Estate Planning Opportunities

Arguably the most effective wealth transfer strategies in the recent past, grantor retained annuity trusts (GRAT) and sales to intentionally defective intervivos trusts (IDIT) have become even more attractive in recent months with the credit crisis and disruption in the U.S. and world markets which has caused many assets to drop in value and interest rates to decline to historical lows. The combination of these events has created a unique opportunity to gift real estate, stocks and/or other assets.

In essence these strategies freeze the value of and return on selected assets at today's prices and yields. The appreciation from these levels along with increased yields in the future accrues to the benefit of your beneficiaries and escapes estate taxation upon your passing. A greater description of these strategies will follow after we lay out some basic facts and assumptions.

The federal estate tax rate for 2008 for estates over $2,000,000 is 45%. For 2009 the exemption increases to $3,500,000. For 2010, the estate tax is scheduled to be zero and for 2011 the exemption goes back to $1,000,000 combined with a 55% rate. It is unlikely that 2010 and 2011 will remain as stated above. More will be known after this year's presidential elections. Most states also assess estate taxes; so many taxpayers over these thresholds could face a total estate and/or inheritance tax rate greater than 50%.

Taxpayers can give $12,000 per year per recipient without incurring tax. In addition, by making payments directly to educational institutions or medical providers, taxpayers can make unlimited gifts for the benefit of others without incurring tax. Finally taxpayers can give up to $1,000,000 in their lifetime in addition to the $12,000 annual amount and unlimited educational and medical amounts without incurring tax.

The basic principle behind GRATs and sales to IDITs involves the gifting or sale of assets with the potential of significant appreciation to the next generation as opposed to lower growth assets since you want to defer the estate tax on future appreciation. Since estate taxes are paid on the value of assets, any chance to transfer assets when valuations are likely to significantly increase in value in the future is an attractive strategy. Also the ability to discount the value of assets because of their lack of marketability and/or lack of control which commonly exists with limited partner and limited liability interests are attractive vehicles to use in transferring assets.

Another strategy is to sell assets to an IDIT, where a grantor trust purchases assets from the grantor in exchange for a promissory note which must bear interest at the applicable federal rate (AFR). A down payment of approximately 10% is usually gifted to the trust by the grantor.

Upon termination of the trust the assets pass to the designated beneficiary. The mid-term AFR for April 2008 is 2.87%, which, like the 7520 rate, is the lowest it has been since July and August 2003 when it was at 2.55% and 2.70%. Like the GRAT all income taxes on the trust's income are paid by the grantor and any gain on the initial sale of assets from the grantor to the trust and interest payments to the grantor are ignored for income tax purposes.

Let's start with a simple example where an individual is comfortable utilizing either the GRAT or sale to IDIT strategy with assets totaling $10 million. Furthermore let's assume this is set up in April 2008 and a fully taxable yield of 10% is earned on the assets over the next nine years, the term of the GRAT and IDIT promissory note. To make the comparative calculations useful, we need to assume the grantor dies which we will assume occurs just after the end of the nine year GRAT.

- Using a GRAT that pays the grantor $1,308,404 or approximately 13% per annum for nine years, the beneficiary will end up with $10.4 million after payment of all income, gift and estate taxes. It should be

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noted that with a payout this high there are no gift taxes paid. This is known as a zeroed out GRAT.

- Using a GRAT that pays the grantor $500,000 per annum for nine years, the beneficiary will end up with $12.9 million after payment of all income, gift and estate taxes.
- Using a sale to an IDIT that pays the grantor $258,300 per annum (interest at 2.87% on the promissory note) for nine years, the beneficiary will end up with $13.6 million after payment of all income, gift and estate taxes.
- If the taxpayer does nothing to reduce his/her estate tax the beneficiary will end up with only $9.1 million.

If you believe that values will appreciate significantly due to the current disruption in the markets and your actual future returns are higher the savings increase dramatically. Combine this strategy with the limited partnerships and/or limited liability companies where you can discount the value of the asset given, the savings become much larger. For example if you were able to take a 35% discount on the assets contributed to a GRAT or sold to a IDIT the beneficiary could receive more than $24.1 million or a savings of more than $15 million.

There are additional considerations when evaluating a GRAT. The term for a GRAT can vary as well as the annuity payments. However, the annuity payments can not exceed 120% of the prior year's payment. A risk with a GRAT is that if the grantor dies during the annuity term, part or all of the trust assets are included in the grantor's taxable estate, reducing or eliminating the benefit of this strategy. But the grantor can never be in a situation worse than if the GRAT was never formed, which is not the case with a sale to an IDIT. In addition to the examples above it is also possible to use several shorter term GRATs "Rolling GRATs" which might be an attractive alternative to a taxpayer who doesn't want to do it all at once or if they don't want to try to "time the market".

Although it is difficult and sometimes dangerous to generalize, we have found that sales to IDITs create a greater benefit due to the following reasons: (1) The hurdle rate is usually lower than for GRAT's since the AFR is usually always lower than the Section 7520 rate; (2) The ability to utilize a commercially reasonable interest only promissory note for many years; (3) Early distributions to the beneficiaries can be made from the grantor trust which is not possible using a GRAT; (4) If the grantor dies during the term of the trust only the note receivable is included in his or her estate; and (5) It is possible to design the trust to be exempt from generation skipping transfer tax which is not possible with a GRAT. However, one possible downside in sales to IDITs is if the asset declines in value by an amount greater than the benefit of having the grantor pay their income taxes they would be in a worse situation than if the sale did not occur.

Also, those taxpayers who are charitably inclined, a charitable lead annuity trust is an attractive vehicle that should be considered when interest rates are low. In this structure, the charity receives the annuity versus the grantor as in the GRAT, with the remainder going to the designated beneficiary.

If you have questions regarding matters contained in this , please contact your locate Auto Team America member today!

Affairs of Estate

It is a common misconception that a will is the final authority when it comes to identifying beneficiaries, but this is not the case. In fact, the beneficiaries you have designated on your insurance, banking, and investment accounts actually wins out over any beneficiaries stipulated in a will.

It is even more important to maintain your beneficiary designations than it is to maintain your will, but for many people this is an afterthought. Not designating a beneficiary for your various accounts can often lead to those accounts entering probate and being lumped together with your estate and dispensed by the court. In this situation, not only are you deferring to the judgment of the court for the distribution of your assets, but your assets may be subject to additional taxes as well.

As your life changes it's vital that your beneficiary designations remain up-to-date. It's often recommended that at least two contingent beneficiaries be named for every primary. This can prove to be an invaluable step if your primary and first contingent should pass way before or simultaneously with you.

It is a good idea to review all of your beneficiary designations for your various accounts at least once a year.

TAX TIP

Roth IRA Conversion Opportunity

As the end of 2009 approaches, a significant opportunity awaits many individuals. Beginning in 2010, taxpayers will be able to convert their traditional IRA (and funds that have been rolled over from a qualified plan) to a Roth IRA, regardless of their income level or filing status. What's more, the tax on the taxable income generated from a 2010 conversion may be deferred until 2011 and 2012. This new conversion option presents both tax planning opportunities and challenges for 2009, 2010 and 2011.

An IRA conversion is treated as a taxable distribution, taxed as ordinary income at your marginal tax rate. This in effect accelerates the taxable income that you would eventually pay on distributions from a traditional IRA once you retire, but does so in exchange for never taxing any future appreciation in the value of your account from what it is today. That is often a significant tax advantage. You should also note that unlike a withdrawal from an IRA, a conversion does not trigger any 10 percent early withdrawal penalty.

Although conversion to a Roth IRA does trigger immediate taxable income, Congress provided a special incentive in 2010 to jump-start Roth conversions. In 2010 (and 2010 only), individuals will have the choice of recognizing their conversion income in 2010 or averaging it over 2011 and 2012. The latter option, which must be elected, allows you to pay taxes on the converted amount ratably over two years, instead of recognizing it all as income in one year. You will be taxed at the rates in effect for 2011 and 2012.

For some taxpayers, their tax rate may rise after 2010 even if their income does not. President Obama has proposed, and Congress is expected to enact, legislation to restore the top two pre-2001 marginal income tax rates after 2010. This means that the top two brackets will be 39.6 percent and 36 percent after 2010. Consequently, if you do not want to take the chance that your income tax rate will be higher in 2011 and 2012 than in 2010, you may want to elect to pay the full tax on the Roth conversion in your 2010 income tax return, at 2010 income tax rates.

Higher-income individuals who plan to pay the entire conversion tax in 2010 instead of ratably in 2011 and 2012 because of the anticipated increase in the top marginal tax rates, may want to avoid, for year-end 2009, the traditional year-end-planning techniques of accelerating deductions and deferring income. Alternatively, consider doing the opposite this year to avoid being pushed into the highest brackets by a large IRA-to-Roth-IRA conversion.

An IRA to Roth IRA conversion should be considered by individuals who:

- Can afford the tax on the converted amounts;
- Anticipate being in a higher tax bracket in the future than they are currently in; and
- Have a significant amount of time before reaching retirement to allow assets to grow tax-free and recoup dollars that may have been lost due to the conversion tax.

If you are planning on taking advantage of the Roth IRA conversion opportunity next year, consider some of the following strategies this year:

- Because of the economic slowdown, many individuals are postponing retirement. Roth IRAs, unlike traditional IRAs, generally have no age limitation on contributions from earned income or on mandatory payouts. This is an advantage for individuals who are extending their careers beyond traditional retirement age.
- If you are able to make deductible IRA contributions this year, do so. This can help you reduce your 2009 tax bill and, if you convert to a Roth IRA in 2010, you will not have to pay back the tax savings until 2011 and 2012, if you elect to ratably pay the tax over the two-year period.

If you anticipate being below the $100,000 AGI level this year, consider converting to a Roth IRA right away while your traditional IRA account balance is still low because of stock market declines. If your situation is different from what you anticipate before you file your 2009 return, you might consider "recharacterizing" your 2009 Roth conversion back to a traditional IRA and then converting to a Roth IRA in 2010 instead.

There are a significant number of tax and financial considerations that come into play when determining whether to convert your traditional IRA to a Roth IRA. If you have any questions about traditional IRA to Roth IRA conversions and the new 2010 planning opportunity, please consult with your ATA representative for further information.