powerful and relatively simple way to transfer value to others without using any of the donor's exclusions from gift tax or triggering any gift tax. Such loan arrangements are fairly straight forward. One family member loans funds to another family member or to a trust at the minimum interest rate allowed by the IRS. The loan is documented by a promissory note which requires interest to be paid (or accrued) at the minimum IRS rate then in effect for the term of the loan. The IRS resets the interest rate monthly. For example, the interest rate on a loan of three years or less made in February, 2008 can be as little as 3.11% annually, and the interest rate on a loan with a term between three and nine years can be as little as 3.51% per year.

If the recipient of the loan invests the loan proceeds in an asset that ends up generating more return than the annual interest, then the lender will have effectively made a tax-free gift to the recipient of the difference between the return achieved and the interest paid. For example, if a parent loans a child $1 million for three years at an annual rate of 3% and the child invests that money in a stock portfolio that generates an annual return of 8% per year, then at the end of the three-year term, the parent will have transferred $150,000 to the child without using up any gift tax exclusion or paying any gift tax.

If the loan is made directly to a child or other individual, then, irrespective of what the loan proceeds are used for, the interest paid will be taxable interest income to the lender. The interest paid, however, may constitute an income tax deduction to the borrower if the funds are used to purchase a house (and the loan is properly documented as a mortgage and recorded) or if the funds are used to purchase investment assets.

If the loan is made to an irrevocable trust that is a "grantor trust" created by the lender (i.e., a trust that is treated as the lender for income tax purposes), then the interest paid will not be taxable income to the lender, and the lender will be responsible for all income taxes on the income generated by the trust property. This payment of income taxes on behalf of the trust will allow the trust assets to grow without being eroded by income taxes. The IRS does not view such payments as a gift. Having a trust's income taxes paid by the creator of the trust can be a powerful way of shifting value to younger generations tax-free.

Some parents and grandparents are tempted to make loans without charging any interest or with below market rates of interest. Federal tax law provides that if you loan funds to another individual at no interest or at a below market rate of interest, the IRS will impute interest income to you and impute a gift from you to the borrower in the amount of the interest income. There are a few exemptions to this general rule but they are usually limited to small loans (such as when the loan does not exceed $10,000) or when the borrower has a limited amount of investment income each year.

Tweaking Existing Loans: If you already have loans in place to family members or family trusts, you should review the terms of those loans. If the interest rate currently being charged on a loan is above the IRS required rate now in effect, you may be able to renegotiate the terms of the loan and reduce the interest rate.

Sale to a Grantor Trust

A variation to making a low interest rate loan is to sell an asset with high appreciation potential for an installment note with a low interest rate. The same principles apply as with a loan — if the sold asset has a higher rate of return (income plus growth) than the interest rate on the note, then there will be a gift tax-free transfer of value to the purchaser of the asset. In addition, if a grantor trust is used as the purchaser, neither the sale nor the subsequent installment note payments will trigger any income tax consequences.

For this technique, the donor creates an irrevocable grantor trust. An irrevocable grantor trust is a trust that is structured to be treated as being owned by the grantor for income tax purposes, but which is not includable in the grantor's estate for estate tax purposes. Once the trust is created, the grantor contributes a sum of money to the trust to provide it with seed money to make the purchase. The trust then purchases an asset from the grantor for its fair market value using a cash down payment that is funded with the grantor's contribution to the trust and a promissory note bearing interest at the minimum rate allowed by the IRS for sale transactions. The asset that is sold to a grantor trust should be one that is expected to generate sufficient returns to allow for future repayment of the note. Stock in a family-owned S company is a particularly good asset to use for a sale to a grantor trust because the trust can use the tax dividends paid by the company to pay down the note. If the asset purchased by the trust appreciates at a rate faster than the interest rate on the note, the "excess"

appreciation and the income generated by the asset are removed from the grantor's estate with no gift tax consequences.

> *Example:* *In October, 2004, Google stock was trading at $190 per share and the short-term IRS rate for loans was 2.26%. As of October, 2007, Google stock was trading at $707 per share. Assume that, in October, 2004, a taxpayer with $5 million of Google stock had made a gift of stock with a value of $500,000 to an irrevocable grantor trust and then sold the balance of the stock (worth $4.5 million) to the trust for a three-year installment note with an annual interest rate of 2.26% and amortized payments of $1.57 million each year. There would have been about $10.8 million of stock remaining in the trust in October, 2007 after full repayment of the note. The taxpayer would have used $500,000 of his lifetime exclusion from gift tax to shelter the initial gift from tax — however, the remaining $10.3 million would have been transferred to the trust without triggering any gift tax or using any of the taxpayer's lifetime exclusion. (For purposes of this example, we have assumed that the increase in Google's price occurred evenly over the three-year term.)*

Because a grantor trust is treated as being owned by the grantor for income tax purposes, the grantor does not recognize gain on the sale of the asset to the trust and the payments of interest to the trust do not generate taxable income. In addition, the trust can repay the note by paying some of the assets back to the grantor without income tax consequences. The trust will take the seller's cost basis in the property, but that is the same as would be the case with a direct gift of the property. The grantor trust character of the trust also means that the grantor will pay the income taxes triggered by the trust property and thus that property will be able to grow income-tax free.

Grantor Retained Annuity Trusts

A "grantor retained annuity trust" or "GRAT" is another highly effective estate planning technique that takes advantage of low interest rates. Like a sale, the GRAT technique uses the IRS assumed rates of return to transfer assets to children or other beneficiaries without incurring any gift or estate taxes.

A GRAT is a trust that makes an annual payment (an "annuity") to its creator (the "grantor") starting at the inception of the GRAT and continuing for a fixed term of years. At the end of the annuity term, the property remaining in the GRAT can pass to the grantor's children or to trusts for their benefit. (The grantor's spouse can also be a beneficiary of these trusts after the annuity term.) The trusts can be designed so there is no gift tax upon creation of the trust, thus saving about 50 cents on each dollar that remains in the trust at the end of the annuity term.

The IRS assumes that the total return on any investment (both income and appreciation) is a fixed annual rate and publishes that rate monthly. The assumed rate of return is tied to market interest rates that prevail at the time of the gift. Thus the lower the interest rates in the real world, the lower the assumed IRS rate. In February, 2008, the IRS assumed rate is 4.2% annually.

The value of a gift made to a GRAT is calculated based on the IRS assumed rate of return for the month in which the GRAT is created and the size of the annuity retained by the grantor. When the IRS calculates what it expects will remain in a trust after the

trust pays an annuity for a term of years, it assumes the trust will earn the assumed rate every year regardless of actual investment performance. Thus, if the investment of the GRAT can outperform the assumed IRS rate, some assets will pass to the grantor's designated beneficiaries absolutely free of transfer tax at the end of the annuity term. The higher the assumed IRS rate, the harder it is to outperform. With the interest rates currently at a historical low (much lower than the historical total return on equity securities) the IRS assumed rates may end up being much lower than the actual near-term return of investment assets. This would result in a tax-free transfer of assets at the end of the GRAT term.

Theoretically, there is no limit on the amount of property that can pass tax-free at the end of a GRAT. It all depends upon how well the assets perform. Of course, it is possible that the trust investments will not beat the IRS rate. In that case, nothing may pass to the grantor's children and all the assets will be returned to the grantor. But, if the GRAT is properly designed, the grantor also will not be charged with making a gift, so nothing is lost.

> *Example: In October, 2004, Google stock was trading at $190 per share and the IRS assumed rate of return was 4.4%. As of October, 2007, Google stock was trading at $707 per share. If, in October, 2004, a donor with $5 million of Google stock had transferred that stock to a GRAT which provided for payments to the donor of $1.86 million every twelve months for three years, then in October, 2007, about $9.4 million would have passed tax-free to the remainder beneficiaries designated by the donor in the GRAT. (For purposes of this example, we have assumed that the increase in Google's price occurred evenly over the three-year term.) This tax-free transfer would have cost the donor nothing — no gift tax would have been paid or lifetime exclusion from gift tax used either at the time the GRAT was funded or at the end of the three-year term.*

As illustrated by the above examples of both the sale and the GRAT techniques, a lower interest rate applies to sale transactions and thus a sale can result in more value being passed to the donor's designated beneficiaries tax-free than a GRAT. A sale also has the advantage of being able to successfully transfer value tax-free even if the donor dies during the term of the note. On the other hand, no taxable gift (i.e., a gift that either generates a gift tax or uses the donor's lifetime exclusion) needs to be made for a GRAT and a GRAT provides better audit protection against the IRS challenging the value of the gift property than a sale does.

Fine-Tuning An Existing GRAT: If the stock market's recent performance has made investments that you hold in your own name better candidates for significant growth than those you hold in a GRAT, then you may want to consider making an exchange. In most cases, the grantor of a GRAT may swap assets that he/she owns personally with assets of an equivalent value owned by the GRAT. The swap does not trigger any capital gains taxes and can allow the GRAT to adjust to market conditions without selling any assets.

Generating Estate Tax Savings From Your Charitable Giving

For donors who make sizable charitable gifts each year, a charitable lead trust ("CLT") presents an opportunity to satisfy that charitable giving objective while using the same assumed IRS interest rate that applies to GRATs to make tax-free gifts to children or other beneficiaries. A CLT works in the same manner as a GRAT except that the annual payments are made to one or more charitable organizations rather than to the grantor. Generally, a donor who creates a charitable lead trust does not receive an income tax deduction for the present value of the charitable "lead" interest. Instead, both the income from the CLT assets and the annual charitable gifts are removed from the donor's personal income tax return. Accordingly, a taxpayer who has reached the limit for deducting charitable gifts on a personal income tax return can use a CLT to avoid this limitation since the income of the trust will not be included on the taxpayer's personal return, but the trust will receive a charitable deduction for the amount paid to charity each year.

Down to the Wire With Estate Tax Reform?

It now appears that Congress will not make a concerted effort to address estate tax reform until 2009, after the presidential election and after the estate tax exclusion amount rises to $3,500,000. The continued delay and accompanying uncertainty is bad news. But there is good news. There appears to be widespread agreement, in Congress and among the presidential candidates, that the estate tax system should not revert to the old $1,000,000 exclusion and 55% tax rate.

The major roadblock to implementing a solution is the budget. A permanent increase in the exclusion is expensive; repeal of the estate tax is even more expensive. It has been suggested that Congress may address this conundrum by extending the 2009 exclusion and rate for five or six years. So, for example, we might continue with the $3,500,000 exclusion and 45% rate through 2014. Repeal would occur in 2015, not 2010, and the current planned return to the old system in 2011 would occur in 2016. A later Congress would be left with the job of finding a permanent solution; but with multiple years of a higher estate tax exclusion having been in place, it would be very difficult at that point for Congress to return to a higher tax regime.

Get Organized — Good Planning In Any Economic Climate

How organized are you? Saving taxes is a great objective and can result in significantly more property being passed to loved ones. However, having your estate plan and financial affairs in order in the event of your disability or death is a gift of matchless importance.

In thinking about how organized your family would find your estate planning and finances, consider the following:

1.) **Up To Date Documents**: Do you have an estate plan and powers of attorney for health care and property in place? Have those documents been reviewed within the last five years? Are the fiduciary designations and gifts made in those documents still appropriate? Are there any circumstances of your beneficiaries (such as a disability) that need to be reflected?

2.) **Retirement Account and Life Insurance Beneficiary Designations**: Have you reviewed the beneficiary designations on your retirement accounts, IRAs and life insurance policies in the last five years? This is particularly important for retirement accounts and IRAs as the rules for designating beneficiaries for those plans have changed in recent years.

3.) **Single Location**: Do you have a single location (such as a file cabinet or safe deposit box) where your family can find copies of your estate planning documents and powers of attorney as well as summaries of your assets, life insurance and other key financial information?

4.) **Ownership of Out-Of-State Real Estate**: Do you own any out-of-state real estate in your individual name? If so, then a separate probate court proceeding will likely need to be opened in order to transfer that real estate at your death. This can be avoided by transferring that property to a revocable trust during your life.

5.) **Stock Ownership**: Do you have your stocks and bonds held in certificate form rather than in a brokerage account? If so, then it will take longer and be more expensive to close the administration of your estate due to the paperwork involved with transferring shares held in certificated form.

6.) **Division of Assets**: If you are married, have you reviewed within the last year how you and your spouse's assets are divided between yourselves? If one spouse has assets in excess of the lifetime exclusion from estate tax (currently $2 million) and the other does not, then some unnecessary estate tax may be triggered at the death of the survivor of you unless additional assets are transferred to the less wealthy spouse.

Protect Your Identity & Your Credit

New Year's Resolution

Identity theft is one of the fastest growing crimes and has been written about extensively. Yet, many people are not doing what they can to protect themselves from having their identity stolen and their credit compromised. Are you? All that a thief needs is your name, address, date of birth, social security number and mother's maiden name. With that information, the thief can (i) obtain credit cards, loans and services in your name, (ii) open bank accounts in your name (and write bad checks), and (iii) rent (and not return) a car or other merchandise.

The following steps can go a long way in protecting yourself from identity theft. Consider how many you can take without disrupting your routine.

1.) **Secure and Monitor Your Mail**: Retrieve your mail promptly, and stop your mail or have a neighbor promptly collect it when you are on vacation. If you move, have your mail redirected for 12 months. Follow-up with a financial institution if an account statement or credit card bill is not received. Regularly check your credit card and bank statements for charges you did not make.

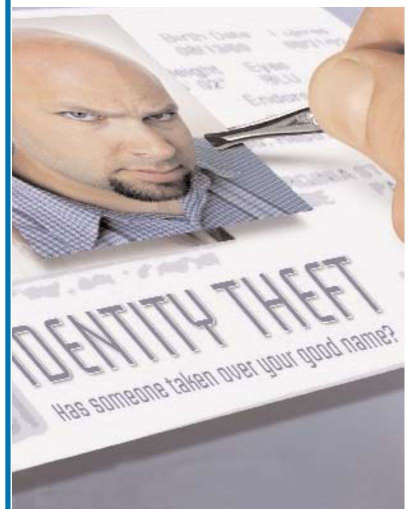
2.) **Keep Documents Secure and Shred Discarded Items**: Do not carry your Social Security card or passport with you unless necessary. Keep blank checks and statements secure. Use a paper shredder for any financial and personal information you discard.

3.) **Do Not Give Out Personal Information and Restrict The Use of That Information**: Do not give out personal data over the phone unless you made the call. Do not give out your Social Security number unless required to do so (such as for tax purposes). Limit your calls by registering on the National Do-Not-Call Registry (see www.ftc.gov/donotcall). Direct the credit companies not to share your personal data for promotional purposes: (i) Equifax Inc., Options, P.O. Box 740123, Atlanta, Georgia 30374-0123; (ii) Experian, Consumer Opt-Out, 701 Experian Parkway, Allen, Texas 75013; (iii) TransUnion, Marketing List Opt Out, PO Box 97328, Jackson, MS 39288-7328.

4.) **Opt Out**: Opt out of all of the following: (i) Pre-screened credit card offers (call 1-888-567-8688), (ii) Direct mail (write The Direct Marketing Association, Mail Preference Service, PO Box 643, Carmel, NY 10512), (iii) Telephone solicitations (write The Direct Marketing Association, Telephone Preference Service, PO Box 1559, Carmel, NY 10512).

5.) **Credit Reports**: Check your credit report each year (visit www.AnnualCreditReport.com or call 1-877-322-8228).

6.) **Computer Protection**: Use virus protection and firewall software and a secure browser. Use passwords that consist of both letters and numbers and that are not your kids' names or birthdates. If a form asks for your mother's maiden name, use a password instead. Before you dispose of a computer, delete the personal information (take a hammer to it) and use a "wipe" utility program to overwrite the hard drive and make the files unrecoverable.



If you are the victim of identity theft: (i) Fill out a police report, (ii) Cancel cards and close accounts that may not be secure, (iii) Call the FTC Identity Theft Hotline at 1-877-IDTHEFT, (iv) Fill out an identity theft affidavit at www.consumer.gov/idtheft, (v) Report the fraud to the credit companies: Equifax: 1-800-525-6285, Experian: 1-888-EXPERIAN; TransUnion: 1-800-680-7289, and (vi) Check www.consumer.gov.

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