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CURRENT MARKET CONDITIONS CREATE OPPORTUNITIES FOR ESTATE PLANNING STRATEGIES

While the current bear market has crippled many portfolios and frightened many investors, there is a bright side to the recent economic anguish. Depressed asset values, illiquid markets and historically low interest rates present opportunities for you to transfer assets to younger generations.

The federal estate tax is imposed on taxable estates at the rate of 45% on amounts in excess of a taxpayer's exemption amount (currently $3.5 million in 2009). The federal gift tax is imposed on a taxpayer during his/her lifetime at rates ranging from 41% to 45% in excess of a taxpayer's exemption amount (fixed at $1,000,000). Oregon's inheritance tax is imposed at rates ranging from 6.4% – 16% on amounts in excess of a taxpayer's exemption amount (fixed at $1 million). Oregon does not have a gift tax.

If you have investments you perceive are likely to appreciate, you may be able to utilize a variety of wealth transfer techniques that will significantly reduce or eliminate your family's estate, gift and generation-skipping transfer ("GST") taxes. Some of these techniques are discussed below.

Technique #1 – Annual Exclusion Gifting

Before venturing into sophisticated strategies, the recent market downturn provides an increased benefit for basic annual exclusion gifting. Currently, you can transfer up to $13,000 to any other individual without incurring any gift tax and without the need to use any portion of your $1 million lifetime gift tax exemption. If you are married, you and your spouse together may gift a total of $26,000 to each donee. Taking maximum advantage of the annual exclusion by making gifts to your children, their spouses, and your grandchildren (or any other individual) has always been a worthwhile "core" gifting strategy as it will reduce your taxable estate in a tax-free manner. Additionally, you also can exploit the annual exclusion through certain types of trusts, which may be preferable if your goal is to defer your family's enjoyment of the gifted asset (see Technique #3 below).

The recent decline in the value of stocks and other traded securities presents an opportunity to leverage an annual gifting program by permitting you to gift low-value securities in lieu of cash, thereby transferring any future value rebound to your descendants. Care should be taken before undertaking an annual exclusion gifting program to ensure that these gifts are coordinated with other wealth transfer techniques that you may already have in place.

The Closely Held Business Team attorneys at Harrang Long Gary Rudnick are committed to serving the needs of business owners in a responsive and proactive manner. They understand the challenges and the opportunities provided by the law in today's business climate, and are focused on the advancement of each client's success in business.

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In deciding which stocks to gift, some thought should be given to the basis in the gifted stock. The IRS provides the basis of a gifted asset to the recipient is the lower of the market value on the date of the gift or the basis in the donor's hands.

Technique #2 – Below-Market Intrafamily Loans in Lieu of Gifting

If you desire to provide liquidity to your children or other family members without making gifts, you can simply make a loan at a minimum IRS-sanctioned interest rate. For example, in February 2009, you can lend an unlimited amount of money to your child at a rate of 0.60% on a loan with a term shorter than three years. Your child can use the proceeds for anything such as purchasing a home, starting a business, making opportunistic investments and paying down higher-interest debt. For loans of more than three years and up to nine years, the current interest rate is 1.65%; for loans with terms longer than nine years, the current rate is 2.96%. In each case, this is a bargain compared to bank loans (if you can get one!) along with avoidance of the need for stellar credit history or the ability to put-up collateral.

With a "gift loan," there is no requirement to include interest on the loan. A gift loan is cumulative loan of less than $100,000 to an individual.

Technique #3 – Gifts in Trust

It is often advantageous for a donor to make gifts to beneficiaries in trust. Trusts are simple and flexible structures for holding assets that allow a donor to determine the degree and timing of control the beneficiaries will have over gifted assets, while removing the assets from the donor's estate for estate tax purposes. For example, a donor can determine whether a portion or all of the gifted assets will be distributed to his or her child outright on reaching designated ages or educational goals, and whether the trustee will have discretion to direct assets away from the child to other family members or to charity.

The utilization of certain trusts can have additional tax planning benefits. A donor can create an "intentionally defective" grantor trust, which is a trust over which the donor retains specific powers (for example, the power to substitute assets of equal value for trust assets) that results in the donor being treated as the owner of the trust assets for income tax purposes, but not for gift and estate tax purposes. Since the grantor of a grantor trust is legally responsible to pay the income taxes on the trust's income, the payment of such taxes is not deemed a further gift to the trust, thereby enabling the trust to grow for the beneficiaries on an income tax-free basis.

Technique #4 – Grantor Retained Annuity Trust

A grantor retained annuity trust ("GRAT") allows a donor to transfer any appreciation in the value of property over a fixed interest rate (2% for February 2009 and reset monthly by the IRS) at a nominal gift tax cost. A GRAT is an irrevocable trust to which the grantor contributes property for at least two years while retaining the right to receive an annuity back from the trust in cash or in kind at the end of each year. At the expiration of the GRAT term, any remaining trust assets after payment of the annuities pass to the trust's remainderman (typically one or more defective grantor trusts for the benefit of children).

When the GRAT is created, the grantor is deemed to make a gift of the remainder interest to the beneficiary. The annuity payments can be fixed, however, such that the value of the GRAT remainder interest at the time of the initial transfer is very close to zero, which will eliminate gift tax exposure. A GRAT works particularly well when the value of the asset at the funding of the GRAT is low, which may prove to be the case following the recent decline in stock prices. Also, the interest rate set by the IRS currently is low by historical standards, making it easier to produce a successful GRAT if such asset appreciates. The current market is thus particularly attractive for the creation of GRATs.

A GRAT will not produce benefits if the investment return on the GRAT assets underperforms the fixed interest rate, or, if the grantor dies during the GRAT term. Since a GRAT is a grantor trust, all GRAT income is taxable to the donor, and none of the transfers between the GRAT and the donor is taxable for income tax purposes.

A GRAT is especially effective for interests in closely held businesses. For example, assume that under current market conditions and after taking into account applicable discounts, the value of your equity in an operating business is $1 million. Assume further that you contribute that interest to a GRAT, and that during the GRAT term, the company's prospects improve to the point where the entire company is sold. If the GRAT's share of the (undiscounted) proceeds is $5 million, almost $4 million will pass to your children free of gift and estate tax.

Comparison of Intrafamily Loan and GRAT

The primary advantage of an intrafamily loan over a GRAT is the lower interest rate required by the IRS. Therefore, it is easier to pass value tax-free to your children. Additionally, the grantor is not required to survive the loan term for this strategy to be successful, whereas a GRAT requires the grantor to survive the entire GRAT term, or the entire trust corpus is returned to his or her estate with no tax benefit.

A GRAT's primary advantage over a loan is that it may be designed to eliminate the risk of a significant taxable gift if the GRAT investment is unsuccessful. If GRAT assets do not perform well (i.e. appreciate) enough to fund in full the required annuity payments to the grantor, then at the expiration of the GRAT term, the grantor receives back whatever GRAT assets remain. The remainder beneficiary has no obligation in respect of the shortfall and no gift tax is payable. In contrast, if loan proceeds are lost and the loan cannot be repaid, it would have to be forgiven and a taxable gift would be made with potential income tax consequences. Another advantage of a GRAT is that unsuccessful GRATS are essentially disregarded and do not dilute positive investment performance of winning GRATs. Thus, the potential to pass value to children using GRATs can be greater than with a loan.

The aforementioned gifting strategies vary in complexity and, depending on your situation, other strategies may be available. The decision about which strategy or strategies to employ hinges upon your goals and your family's particular circumstances. It is important to gain a full understanding of the various options available to you prior to embarking on a gifting program. We encourage you to contact Randall L. Duncan, Jonathan D. Mishkin or Doug Chiapuzio at (503) 242-0000, and we will be glad to assist you.

Nothing in this communication creates or is intended to create an attorney-client relationship with you, constitutes the provision of legal advice, or creates any legal duty to you. If you are seeking legal advice, you should first contact a member of the Closely Held Business Team with the understanding that any attorney-client relationship would be subsequently established by a specific written agreement with Harrang Long Gary Rudnick P.C. To maintain confidentiality, you should not forward any unsolicited information you deem to be confidential until after an attorney-client relationship has been established.

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