"Tune Up" Your Estate Plan in Anticipation of Sweeping Changes to Estate Taxes

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There is a strong indication that the Congressional log-jam that has plagued the estate tax since 2002 will be cleared temporarily and then, hopefully, permanently. Let's couple this expected Congressional action with the recent turbulent economic environment and an increased urgency to seek preservation of family wealth and the need for an estate plan "tune up" is clear. A current estate plan update and review should increase the expected planning benefits.

Introduction

Under the Economic Growth and Tax Relief Reconciliation Act of 2001, this year saw an increase to the federal estate and generation skipping transfer tax exemptions from $2.0 million to $3.5 million. The highest federal estate and gift tax rates remains at 45 percent. On January 1, 2010, however, the much-touted one-year estate tax repeal is still, currently, slated to occur and there will be a suspension of the levy of federal estate tax.

Further, on January 1, 2011, the federal estate tax rate will revert back to prior law and return to a 55 percent rate with a federal estate tax exemption amount of $1 million. The generation skipping transfer tax exemption becomes $1.12 million, subject to further inflation adjustment.

The Congressional majority agrees that new federal legislation should stop this repeal and reversion to prior law, and soon. In fact, it is expected that an extension of the current 2009 estate tax rates is inevitable before the close of this year's Congressional session.

This extension would include a freeze of the federal estate tax exemption amount at $3.5 million, with a top estate tax rate of 45 percent with no repeal. And, this extension would allow Congress to address some of the more pressing matters and to readdress a permanent estate tax solution, as well as other tax reforms, in the future.

A summary of the gift and estate tax rates and the estate tax exemption amounts—for the period of 2001 through 2010—is presented in Exhibit 1.

Review Your Current Estate Disposition

While the law remains in flux, it is a particularly important time for planning wealth transfers. Individuals who have been waiting on the sidelines should take action to confirm that their estate plan is in order. To begin, you should evaluate your current plan. You should determine the disposition of the assets in light of current goals and objectives, as well as life events and recent changes to wealth.

You should determine where assets should be distributed based on your current balance sheet, asset ownership and beneficiary designations. You should assess your potential estate tax liability and how that may be funded. Further, you should evaluate whether the disposition of these assets will be completed in the most tax-efficient manner.

This estate plan review should assess if the plan (1) incorporates current law, (2) maximizes tax efficiency, and (3) distributes assets appropriately to heirs and/or charity according to your desires. If your current estate plan does not represent your objectives, then you should (1) make appropriate revisions and (2) be mindful to make changes in conjunction with plans for incapacity and current wealth-transfer strategies.

Estate Planning Is Not Exclusive to Taxable Estates

It is noteworthy that estate planning is not exclusive to taxable estates above the $3.5 million threshold. There is a

Exhibit 1
Phase-out Schedule: Estate, Gift, and GST Tax Rates

	Year	Estate tax exemption	GST tax exemption	Gift tax exemption[1]	Top estate & GST tax rates[2]	Top gift tax rate[1]
	2001	$675,000	$1,060,000	$675,000	55%[3]	55%
Phase-out	2002	1,000,000	1,100,000	1,000,000	50	50
Phase-out	2003	1,000,000	1,120,000	1,000,000	49	49
Phase-out	2004	1,500,000	1,500,000	1,000,000	48	48
Phase-out	2005	1,500,000	1,500,000	1,000,000	47	47
Phase-out	2006	2,000,000	2,000,000	1,000,000	46	46
Phase-out	2007	2,000,000	2,000,000	1,000,000	45	45
Phase-out	2008	2,000,000	2,000,000	1,000,000	45	45
Current year	2009	3,500,000	3,500,000	1,000,000	45	45
Full repeal	2010	0	0	1,000,000	0	35[4]
	2011 & after	1,000,000	1,120,000	1,000,000	55	55

Notes:
Credit for state estate taxes phased out: the federal credit for state estate taxes was eliminated in 2005. Depending on the taxpayer's domicile at death and taxable estate, total estate taxes could actually increase based on payment of additional state estate taxes.
New carryover basis: New "step-up" rules will be implemented in 2010. Step-up will be limited to adding $1.3 million of basis to property selected by the executor for assets transferred, plus an additional $3 million step-up for assets transferred to a surviving spouse.
1. The gift tax is not scheduled to be repealed under this law.
2. Top rates apply to transfers of more than $2.5 million.
3. The 5% surcharge on taxable estates larger than $10 million is repealed.
4. In 2010, the top gift tax rate will equal the highest ordinary income tax rate.

universal need for estate planning based on goals, life-stage, wealth, health, and many other factors. A well-thought-out estate plan should protect, preserve, and distribute assets according to the plan.

It is also important to plan for incapacity and for the care of yourself and your assets should such a need arise. For this reason, powers of attorney for property and health care—as well as health care directives and living wills—should be reviewed as part of your estate plan update.

Additionally, naming the appropriate parties to care for minor children, yourself, and your assets is important. You should confirm that the right parties (and successors) are selected to act as guardian for minor children, health care representative, attorney in fact, executor and trustee, where applicable. Also, you should name your desired beneficiaries.

Consider the Implications of the 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 estate plan in light of two items: (1) retirement assets and (2) state estate tax.

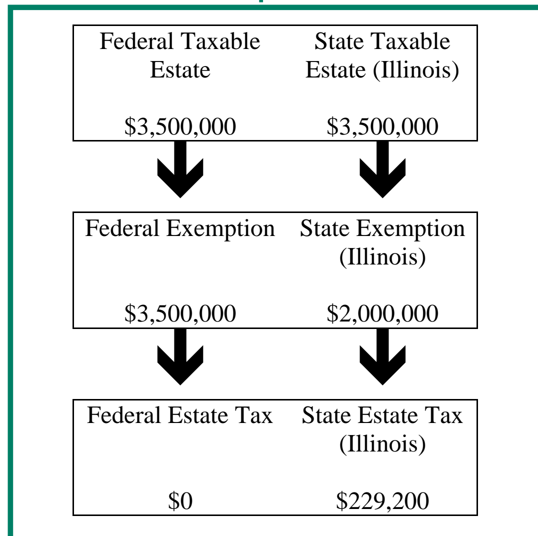
Let's consider individuals whose balance sheet consists predominantly of retirement assets. It is important to ensure that these assets are not allocated to the estate tax exemption to the detriment of either meeting the needs of a surviving spouse or overall family wealth by either (1) overfunding or (2) incurring income tax unnecessarily. The recent developments with retirement plan asset tax rules should not be overlooked.

For individuals who live in one of the many states that assess a separate state estate tax, it is important to consider that state's estate exemption amount. Many states have estate exemptions that are lower than the federal exemption amount. For this reason, an estate that is not taxable for federal purposes could still be subject to a state estate tax.

It is noteworthy that Illinois, for example, has recently implemented a law that allows the estate of the first spouse to die the ability to defer payment of the state estate tax. The first spouse may make an election for Illinois estate tax purposes, such that the state estate tax will not be due until the death of the second spouse.

A comparison of the federal estate tax exemption and the Illinois estate tax exemption is presented in Exhibit 2.

Exhibit 2
Comparison of Federal and Illinois Estate Exemption Amounts



Take Advantage of the Wealth Transfer "Gifts" from the Service

Once the basic estate elements are covered, consider the wealth transfer "gifts" from the Internal Revenue Service. These "gifts" include the annual exclusion amount of $13,000 a year per individual, including front-loading of Section 529 plans with five years of the annual exclusion. Also, each person has the potential to give up to $1 million during his or her life without incurring a gift tax.

Also, gifts for the direct payment of medical and education expenses to the health care or education institutions may not count against annual exclusion gifts. Taking advantage of these Internal Revenue Service "gifts" provides the potential to avoid the gift tax and may significantly reduce your taxable estate over time.

Take Advantage of Wealth Transfer Strategies That May Be Beneficial in the Current Economic Environment

Deep market declines present a tremendous potential estate-planning opportunity. Several strategies incur little or no gift tax that, with a market recovery, could successfully transfer wealth to heirs. As indicated in Exhibit 3, strategies such as grantor retained annuity trusts (GRATs), charitable lead annuity trusts (CLATs), intra-family loans, and installment sales to intentionally defective grantor trusts (IDGTs), are designed to transfer to heirs the appreciation on these temporarily depressed asset values above a statutorily specified interest rate, often referred to as the "hurdle rate."

So long as you outlive the trust term, the appreciation may be removed from your estate. With asset values and interest rates at historical lows, conditions may favor implementing one or more of these planning strategies now.

A GRAT allows a taxpayer 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 2009 are at historically low levels.

As illustrated in Exhibit 4, let's assume that your assets appreciate more than the hurdle rate during the term of the trust. At the end of the GRAT 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.

It is notable that there is a proposal (included in the Obama Administration Budget proposal) that may impair the viability for GRAT implementations in the future by requiring a 10-year term versus the currently available shorter 2-year term. A 10-year term requirement would subject the strategy to a higher risk of failing due to increased mortality risk (i.e., the risk that you die during the term of the trust). As noted above, in order for the GRAT strategy to successfully transfer assets to your heirs, you must outlive the trust term.

The possibility of imposing a gift tax with GRAT creation is also being discussed. As the term rules and gift imposition are only proposals currently, GRATS remain a favored and potent planning solution that should be considered currently, although legislative activity should be monitored.

The CLAT is based on the same principles as the GRAT, except that during that 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 those who are 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 2.59 percent 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 loan principal plus 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 your heirs, who are the beneficiaries of the grantor trust. This sophisticated strategy requires some homework and compliance in order to yield favorable tax results.

Exhibit 3
Structural Overview of a GRAT, CLAT, Intra-Family Loan, IDGT, and QPRT

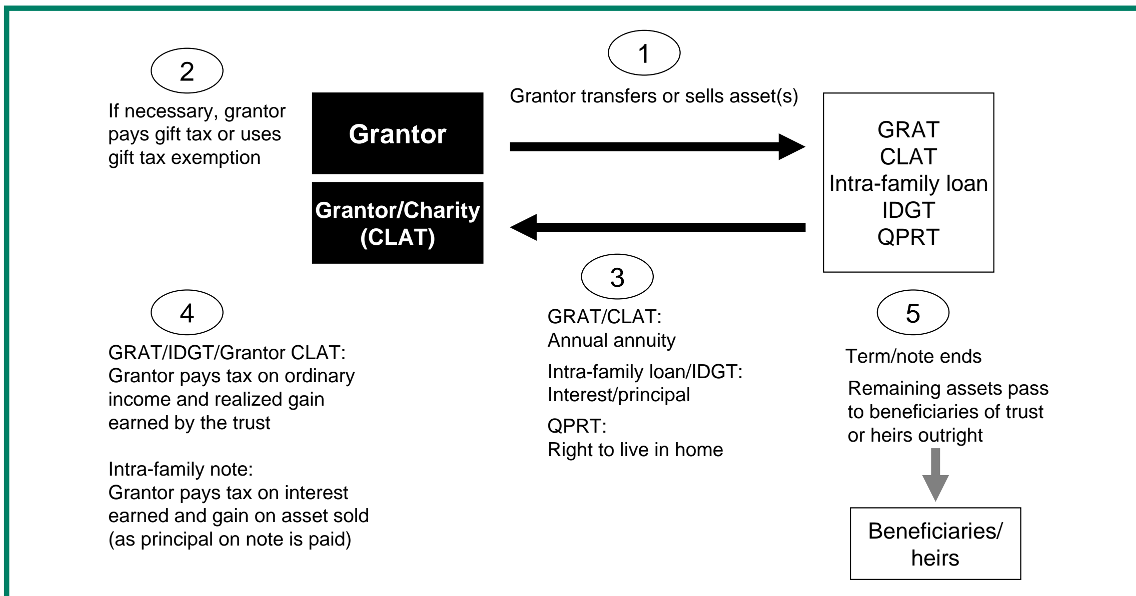


Exhibit 4
Appreciation in Excess of "Hurdle Rate" Represents a Tax Free Gift

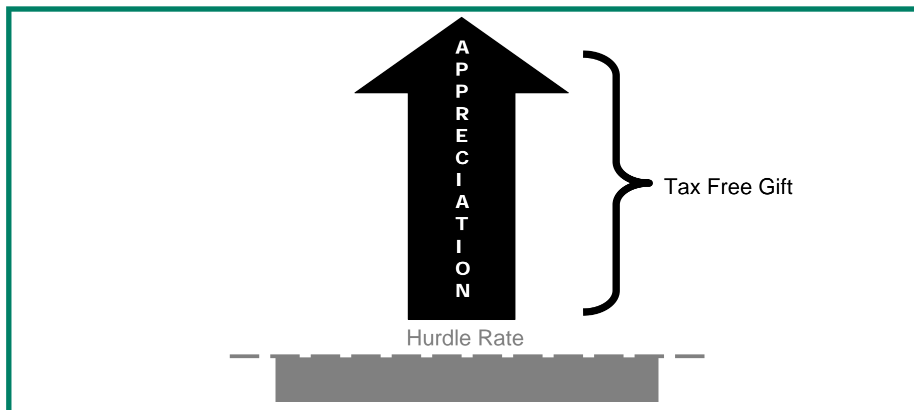
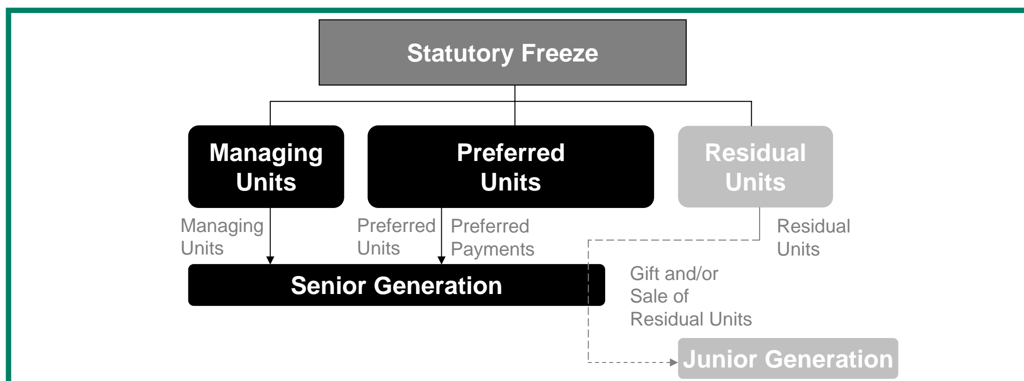


Exhibit 5
Typical Structure of the Statutory Freeze Estate Planning Procedure



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 positive investment results.

As illustrated in Exhibit 5, typically, the senior generation (1) retains general management control over the entity and (2) receives a fixed, cumulative annual return and a fixed value on liquidation with their managing units and preferred units.

The junior family members receive units that provide for the excess return, after satisfying the managing unit's interest and the preferred return. Although 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. Furthermore, although there are proposals to eliminate some valuation discounts in an estate tax context (a common component of the family entities used in estate planning), these proposals would not be wholly applicable to a statutory freeze implementation.

Don't Forget the Qualified Personal Residence Trust (QPRT)

An often overlooked planning strategy is a QPRT. With a QPRT, the homeowner (1) transfers an interest in a personal residence to a trust and (2) retains the right to live in the home for the 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 new successor owners (the children).

In comparison to the strategies previously discussed, QPRTs tend to incur a larger gift tax upon establishment due to the current lower-interest-rate environment. Therefore, QPRTs tend to be in less favor as interest rates decline. However, (1) given the likelihood that the estate tax will continue to be assessed and (2) in a climate of depressed home values, a review of its application is in order.

Individuals with portfolios that have lost significant value may have a reluctance to transfer their business or investment assets until they (1) see market recovery and (2) are sure that 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 gift tax would be paid based on current depressed values. Paying the gift tax or using lifetime gift exemption on today's lower value may be more beneficial than paying the estate tax on the future appreciated value.

Reevaluate Wealth Transfer Strategies That Are Already in Place

For individuals who have implemented estate planning strategies, opportunities may exist to be defensive in repairing and building on the existing plan. It is increasingly important to review the performance of existing estate plan strategies. GRATS, for example, may have options for estate plan repair such as rebalancing the investments, substituting assets or purchasing the assets.

It is also an opportune time (1) to review the terms of any intrafamily loan arrangements and (2) to refinance installment sales to grantor trusts. With the current low interest rate environment, it may be beneficial to modify the borrowing terms.

Summary and Conclusion

With depressed asset values and some certainty from the lawmakers in Washington, D.C., that the estate tax is here to stay, it may be time to take action by:

- thoughtfully reviewing your current estate plan so as to ensure that your goals are met,
- remembering health care decisions and property management planning needs,
- ensuring that the right parties are named to act for you and to receive your assets,
- using the Internal Revenue Service "gifts" and other wealth-transfer techniques to take advantage of the currently depressed economic landscape, instead of sitting on the sidelines,
- reviewing current wealth-transfer plans and making plan repairs and enhancements where possible, and
- continually monitoring and adjusting your estate plan as (1) major life events occur and (2) there are anticipated changes to the existing transfer tax law.

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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