# Recent Estate Planning Developments and Newsletter

## Winter 2008

A Summary Provided by the:

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SEASONS GREETINGS & BEST WISHES

FOR A

HAPPY, HEALTHY & PROSPEROUS 2009!

## NOW IS THE TIME TO REDUCE ESTATE TAXES

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## STATUS REPORT: REFORM OF FEDERAL ESTATE TAX

**2001 Tax Act.** We are now eight years through the ten year lifetime of the 2001 Tax Act. As you will recall, when this Act was passed there were not enough votes to make it permanent. As a result, the Act will “sunset” in 2011. Under this Act, in 2009 the applicable exclusion amount (the amount that you can transfer tax-free at death) increases to $3,500,000. In 2010, the federal estate tax is repealed for one year, and in 2011 the estate tax comes back into effect and the applicable exclusion amount is reduced to $1,000,000. During 2009, once the exclusion amount is used, the tax rate is

45%. In 2011, the old graduated rate structure will come back into effect with a maximum rate of 55%.

**New Legislation in 2009.** In our prior newsletters we have discussed how estate tax repeal has changed to estate tax reform over the years since 2001. Our present economic problems, coupled with Democratic control of the Executive Branch and Congress, sound the death knell for repeal. Barack Obama, during his campaign, stated that he would support maintenance of the $3,500,000 applicable credit, together with a continued 45% tax rate.

It is highly likely that the Administration and Congress will work together to enact new estate tax legislation in 2009. It would be irrational to allow one year of repeal to occur, as would be the case if legislation were postponed until the 2001 Act sunsets in 2011. Further, such a one-year "repeal" would result in a significant loss of revenue during a time when the government is searching for additional funds.

What types of new estate tax legislation can we expect in 2009? The new laws may not only include the credit and rate subjects discussed above, but also other changes which have recently been discussed. Some of these may be favorable to taxpayers, such as relief measures for family owned businesses and farms, and perhaps the "portability" of unused applicable credit when the first spouse dies to the second spouse. However, we also should expect that the Treasury Department will recommend changes which will substantially restrict estate planning techniques which are presently being used. For example, see the discussion of restrictions on valuation discounts, grantor retained annuity trusts, and qualified personal residence trusts discussed in the next section.

## NOW IS THE TIME TO REDUCE ESTATE TAXES

On October 18, 2008, the *Wall Street Journal*, on the front page of its "The Journal Report" section, wrote an extensive article entitled "Why Now is the Time to Help Your Heirs." The article began "[t]he economy is a mess, home prices are reeling, and stocks have plunged. But for those likely to become ensnared in the estate tax, there's a silver lining: These troubled times offer some of the best opportunities in years to transfer wealth to younger generations, without triggering much or any inheritance tax along the way."

**Values Are Depressed.** The *Wall Street Journal* emphasized that our present economic problems have depressed the value of assets which we own. These may include interests in closely held businesses such as corporations or limited liability companies, real estate and, certainly, our portfolios of stocks and bonds. When these values are low, more assets can be transferred into irrevocable trusts which will protect these assets from being taxed under the estate tax at our death.

**Interest Rates Are Low.** A second factor makes this an ideal time to accomplish estate tax minimization planning. Interest rates are close to an all time low. The government, in response to our economic problems, has continued to reduce interest rates. As a result, the Applicable Federal Rate is close to its all-time low. This AFR rate is very important for Grantor Retained Annuity Trusts, Sales to Grantor Trusts, and Charitable Lead Trusts, discussed in the section below. When the AFR rate is low, these estate tax planning approaches become much more effective.

**Tax Law Changes.** A third factor encourages timeliness in accomplishing these estate planning changes. We can expect the new Administration and Congress to enact changes to the estate tax law which will substantially restrict the use of present estate planning techniques. For example, on November 5, 2008, Leimberg's *Estate Planning Newsletter* provided a lengthy discussion of a prior proposal by the Joint Committee on Taxation to severely restrict the use of valuation discounts. These minority interest discounts, lack of marketability discounts, and fractional interest discounts have been widely used and approved by the courts for decades. However, this proposal would effectively eliminate them in the estate planning area. Leimberg's article concluded:

> "[a] window of opportunity exits to employ existing valuation principles of lack of marketability discounts, minority interest discounts, and fractional interest discounts, which window may or may not close after 2008."

In addition to the above-described potential change, rumors are circulating that the Treasury Department will propose restrictions on the use of Grantor Retained Annuity Trusts and will propose the elimination of Qualified Personal Residence Trusts. Also, Treasury is on record with its desire to restrict the use of "Crummy" withdrawal rights, which are used to qualify annual exclusion gifts ($13,000 in 2009) for gift tax-free treatment.

When a new tax law is introduced in Congress, often its effective date is the date of introduction. This to prevent taxpayers from hurrying and accomplishing techniques before the legislation is actually enacted by Congress. Since we can expect new legislation to be introduced and probably enacted which will substantially restrict estate planning in 2009, we have a "window of opportunity" which may close with respect to the estate tax planning techniques now available.

**Should You Plan Now?** Who should be concerned about taking advantage of this planning opportunity while it lasts? If we assume that the Administration and Congress agree to maintain the applicable credit at $3,500,000, then this is our measuring point. If you have assets, including life insurance coverage and retirement accounts, which have a value greater than this amount, then estate tax reduction planning is important for you. If you are married, then with appropriate planning in your wills or revocable trust, a married couple can protect $7,000,000 from transfer taxes. After these measuring points, it is important to consider other estate tax reduction approaches.

What are the planning techniques that can be used to reduce estate taxes in today's depressed valuation and low interest rate environment? Some of the most effective techniques are discussed in the section below. The effectiveness of these techniques may well be reduced by 2009 tax legislation.

## ESTATE TAX REDUCTION TECHNIQUES YOU SHOULD CONSIDER

**Five Excellent Approaches for Reducing Estate Taxes in Today's Environment.** The *Wall Street Journal* in its October 18, 2008, article recommended grantor retained annuity trusts, sales to grantor trusts, and charitable lead trusts. Before any of these techniques are used, a family should consider tax-free gifting. All of these techniques are discussed below.

1. **Gifting.** We discussed this subject extensively in our Winter 2007 newsletter, which can be found on our web page. Here, we will just emphasize several important gifting methods.

Tax-free annual exclusion gifts should be the first method for consideration. Each person may gift up to $13,000 (in 2009) to another person each calendar year. For example, you could gift $13,000 to each child, grandchild, and friend each calendar year. These gifts can be cash, property, or fractional interests in property. In addition, tax-free annual exclusion gifts include the payment of any amount of tuition to an educational organization for the education or training of the donee. Also, tax-free annual exclusion gifting allows an unlimited gift-tax exclusion for amounts paid on behalf of a donee directly to a provider for medical care.

A second type of gifting involves using the $1,000,000 tax-free gifting portion of your applicable credit amount. As discussed above, in 2009, your applicable credit will allow $3,500,000 of transfers tax free. Of this amount, $1,000,000 can be used during your lifetime.

Both of these gifting techniques can take advantage of valuation discounts. For example, if you are gifting interests in a closely held corporation or limited liability company, those interests may qualify for minority interest and lack of marketability discounts. Further, fractional interest

discounts in land or other property may also produce significant reductions in value.

There is a substantial advantage to gifting assets during your lifetime rather than waiting until your death to transfer them to your beneficiaries. If you gift assets during your lifetime, then the value of those assets plus all of their growth is excluded from your taxable estate. If the gifting is leveraged through the use of discounts, as discussed above, this advantage becomes much greater. These assets can be gifted directly to your beneficiaries, or to an Alaska Self-Settled Discretionary Spendthrift Trust, which includes you as a discretionary beneficiary. These trusts are discussed further, below.

2. **Grantor Retained Annuity Trust.** Assume you have $1,000,000 of assets which you anticipate will grow at approximately 10% per year. You contribute these assets to a GRAT. In exchange, the trustee of the GRAT will pay you annuity payments over a ten-year period which will equal $1,000,000 plus interest (3.4% per year if the GRAT was established in December 2008). The *Walton* Tax Court case establishes that no gift occurs when you create such a zeroed-out GRAT. (That is, a GRAT where the annuity payments equal the value of the property contributed, plus interest.) At the end of the ten-year period, due to the 10% per year growth, $687,068 will be left in the GRAT. These assets will then be transferred to your beneficiaries or to an Alaska Self-Settled Discretionary Spendthrift Trust, which includes you as a discretionary beneficiary. These trusts are discussed further, below.

The reason that we have $687,068 left at the end of the ten-year period is that this is the growth amount resulting from the difference of the 10% growth and the low 3.4% required interest rate. You can see that if this interest rate were high (for example, the10% that existed in 1989), then no amount would be left in the trust at the end of the ten-year period. Therefore, low interest rates make GRATs a very valuable technique for estate tax reduction.

The annuity payments can be designed so that they increase by 20% each year. This allows for lower annuity payments in early years and higher ones in late years. As a result, more of the "growth" is kept in the trust at the end of the fixed term. If the trust does not have cash to make the payments, the trustee can return some of the assets as payments in-kind.

A strong advantage of a GRAT is that it is expressly authorized by the Internal Revenue Code and its regulations. The "zeroed-out" benefit has been provided by the *Walton* Tax Court case.

The disadvantages of a GRAT are that you have to live the fixed term (ten years in the above example) for it to work. If you die during the fixed term, the assets are included in your gross estate and taxed under the Federal Estate tax. Also, you cannot allocate GST exemption to the GRAT until the end of the fixed term.

3. **Sale to Grantor Trust.** A similar popular technique is an installment sale to a grantor trust. Assume $1,000,000 of assets is sold to the trust in exchange for interest-only payments for nine years, and a balloon payment at the end of the nine-year period. If the trust does not have cash to make the payments, the trustee can return some of the assets as payments in-kind. Since you are selling the assets for their full fair market value, again, no gift occurs. The lower the interest rate, the lower the interest-only payments during the ten-year period. All of the growth of the assets (assumed to be 10% per year) in excess of the interest rate (3.4% if the sale occurs in December 2008) will remain in the trust at the end of the payment period. These assets will be transferred to your beneficiaries or to an Alaska Self-Settled Discretionary Spendthrift Trust, which includes you as a discretionary beneficiary. These trusts are discussed further, below.

The trust is called a "grantor trust" because you have retained certain administrative powers. Because of your retention of these powers, present law provides that all income and deductions of the trust are taxed to you. To state this another way, there can be no taxable events between you and the trust. As a result, no capital gain tax is payable upon the sale of the assets to the trust, and the interest income is not taxed.

The amount left in the grantor trust at the end of the fixed term (nine years, here) will be very

similar to the amount left in the GRAT example described above. Again, this amount is so large because of the substantial difference between the assumed growth rate (10%) and the required interest rate (3.4% for a sale to a grantor trust in December 2008).

It is important to recognize that the growth rate may be much larger than what you assume if the asset value was discounted when it was contributed to the GRAT or sold to the grantor trust. For example, assume that you had first contributed $2,000,000 of assets to a family limited liability company. Your appraiser determined that the value of the limited liability company interests are subject to a 50% discount because of minority interest, lack of marketability, and the restrictions of the family limited liability company entity. As a result, the assets in the GRAT or the grantor trust would produce “growth” that would be approximately twice the 10% assumed above. This makes the GRAT or grantor trust doubly effective.

The advantages of the sale to grantor trust technique are that the grantor does not have to survive the fixed term for the transaction to work. Also, GST exemption can be allocated to the trust at the time of formation rather than waiting until the end of the fixed term. Further, the interest rate is lower than that used for a GRAT.

The disadvantages of the sale to grantor trust technique are that it is not based on a specific statute and regulations. Rather, it is based upon a series of authorities which tax planners have put together to support the entire approach. Also, either a gift of approximately 10% of the value of the assets sold or a guarantee of that amount needs to be made in order to establish the “validity” of the trust before it purchases the assets.

4. **Charitable Lead Trust.** This approach allows charitably inclined grantors to provide significant current charitable benefits as well as save substantial estate taxes. A charitable lead trust is similar to a GRAT, with the annuity paid to charity instead of being retained by the grantor. For example, assume that you contribute $1,000,000 of assets to a CLT. Each year for ten years, the trustee will pay $119,635 to the charity you have chosen. These annuity payments equal $1,000,000 plus 3.4% per year (the December 2008 interest rate). As a result, there is no taxable gift when this trust is created. Assume that the assets in the trust grow at 10% per year. At the end of the ten-year period, $687,055 will be left in the trust. These assets can be transferred to your beneficiaries or to an Alaska Self-Settled Discretionary Trust, which includes you as a discretionary beneficiary. These trusts are discussed further, below.

Again, these remaining assets are so large because they represent the difference between the assumed 10% growth rate and the required interest rate (3.4% for December 2008). Our planning is designed to take advantage of the great difference between these two rates due to the very low interest environment we are presently experiencing.

A charitable lead trust is very popular in a low interest environment. It provides you with the opportunity to make charitable contributions now to your favorite charities, to your private foundation, or to a donor-advised fund with a public charity such as a community foundation.

A charitable lead trust is not income tax exempt. However, the income earned by the trust each year is offset by the charitable deduction obtained when the income is distributed to charity as the annuity payment.

Charitable lead annuity trusts are reportedly the technique used by Jacqueline Onassis in her estate planning.

5. **Alaska Self-Settled Discretionary Spendthrift Trusts.** In 1997, Alaska was the first state to enact a usable statute authorizing self-settled discretionary spendthrift trusts (also called Domestic Asset Protection Trusts, “DAPTs”). Now, twelve states have enacted this type of statute. This new legislation reversed prior law and provides that a person may create an irrevocable trust, transfer assets to it, and be a discretionary beneficiary of the trust; but the settlor's creditors cannot reach the assets in the trust.

From an estate tax standpoint, because the settlor's creditors cannot reach the assets in the trust, the settlor's "ability to incur debt" does not give the settlor "dominion and control" over the trust assets. Accordingly, the settlor's transfers to a DAPT are completed gifts. The IRS has agreed. In addition, strong arguments exist that none of the inclusion provisions of the federal estate tax apply to assets in a DAPT. The reason is that the settlor has not *retained* the enjoyment or income from the assets, nor does the settlor possess at death the power to alter, amend, revoke, or terminate the transfer. In Revenue Ruling 2004-64, the IRS seems to agree with this reasoning in an analogous situation.

As a result, you can create an Alaska DAPT, and contribute assets to it either directly through gifts, or indirectly through the use of a Grantor Retained Annuity Trust, Sale to Grantor Trust, or Charitable Lead Trust, and you can be included in the class of discretionary beneficiaries to whom an independent trustee may make distributions. A strong position exists that these assets will not be included in your gross estate at your death. If you need funds in the future, due to an unexpected financial downturn, the trust assets are available.

## ALASKA ESTATE AND TRUST LEGISLATION

In our last newsletter, we reported on **House Bill 197**, which was pending before the Alaska Legislature. This bill was passed in the 2008 legislative session. In summary, this bill allows shares of professional corporations to be owned by a revocable trust; provides extensive provisions relating to trustees; provides that Alaska's "decanting power" is available to trustees of trusts which have been moved to Alaska; allows the trustee of a charitable trust to select the percentage payout; and clarifies that a settlor's expressed intention to protect trust assets from a beneficiary's potential future creditors is not evidence of an intent to defraud.

You may refer to our Winter 2007 newsletter for a fuller description of these new provisions.

**House Bill 196** enacted the Uniform Anatomical Gift Act. In addition, this bill enacted several important and practical probate and asset protection provisions. Existing statutes have always allowed for a "probate by affidavit" procedure for estates involving assets with a value of less than $15,000. This procedure is very simple and avoids the complexity and formalities of a full informal probate. The new statute increases the value for vehicles which do not exceed $100,000 and for personal property other than vehicles that does not exceed $50,000. Therefore, it will be much easier to probate small estates in the future.

House Bill 196 also clarifies and broadens protection from creditors for life insurance and retirement plan proceeds. These payments are not subject to the debts of the insured under a life insurance policy or the debts of a participant in a retirement plan. This protection applies even though the life insurance proceeds or retirement plan payments are payable to a decedent's estate, the decedent's revocable trust, or another trust. An exception is provided if the decedent owes child support or spousal support arrearages.

In summary, this new legislation protects life insurance proceeds and retirement plan payments from the creditors of the deceased insured or the participants in a retirement plan regardless of the recipient of the proceeds or payments. A simple example would be a decedent who had a $100,000 life insurance policy which was paid to his estate. Even though he had claims against his estate of a much greater amount, all of the life insurance proceeds would go to his beneficiaries designated under his will.

The full text of House Bill 196 and House Bill 197, as enacted and effected in 2008, is available on the "Statutes" page of our web site.

## EXXON VALDEZ CLAIM TAX REPORTING

Distributions will soon be made as part of the resolution of the Exxon Valdez oil spill litigation. In the Emergency Economic Stabilization Act of 2008, Congress enacted legislation which is designed to ease the tax consequences to Exxon Valdez claimants. In summary, the Act allows commercial fishermen and other individuals whose livelihoods were impacted by the oil spill to average their settlement over three years for federal income tax purposes. In addition, a claimant may contribute up to $100,000 to a retirement account and thereby avoid recognition of taxable income until the amounts are withdrawn from the retirement account. Finally, the Act provides that no portions of the settlement income shall be treated as self-employment income or wages for Social Security purposes.

## OUR OFFICE ESTATE PLANNING PRESENTATIONS

Clients and professionals have contacted us and requested basic presentations describing estate planning and related subjects such as business succession planning. As a result, we have started a program of offering presentations periodically in our office conference room. Presentations are scheduled for late afternoon and usually last for an hour and a half. One of our attorneys will narrate a PowerPoint presentation for approximately forty-five minutes and then we have approximately forty-five minutes of discussion and questions. These sessions have been very popular.

**You are invited** to attend one of these sessions if you would like a refresher in estate planning. Please consider recommending them to your family and friends. If you are a professional, we are happy to host you and your clients for a presentation. Of course, there is no charge or obligation connected with these presentations. We hope that you will find them useful, and we hope that you will consider us in the future for you estate planning needs.

If you are interested, please call Kim to find out the time of the next presentation.

## OUR STAFF AND THEIR ACTIVITIES

**Dave** published articles in the March and April 2008 editions of ESTATE PLANNING magazine comparing the laws of the eleven states that had enacted domestic asset protection trust statutes. Attorneys from each of the eleven states assisted in editing the material for their state laws. The resulting comparison has been very popular, and law professors and attorneys giving estate planning presentations have contacted us for permission to use these materials.

In December, Dave will participate in a national closed circuit television presentation for financial planners. The topics to be discussed include grantor retained annuity trusts, sales to grantor trusts, and charitable lead trusts.

We have a **new legal assistant**, Terise n'ha Caitriona.

Terise is very happy to be an East Coast transplant to Alaska. She graduated from the University of Alaska Anchorage in 2000 with a Bachelor's Degree in English Rhetoric and her Paralegal Certification and has worked in the fields of business and personal injury law.

Terise assists clients with the implementation of their estate plans, including trust funding, gifting, limited liability companies, and other business entities.

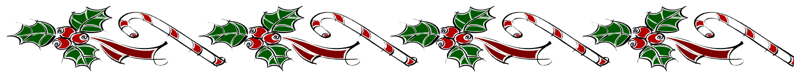
When not working, she and her husband can be found being led on a merry chase by their three-year-old twin daughters.

## OUR WEB SITE

You may refer to our website for a variety of information:

- A "what's new" discussion of developing estate planning subjects;
- New federal and state legislation affecting estate planning;
- A "checklist" for evaluation of your estate planning;
- Discussion of a number of relevant estate planning techniques;
- Our past newsletters;
- Key Alaska estate planning statutes; and
- Many articles which we have written about Alaska estate planning techniques.

We hope you will visit our web page at your convenience. Please email us at <**info@shaftellaw.com**> with your estate planning questions or topics which you would like to see discussed on our web site.



***We hope the above information is helpful to you. We remain available to help you create and maintain your estate planning and to add appropriate new techniques when you so desire. If you would like to meet with one of our staff to discuss your planning, please call.***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