Silver Lining: Year-End Planning Strategies in Challenging Economic Times

Not a day goes by without troubling economic news. Yet, these times present important opportunities and challenges for estate and gift tax planning due to the current environment of depressed markets and low interest rates. This special client alert will highlight some of these planning strategies and challenges.

Grantor Retained Annuity Trusts

A grantor retained annuity trust (commonly known as a "GRAT") permits an individual to transfer appreciation in the value of trust property at little or no gift tax cost. The individual contributes property to the trust, and in exchange receives a dollar-specific annuity (payable in cash or in kind) for a term of at least two years. The present value of the annuity is calculated based on the value of the assets contributed to the trust and a discount rate set by the IRS for the month in which the GRAT is funded.

The annuity payments are typically set at a level that virtually eliminates any possible gift tax. If the trust's assets grow (income and appreciation) at a rate faster than the IRS rate (3.6% for GRATs funded in November 2008 or 3.4% for GRATs funded in December 2008), the assets remaining in the GRAT at the end of the term after payment of the last required annuity payment pass to the remainder beneficiaries of the trust without any gift tax.

If you own stock that you believe (or at least hope) is likely to appreciate substantially over the next few years, you may want to consider creating a GRAT to take advantage of the current depressed prices and low IRS discount rate.

A common variation on the GRAT strategy is to employ a series of "rolling" or "cascading" GRATs. This strategy involves taking the annuity payments received each year and creating a new GRAT to hold such payments for a similar term. Recent financial research indicates that a series of rolling short-term GRATs funded with publicly-traded stocks is more likely to succeed at transferring wealth than an identically funded long-term GRAT. Thus, if you have already created a GRAT from which you are currently receiving annuity payments, you may want to consider creating a new two-year GRAT this year and in each subsequent year in which you receive annuity payments to take advantage of such research results.

Low-Interest Loans to Family Members

Loans (including interest-only loans) may be made to family members, or to trusts for their benefit, without running afoul of technical rules that give rise to gift and income tax consequences for "below-market" loans, provided that interest is charged on the loans at a rate at least equal to the "applicable federal rate" ("AFR") in effect for the month in which the loan is made. These rates are divided into three general categories, depending on the length of the loan: (a) the short-term AFR applies to loans that are not over three years, (b) the mid-term AFR applies to loans that are over three years but not over nine years, and (c) the long-term AFR applies to loan over nine years. For loans made in November 2008 with annual interest payments, the short-term rate AFR is 1.63%, the mid-term AFR is 2.97%, and the long-term AFR is 4.24%. For similar loans

made in December 2008, the short term AFR is 1.36%, the mid-term AFR is 2.85%, and the long-term AFR is 4.45%.

These low interest rates offer a prime opportunity to lend funds to family members to allow them to purchase assets. To the extent that the return on the assets purchased by the borrower with the loan proceeds is greater than the AFR, the lender effectively is permitted to make a transfer free of gift tax of the difference between the investment return and the interest rate being paid.

Further, in the current tight credit markets, borrowing from family members can be a viable means of providing liquidity to younger generation family members to purchase residences or fund businesses without requiring the senior generation family members to make costly gifts and incur a gift tax liability. One must be careful, however, to properly document each such loan, and the borrower should have the ability to repay the loan. Failure to abide by the loan terms may cause the transaction to be recharacterized by the IRS as a gift.

Gifts and Sales to Intentionally Defective Grantor Trusts

Gifts and sales of assets to an "intentionally defective grantor trust" ("IDGT") established for family members can provide a number of tax benefits. Transfers to an IDGT, whether made by gift or sale, are completed transfers (and thus "effective") for gift, estate tax, and generation-skipping transfer tax purposes. However, for income tax purposes, the transfers are not complete (and thus "defective").

A properly structured sale or gift of assets to an IDGT removes the assets from the transferor's estate, and this allows future appreciation and income to be transferred to the trust beneficiaries without any further gift or estate tax liability. However, in the case of a sale, the unpaid balance of any promissory note given in connection with the sale remains an asset of the transferor's estate, as do the income and principal payments received as loan payments that remain on hand at the transferor's death.

As long as the IDGT remains a "grantor trust" under federal income tax law, the transferor remains responsible for all income tax liabilities arising from the IDGT's taxable income. However, payment of such liabilities by the transferor does not constitute a gift to the trust beneficiaries under current tax law, and such payment by the transferor increases the IDGT's after-tax growth. In addition, because the transferor is treated as the "owner" of the trust for income tax purposes, the sale of assets by the transferor to the trust does not give rise to recognition of capital gain on the transaction or income tax liability to the transferor for the interest received under the promissory note. However, if the trust ceases to be a grantor trust in the future (because of the transferor's death, a beneficiary's right to withdraw assets, or for other reasons), gains may be taxable at such time.

At current depressed market values and low AFR rates, significant potential future appreciation can be transferred by means of an IDGT at relatively minimal cost. Further, depending on the nature of the assets being transferred, valuation discounts may be available to reflect lack of marketability, minority ownership, or other attributes of the transferred interests, which in turn can reduce the transfer costs.

Gifts of Non-Qualified Stock Options

Key employees often receive non-qualified stock options as a form of compensation. In the current depressed market, there may be planning opportunities that will allow the transfer of wealth to family members at a reduced transfer tax cost. This type of transfer can be particularly appealing where the option holder believes that the current depressed price is not reflective of the company's underlying strength, and that it will simply be a matter of time before this value is once again recognized in the marketplace.

For example, consider an executive employed at Solid Company who is granted the right to acquire 5,000 shares of Solid Company at the price of $25 per share. The terms of the option grant specify that the option will vest over five years at the rate of 1,000 shares per year. The option will expire if not exercised within ten years from the grant date. Assuming the option plan has been properly structured, the executive will not be required to recognize income for income tax purposes either on the date of the grant of the option or when the option later vests, but rather only if and when the option is actually exercised to purchase the stock. At that time, the executive will recognize taxable income at ordinary income tax rates based on the difference between the option exercise price ($25 in this example) and the fair market value of the stock at the time of option exercise.

If the plan so permits, the executive may transfer his non-qualified stock options to family members. Assume the executive transfers his vested option rights to purchase 3,000 shares of Solid Company to his children. The executive will need to obtain an appraisal for gift tax purposes of the value of the transferred stock options. A depressed and volatile market like what we have been experiencing lately will reduce the value of the option and, as a result, the gift tax cost to the executive in making the transfer. If the executive's children later exercise the option at a time when the value of Solid Company shares has recovered, the children will be able to realize the appreciation in the stock value. In addition, the children will benefit from the executive's payment of the income tax liability that arises on the exercise of the stock option. Because the executive continues under tax law to be legally obligated to recognize the income on the exercise of the stock option, the payment of the executive's income tax liability arising as a result of the option exercise is not considered a gift by the executive to his children under current law.

If you own nonqualified stock options that have declined in value in light of current market conditions, you may want to explore the possibility of gifting such options to family members.

Charitable Contributions from IRA Accounts

If you are age 70½ or older and own an Individual Retirement Account ("IRA") from which you must take a required minimum distribution before year-end and you also are charitably-minded, a special provision in the tax law was recently extended that can provide significant tax savings in 2008 and 2009. You may arrange to have up to a maximum of $100,000 from your IRA account distributed by the trustee of your IRA directly to a qualified charity of your choice in 2008 (and, if so desired, again in 2009). The amount of this qualified charitable distribution is excluded from your gross income for federal income tax purposes; nonetheless, the distributed amount is applied against your IRA minimum distribution requirement for the year. Since neither you nor the charity pay income tax on the distribution from the IRA account to the charity, this allows 100% of those funds to be directed for charitable purposes. Note, however, that you are not allowed to also claim a charitable income tax deduction for the amount distributed to the charity from your IRA. Further, the selected charity must be a public charity, rather than a donor-advised fund or a private foundation.

Review of Estate Plan

In light of the severe decline in value across multiple asset categories, you may need to review your estate plan to determine if changes are appropriate. The drop in asset values may have significant and unintended consequences under your estate plan.

For example, consider a married individual with a gross estate for estate tax purposes of $15,000,000, whose estate plan provides for an estate-tax free gift of $5,000,000 to the individual's children from a prior marriage, with the after-tax balance of assets to be distributed to the individual's spouse. Using the 2009 estate tax rate and exemption, the estimated federal estate tax under this estate plan would be approximately $1,227,275, thereby leaving $8,772,725 for the surviving spouse. However, if the value of the individual's estate has dropped to $10,000,000, the surviving spouse's share of the estate after the payment of federal estate tax will shrink to $3,772,725.

The same dramatic change would apply in the case of an unmarried individual initially having a gross estate of $15,000,000 that drops to $10,000,000, where the individual's plan provides for a gift of $5,000,000 to children with the balance passing to charity. While the plan as drafted would result in charity receiving approximately $8,772,725 if the individual's estate is valued at $15,000,000, the gift to charity will shrink to $3,772,725 if the value of the individual's estate has dropped to $10,000,000.

Conclusion

While declining net worth statements and balance sheets do not give cause to cheer, they do present unquestionable planning opportunities to allow for the transfer of wealth at reduced transfer tax costs. As you approach the holiday season and take stock of your year-end tax planning strategies, consider this at least a modest silver lining. We would be pleased to discuss these planning opportunities with you if you have any questions. We wish all of you a peaceful and prosperous new year.

For more information about any of the techniques and strategies discussed in this newsletter, or any other income or estate tax planning assistance, please feel free to contact any member of our High Net Worth Family Practice Group.

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