

Supercharge your estate planning

The advantage of low interest rates

The IRS, after years of being understaffed, has recently hired 14 new Estate Tax Attorneys for Northern California – all housed in Oakland.

During recent audits I've personally met with 7 of the 14 new ETAs and their group manager, Kyle Martin. I'm informed that initial training is complete, cases are assigned, and their plates are full with estate and gift tax audits in the Bay Area and Central Valley.

You can read this as a signal that the IRS does not expect the estate and gift tax to go away and is part of an organizational shift away from the Bush administration's estate and gift tax enforcement policy.

Meanwhile, the captains of economic intervention (now led by Bernanke at the Fed and Geithner at Treasury), have been using almost every weapon at their disposal to stimulate the economy. By

slashing Federal Fund interest rates basically to zero, the Fed hopes to stimulate lending and ease the damage to financial institutions and to the public.

Most of the populace has been unable to take advantage of these interest rate reductions. Financial institutions are passing on the low rates when it comes to the interest they pay for savings accounts, CDs, and the like, but not when it comes to the interest rates they charge on credit cards, home and auto loans and commercial loans. This is an unwritten part of the bank recapitalization program.

So how can you take advantage of the low interest rates? One way for those with large estates to do so is to use estate planning techniques designed to work best in a low interest rate environment. There are a number of wealth transfer strategies which provide supercharged estate planning benefits when rates are low.

For purposes of estate planning, the interest rates in question are the "Applicable Federal Rates" of interest (AFRs) under IRC §1274 and under IRC

§7520 (the "7520 Rate"). In looking at the AFRs, we see the 7520 Rate used for estate and gift tax planning purposes trending from highs back in the late 80s in excess of 10 percent down to the current quarter century lows of 1.98 percent in February 2009.

Among the strategies which are more powerful when low interest rates prevail are intra family transfers such as: (1) Intra-Family Installment Sales; (2) Grantor Retained Annuity Trusts (GRATs); (3) Qualified Personal Residence Trusts; (4) Charitable Lead Annuity Trusts (CLATs); and (5) Private Annuities. These techniques can be powerful devices for mitigating estate taxes and some also shift income to younger generation family members who are frequently in lower income tax brackets, producing an overall tax savings for a family.

Tax planning strategies which are either interest neutral or adversely affected by low interest rates include Charitable Remainder Trusts (CRTs), Charitable Lead Unitrusts, Charitable Gift Annuities and Pooled Income Funds.

Let's look at an intra-family installment sale as an example. This strategy works best when high income assets or assets with high appreciation potential are involved (e.g., an interest in a closely held family business).

On the estate tax side, installment sales freeze the value of an asset for estate tax purposes at today's value. This is known as an estate freeze because it freezes the value of the senior generation estates. Post transfer appreciation then benefits the younger generation family members who are purchasing the property or receiving a remainder interest from a GRAT, QPRT or CLAT type trust.

Upon sale to a younger generation family member (or a trust for his or her benefit), the value the senior generation had in the property becomes reflected in the promissory note issued by the younger generation family member to make the purchase. Therefore, post-sale appreciation will not be included in the estates of the older generation family members. After transfer of the asset, the senior generation simply retains some cash and a promissory note for the balance.

Interest on the note is deductible and can be made on very favorable terms to younger generation family members. To avoid gift tax ramifications, the interest payable on the note must equal or exceed the minimum applicable federal rate (AFR) of interest otherwise the IRS can characterize the sale as a partial gift.

For installment sale purposes the AFRs for March 2009 are 0.72 percent for short term loans (less than 3

years), 1.92 percent for mid term loans (3 to 9 years) and 3.46 percent for long term loans (over 9 years), compounded monthly. Plus a promissory note retained by the seller can often be discounted for estate tax purposes on the seller's death because the below market interest rate on the note makes it difficult to sell the note at face value at a later date.

So in many cases, the retained value of the note in the hands of senior generation family members not only freezes the value for transfer tax purposes at the date of transfer value, but reduces it further, producing additional estate tax savings. This can happen, for instance, where the market interest rate used in valuing such notes is much higher at the time of the transferor's death.

An installment sale transaction can also have income tax benefits, although this is not true in every case. If the asset produces a relatively high rate of return, then the sale can shift the income stream to younger generation family members who may be in lower income tax brackets. However, depending on the structure and tax basis, the sale can be an income recognition event to the senior generation and this needs to be balanced.

Installment sales and the other estate freeze transactions such as GRATs, QPRTs, and CLATs are primarily wealth preservation strategies implemented with estate and gift tax savings in mind. The transactions are intended to improve the cash flow for younger generation family members and reduce the estates of senior generation members.

Perhaps the Obama administration will orchestrate a mechanism to pass the benefits of low interest rates down to borrowers. But if this is an economic war we are fighting, then so far the general populace and even the wealthy among us are more like refugees being shuttled off to camp than victors who can look forward to receiving the spoils of the war.

One way to turn the tables is to implement an estate plan which factors in the current economic and interest rate environment.

As with most tax and legal subjects, there are many complexities in the law relating to techniques described in this article. Whether any given technique will be beneficial to an individual taxpayer will depend on variables which are beyond the scope of this article. You should not make changes to your current estate and tax strategies without consulting experienced professional advisers.



Scott Beattie, JD, LLM



Invest in Miracles.

Some miracles offer miraculous returns. Like the Fatima Pavilion at St. Joseph's for example. Planned in response to the needs of our growing community, this vital addition will not only deliver more babies and provide private patient rooms. However, more than providing critical rooms and equipment, the new Fatima Pavilion is an investment in the health and safety of every family who calls our community home. Due to reach our \$20 million fundraising goal and make this new Pavilion a reality, we need you to invest in us. Together, we'll make miracles happen.

SALES REPRESENTATIVE WELLS, CAPITAL COMPANIES

Give.



St. Joseph's Foundation

200 N. California Street, Stockton, CA 95204
(209) 467-6347 • StJosephsCare.org