khabar®

May 2009

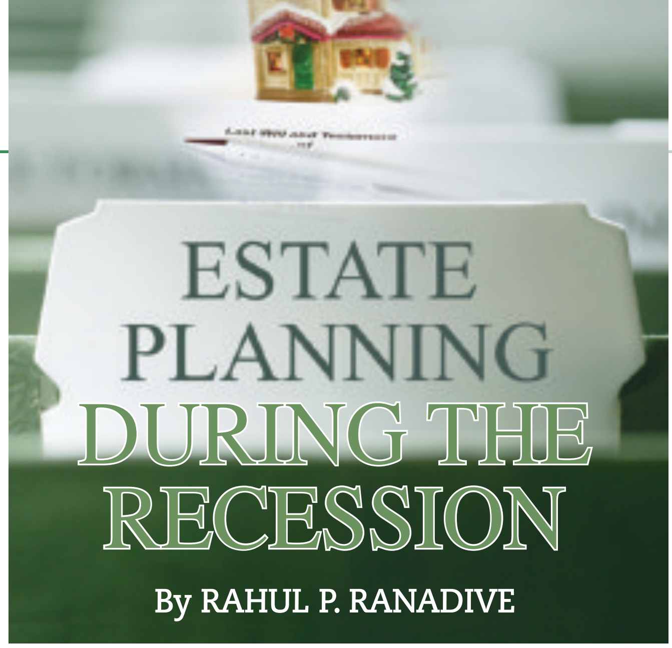
Your Passport to the Indian-American Community

www.khabar.com

WEALTHY! A TRIBUTE TO A MOTHER

MINAL HAJRATWALA'S *LEAVING INDIA*

If You're Not on Facebook Do You Exist?



ESTATE PLANNING DURING THE RECESSION

By RAHUL P. RANADIVE

Transferring wealth to younger generations now can save you estate taxes in the future.

Lately, we've only heard bad news about the economy and the financial markets. Banks and venerable corporations once perceived as "blue-chip" are collapsing, or on the verge of collapsing. Home values are plunging in most areas of the country and almost everyone's retirement savings have taken substantial hits. But there is a silver lining in this cloud of gloom, which comes from where you least expect it: the IRS. Estate planning can be a complicated endeavor, more so during recessionary times,

WITH DEPRESSED ASSET VALUES AND THE LOWEST APPLICABLE FEDERAL INTEREST RATES ("AFR" SET MONTHLY BY THE IRS) WE'VE SEEN IN HISTORY, A PERFECT STORM EXISTS FOR PASSING FAMILY WEALTH AND FUTURE GAINS TO YOUNGER GENERATIONS NOW AT LITTLE TO NO TRANSFER TAX COST, PARTICULARLY FOR FAMILIES WITH AN ILLIQUID FAMILY BUSINESS, DEPRESSED REAL ESTATE OR PORTFOLIO INVESTMENTS, OR EXCESS LIQUIDITY.

since most estate planning techniques fail in falling markets. The current environment does, however, provide ideal conditions for estate planning techniques to succeed. With depressed asset values and the lowest applicable federal interest rates ("AFR" set monthly by the IRS) we've seen in history, a perfect storm exists for passing family wealth and future gains to younger generations now at little to no transfer tax cost, particularly for families with an illiquid family business, depressed real estate or portfolio investments, or excess liquidity.

This article summarizes estate planning techniques designed to succeed in this negative economic climate. A brief caveat, however, first. Current transfer tax laws are in a state of uncertainty and likely to change before year-end to avoid the pending change in law where 2010 has no estate tax at all, and January 1, 2011 brings back transfer tax laws that existed before 2001, with lower exemption amounts ($1,000,000 instead of $3,500,000) and higher rates (potentially up to 55 percent instead of the maximum 45 percent rate currently in effect). Many proposals that might reduce the benefits of estate planning techniques are floating around congressional tax-writing committees. Accordingly, since there may be changes to the transfer tax system, families considering any such transaction may wish to take advantage of the opportunities presented now before the law changes.

If your net estate is among the approximately 99.8 percent of all estates in the United States annually that are below the current exemption limits ($3,500,000 per individual, or $7,000,000 collectively for a husband and wife), your estate should not be subject to federal estate taxes; and the tax-planning techniques described below will be less applicable to your situation, if at all. Nevertheless, having your basic estate documents in place for non-tax purposes is still a very prudent thing to do. Every married couple should have **wills** drafted to determine orderly distribution of family assets and, if minor children are involved, who will be responsible for their care until they are 18; **revocable trusts** in place to serve as probate avoidance or minimization devices; **durable powers of attorney** to manage family and business assets during a long-term illness, or other temporary or permanent incapacity; **living wills** to set forth desired guidelines and standards for medical care decisions involving invasive procedures, life-prolonging treatments and machinery, and end-of-life decisions; and **health care surrogate documents** to maintain control over who makes such important health care decisions.

All families should address such basic non-tax estate planning questions early, and periodically review and update their documents every few years to account for major changes in life circumstances. Even if you don't need tax planning because your net estate does not exceed the exemption thresholds, there still remain many non-tax legal issues that need to be addressed by a successful estate plan.

Family Loans

One of the easiest and most effective ways to transfer wealth tax free is to loan money to your children at interest rates substantially lower than prevailing bank loan rates. This is true even if your net estate is within the exemption limits and you don't expect to have an estate tax upon death. Assume your son recently married and needs to buy a house but can't qualify for a mortgage in this tight credit environment. Or perhaps your daughter is presented with an excellent business opportunity but doesn't

>>

have sufficient funds for the investment. Or another child needs seed capital to start a business.

You can loan money to your children and avoid any gift tax by making the loan at an interest rate at least equal to the minimum AFR set by the IRS. For April 2009, the AFR ranges from 0.83 percent to 3.61 percent depending on the maturity date of the note, while in February 2009 the AFR ranged from 0.60 percent to 2.96 percent, the lowest in history. As the monthly AFR slowly inches back upwards, the benefits of intra-family loans are slowly being reduced. Locking in the lowest rate possible will lead to maximum transfer tax savings, so if you're already considering this technique, you may wish to act now before the rates move back up significantly.

Another attractive feature of intra-family loans is the ability to use them together with annual gifting strategies to achieve even greater transfer tax savings. To do so, Parent simply forgives $13,000 ($26,000 if loan is made by Mom and Dad) of the outstanding principal every year. This reduces the total amount of interest Child pays to Parent while the latter reduces the size of her estate by the amount forgiven annually, a benefit to both sides.

Grantor Retained Annuity Trusts (GRATs)

This technique is especially effective for illiquid assets expected to appreciate rapidly in the coming years. A properly drafted GRAT can push all of the expected post-transfer appreciation to younger generations completely free of transfer tax. GRATs rely on a specific tax law provision, known as the "7520 hurdle rate," which mandates the amount of annuity payment the donor must receive from the GRAT in order to avoid transfer taxes. If the asset contributed to the GRAT appreciates faster than the hurdle rate over the GRAT's life, such appreciation accrues entirely to the trust beneficiaries completely free of transfer tax.

For example, Parent owns a Ramada Inn that has dropped value in the current market, but is expected to recover rapidly in a few years because a new highway will be built in the area. Parent is considering retiring in a few years anyway, so Parent transfers the asset to a GRAT set to expire at a specified time (at least two years) in the future and designates Child as the beneficiary of the GRAT. To avoid gift tax on this transfer, Parent must receive an annuity payment back from the GRAT calculated using the 7520 hurdle rate in effect when the GRAT is established, the value of the contributed asset and the GRAT term. If the asset appreciates faster than the 7520 rate hurdle rate, all excess appreciation above the hurdle rate accrues to the benefit of Child completely free of transfer taxes to Parent. For February 2009, the 7520 rate was 2.0 percent, an all-time historic low. Already, for April 2009, the 7520 rate has jumped back to 2.6 percent, so if you are considering a GRAT, you may wish to act soon to lock in the lowest hurdle rate possible.

Intentionally Defective Trusts (IDITs or IDGTs)

A slightly more complex technique capable of producing higher transfer tax savings than GRATs is the sale of the same asset (our Ramada Inn from above) to an intentionally defective irrevocable trust (IDIT), also known as an intentionally defective grantor trust (IDGT). The trust is designed so Parent is intentionally treated as the trust's owner for income tax purposes, not the beneficiaries.

Here, Parent establishes the IDIT with a contribution of cash and debt (not exceeding a maximum amount of ten times the cash contribution) with the total cash/debt amount sufficient to purchase the Ramada Inn at its current depressed fair market value. So, if the Ramada Inn is worth $1,100,000, Parent would contribute $100,000 tothe IDIT and loan the IDIT another $1,000,000. The IDIT then buys the Ramada Inn from Parent and makes interest payments on the $1,000,000 loan to Parent. Because Parent is selling the asset to himself as the owner of the IDIT (hence the "intentionally defective" name) no capital gains is due on the sale, and because Parent similarly is paying interest to himself, no income tax is due. As long as the asset appreciates faster than the interest rate due on the loan, all appreciation in the asset beyond what's necessary to pay the loan accrues to Child within the IDIT and escapes transfer taxation to Parent.

A cautionary note regarding IDITs: they are not specifically addressed anywhere in the tax code or in case law, and the IRS has been known to challenge particularly aggressive IDITs. Accordingly, take great care to draft the IDIT within allowable parameters to reduce the risk of an IRS challenge.

An opportune time

In summary, now is the ideal time to be thinking about estate planning techniques that take advantage of depressed valuations and historically low AFR and 7520 rates. Whether you are approaching retirement and wish to pass the family business to the next generation, or have a depressed stock portfolio or income-producing property, or wish to make a loan to your children, the current economic environment and existing transfer tax laws make this an opportune time to consider any of the strategies outlined above. But, as noted above, the window may soon close on this perfect storm as interest rates move back upwards and Congress considers various proposals to change existing transfer tax laws.


Rahul Ranadive

Rahul P. Ranadive is admitted to the Florida and California bars and the U.S. Tax Court, and has practiced international and domestic tax planning focusing on high net-worth families with international ties for over 10 years. His law firm, Ranadive & Associates, P.A., is based in Miami, Florida, with satellite locations globally. He can be reached via e-mail at rpr@ranadivelaw.com or by phone at 305-913-7128.