[Alerts and Updates]

Challenging Times: Rethinking and Reshaping Estate Plans in New Tax and Economic Environments

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Recent changes to the estate, gift and generation-skipping transfer (GST) tax systems, along with historically low interest rates and depressed asset values, may have a significant impact on carefully crafted estate plans. However, these challenging economic times may provide unprecedented planning opportunities. Now is the time for individuals to review their current estate plans and contemplated transactions to ensure that their goals and needs are achieved.

Tax Law Changes

As of January 1, 2009, certain changes in the federal estate, gift and GST tax systems became effective.

The amount that is exempt from the federal estate tax increased from $2 million to $3.5 million. With the use of certain estate planning techniques, such as a "credit-shelter trust," the estate tax exemptions for married individuals can be combined, so that effectively $7 million may pass free from federal estate tax upon the death of the surviving spouse. The significant increase in the estate tax exemption amount, especially when viewed in conjunction with depressed asset values, indicates that fewer individuals and married couples will be subject to the federal estate tax.

However, estate plans that were prepared on the basis of pre-2009 exemption amounts may require adjustment. For example, an estate plan that creates a credit-shelter trust with assets equal in value to the estate tax exemption amount and transfers the excess, if any, to the surviving spouse, will result in fewer assets being transferred to the spouse than was the case before 2009—especially given the recent decrease in value most assets have experienced.

Like the estate tax exemption amount, the GST tax exemption amount increased from $2 million to $3.5 million this year. Careful planning may preserve the GST tax exemptions for married individuals, so that up to $7 million can be transferred free from GST tax to (or in trust for the benefit of) grandchildren and more remote descendants upon the surviving spouse's death. Again, an estate plan that was prepared on the basis of pre-2009 exemption amounts may require adjustment—for example, a plan that made a direct gift of the individual's unused GST exemption to grandchildren now may result in more assets being transferred to them than were originally intended.

While the lifetime gift tax exemption amount did not change this year and remains at $1 million, the "annual exclusion" from gift tax (that is, the amount an individual can give to each recipient each year without utilizing his or her $1 million lifetime gift tax exemption) increased from $12,000 to $13,000. A married couple can combine its individual annual exclusions and thus give up to $26,000 per recipient each year free from gift tax consequences. While the $1,000 increase may appear modest, proper planning with multiple annual exclusion gifts over many years can achieve remarkable transfers of wealth. Thus, even this relatively small change may provide planning opportunities.

Although the federal transfer tax system has undergone some significant changes, most states' transfer tax systems have not changed. Individuals living in certain states—for example, New Jersey, New York and Massachusetts—may want to review their existing estate plan with legal counsel to determine whether an increase in their anticipated state estate tax liability will occur. For example, a New York resident whose will provides for the creation of a credit-shelter trust funded with his or her full federal estate tax exemption amount ($3.5 million) may incur a New York estate tax of $229,200 if he or she were to die during 2009, even though no federal estate tax would be owed. It may be possible to mitigate the effects of the state estate tax, and even to eliminate or postpone such tax entirely. The right course of action is likely to depend upon a case-by-case review.

Planning Opportunities Involving Low Interest Rates

Many estate planning techniques make use of interest rates that are set by the federal government. These rates are derived from general economic conditions and vary from month-to-month. It is unlikely to be surprising that these rates recently have been at historic lows. This may make certain estate planning techniques particularly effective.

Loans and Sales

A relatively straightforward technique is an intra-family loan, where one family member lends money to another family member (or to a trust for the other family member's benefit). In order to protect against potential adverse income and gift tax consequences, the loan should be evidenced by a promissory note that bears interest at a rate which is at least equal to the interest rate set by the federal government. The borrower can use the lent funds to invest in assets that are expected to yield a return higher than the federal government's rate, or to pay down existing debt incurred at an interest rate higher than the federal government's rate. Either way, the low interest rate on the intra-family loan may benefit the borrower.

Another common technique utilizing the low interest rates set by the federal government is an installment sale of assets, such as interests in a family business, to a special type of trust, known as a "grantor trust," for the benefit of the seller's family members. As with an intra-family loan, the sale should be evidenced by a promissory note that bears interest at a rate which is at least equal to the interest rate set by the federal government, in order to protect against potential adverse tax consequences. As the promissory note is repaid, the seller receives back assets worth the initial purchase price of the assets, plus interest at the federal government's rate. However, any appreciation in excess of the federal government's interest rate accrues for the benefit of the beneficiaries of the grantor trust, free from estate and gift taxes. Thus, this technique may be particularly attractive when, such as now, the rate set by the federal government is low.

In addition to transactions involving new promissory notes, it may be possible to renegotiate an existing promissory note, such as one executed in an earlier year when the interest rate set by the federal government was higher, to substitute a lower interest rate. To ensure that no negative tax consequences result from such a renegotiation, interested parties should consult legal counsel for a thorough analysis of their particular situations.

GRATs and CLATs

There are also estate planning techniques utilizing the low interest rates set by the federal government that do not involve promissory notes. Two such techniques are a gift to a "grantor retained annuity trust" (a "GRAT") and a gift to a "charitable lead annuity trust" (a "CLAT"). The goal of both techniques is to pass appreciation in assets to family members with little (or no) gift tax consequences.

A GRAT is a special type of trust to which a donor contributes assets. The GRAT is required to pay an annuity to the donor each year for a specified number of years (the GRAT can pay the annuity by returning part of the assets that were originally contributed by the donor). The number of payments and the amount of each payment are calculated so that the value of the annuity payments is close to (or equal to) the value of the assets contributed to the GRAT. As a result, the "net" gift is low (and is possibly nonexistent).

Once the final annuity payment is made, any remaining assets pass, free of tax, to the beneficiaries of the GRAT. If the assets contributed to the GRAT appreciate at a rate higher than the interest rate set by the federal government, currently approximately 2.8%, assets will remain for the beneficiaries. The more the appreciation exceeds the federal government's interest rate, the more assets will remain. One of the keys to using a GRAT is to fund it with assets that are likely to "beat" the federal government's rate. Since the rate set by the federal government is at a historic low, the use of GRATs is likely to be much more appealing.

It is important to note that members of Congress recently have suggested requiring the "net" gift with a GRAT to be equal to at least 10% of the value of the assets contributed to the GRAT, and the Obama administration recently has recommended a minimum 10-year term for GRATs. It is unknown at this time whether these changes will be implemented; but even if they are, the use of GRATs likely will remain an effective strategy for transferring wealth to family members.

A CLAT is similar to a GRAT, except that the annuity payments are made to one or more charities rather than to the donor. Like a GRAT, if the assets contributed to a CLAT appreciate at a rate in excess of the rate set by the federal government, assets will remain in the CLAT after the final annuity payment is made that will pass, tax-free, to the beneficiaries of the CLAT. Thus, as with a GRAT, the current low interest rates is likely to make the use of CLATs attractive. An additional benefit with a CLAT is that the donor may be able to claim a partial charitable deduction for income tax purposes with respect to the assets contributed to the CLAT.

Planning Opportunities Reflecting Lower Asset Values

While the general economic climate may make it more challenging to give assets away to family members, for those who can afford to do so, now is an opportune time to make gifts. The tax consequences of a gift depend on the value of the gift—the greater the value, the greater the amount of gift tax exemption that must be used to shield the gift from gift tax, or the greater the amount of gift tax that will be owed (for donors who have already used their entire gift tax exemptions). Therefore, giving an asset away at this time, when its value likely is lower than it was even a year ago, may be prudent. Moreover, if the asset rebounds in value, the increase will occur in the hands of the recipient, and thus avoid the higher gift or estate tax that would have otherwise been incurred upon a later transfer of the asset.

For individuals who are the beneficiaries or trustees of existing trusts, lower asset values may present income tax planning opportunities. For example, in the case of a "marital trust" created for the benefit of a surviving spouse under a predeceased spouse's estate plan, now may be an advantageous time to harvest some of the losses that recently may have occurred. This is because, if a loss is realized, then it can be carried forward to offset later gains that are incurred by the trust during the surviving spouse's lifetime; and following the surviving spouse's death, the loss will pass to the other beneficiaries of the trust to be used by them. However, if the loss remains unrealized at the surviving spouse's death, it will be eliminated at that time and will not be available for use by the other beneficiaries of the trust.

What Is on the Horizon?

Additional changes to the estate, gift and GST tax systems are expected in the upcoming year. Several bills have been introduced in Congress to reform aspects of the tax system, and the Obama administration also has recommended many changes as part of its budget proposal.

Some of the changes that have been proposed include increasing the estate tax exemption amount, increasing the gift tax exemption amount to match the estate tax exemption amount, simplifying the ability of a surviving spouse to utilize any estate tax exemption not used by his or her predeceasing spouse, modifying the estate and gift tax rates and imposing stricter rules for valuing interests in family-controlled entities (such as limited partnerships and limited liability companies).

While many proposals have been made, the proposals focus on "reforming" the current tax system, rather than on "repealing" it. For this reason, it is unlikely that the one-year repeal of the current estate tax system, which is scheduled to take effect on January 1, 2010, will occur.

It is anticipated that additional reform bills will be introduced, and that the debate is likely to intensify this summer. With changes in the tax law on the horizon, interested parties contemplating action with respect to their estate plans may want to seek legal counsel to determine what steps should be taken before legislation becomes effective. We will continue to inform you of further developments.

About Duane Morris

The attorneys in the Duane Morris Estates and Asset Planning Group assist clients with updating their estate plans and lifetime gift programs to take advantage of current planning opportunities, working with them to make more extensive adjustments in changing economic times such as these. Individuals may want to review their estate plans every few years, or sooner if certain life events, such as the birth or adoption of a child or a change in marital status occur, to ensure that their plans are up-to-date with both their objectives and current law.

For Further Information

If you have any questions regarding this Alert or would like more information, please contact any of the attorneys in the Estates and Asset Planning Practice Group, or the attorney in the firm with whom you are regularly in contact.

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