



The Wealth Counselor

A monthly newsletter for wealth planning professionals

Year-End Planning Opportunities: More Than You Might Expect

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With unprecedented stock market volatility, depressed real estate and business values, the banking, mortgage and automobile industry crises, and numerous negative economic indicators, many clients are wondering what planning they should do now, if any. Some may view planning as discretionary, and without education these individuals may not move forward because of their unwillingness to make large discretionary expenditures during these uncertain times.

For many clients, however, planning is not discretionary. These clients have personal concerns that they need to address now because these concerns are unrelated to the economy - and may even be exacerbated by the current economic downturn. For more affluent clients, unusual circumstances have created a "perfect storm" that will not last long. This issue of *The Wealth Counselor* addresses some of those planning areas and discusses strategies that may create the biggest opportunities for clients - and you - today.

Recession-Proof Planning Needs

Many planning needs are unrelated to the economy. They include:

- Disability and retirement planning;
- Special needs planning;
- Divorce protection;
- Spendthrift protection;
- Creditor protection; and
- Second marriage protection.

These planning needs may be more critical for clients with fewer assets than for wealthier clients.

Disability Planning

For Americans aged 65 and older:

- 43% will need nursing home care;
- 25% will spend more than one year in a nursing home;
- 9% will spend more than five years in a nursing home;
- Average stay in a nursing home is more than 2.5 years.

Nursing home costs are increasing much faster than the inflation rate would imply. Your clients with non-

From [Randall Fisher](#)

Fisher Law Office

170 Jennifer Road
Suite 205
Annapolis, MD 21401
443-270-6305



The Fisher Law Office focuses on estate and wealth planning, business acquisition, operations and succession planning, and business and commercial law for single, married, or domestic partner situations or businesses in Maryland, Texas and the District of Columbia.

taxable estates are quite appropriately very worried about how they will pay for that kind of care if they need it.

Planning Tip: Careful consideration of long-term care insurance is critical for most clients.

Also of concern is who will care for your clients and whether they will care for your clients in the way your clients desire. For many, there is a strong desire to stay at home as long as possible. For others, the companionship found in an assisted living facility makes that choice preferable. Still others need care that cannot be provided at home at all or only at prohibitive cost.

Planning Tip: A trust with carefully drafted disability provisions is the best way to ensure that each client's planning meets his or her personal goals and objectives.

Special Needs Planning

Special needs planning is another area unrelated to the economy. According to the 2002 U.S. census:

- 51.2 million people reported having a disability;
- 13-16% of families have a child with special needs;
- Autism occurs every 1 in 150 births, and between 1 and 1.5 million Americans have an Autism spectrum disorder.

Failure to properly plan for a person with special needs can have disastrous consequences, especially if the person is receiving government benefits. A Special Needs Trust that incorporates specific care provisions is a critical component of the planning needed for a special needs person who needs ongoing support.

Insurance on the life of a special needs person's parents or grandparents can provide the trust funds necessary to pay for the care of a special needs beneficiary.

Planning Tip: Clients with special needs children or grandchildren are typically very motivated to plan for them.

Beneficiary Protection Planning

Protecting an inheritance from being lost in a divorce or to a beneficiary's creditors is a serious client concern. The potential for creditor attack or for beneficiary dissipation of an inheritance is greater during difficult economic times. Many older generation clients fear that their children and grandchildren lack strong financial decision-making skills.

Divorce rates exceed 50% nationally. Many clients today express concern about their children and grandchildren divorcing - they don't want the assets they worked so hard to accumulate winding up in the hands of a former daughter- or son-in-law, etc. Divorce rates increase in difficult economic times, making this planning even more important now.

Blended Family Planning

A higher divorce rate leads to more second and subsequent marriages - each with a higher statistical probability of ending in another divorce. With blended families (i.e. with potentially his, her, and their kids), it is critical that each parent's planning protect his or her children in the event that parent predeceases the subsequent spouse. Failure of blended-family parents to do this type of planning practically guarantees that somebody's kids will be disinherited or a messy probate will result.

Planning Tip: Carefully drafted estate plans protect beneficiaries from divorce, creditors and themselves.

Such plans can also provide for children from prior marriages, which is often the only way to ensure that these beneficiaries actually receive any inheritance.

The "Perfect Storm" for Taxable Estate Tax Planning

Certainty as to the Federal Estate Tax

The prospect for a repeal of the federal estate tax in the foreseeable future is essentially zero and, in half of the U.S. jurisdictions, there is a state estate tax (the threshold for which is as low as \$338,000 per person in one jurisdiction, and \$675,000 in several others). Nobody knows whether the Congress and President will agree to a new exemption amount or, if they do, what it will be - especially in light of the federal spending developments of the past few months. If that spending leads to greatly increased inflation, many more of your clients will face having taxable estates. Because of the virtual certainty that we will continue to have an estate tax, many of your clients must plan if they wish to avoid paying it. As the U.S. Supreme Court said:

"Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. Therefore, if what was done here was what was intended by [the statute], it is of no consequence that it was all an elaborate scheme to get rid of [estate] taxes, as it certainly was."

For clients who may be subject to federal or state estate tax, we are in a "perfect storm" that creates exceptional planning opportunities not likely to be seen again for many years. The factors that have come together to create this "perfect storm" are (a) significantly reduced asset values; (b) clarity in the law as to limited partnerships and limited liability companies; and (c) historically low interest rates.

Depressed Asset Values

Reduced values for stocks, real estate, businesses, etc., mean that clients can transfer these assets for less today than they could have just a few months ago.

For example, if a particular stock declined from \$100 per share to \$80, now the client can transfer 150 shares with a \$12,000 annual gift tax exclusion (which is going up to \$13,000 on January 1, 2009) instead of 120 shares. Married couples can give twice that amount, or \$24,000 per person, per year (\$26,000 beginning January 1, 2009). Typically, clients transfer this amount to children, grandchildren and other close family members.

In addition, reduced real estate and business values mean that clients can transfer a larger percentage of their assets now by using their \$1 million lifetime gift tax exemption.

Planning Tip: At a minimum, clients subject to federal or state estate tax should take advantage of the annual gift tax exclusion (\$12,000 per person in 2008; \$13,000 in 2009) to transfer assets with depressed values to children, grandchildren and others. Ideally, the gifts should be made in trust to provide the beneficiary protection from divorce, creditors, predators, and themselves.

Clarity in the Law as to FLPs and FLLCs

At the same time, we now have clarity in the law as to the use of the family limited partnership ("FLP") and family limited liability company ("FLLC") for asset protection and other purposes. This is a "perfect storm" factor because your clients can substantially increase the amount of assets transferred using their annual exclusions and lifetime exemptions by wrapping the assets in an FLP or FLLC and then giving away interests in the FLP or FLLC.

This clarity comes from two recent Tax Court cases, *Estate of Mirowski*, 95 TCM 1277 (March 26, 2008) (read at www.ustaxcourt.gov/InOpHistoric/mirowski.TCM.WPD.pdf), and *T.H. Holman*, 130 TC No. 12 (May 27, 2008) (read at www.ustaxcourt.gov/InOpHistoric/Holman.TC.WPD.pdf).

In *Mirowski*, the Tax Court concluded that assets transferred to an LLC were not includible in the decedent's gross estate despite the fact that the taxpayer both formed the LLC and made gifts of interests in the LLC within 30 days of her death. In *Holman*, the Tax Court concluded that an FLP funded with Dell stock six days before making gifts of limited partnership interests was a valid partnership. In both cases, the court found that the taxpayer had valid non-tax reasons for forming the entity.

Planning Tip: The first line of attack for the IRS is a challenge to the validity of the FLP or FLLC - in other words, whether it should be disregarded in determining the value of its assets. Contemporaneous documentation of the valid non-tax reasons for forming the entity can provide a formidable defense to that attack.

The *Holman* court also held that there should be downward value adjustments for minority partnership interests because of lack of control and limited marketability.

Planning Tip: Lack of marketability and minority interest valuation adjustments to the FLP or FLLC, established by a competent and experienced appraiser, allow clients to leverage gifts so that they can make larger transfers of assets. Thus, a gift otherwise limited to \$12,000 if made in cash increases to \$20,000 if made with FLP or FLLC interests for which a 40% asset value adjustment is appropriate. With such value adjustments, a married couple can transfer approximately \$40,000 of underlying assets per beneficiary per year.

Historically Low Interest Rates

The last piece to the "perfect storm" is today's historically low interest rates. The December 2008 Applicable Federal Rates (AFRs) - the "safe harbor" interest rates provided by the government for, among other things, intra-family loans - are as follows:

- Short-term (not over 3 years): 1.36%
- Mid-term (over 3 but not over 9 years): 2.85%
- Long-term (over 9 years): 4.45%

These low interest rates make the strategies discussed below even more attractive, particularly when applied to interests in an FLP or FLLC that holds depressed value assets.

Installment Sales to Trusts

Over the past 100 years in the U.S., a bull market has always followed a bear market. Selling depressed assets to a trust for a child or grandchild in return for a long-term installment note at today's historically low interest rates can be an effective way to "freeze" the current asset values in your client's estate and have the recovery in asset value that comes in the bull market escape exposure to estate taxation for at least a full generation.

Planning Tip: For the installment sale technique to work properly, the sale must pass the arms-length test of being for full value and adequately secured as to any part of the sale price that is not paid up front. If it is not, the IRS will treat the transaction as part sale and part gift.

How does the trust obtain the ability to purchase the assets? One common way is by the client making a

gift to the trust followed by the trust purchasing the assets using an interest-bearing promissory note (with terms similar to a financing transaction with a third-party lender) at or above the minimum interest rate established by the IRS: the current AFR.

Grantor Trusts

A "grantor" trust is something defined by the Internal Revenue Code. Under the Internal Revenue Code, a transfer to a grantor trust is disregarded for tax purposes. Interestingly, what makes a trust a grantor trust for income taxes is defined by one part of the Internal Revenue Code and what makes a trust a grantor trust for gift and estate taxes is defined by an entirely separate part of the Internal Revenue Code and *the rules don't match*. Therefore, with careful design, an irrevocable trust can be made to be a grantor trust for income tax purposes - yet not be a grantor trust for gift and estate tax purposes.

By using this long-standing wrinkle in the Internal Revenue Code, the strategies for transfers of assets by gifts and sales to trusts discussed above can all be virtually "supercharged." Making the recipient trust a grantor trust for income tax purposes but not for estate tax purposes produces tax-free compounding of income in the trust and estate depletion for the donor through his paying taxes on that same income. And, paying those taxes is not an additional gift to the trust.

Planning Tip: Clients sometimes tire of paying taxes on income not received, or clients' economic situations change and they can no longer afford to pay the extra taxes. To deal with such contingencies, good planning includes having a "spigot" provision in these grantor trusts so that the trustee can turn off grantor trust status for income tax.

When is a Sale Not a Sale?

Under the Internal Revenue Code, when a client sells an asset he must pay income tax on the amount above his "basis" in the property. In its most simplified sense, basis is the amount the client paid for an asset when he purchased it, or if he received it by gift, it is his donor's basis in the property. A typical sale of appreciated property thus causes imposition of income tax.

However, the IRS treats a grantor trust for income tax purposes as being a mere extension of the donor. And, since one cannot "sell" property to himself, the IRS ignores (for income tax purposes) a sale to such a grantor trust. The donor simply continues to report all items of income, realized gain or loss and deduction from income associated with the assets of the grantor trust on his or her individual income tax return.

Planning Tip: Grantor trusts are useful planning tools in several circumstances, particularly where the client desires to sell appreciated assets without immediately incurring income tax. Today's historically low interest rates make this strategy even more effective. For example, in December 2008, a sale to a grantor trust for a 9-year promissory note requires interest at only 2.85% per year.

Grantor Retained Annuity Trusts

Another strategy aided by low interest rates is the Grantor Retained Annuity Trust ("GRAT"). GRATs are a type of trust specifically authorized by the IRS regulations interpreting the Internal Revenue Code. This type of irrevocable trust permits your clients to make a lifetime gift of assets to an irrevocable trust in exchange for a fixed payment stream for a specified term of years.

At the end of the term of years, after making the final payment to the donor the balance of the GRAT property, if any (the "remainder interest") transfers to the beneficiaries of your client's choice -- typically children or grandchildren.

IRS-published interest rates at the time of the transfer determine the gift for federal gift tax purposes. This

rate, the "Section 7520 rate," is 120% of the mid-term AFR (i.e. 3.4% for GRATs established in December 2008). Critically, this rate does not take into consideration any future appreciation in the value of the property, and therefore the trust maker can reduce the value of the gift to as low as zero.

During the term of years the GRAT must pay the donor a set amount at set intervals, which can be no less frequently than annually. The term of years and the amount of the payments are fixed at the time the trust maker establishes the GRAT. During the term of years of the GRAT, the donor can be the GRAT's sole trustee or a co-trustee with complete control over all decisions of the GRAT and the assets in the GRAT. Alternatively, the GRAT can appoint a financial advisor to manage GRAT assets.

A way to explain how a GRAT works to your clients is "heads you win, tails you tie." If the performance of the assets in the GRAT exceeds the 7520 rate, the excess value is transferred without estate or gift tax. If the performance of the assets in the GRAT equals or falls below the 7520 rate, the donor gets all the GRAT assets back.

Planning Tip: GRATs are particularly suited for assets expected to grow rapidly in value.

Planning Tip: GRATs are also particularly suited for assets that have been the subject of downward value adjustments, such as those represented by minority interests in closely held businesses, FLPs and FLLCs.

Since GRATs are grantor trusts under the income tax laws, during the initial term of years all GRAT income, losses, etc., appear on the maker's personal income tax return. Since GRATs are grantor trusts under the estate tax laws, if the maker dies during the term of years, the IRS will include the GRAT property in the donor's estate for tax purposes, but the donor will be no worse off than had he not created the GRAT.

Conclusion

Despite these difficult economic times, there are numerous reasons why clients should plan *now* rather than wait until we have more economic certainty - and these reasons exist regardless of clients' net worth. Furthermore, for clients who may be subject to federal or state estate tax the "perfect storm" creates a great opportunity for the planning team to help them meet their unique goals and objectives.

Now is the time for us to proactively reach out to clients to ensure that they understand these planning needs and opportunities. When life gives you lemons, make lemonade!

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