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The Time to Act is Now For Incredible Tax Planning Opportunities!

By Richard M. Morgan & Loraine M. DiSalvo

What do you get when you mix low business, real estate, and other asset values with historically low interest rates and a historically low gift tax rate? Incredible tax planning opportunities!

The economic turmoil which surrounds us today has caused many people to freeze, afraid to make changes to their assets. However, this same economic turmoil creates great opportunities for proactive tax planning.

Among its many other benefits, well-done estate planning can significantly reduce the impact of various taxes on assets which you want to transfer to your loved ones, either during your lifetime or at your death. The federal wealth transfer taxes are the Estate, Gift, and Generation Skipping Transfer ("GST") taxes. Many states also have similar wealth transfer taxes.

How can the current economic situation help you with your estate planning? First, understand that, when making any estate planning transfer, the goal is usually to transfer as much value as possible, while minimizing the tax and other costs of the transfer. The sooner you begin making estate planning transfers during your lifetime, the better your ability to maximize the value of those estate planning transfers. Part of the benefits of a lifetime asset transfer (a gift) often result from the fact that, by making the gift, you have prevented the future income and appreciation on the transferred assets from being included in your estate for estate tax purposes, in addition to removing the value of the transferred assets themselves. For example, the value of a $1 transfer at death is $1, but the value of a $1 gift during your life is equal to $1 plus all the income and appreciation on that dollar after the date of the gift.

Next, understand that most advanced lifetime estate planning requires you to actually make some type of transfer while you are still living. Sophisticated estate tax planning techniques can sometimes let you keep effective access to and control over transferred assets, but to benefit for estate tax purposes it is still usually necessary to actually give something away. The best way to approach lifetime estate planning is to first work with your advisors to determine ways in which you can feel comfortable with the transfers you plan to make and their effect on your life, and then work with your advisors to figure out how much you can transfer, and how quickly, without negative tax consequences.

Determining how much and how quickly assets can be transferred without negative tax consequences is where low asset values, historically low interest rates, and a historically low gift tax rate can really help. Many estate planning related transfers are required to use a certain federally-prescribed interest rate, which is known as the Section 7520 rate. For the transfers it applies to, the Section 7520 rate effectively sets the "hurdle" rate of return which the transferred assets have to exceed for the transfer to really produce a good tax planning result. The Section 7520 rate for transfers taking place during October 2010 is at a historical low of 2%. This means that assets transferred in some types of estate planning transfer during October 2010 need only generate a rate of return higher than 2% after the transfer in order for the tax benefits of the transfer to be realized. The greater the extent to which the rate of return earned on the transferred assets actually exceeds the Section 7520 rate, the greater the tax benefit realized. Other techniques can help reduce the effective tax rate paid on transfers.

Consider the following techniques:

1. **Net Taxable Gift.** If your assets are valuable enough to cause a large estate tax at your death, making a large lifetime transfer now could be hugely beneficial to your family or other intended beneficiaries ("your loved ones"). The net taxable gift technique involves making a gift which is large enough to exceed your remaining $1,000,000 gift tax lifetime exemption. A gift tax actually becomes payable on the amount of the gift which exceeds your remaining gift tax lifetime exemption. While normally the person making the gift pays any resulting gift tax, in this technique the recipient of the gift agrees to pay the gift tax generated by the gift, and pays the tax with either the gifted assets or other funds. The agreement to have the gift recipient pay the gift tax effectively reduces the tax rate actually paid on the gifted assets, since the final value of the gift for gift tax purposes equals the value of the gifted assets reduced by the value of the taxes paid by the recipient. The gift tax for 2010 is already at the historically low rate of 35%, and the opportunity to reduce that rate further can produce great results. For example, if you make a taxable gift during 2010, the gift tax will be initially determined based on the 35% rate. By having the recipient agree to pay the gift tax, the effective gift tax rate can be reduced to approximately 26%. Contrast this 26% effective rate to the potential 55% gift tax rate which is scheduled to take effect on January 1, 2011. In addition, as with any other gift, the future income and appreciation on the gifted assets (and possibly the gift tax paid) should be removed from the estate and gift tax system. The benefits of a net gift can be combined with the benefit of other estate planning techniques, such as trusts and related party loans, for even better results. Of course, most of the benefits to lifetime taxable gifts which are discussed here will still apply under the rules scheduled to take effect in 2011, but the effective rate realized will not be nearly as low as the 26% which could be achieved through a net gift in 2010, and the opportunity to use assets which are suffering from depressed values to make the gift may disappear in the future as the economy eventually recovers. We don’t often recommend that clients pay taxes before they absolutely have to. However, the potential benefits available through gifting transfers during 2010 are significant enough that, if you are in the right situation, you should strongly consider prepaying some gift taxes at this time.

2. **Charitable Lead Annuity Trust ("CLAT").** If you are facing the possibility of a large estate tax at your death and you are charitably inclined, you can use a properly structured CLAT to provide a beneficial stream of payments to your favorite charity while also transferring a significant amount of assets to your loved ones with reduced or eliminated wealth transfer taxes. The savings results from the fact that the eventual gift to your loved ones is equal to the value of the assets transferred to the CLAT, less the value of the stream of payments to be made to the charity. While CLAT transactions have been around for a long time, they are especially

beneficial now because of the historically low interest rates. In addition, bright minds in the estate planning world have developed a number of alternative structures which can really allow you to take full advantage of this low interest rate environment using a CLAT. The types of charitable beneficiaries can include not only your favorite public charities, but can also include your own charitable family foundation.

3. **Grantor Retained Annuity Trust ("GRAT").** If you are facing the possibility of a large estate tax at your death and you are not particularly charitably inclined (or you have already made provisions for the benefit of charities and don't want to add to those), you can use a GRAT. A GRAT is a trust which is created by a person (the "grantor") who then retains the right to receive a series of payments from the trust for a period of time (generally, a relatively small number of years). At the end of the period, the GRAT will distribute any remaining assets it holds to the remainder beneficiary, which could be another trust for the benefit of the grantor's desired individual beneficiaries. The primary benefit of the GRAT is that it lets you transfer, gift tax free, the amount of income and appreciation on the transferred assets that exceeds the Section 7520 rate (2% for October 2010). With proper structuring, the value of the taxable gift made when the GRAT is created could be very small or even zero. Add to this the fact that a GRAT is one of the few statutorily created estate planning transactions and the risk of this type of transaction is minimal. A GRAT does have some risks, but the biggest risk is that it will fail to produce any significant tax benefit, and that the assets contributed to the GRAT are simply returned to the grantor with nothing left to pass to the intended remainder beneficiary. This can occur where the grantor dies during the term of the GRAT or where the contributed assets do not earn income or grow in excess of the Section 7520 rate. With proper planning, these minimal risks can be reduced as well. Those who are interested in a GRAT need to move soon, however, since both interest rates and asset values are likely to go up in the future, and, in addition, the federal government has indicated that it may consider setting a minimum payment term and a minimum gift value for GRATs. The last two changes could significantly decrease the potential benefits of GRAT planning.

4. **Related Party Loans and/or Sales.** If you are facing the possibility of a large estate tax at your death, making a loan or selling assets to a related party in exchange for a promissory note can let you take full advantage of the current historically low interest rates. The sale transaction is similar to the GRAT transaction but can use an even lower interest rate than the Section 7520 rate, hence the hurdle rate to achieve a tax benefit is even lower than with the GRAT. A related party sale or loan transaction has to use an interest rate no lower than a federally determined rate called the "Applicable Federal Rate," or "AFR." The exact AFR used for a particular transaction depends on the terms of the loan or promissory note, but can be below 1% at current rates. In addition, these types of transactions can be structured to be more flexible and beneficial than a GRAT. However, on the downside, you take on somewhat more risk since these types of transactions are not statutorily created like a GRAT. As with the other techniques discussed here, the benefits of related party loans or sales can be mixed with other estate planning techniques to really maximize the desirable effects of the transactions.

In summary, you can use different types of assets with the estate planning techniques discussed here. A successful business, a business with significant future potential, or even an opportunity for a new business are all assets which can be used in lifetime transfers and produce great tax results. One of the best types of assets is one we refer to as a "cash cow:" a business or other asset which generates a steady income stream in earnings, dividends, or rents. In fact, we are in such an unusual environment that cash or marketable securities, even without depressed values, can still be used to achieve incredible results.

The type of estate planning which is right for you depends on your particular circumstances. However, you should consider both basic and more advanced techniques now, while current conditions may greatly increase the benefits these techniques can produce. Contact Scarlett Ollila at (678) 720-0750 or sollila@morgandisalvo.com as soon as possible, to schedule a time to discuss your situation and available options. This window of opportunity is likely to close very soon. Don't waste your chance to realize some potentially great tax and estate planning results.