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ESTATE & GIFT TAX UPDATE MAY 2009

The current "down economy" may be an excellent time for individuals to transfer ownership of portions of their closely-held businesses to family members or to engage in other estate and gift planning. This article describes possible changes in the estate and gift tax laws in the near future and offers some wealth transfer and estate planning techniques that take advantage of the current low interest rate environment.

The Law Today & Possible Changes

Many individuals have delayed making decisions about their estate and gift planning, hoping that the laws would be repealed. In recent years, several Congressmen and Senators have offered up bills to simply get rid of these taxes; however, none have come close to being enacted. At present, it appears that estate and gift taxes will continue to be part of the overall tax landscape for the foreseeable future. President Obama stated that he would like estate and gift taxes to continue at their current rates and also said he would like to lock the estate exemption amount at its current level. Recent bills introduced in Congress provide insight as to how the estate and gift tax laws could be changed for future years.

By way of background, in 2001 the estate tax law was changed to provide increases in the estate exemption amount over a period of years as follows:

2001	\$ 675,000
2002-2003	\$1,000,000
2004-2005	\$1,500,000
2006-2007	\$2,000,000
2009	\$3,500,000

The "estate exemption amount" represents the net value of assets owned by an individual that will escape estate transfer taxes upon the individual's death. This amount may be reduced as a result of lifetime gifts made by the individual. So, the entire estate exemption amount may not be available at death to shelter the decedent's estate.

The 2001 Tax Act also reduced the maximum estate tax rate from 55 percent in 2001 to 45 percent beginning in 2007.

Additionally, the 2001 Tax Act provides that the estate tax is to disappear for one year in 2010. In 2011, current law states that the estate exemption amount and the maximum tax rate will revert to their unfavorable 2001 levels (\$675,000 and 55 percent). Congress and the President appear poised to pass legislation to avoid this disappearing act in 2010 and the reinstatement in 2011.

During his presidential campaign, President Obama stated that he would like the estate exemption amount to be frozen at its current level of \$3,500,000 and the maximum estate and gift tax rate to be frozen likewise at 45 percent. On March 26, 2009, Senator Max Baucus, the Chairman of the Senate Finance Committee, introduced proposed legislation that, if enacted, would carry out President Obama's wishes. Incidentally, candidate McCain also called for continuation of the estate and gift tax laws, however at a higher estate exemption amount and a lower tax rate.

The Baucus legislation would make permanent the \$3,500,000 estate exemption amount and would cap the maximum estate and gift tax rate at 45 percent. In addition, for deaths occurring after 2010, the \$3,500,000 exemption amount would be increased by an inflation-based amount. The proposal would also reunify the lifetime gift tax exclusion with the estate exemption amount by providing that lifetime taxable gifts up to \$3,500,000 are exempt from gift tax. (At present, gift tax must be paid if lifetime taxable gifts exceed \$1,000,000.) The Baucus bill would also allow for "portability" of the exemption amount between spouses. This means that a surviving spouse could elect to take over the unused estate exemption amount of his/her predeceased former spouse and therefore: 1) not waste any of the exemption of the first spouse to die; and 2) potentially reduce the amount of assets passing into a trust formed as a result of the first spouse's death.

As an aside, it should be noted that estate transfer taxes payable to Washington State are based upon a lower \$2,000,000 estate exemption amount. Therefore, it is possible to have a taxable estate for Washington purposes even though there is no taxable estate for federal purposes because the net estate is less than \$3,500,000.

Potential Planning Strategies In A Low Interest Rate Environment

If you believe that the estate and gift tax laws will continue into the future and also think you will have a taxable estate, there are a number of fairly straight-forward techniques that might be used to take advantage of current low interest rates. Many assets have recently experienced a decrease in value due to the current recession, so now may be an excellent time to transfer wealth to children and grandchildren by taking advantage of estate planning techniques that benefit from these conditions. Some of these techniques can be coupled with minority and marketability discounts in valuing the assets transferred or sold, which makes the transfer or sale even more compelling. However, a bill has been introduced in Congress that would eliminate minority or marketability discounts when property is transferred to a relative. This bill, if enacted in its current form, would apply only to transfers after the date of enactment.

The wealth transfer and estate planning techniques described below require that interest be charged at minimum rates set monthly by the IRS. These rates are known collectively as the "Applicable Federal Rates" (AFRs) and are generally much lower than commercial loan rates. The AFRs for loans established during May 2009 which require monthly payments are:

<u>Loan Term</u>	<u>Interest Rate</u>
Three years or less (short-term)	.76%
More than three years but not more than nine years (mid-term)	2.03%
More than nine years (long-term)	3.52%

Strategies that benefit from low interest rates include:

1. GRATs. In a GRAT (Grantor Retained Annuity Trust), the owner of a property ("the grantor") transfers the property to a trust in exchange for a fixed annuity payment for a defined period of time. A beneficiary, often a family member, is named to receive assets remaining in the trust upon its termination. During the term of the trust, the grantor receives an annuity payment of cash or other assets determined with reference to the value of the property placed in the trust and the applicable interest rate. It is possible to define the amount of the annuity payments so that little or no part of the transfer to the trust counts as a gift made on behalf of the beneficiary. For GRATs established during May 2009, the applicable interest rate is 2.4 percent. If the property placed in the trust appreciates more than 2.4 percent over the term of the trust, the excess transfers to the named beneficiary at termination, free from any additional estate or gift tax, along with the other remaining trust assets. Under the right circumstances, GRATs can be used to transfer large amounts of high value assets at relatively low estate and gift tax cost.
2. Intra-Family Loans. Loans to family members can be made using the AFRs as their stated interest rates. A loan, documented in writing, from a parent to a child might allow the child to make an investment that yields a much higher rate of return than the interest that must be paid on the loan at the AFR by the child to the parent. Any excess earnings are retained by the borrower, free from estate or gift taxes. As another example, a parent or grandparent might finance part or all of the acquisition of a child or grandchild's principal residence at the long-term AFR, a rate which is currently at least one percentage point below the rate that would be payable to a commercial mortgage lender. Note that to make the interest deductible by the borrower, the loan must be secured by the residence and officially recorded with the county or other authorities, just as a commercial lender would do.

3. Installment Sales. Stock in a closely-held business, the value of which has been temporarily depressed by the current recession, is an excellent candidate for an installment sale to a lower generation family member. If the business is still producing income and cash yield in excess of the AFR interest rate that must be charged on the loan, distributions from the business can be used to make the payments. All appreciation in the value of the transferred stock after the sale and all excess earnings will be transferred to the purchaser, free from estate or gift tax.

The suggestions above are just a few of the many possible techniques that take advantage of the current low interest rates and allow the transfer of wealth to younger generations at little or no estate or gift tax cost. However, before engaging in any wealth transfer or estate planning, you should consult an attorney, accountant, or other tax advisor who is knowledgeable regarding your situation and the suitability of a particular technique for you.

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