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Estate Planning Alert

Part 2: Potential Estate and Gift Tax Legislative Changes

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An issue that received limited attention in the 2008 presidential election was the estate tax. Both candidates had fairly similar proposals and this was not a hotly debated item. Senator Obama favored retaining the estate tax exemption amount at $3.5 million and a 45 percent tax rate after 2009; Senator McCain proposed a $3.5 million exemption after 2009 that would gradually increase to $5 million by 2015.

President Obama adhered to his campaign promise and recently proposed that the estate tax exemption amount be frozen at $3.5 million after 2009 and that the tax rate remain at 45 percent. A number of other legislative proposals are currently making their way through Congress – these include the Pomeroy Bill (H.R. 436), the Mitchell-Kirk-Nye Bill (H.R. 498), the Baucus Bill (S. 722), and the McDermott Bill (H.R. 2023), in addition to the Obama Administration's 2010 Revenue Proposals.

We are keeping a close eye on the Baucus Bill and the Obama Administration proposals, as they have the greatest level of support, but elements of some of the other bills could be incorporated into the final bill. The most prominent features include the following and are discussed in greater detail below:

- Estate and Gift Tax Exemptions and Rates
- Re-Unification of the Estate and Gift Tax System
- Portability of Estate Tax Exemption
- Limitations on Valuation Discounts
- Limitations on Grantor Retained Annuity Trusts

Estate and Gift Tax Exemptions and Rates

The Pomeroy Bill and the Obama Administration proposal would freeze the estate tax exemption amount at $3.5 million and freeze the estate tax rate at 45 percent. The Baucus Bill is similar to these proposals and would start the exemption amount at $3.5 million, but would also index this amount for inflation.

At the opposite ends of the spectrum are the Mitchell-Kirk-Nye Bill and the McDermott Bill. The Mitchell-Kirk-Nye Bill would start the exemption amount at $5 million and index it for inflation, while the McDermott Bill would start the exemption at $2 million and index it for inflation. The tax rates are also at opposite ends of the spectrum - the Mitchell-Kirk-Nye Bill would tie estate tax rates to the capital gain rate (currently 15 percent) for estates up to $25 million and twice that rate for estates over that amount. The McDermott Bill would start estate tax rates at 45 percent, go to 50 percent for the incremental amount over $5 million but below $10 million, and then go 55 percent for the incremental amount over $10 million.

Another possibility (and one that is becoming more likely) is a one-year "patch" to the estate tax. The patch would extend the current exemption and rates ($3.5 million and 45 percent tax rate) into 2010. On Sept.2, John Buckley, chief tax counsel for House Ways and Means Committee Democrats, made reference to this possibility in a

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speech to a group of accountants. Because of the peculiarities of the Congressional "pay as you go" budgeting process, a one-year patch has some appeal, especially at a time when deficits are soaring and a one-year patch (which eliminates the estate tax repeal in 2010) actually has the effect of raising revenue.

Re-Unification of Estate and Gift Tax System

You may recall that until 2004, the estate and gift tax exemptions were the same amount. Therefore, if you gifted $400,000 during your lifetime, you would only have $600,000 of your exemption available for transfers at death. This was a "unified" system and it did not matter whether you consumed your estate and gift tax credit during your lifetime or at death.

In 2004, the gift tax exemption was frozen at $1 million, while the estate tax exemption increased to $1.5 million (and has since increased to $3.5 million). This is often referred to as the "de-unification" of the estate and gift tax system. As a consequence, a client could gift up to $1 million during their lifetime, but any taxable gifts in excess of this amount would be subject to gift tax. At death, an additional amount (an extra $500,000 in 2004 and 2005; an extra $1 million in 2006 to 2008, and an extra $2.5 million in 2009) is made available for transfers taking effect at death.

Several of the legislative proposals that Congress is currently considering, most prominently the Baucus Bill, would "re-unify" the estate and gift tax exemption amounts at the $3.5 million level. This means that clients who have consumed the full amount of their $1 million gift tax exemption could gift an additional $2.5 million during their lifetime without paying any additional gift tax. This would present numerous planning opportunities for clients who were previously capped in their ability to make substantial gifts and to engage in sophisticated gift tax planning.

Portability of Estate Tax Exemptions

Under current law, in order to fully utilize the estate tax exemption at the death of the first spouse, the first spouse's estate must provide that assets equal to the exemption amount pass into a trust designed to shelter the assets from inclusion in the second spouse's estate – commonly referred to as a credit-shelter trust, by-pass trust, or "family trust."

A "portability" proposal could potentially eliminate the need to create such a trust at the death of the first spouse. Under this proposal, the first spouse could simply transfer his or her estate tax exemption to the surviving spouse. The second spouse could use the first spouse's estate tax exemption (along with his or her own exemption) and eliminate the need for a credit-shelter type trust.

This proposal has a great deal of appeal from a tax simplification perspective, but we have already identified a number of concerns. First, there is the so-called "Black Widow" problem — how many estate tax exemption amounts can one person accumulate from successive spouses?

Second, there is a related issue of "privity." Consider this example: Husband and Wife are married. Wife dies and leaves her $3.5 million exemption to Husband. Husband remarries Wife2 and then Husband dies. Wife2, a person who may have never known or met Wife, is now the recipient of Wife's estate tax exemption, along with Husband's exemption. This may not sit well with some family members. Third, and this is beyond the scope of this summary, there are fairly significant generation skipping transfer tax concerns associated with this proposal.

Setting aside all of the tax issues, trusts are quite useful and this proposal would discourage the use of trusts. Trusts are often used to assist in asset management, to distribute assets to beneficiaries at appropriate times and ages, to prevent the imprudent use of funds, and to protect assets from creditors, among many other reasons.

So, while we are intrigued by this proposal, the "devil" is in the details. The Baucus Bill includes a portability provision and, in fact, attempts to address the "privity" issue discussed above. The Mitchell-Kirk-Nye and McDermott Bills also contemplate portability, but neither of these bills addresses the privity issue.

Limitation on Valuation Discounts

A significant area of our practice focuses on valuation discount planning. Valuation discounts, such

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as discounts for lack of marketability and lack of control, are typically applied to interests in closely held businesses, such as corporations, limited liability companies, and partnerships. In addition, fractional interest discounts are often applied to less than 100 percent interests in real estate. Valuation discounts allow clients to transfer larger interests in closely held business entities, because the interest being transferred is discounted by 20 percent to 40 percent from its underlying value.

While the Internal Revenue Code and the courts recognize the validity and appropriateness of valuation discounts, many taxpayers have engaged in prolonged legal battles with the IRS over the size or amount of the discount. The good news is that, in most cases, taxpayers have been largely successful in achieving significant victories over the IRS. The bad news is that the IRS is having a great deal of difficulty winning their cases, based on the law as it exists.

So, if you can't win the game, change the rules. And that is exactly what the IRS is trying to do. Two proposals currently seek to modify the rules for valuing interests in closely held businesses. The Pomeroy Bill would eliminate minority interest discounts in family owned entities. In addition, if an entity, such as an LLC, holds cash or marketable securities, the underlying assets are valued at their net asset value and not at a discount. The Obama Administration proposal is a bit more opaque and would add teeth to existing regulations that are intended to limit taxpayer's ability to obtain valuation discounts in family-owned entities. The details of the Obama Administration proposal are limited, but we are watching developments closely.

The specter of legislative change in this area has caused many of our clients to accelerate gifts of business interests or structure sales to trusts for the benefit of family members, with the idea that they can "lock in" the discounts and stay ahead of the legislation. Clients who have interests in closely held businesses should consider similar moves, especially given the lower valuations that would be applied in the current macro-economic climate.

Limitations on Grantor Retained Annuity Trusts (GRATs)

One of our favorite planning techniques is the Grantor Retained Annuity Trust or "GRAT." In a GRAT, the client transfers assets to the trust and retains the right to receive assets having a value equal to the original contribution back from the trust over a two-year period, plus an IRS assumed rate of return. Because interest rates have been low, the IRS assumed rate of return is also low – hovering around 2 to 3 percent for the last 12 to 18 months. If the assets appreciate above the IRS hurdle rate, the excess amount is transferred tax-free to the client's children.

For example, a client contributes $1 million to a GRAT. Over a two-year period, the client receives back payments valued at approximately $1,050,000. If, at the end of the two-year term, the assets have grown to $1.5 million, the children receive $450,000 ($1.5 million less $1,050,000) gift tax-free. The beauty of this technique is that, if the assets do not outperform the IRS hurdle rate, the client simply receives the assets back, without any gift tax consequence. One client aptly described it as a "Heads, I win; Tails, I don't lose" proposition.[1]

Using this technique, we have assisted clients in transferring hundreds of millions of dollars to their children gift tax free. Unfortunately, the Obama Administration is concerned that taxpayers are using this technique <u>too</u> effectively. The Administration's proposal contains a provision that would extend the minimum term of a GRAT from two years to 10 years. This effectively injects two greater levels of risk into this planning technique. First, if the assets do well for nine years, but underperform in the 10th year, the possibility of transferring excess value to children is diminished.

Recent investment experience illustrates this point exceptionally well. One dollar invested in the S&P 500 on Jan. 1, 1999 would be worth $0.86 on Dec. 31, 2008. However, during discrete two-year periods over the last 10 years, there were instances when the S&P 500 was up significantly. A dollar invested in the S&P 500 in 2003/2004 would yield $1.43 and the same dollar invested in 2005/2006 would yield $1.21. The use of a short-term two-year GRAT gives clients the opportunity to capture the relatively short upticks in the

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markets, without risking the downside in future markets. A 10-year GRAT forces clients to ride the markets up and down. This eliminates the opportunity afforded by short term GRATs to reap the benefits when the market is up, but not bear any investment risk when the market is down.

Second, if the client dies during the 10-year term, the tax benefits are lost. All of the assets are brought back into the client's estate at its current value. With a two-year GRAT, the mortality risk can be mitigated. Once again, we are encouraging our clients to employ GRATs aggressively. Market valuations are still below their historical highs and the opportunity to create short term GRATs may disappear in the next few months. Now is a great time to employ this planning technique.

What Should I Be Doing Now?

You may be asking yourself, "What should I be doing now, in response to these possible legislative changes?

First, stay tuned. The legislative climate is quite dynamic and the mood of Congress can shift quickly and unexpectedly. Therefore, be prepared to expect the unexpected.

Second, consider planning techniques that take advantage of the current low interest rate environment – this includes the creation of GRATs, as discussed in the client summary, and low interest rate intra-family loans. For clients that are charitably inclined, the low interest rate environment makes charitable lead annuity trusts quite attractive from an income tax and wealth transfer tax perspective.

Third, consider employing estate planning techniques that "lock in" valuation discounts before any legislative changes are enacted. One technique that we have used with great success for many years is a sale of business assets to a grantor trust, sometimes called an "intentionally defective" grantor trust[2]. The sale of the business asset to the trust will "lock in" the discount ahead of any legislative change that would otherwise eliminate the availability of valuation discounts.

If you have any questions about your estate plan or any planning techniques that you should consider, please feel free to call me or any of the estate planning attorneys at Williams Mullen.

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For more information on this matter and similar issues, please contact the author, Farhad Aghdami at 804.783.6440 or via email at aghdami@williamsmullen.com.

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[1] Find more information on grantor retained annuity trusts (GRATs) on our website at **http://www.williamsmullen.com/grats**

[2] For more information on sales to grantor trusts (sometimes called intentionally defective grantor trusts or IDGTs), see our white paper on the topic, available at **http://www.williamsmullen.com/files/upload/IDGT.pdf**

About the Author

Farhad Aghdami works with high net-worth individuals and families, corporate executives, and business owners primarily in the areas of estate and gift tax planning, business succession planning, and general tax and corporate matters. Mr. Aghdami is a fellow in the American College of Trust and Estate Counsel and is listed in The Best Lawyers in America in both the Tax and Trusts and Estates categories. A 1989 graduate of the University of Virginia, he graduated in 1992 from Wake Forest University School of Law, where he received academic honors. Mr. Aghdami received his masters of laws in taxation from Georgetown University Law Center in 1995.

About the Trust & Estate Planning and Administration Practice

Williams Mullen offers an array of sophisticated estate planning services for the disposition of family wealth and the sheltering of assets from income, gift, estate and generation-skipping transfer taxes. Our experienced team of attorneys and paralegals also help individual and institutional fiduciaries handle the legal and tax complexities of estate and trust administration. Because estate planning calls for approaches and techniques that vary with the particular client's needs, the firm offers an array of estate planning services.

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