



SOME SILVER LINING IDEAS IN THE ECONOMIC STORM CLOUDS

HARRIS myCFO | BY CLAUDIA B. SANGSTER, DIRECTOR, PHILANTHROPY, ESTATE & TRUST SERVICES, HARRIS myCFO, INC.

These are tough times.

It seems that every time we open a paper or turn on the television or Internet we are confronted with bad economic news. The credit markets are tight, the stock market is fluctuating wildly, 401(k) plans have dropped precipitously, layoffs are becoming routine, home foreclosures are at an all time high, and bail-outs in excess of a trillion dollars have been approved by Congress or are under consideration to either shore up capitalization and safeguard banks or stimulate the economy. Worsening economic news is heralded from the headlines in a seemingly relentless stream of dismal financial reports. However, there are opportunities even during difficult economic conditions. **Yes, there is some good news! There is a silver lining in the storm clouds that have gathered around us.**

For estate planners and wealthy families, this may be an unprecedented opportunity to take advantage of low valuations and low interest rates to pass significant wealth to the next generation. And, it couldn't come at a more opportune time. Since 2001, estate planners have been in a kind of "limbo" in terms of planning for their clients. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) changed the estate tax rules to increase the lifetime exemption over time until this year—2009; the exemption is \$3.5M per person. Additionally, for the year 2010, the estate tax is scheduled to "disappear" and then miraculously "reappear" in 2011 at its 2001 exemption amount. It is doubtful that the current Congress will allow the estate tax to be repealed—even for one year—and in fact legislation has already been introduced to freeze the lifetime exemption at \$3.5M with the highest marginal tax rate of 45%.

For those individuals who remember headlines in 2001 that shouted, "The Estate Tax Is Dead!" the reality is that it appears that such will not be the case. Even though a husband and wife with proper planning can currently shelter a combined \$7M in their estates, for wealthier clients, planning still must be undertaken if the tax man is to receive a smaller share of the estate.

Also on the horizon is the specter that Congress will eliminate discounts on inter-family transfers of closely held stock, partnership or limited liability company interests. A bill addressing those common techniques is pending as this is written. For families who have created entities such as family limited partnerships and whose partnership does not run an active trade or business,

this may herald the death knell for minority and lack of marketability discounts when those partnership interests are transferred to family members.

Estate planners have always sought ways to move assets inter-generationally with the minimum of transfer tax costs. Given the fact that there will likely be an estate tax and it will be harder to take advantage of valuation discounts for inter-family transfers, several popular techniques should be seriously considered now more than ever:

1. Grantor Retained Annuity Trusts (GRATs).

The current low-interest environment coupled with historically low asset values (which can be enhanced if utilizing interests in partnerships or LLCs or closely-held stock while the current law is in effect for discounts) allows the Grantor to move significant value to the next generation with less transfer tax cost. This is how it works. The Grantor transfers property to an irrevocable trust which is to last for a term of years. The Grantor retains an annuity, based on the value of the assets contributed at the time the trust is established. Based upon the amount of the annuity, the length of the term of the trust and the federal discount rate set by the IRS for the month in which the trust is established, the present value of the annuity interest retained by the Grantor is determined. The lower the discount rate and the longer the term, the higher the value of the Grantor's annuity interest. The net taxable gift to the GRAT's remainder interest beneficiaries, i.e., the children, is only a small fraction of the value of the initial gift because the retained interest accounts for most of the present economic value.

If the Grantor lives to the termination of the trust, the value of the remaining assets (plus any appreciation) passes to the children with no further transfer tax cost. There is a hitch, though, if the Grantor dies prior to the termination of the trust. If that occurs, the value of the assets in the trust necessary to provide the annuity at the Grantor's death is included in the estate for tax purposes. However, although the intended benefits may not be realized (passing the assets to the next generation at a reduced tax cost), the Grantor does not risk an adverse estate tax result if the trust is drafted to have the remaining assets pass to the Grantor's spouse in such a way that no estate taxes are payable at the Grantor's death.

CONTINUED NEXT PAGE >

2. Sale to Grantor Trusts. Another technique to think about is the sale of an asset that is expected to appreciate substantially over time, to a Grantor Trust. With this planning, the Grantor first transfers assets to an irrevocable trust that is structured to be treated as owned by the Grantor for income tax purposes. The Grantor then sells the asset which he or she intends to pass to the next generation, to the trust, usually on an installment basis. The assets which were previously transferred to the trust by the grantor are utilized as the down payment for the sale between the Grantor Trust and the Grantor. Because this is a special type of trust (a Grantor Trust), there are no tax consequences to the Grantor for entering into the sale transaction—the Grantor is in effect selling the asset to himself or herself for tax purposes.

It is important that good asset valuations be procured and that the sale transaction is not only properly documented but that the payments are actually made from the trust to the Grantor under the installment payout plan. The arrangement must have substance and the trust must be ready to enforce its rights to collect on the payments just as any third party would do, including litigation. But, again, with values and interest rates at historical lows, the cost of the sale to the trust is lower and the ultimate beneficiaries, i.e., the children, are able to ultimately receive appreciated assets at a lower transfer tax cost.

3. Charitable Lead Trusts (CLTs). If you can part with assets without jeopardizing your financial security and you want to transfer them to the next generation in a tax-advantaged way, now is the time. Unlike Charitable Remainder Trusts, which won't benefit your favorite charity until the trust terminates, a CLT makes payments to the charity throughout the term of the trust. What's more, the non-charitable beneficiary (typically your children and/or grandchildren) receives the remaining trust assets at the termination of the trust. And when

interest rates are low, as they are now, the present value of the remainder interest (calculated when a CLT is created) is generally lower, which means the value of the gift that you are considered to be making to the next generation is also lower. Lower remainder interest values mean lower transfer tax costs. In the end, CLTs create precisely the win-win situation that estate planners look for when advising their clients: immediate payments to benefit your favorite cause and lower transfer taxes when you pass the assets on to the next generation.

4. Direct sales of assets to children and grandchildren.

Even simpler, individuals should consider selling assets to their children or grandchildren directly. Currently, valuations and interest rates are low and this is a way to “freeze” the value of an individual's estate because the installment payments are fixed and determinable. All the future appreciation will accrue to the benefit of the next generation and out of the hands of the tax collector, if properly structured and implemented.

5. Finally, gifts of assets to children and grandchildren.

Let us not forget that individuals can make outright gifts to children and grandchildren. Before family transfer discounts are swept away by Congress, before the asset values start to grow, this is the ideal time to consider making gifts. The lifetime gift tax exclusion has not changed—it is still \$1M—but if an individual has not taken full advantage of the lifetime exclusion, smart planning now can reap significant transfer tax savings.

The news out there is disconcerting. However, there is good news if one only looks for it. Low values and low interest rates are not all bad, particularly when there is a need to make inter-generational transfers in a tax-cost advantaged manner. These strategies demonstrate that there is a “silver lining” even in these difficult economic times!

© 2009 Harris Bankcorp, Inc.

Harris myCFO™ is the brand used by Harris myCFO, Inc., providing family office services, Harris myCFO Investment Advisory Services LLC, an SEC-registered investment adviser, and certain divisions of Harris N.A. and its affiliates that are national banks with trust powers.

United States Department of Treasury Regulation Circular 230 requires that we notify you that this summary is not intended to be tax or legal advice. This summary cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. This summary is being used to support the promotion or marketing of the planning strategies discussed herein. Harris N.A. and its affiliates do not provide legal advice to clients. You should review your particular circumstances with your independent legal and tax advisors.

ESTATE PLANNING REQUIRES LEGAL ASSISTANCE, WHICH HARRIS N.A. AND ITS AFFILIATES DO NOT PROVIDE. CONSULT YOUR PERSONAL COUNSEL.

