

# Effective Wealth

A Newsletter of Rothstein Kass®

First Quarter 2009

## Estate Planning Alert:

### Finding a silver lining in the current economic environment

**The state of the economy has been headline news for several months. A "credit crisis" created the current economic environment, starting a chain reaction that is affecting all areas of commerce resulting in economic uncertainty for the next few years. A new presidential administration and a clear Democratic majority in Congress suggest we may see significant shifts in tax policy, as well as in overall economic and governmental philosophy.**

While many are concerned over the economic indicators and their battered investment portfolios, this current market stress may have a "silver lining" for high-net-worth individuals that may seem counterintuitive.

The market volatility and uncertain outlook has already had a significant impact on valuations:

- Many marketable securities are priced substantially lower than they were a year ago.
- The real estate "bubble" has burst and both residential and commercial markets are in a slump. Financing has become significantly more difficult to obtain.
- Many closely-held businesses will have a reduction in revenues and profits as a result of the shortage of credit and the decrease in demand for goods and services which will depress a company's value.
- Current global macroeconomic trends result in lower multiples of EBITDA, price to earnings ratios, and other key multiples, which also reduce valuation.

The proposed Obama tax plan will keep the estate tax and "repeal the repeal" enacted under the Bush administration. (The current law eliminates the Federal estate tax for those who die in 2010.)

The estate tax exemption increases in 2009 to \$3,500,000 per decedent (allowing a married couple to shelter up to \$7,000,000), and will likely remain at that level in 2010, and beyond. The \$1,000,000 gift-tax exemption is not likely to change. The Federal estate tax will continue at a 45% rate, and gift taxes will continue at a marginal rate of 41% to 45% for gifts in excess of the donor's gift-tax exemption. The Federal generation skipping transfer (GST) tax, a separate tax from estate and gift taxes, is imposed on transfers to, or for, the benefit of grandchildren (and more remote descendants). The GST exemption will be \$3,500,000 in 2009, and will likely remain at that level in 2010, and beyond. Transfers to grandchildren in excess of the exempt amount are subject to a flat GST tax assessed at the top estate tax rate.

Under the Obama plan, there are several potential transfer tax reform items. The first revision is intended to simplify tax-driven estate planning for married couples by making the unused estate tax exemption (up to \$3,500,000) of a predeceased spouse "portable" (meaning, usable by the estate of the surviving spouse upon his or her subsequent death). This is intended to eliminate the need for married couples to establish trusts for the sole purpose of maximizing the use of their combined estate tax exemptions.

All families should seriously consider estate planning. The fundamental goals of estate planning generally include the following:

- Determine the financial and nonfinancial priorities and related timeline for the family, and plan for the orderly tax efficient disposition of property to reflect those priorities.
- Maximize tax strategies to minimize transfer taxation (e.g., estate, gift and GST tax).

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“For many donors, the simplicity of direct charitable giving is attractive.”

- Utilize techniques that will preserve the family's wealth from future uncertainty such as creditors, litigation, bankruptcies and unhappy marriages.

You should consider estate planning now to take advantage of the benefits of lower valuations. The lower the value of the property being transferred, the lower the tax liability, and therefore the greater intrinsic value you can transfer out of your taxable estate to future generations. You can also lock in the benefits of lower interest rates by transferring property using a technique that derives its benefits from computations based on Federal interest rates.

Begin the process of estate and gift planning by objectively assessing your current financial situation.

- What is the current value of your assets? Will your estate be subject to tax, and if so, how much? Is your estate liquid enough to cover the tax liability, or should you consider liquidity strategies (perhaps including life insurance) to enable your estate to maximize the value of the assets passing to your beneficiaries?
- How are you transferring your wealth to the next generations? What does your current plan provide?
- Can you comfortably afford to part with a portion of your wealth now? If so, how much?
- Do you have the proper documents in place to achieve your goals of effectively minimizing your potential estate and gift taxes?

## GIFT OPPORTUNITIES

An “Outright Gift” of assets might be the simplest way to reduce the value of your estate, particularly if you are able to utilize your annual gift-tax exclusion (\$13,000 per donee in 2009, \$26,000 per donee if you are married and your spouse consents to split your gift), and your lifetime gift-tax exemption (a maximum of \$1,000,000, or \$2,000,000 with spousal consent). Outright gifts free of trust may potentially carry certain financial and nonfinancial risks. If the recipient sells the property, the capital gain will be computed using your cost basis. You should not gift assets with basis in excess of their current fair market value, as a loss when realized, will not be recognized for tax purposes.

Select assets from your investment portfolio (stocks, real estate investments, and closely-held business interests, preferably ones with currently depressed values and solid appreciation potential) and work with your advisors to develop a tax-efficient plan to give them to your loved ones, or to a trust for their benefit, in a manner that meets with your values and lifestyle.

Charitable giving is often an important piece of a high-net-worth family's financial and nonfinancial planning. Outright donations of property, particularly

appreciated marketable securities, are an efficient way to reduce your estate and obtain valuable income tax deductions. For many donors, the simplicity of direct charitable giving is attractive.

## Low Interest Rate Loans

You can lend money to your family members and, as long as such bona fide loan is evidenced by a promissory note earning interest at the prevailing Applicable Federal Rate (AFR), the loan is not subject to gift tax. An intra-family loan is essentially an estate freeze. If your family member invests the proceeds and earns a rate of return in excess of the interest rate charged, such excess return will inure to his or her benefit. The AFR for a mid-term loan (3–9 years) made in December 2008 was .85%.

The aforementioned note can be structured as an annual interest-only note, with a balloon principal payment due upon maturity. If you later decide to forgive the interest or principal payment, such forgiveness, subject to facts and circumstances, will constitute a gift and may qualify for the gift tax annual exclusion or exemption. Interest received or forgiven must be included in the lender's taxable income each year. If the proceeds of the loan are used to purchase a residence or investment assets, the interest on such proceeds may be deducted by the borrower.

## Installment Sale To an Intentionally Defective Grantor Trust

If you have an asset that is temporarily depressed in value but produces income in excess of the applicable Federal interest rate, such as a closely-held business interest, you could set up an “intentionally defective grantor trust” (IDGT) and sell that asset to the trust in exchange for a low-interest promissory note. An IDGT is an irrevocable trust that, for income tax purposes, is deemed to be owned by you (the Grantor), but is excludable from your estate. Therefore, both the gain on the sale to the trust and the interest received on the promissory note are not taxable, however, the sales proceeds and unpaid balance of the note receivable are includable in your estate. Like an intra-family loan, a sale to an IDGT is also an estate freeze, and all of the appreciation on the asset is shifted out of your taxable estate. Using an IDGT also affords an ideal opportunity to maximize the use of your Federal GST tax exemption, should you decide to benefit your grandchildren or others.

## Grantor Retained Annuity Trust (GRAT)

If you have assets that have significant short-term growth potential, utilizing a GRAT may enable you to capture value and transfer that appreciation to the next generations. A GRAT operates on similar principles as the installment sale technique described above and is best utilized when interest rates are low (as previously discussed).

When assets are transferred to a GRAT, the trust is required to pay a fixed amount each year for the term of the trust (typically five years or less). If structured correctly, the annuity returns the initial contribution (along with interest) to the Grantor. Any additional income or appreciation is transferred to the next generation.

Minimizing the term of the trust reduces the risk of (a) your death during the term of the GRAT (which results in all of the appreciated GRAT assets being subject to estate tax); and (b) less than optimal investment performance “dragging down” the GRAT and limiting the appreciation that you want to pass to your children.

The ability of the GRAT to “zero-out” the taxable gift is particularly helpful for those who have already utilized their entire lifetime gift-tax exemption. Where the installment sale technique may be better suited for transferring assets that generate cash flow, the GRAT tends to be better for transferring assets that will increase in value in a relatively short period of time. For example, if you think that the current market environment will experience a turnaround in the next two years, stocks that are currently seemingly undervalued might be appropriate assets to fund a GRAT.

One of the advantages of using “zeroed-out” GRATs is that if they fail, there is no cost to the Grantor, except for the initial set-up costs. Grantors who transfer wealth through “zeroed-out” GRATs typically use a “rolling” technique where, every two or three years, they contribute all of the annuity payments they have received from their existing GRATs to a new GRAT. This continuous cycle of GRAT funding tends to increase their chances of successful wealth transfer by capturing the value generated by “up” markets and minimizing the effect of “down” markets. Consecutive “rolling GRATs” have the ability to transfer wealth to children without any gift or estate tax cost.

#### **Personal Residences**

Residential real estate values have dropped significantly over the past year. Provided you have gift-tax exemption available to cover the value of the gift, this might be a good time to transfer a residence either outright to your descendants or, if you choose to continue to use the property, to a Qualified Personal Residence Trust (QPRT). You might also want to consider selling this residence to the next generation utilizing a low interest rate mortgage loan, allowing the benefit of appreciation to go to your offspring. Selling a primary residence allows you to take advantage of the \$500,000 capital gain exclusion (for married taxpayers filing a joint return; \$250,000 for single taxpayers).

Generally, QPRTs are most beneficial when a primary home or a vacation property has reasonable prospects for mid- to long-term appreciation. If you transfer your residence to a QPRT, you are


able to retain the right to live in or use the property for a fixed period of time (often 15 or fewer years, depending on the donor’s age and the valuation of the property.) At the end of that term, the property passes to your children and thereafter you may only continue living in or using the property if you pay fair market rent. If the house is sold during the period, the proceeds can be used to purchase a new home, or must be held and invested in other assets in the form of a GRAT. For gift tax purposes, the Tax Code states that the value of the gift is the fair market value of the house, less the present value of your right to live there, during the term of the trust. The present value is based on the Federal 7520 Rate, which is equal to 120% of the mid-term AFR. (In December 2008, the 7520 Rate was 3.4%.) Provided you survive the trust term, the value of the residence will be excluded from your estate for Federal estate tax purposes; otherwise, the property is included in your estate at its then current value.

#### **Charitable Giving and Low Interest Rates**

If you prioritize philanthropy as an important wealth transfer goal, you should consider establishing a Charitable Lead Annuity Trust (CLAT), which is generally established to serve two purposes. It provides a cash flow stream to charities of your choice (even to your own private foundation, if structured appropriately), and if the investments generate returns in excess of the 7520 Rate, a CLAT can shift appreciation out of your estate to the beneficiaries of the trust.

For gift tax purposes, the value of a gift made by way of a CLAT is the fair market value of the property contributed, minus the actuarial value of the cashflow stream (discounted by the 7520 Rate) payable to charity each year. At the end of the trust term, the remaining property in the trust is payable to your descendants, tax free. If the trust is structured as a “grantor trust” for income tax purposes you can claim an upfront charitable income tax deduction in an amount equal to the anticipated cash flow stream. The quid pro quo, however, is that you will be subject to tax on the trust’s income and gain during the trust term. If the trust is structured as a non-grantor trust, you will not obtain an upfront charitable deduction on your personal income taxes, but the annual charitable contributions made by the trust will qualify for a tax deduction against income at the trust level. The decision of whether to use a grantor or a non-grantor trust depends on several factors, including the type of asset to be contributed (for example, grantor trusts are more appropriate for assets such as partnership and S-Corporation interests whose pass-through items would be considered “Unrelated Business Taxable Income” in a non-grantor CLAT), and the use of an upfront charitable income tax deduction for the Grantor to offset high taxable income.

“QPRTs are most beneficial when a primary home or a vacation property has reasonable prospects for mid to long-term appreciation.”

Although your net worth may be less today, and gifting now may seem counterintuitive, that economic reality provides unique opportunities to preserve and transfer your wealth for the benefit of your family in a tax-efficient manner (i.e., giving away the same asset today as you might have at another time using less of your gift-tax exemption while transferring potential major appreciation to the next generation). All of the techniques and strategies discussed here have additional alternatives or methods of implementation which may also have additional complications and risks. To learn more about these techniques and review your potential estate planning strategies, contact your Rothstein Kass professional. 

For more information, please contact Paul Rich, CPA, CM&AA, Principal at 212.997.0500 ext. 3962 or via e-mail at [prich@rkco.com](mailto:prich@rkco.com).

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### Paul Rich, CPA, CM&AA, Principal

Paul is a principal based in Rothstein Kass' New York office, where he is co-leader of the Firm's Business Consulting Group, which provides a wide range of strategic business counseling services. He is a seasoned consultant who brings clarity of mind and hands-on experience to his work with family-owned and closely-held businesses, concentrating heavily on profit enhancement issues. He also has expertise in the areas of succession planning, structuring and negotiating mergers and acquisitions, and facilitating as an executive coach for business owners and high-net-worth individuals. In addition, he has extensive experience securing bank and private financing and rendering IPO and private placement advisory services.

Paul is a member of The Family Firm Institute, International Coach Federation, Institute of Management Consultants and Attorneys for Family-Held Enterprises. He has instructed courses in accounting, economics and finance for an M.B.A. program at Fairleigh Dickinson University. Paul earned the Family Firm Institute's (FFI) Certificate in Family Business Advising and is currently enrolled in the FFI Family Wealth Advising certificate program. He earned the professional designation of Certified Merger & Acquisition Advisor (CM&AA) which was offered by the Alliance of Merger & Acquisition Advisors. The CM&AA designation provides a benchmark for professional achievement and exposes practitioners to a multi-disciplinary course of study including law, tax, finance, marketing, operations and psychology.

Paul belongs to the American Institute of Certified Public Accountants (AICPA), the New Jersey Society of Certified Public Accounts (NJSCPA), the New York State Society of Certified Public Accountants (NYSSCPA) and serves as a member on numerous committees. Paul is also active in a number of civic and charitable organizations and serves as a board member on The Ackerman Institute for the Family, The National Foundation for Teaching Entrepreneurship (NFTE), Project Renewal, and Open Art Studio, NYC.

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Rothstein Kass has offices in New York, New Jersey, California, Colorado, Texas and the Cayman Islands.

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(December 2008)—A survey of 89 agents to sport professionals reveals advanced planning practices and opportunities – including estate planning and asset protection – as well as lifestyle concerns and influences that affect athletes during their careers and into retirement.

### On the Rise

(September 2008)—We report the findings of our survey of 107 family offices solicited for feedback on their established hedge fund investment allocations and strategies for the future.

### At Risk: Managing for the Future

(August 2008)—349 senior partners of hedge fund management companies were interviewed on how well hedge fund owners are prepared for succession-related events.

Copies of these reports can be downloaded from the Rothstein Kass website: [www.rkco.com](http://www.rkco.com).

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