



VERDON'S VIEWS

With so much turmoil in the economy in the last two months, coupled with the tax law changes expected with the new administration and Democratic-controlled Congress, we felt it timely to send out a special client newsletter that addresses how these factors impact your estate and income taxation planning. These times certainly present their challenges; but with these challenges come growth and opportunity—particularly in the areas of estate and gift tax planning. This newsletter will highlight some of these challenges, discuss areas in your existing planning that should be reviewed as a result thereof, and explore planning opportunities that are available to you.

A few points to consider:

- With proposed estate tax law changes under the new administration, particularly anticipated restrictions on valuation discounts, there are various strategies that should be considered to ameliorate the negative impact on your estate.
- In light of the severe decline in value across multiple asset categories, it is prudent to review your estate plan to ensure that the drop in asset values does not have significant and unintended consequences to your desired planning.
- Reduced asset values and low federal interest rates provide once in a lifetime transfer wealth opportunities at reduced transfer tax costs. For instance, consider creating a Grantor Retained Annuity Trust (GRAT) for income producing assets to take advantage of the current depressed prices and low IRS discount rate.
- With the turbulent economy, frivolous law suits are on the rise, so now is a good time to integrate asset protection strategies into your estate plan.

We hope you find value in this newsletter and we look forward to receiving your comments. Everyone at the firm wishes all of you a peaceful and prosperous holiday season and New Year.

— Jeffrey M. Verdon, Esq.

FEATURED ARTICLE

THERE MAY BE DEFLATION, BUT THE COST OF DYING WILL LIKELY INCREASE

By Andy J. Epstein, Esq. CPA, LL.M. (Taxation)

The Consumer Price Index decreased by 1% for the month of October 2008. This was the biggest decrease since the Great Depression and is likely to continue. However, there are at least two costs that will likely increase after the new President takes office on January 20, 2009: the cost of dying and the cost of giving gifts.

Politicians love tax increases that do not look like tax increases. A 2005 Congressional Report offered two proposals for increasing estate taxes without increasing rates. This Report has sat on the shelf for the last three years; however, the new Congress is likely to enact these proposals—as early as next year. The two proposals would restrict valuation discounts and thus subject transfers of property to higher estate and gift taxes. The first proposal would restrict the use of “minority interest discounts” and the second would restrict the use of “lack of marketability discounts.”

The new law could affect donors and decedents as early as January 1, 2009. Therefore, a window of opportunity exists now to reduce potential estate and gift tax liability.



The Problem - Your Estate Tax Could Double

Currently, a property that is worth \$200,000 might be valued at \$100,000 after taking both a "minority interest" discount and a "lack of marketability" discount. This property would be subject to estate tax of \$45,000. Under the proposed changes (which reduces the minority and lack of marketability discounts), this same property could be valued at \$200,000 and subject to estate tax of \$90,000. The two proposals, which do not ostensibly raise tax rates, could still end up doubling the amount of estate tax due on the transfer of the very same property. Higher estate and gift taxes mean less property to pass onto your heirs.

Minority Discounts Will Be Limited

Currently, property is valued for estate and gift tax at its fair market value. This value is further reduced where the owner of the property is passing on a less than one-half interest. Discounts of 25% and more have been allowed by the Courts and reflect the fact that an owner of less than a one-half interest has limited control over the asset.

Under the first proposed change, these discounts would be eliminated when either immediately prior to the transfer or immediately after the transfer, either the transferor or the recipient owns a majority interest in the property. To make matters even worse, the interests of a husband and wife would be combined in determining whether either the original owner or the recipient of the transfer has a controlling interest in the property.

For example: If a husband and wife each own a 30% interest in an entity, a transfer of any interest by either would be subject to the proposed rules, because combined they own a 60% majority interest in the entity.

Marketability Discounts Will Be Limited

Currently, if an interest in an entity such as a limited liability company is gifted or passes at death, the value of the interest for tax purposes may be reduced for lack of marketability.

Under the second proposed tax law change, if the conditions discussed above apply, and at least one-third of the entity's value comes from assets such as cash or stock, no lack of marketability discount will be allowed for this portion.

The Solution

These proposals could impact you as early as January 1, 2009. There are various strategies that can be employed to minimize the impact of these anticipated estate tax law changes on your estate planning.

For example: If marketable assets such as cash comprise one-third or more of the assets of an entity, the owners can contribute non-marketable assets in an amount that reduces the relative share of marketable assets to less than one-third. This strategy would eliminate the effects of the limitation on the use of marketability discounts.

For information about alternate strategies to meet your planning goals and objectives, please contact the firm or visit www.jmvlaw.com.

ESTATE PLANNING Q&A

Question 1: What changes can we expect to the Estate Tax and relevant exemptions with the new administration?

Answer: Under current law, the estate tax disappears in 2010 and comes back in 2011 under the rules that were in effect in 2001. Nobody expects the law to stand as is. It is widely anticipated that the estate tax exemption of \$3.5M for 2009 and the rates for that year will be made permanent and that the maximum estate tax rates will be 45%. In addition, the rules allowing valuation discounts will probably be made stricter thereby eliminating some of the discounts that are currently available (*see Featured Article*). This would result in a decedent's taxable estate having a higher value than under current law and thereby resulting in higher estate taxes.



Question 2: What are some recommended year-end planning strategies to put in place before the Democratic administration begins?

Answer: Take advantage of the gift tax exemption for 2008! Each person currently has the ability to gift up to \$12,000 per year to any other person or to special trusts that are established for other people who have special withdrawal rights over these trusts. Therefore, an immediate opportunity exists to transfer wealth outside of the “taxable estate” by making use of this gift tax exemption. For example: A married couple with two children and one grandchild could gift a total of \$72,000 worth of assets to them or in trust for their benefit without this counting as a taxable gift, i.e. a gift of \$12,000 from each parent to each child and grandchild. Note: If you gift more than the exempt amount, you must file a tax return with the IRS on the excess amount (which will be subtracted from your \$1 million lifetime gift tax exclusion).

In addition to annual gifting, there are many other strategies that can be utilized to shift value while preserving the estate tax exemption allowances. Following is a summary of some of the strategies utilized by our clients:

- a. ***Make an outright gift of assets to children and grandchildren*** – This is the simplest form of gifting, but the downside is that there is no ability to regulate how those gifts are utilized.
- b. ***Establish 529 (Educational) Plans*** – This is a plan (which must be funded with cash, not other assets), for the purpose of providing college education and living expenses for family members. The 529 rules allow you to contribute up to \$60,000 in a single year (5 year’s worth of \$12,000 gifts). This contribution will not reduce the amount of your lifetime federal estate tax inclusion, as long as you don’t contribute any more to the plan for the next 5 years. However, if you die before the 5 years are up, a portion of your contribution will be included in your taxable estate.
- c. ***Establish and fund an Irrevocable Gifting Trust*** – Many of our clients already have already chosen to establish and fund irrevocable trusts for their heirs. These trusts typically provide that the trustee can make distributions to or for the children as reasonably needed. On the death of the grantor or surviving spouse, the trust will typically divide into separate equal shares for each child and may be held for the lifetime benefit of each child.
- d. ***Gift partial ownership interests in FLPs or LLCs to children or to a trust benefiting the children*** – This type of giving takes advantage of the “valuation discount” rules on estates (*see Featured Article for more detailed information*). For example: A gifting of a 10% (minority) ownership interest in a Family Limited Partnership (“FLP”) which holds \$3M in assets may be worth for valuation purposes (assuming a 30% “minority interest” discount) only \$210,000. A gift of that 10% interest effectively removes \$300,000 of actual value plus 10% of the partnership’s future growth from the estate. Note: the amount of discount applicable for valuation purposes will vary based on the circumstances of the partnership or LLC. If the interest in the FLP or LLC is gifted directly to the children, they will be responsible for paying the taxes on that interest. If the interest is gifted to a trust benefitting the children, the trust can be structured so the grantor is responsible for the taxes. Properly structured gift trusts and FLPs may be disregarded for income tax purposes; which means the grantor(s) of the trust simply report all of the income and deductions of the FLP and trust on their personal tax returns. If you have a FLP, you may wish to engage in annual gifting based on the probability of the estate tax continuing for the next few years.
- e. ***Set up a “SuperFreeze” Trust*** – If you (or your FLP or LLC) hold income producing assets the value of which exceeds the lifetime Federal Gift Tax exclusion amount, then selling (rather than gifting) the interest to an estate freezing trust is the most effective wealth transfer strategy. This strategy freezes the value of the assets at the time of the sale to the trust, allowing the future growth of the asset to benefit your children. For example: If you own \$10M in growth assets, you can sell those assets to a gifting trust in exchange for a 9-year interest only promissory note at 2.95% interest. The investment growth inures to the gifting trust (rather than to you) and you are owed the \$10M promissory note + 2.95% interest. Another example: If instead, the \$10M in growth assets were owned by a FLP/LLC and you own a 50% interest that entity, then the 50% FLP interest (\$10M) might be sold to a gifting trust for \$7M (taking into account a 30% valuation discount). The growth on the \$10M in assets inures to the trust for the children, which owes back to you only \$7M plus interest at 2.95%. Conceptually, this immediately moves \$3M worth of wealth from your taxable estate, and if the \$10M worth of assets increases to \$20M, the difference between \$20M and \$7M plus interest at 2.95% has been shifted to the trust for the children.



- f. **Establish a Grantor Retained Annuity Trust (“GRAT”)** – A GRAT is an effective vehicle to transfer appreciation in the value of trust property at little or no gift tax cost. The Grantor contributes property to the trust that pays a set amount of income (annuity) payable in cash or in kind back to the Grantor. The present value of the annuity is calculated based on the value of the assets contributed to the trust and a discounted rate set by the IRS for the month in which the GRAT is funded. The annuity payments are typically set at a level that virtually eliminates any possible gift tax. If the trust’s assets grow at a rate faster than the IRS tax rate (3.4% for GRATs funded in December 2008), the assets remaining in the GRAT at the end of the term after payment of the last required annuity payment pass to the remainder beneficiaries of the trust without any gift tax. If you own stock you expect to appreciate substantially over the next few years, you may want to consider creating a GRAT to take advantage of the current depressed prices and low IRS discount rate.
- g. **Qualified Personal Residence Trust (“QPRT”)** – With the current low real estate values, many clients are considering a transfer of their vacation properties or personal homes into a QPRT. This kind of trust removes your home from your taxable estate, but enables you to continue to live in the home for a predetermined length of time, usually 10-15 years. Then, ownership of your home is either transferred directly to your beneficiaries or to another trust.

To find out more about these strategies and to determine which of them are right for you, please contact the firm or visit www.jmvlaw.com.

Question 3: How often should I have my estate plan reviewed?

Answer: It is important to review your plan regularly to ensure it continues to achieve the objectives of you and your family. Your estate plan may need revision:

- when your financial situation changes, e.g. real estate or stock values decrease or upon sale of an asset or assets;
- when your family situation changes, e.g. divorce or death, or birth of child;
- when the economy takes a significant up or downturn; or
- when the laws impacting income and estate taxation change or are expected to change.

For example: Your estate plan may provide that the estate tax exemption amount passes to the children with the remaining assets passing to the surviving spouse. However with the increase in estate tax exemption amount (from \$2M in 2008, to \$3.5M in 2009), coupled with the recent downturn in financial markets, this plan may leave a surviving spouse with insufficient funds to maintain his/her lifestyle. This is just one example of why you should review your current estate plan. To schedule a planning review, please contact Lisa Leslie, Director of Client Relations, at lisa@jmvlaw.com.

For more information about any of the techniques and strategies discussed in this newsletter, or any other income or estate tax planning assistance, please contact us at info@jmvlaw.com or 1-800-521-0464.

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