VENABLE LLP

estate planning alert

A PUBLICATION OF VENABLE'S TAX & WEALTH PLANNING GROUP

www.Venable.com

March 2009

Please contact any of the following attorneys in our Tax & Wealth Planning Group if you have any questions regarding this alert.

Washington, DC:
Stef Tucker
sftucker@Venable.com
202.344.8570

Chris Sega
acsega@Venable.com
202.344.8565

Jeanne Newlon
jlnewlon@Venable.com
202.344.8553

Sarah Johnson
smjohnson@Venable.com
202.344.4035

Jessica Baggenstos
jbbaggenstos@Venable.com
202.344.4563

Jennifer Birchfield
jabirchfield@Venable.com
202.344.4452

Tysons Corner, VA:
Everett Hoeg
ehoeg@Venable.com
703.760.1908

Lisa Hughes
lhughes@Venable.com
703.760.1909

Rockville, MD:
Laura Quam
llquam@Venable.com
301.217.5663

Baltimore, MD:
Jeff Gonya
jkgonya@Venable.com
410.244.7507

Jeff Radowich
jjradowich@Venable.com
410.244.7516

Jennifer Pratt
japratt@Venable.com
410.528.2883

Sarah Kahl
sbkahl@Venable.com
410.244.7584

Ashley Short
acshort@Venable.com
410.244.7751

In this issue:

1. Increase in Gifting and Estate Tax Exemption Amounts in 2009
2. Federal Estate Tax Legislation Update
3. Charitable Giving with IRAs
4. Planning to Take Advantage of Lower Interest Rates
5. GRAT Swaps
6. State Estate Tax for Maryland and DC Taxpayers

Increase in Gifting and Estate Tax Exemption Amounts in 2009

On January 1, 2009, the gift tax annual exclusion amount increased from $12,000 to $13,000. This means that an individual may give $13,000 (and a married couple electing to gift-split may give $26,000) to any person in 2009 without any gift tax consequences. This also means that a single donor may then transfer up to $65,000, and a married couple may then transfer up to $130,000, to each new Section 529 Plan.

In addition to the increase in the gift tax annual exclusion, the Federal estate tax applicable exemption amount increased in 2009. This is the amount that an individual can pass at his or her death free of Federal estate tax. As of January 1, 2009, the Federal estate tax exemption amount is $3,500,000. (Please note that the donor's lifetime gift tax exemption amount remains at $1,000,000. Moreover, the estate tax exemption available at an individual's death is reduced by the portion of the $1,000,000 gift tax exemption the individual used during his or her lifetime.)

Back to top

Federal Estate Tax Legislation Update

As 2010 rapidly approaches, the future of the Federal estate and gift tax continues to be uncertain. The estate tax exemption is $3,500,000 for individuals who die in 2009. Under current law, in 2010, there will be no estate tax imposed, and the familiar step-up in basis rule will be replaced with a somewhat complex carry-over basis regime. In 2011, the pre-2001 estate and gift tax law returns, which includes, among other changes, an estate tax exemption amount of only $1,000,000.

Both President Obama and the U.S. Congress have expressed interest in modifying the estate and gift tax laws to avoid the uncertainty and inconsistency of the present law. On January 9, 2009, Representative Earl Pomeroy (D-N.D.) introduced H.R. 436, the "Certain Estate Tax Relief Act of 2009" ("H.R. 436"). On January 14, 2009, Representative Harry Mitchell (D-AZ) introduced H.R. 498, the "Capital Gains and Estate Tax Relief Act of 2009" ("H.R. 498"). An overview of the key features of both pieces of legislation follows.

Laura Pacanowsky
lpacanowsky@Venable.com
410.528.2800

Kelly Moore
ktmoore@Venable.com
410.244.7445

H.R. 436: Certain Estate Tax Relief Act of 2009

The relatively straightforward H.R. 436 includes the following features: an exemption amount of $3,500,000 per individual, a maximum estate tax rate of 45% for estates up to $10,000,000, permanent incorporation of most of the 2001 estate and gift tax law changes and new limitations on valuation discounts.

Imposition of the Estate and Gift Tax

H.R. 436 makes permanent most of the Federal estate tax, gift tax, generation-skipping transfer tax and the step-up (or step-down) in basis rules applicable in 2009. The estate tax would continue to be imposed on estates valued at $3,500,000 or above. The maximum rate of estate tax for estates valued up to $10,000,000 will continue to be 45%. However, estates valued in excess of $10,000,000 will be subject to an additional 5% tax, not to exceed $3,619,200. Furthermore, gifts to individuals, other than a spouse, up to an aggregate lifetime amount of $1,000,000, will be exempt from the Federal gift tax. All other changes introduced in the 2001 tax legislation (and any modifications to those provisions made during the interim period) are made permanent. These provisions would be effective for decedents dying and gifts made after December 31, 2009.

Changes to Valuation Rules

A significant feature of H.R. 436 is its proposed modification to the rules applicable to valuing the donor's interest in a family limited partnership or limited liability company ("FLP") that holds investment assets.

First, the legislation disallows any discount for minority interests in an FLP that is controlled by the donor's "family members". For purposes of the rule, "family members" include the donor's spouse, parents, grandparents, children, grandchildren, more remote descendants and the spouses of the donor's children, grandchildren and more remote descendants.

Second, "nonbusiness assets" held in the FLP will be valued as if the assets had been transferred directly by the donor to the donee. Nonbusiness assets are any assets not used in an active trade or business. There is an exception for real estate that is used to conduct a trade or business (such as development) in which the transferor materially participates.

To illustrate this proposed rule, assume that an FLP owns $2,000,000 worth of stocks and bonds. Absent the legislation, if the donor transferred a non-managing 10% interest in the FLP to his daughter, depending upon the terms in the FLP Agreement, the value of the interest might be discounted by about 35% for lack of marketability, minority interest and lack of control. Thus, for gift tax purposes, the value of the 10% interest would be $130,000, rather than $200,000. However, under the proposed legislation, the donor will instead be treated as having transferred 10% of the stocks and bonds to his daughter, which would be valued at $200,000, as no discounts would be available.

The effective date for the new valuation provisions is the date of the legislation's enactment.

H.R. 498: Capital Gains and Estate Tax Relief Act of 2009

The notable features of H.R. 498 include: a permanent reduced capital gains tax rate; the phasing in of a $5,000,000 estate tax exemption; the elimination of the Federal estate tax deduction for state estate taxes; the unification of the estate and gift tax; and "portability" of the estate tax exemption for spouses. H.R. 498 also allows several of the 2001 estate and gift tax laws to sunset as of December 31, 2010. The current step-up (or step-down) in basis rule, however, is made permanent.

Capital Gains Tax

H.R. 498 makes permanent the reduced capital gains tax rates enacted in 2003. Generally, this rate is 15%. However, the legislation eliminates the taxation of dividends at capital gains tax rates.

Imposition of the Estate Tax

Under H.R. 498, the estate tax exemption would increase in increments to $5,000,000 by 2015. After 2015, the $5,000,000 exemption would be adjusted for inflation in $50,000 increments. The rate of the estate and gift tax would be tied to the capital gains tax rate. Estates valued up to $25,000,000 would be subject to a tax at the 15% capital gains rate. Estates that exceed $25,000,000 would be subject to a tax at two times the capital gains rate, or 30%. The $25,000,000 value used for determining the rate of tax would be adjusted for inflation as of 2015 in $50,000 increments.

H.R. 498 repeals two notable deductions. First, it takes away the Federal estate tax deduction for state estate taxes paid. Second, it repeals the deduction for family owned business interests currently available under the tax law.

Portability

H.R. 498 introduces the concept of "portability" to the estate tax system. This means that when a spouse dies, the estate tax exemption of the surviving spouse is increased by the deceased spouse's unused exemption. For example, assume that Hank and Whitney are married and do not make any taxable gifts during their lifetimes. Hank dies in 2015 (when the exemption is $5,000,000) with a taxable estate of $3,000,000. Whitney dies in 2017 (when the exemption is $5,000,000) with a taxable estate of $10,000,000. Whitney will be able to pass $7,000,000 worth of assets from her estate free of Federal estate taxes. This $7,000,000 amount includes Whitney's exemption of $5,000,000 plus the $2,000,000 of exemption that Hank did not utilize upon his death.

Current Status

Both H.R. 436 and H.R. 498 have been referred to the House of Representatives Committee on Ways and Means. As of the date of this article, the Committee has not scheduled a markup, hearing or other action relevant to either bill. H.R. 436 has no co-sponsors. H.R. 498 is co-sponsored by Mark Kirk (R-IL) and Glenn Nye (D-VA).

Back to top

Charitable Giving with IRAs

In 2006, Congress passed the Pension Protection Act of 2006. Pursuant to Section 1201 of the Act, individuals may utilize funds in their Individual Retirement Accounts (IRAs) to make charitable contributions. Although this provision had expired for years after 2007, Congress recently extended Section 1201 to apply to charitable contributions made in 2008 and 2009.

Typically, most withdrawals from an IRA are subject to Federal income tax. Under the Act, individuals over age 701/2 may withdraw up to an aggregate of $100,000 per year from their IRAs tax free, so long as such amount is contributed to certain qualified tax-exempt organizations before the end of the year of withdrawal. The withdrawal amount may be used to satisfy the individual's minimum required distribution. Although the charitable contribution is not tax deductible, the amount withdrawn is not included in the IRA participant's income.

This provision offers a significant planning opportunity for individuals over 70 1/2 who wish to make charitable contributions in 2009. (Note: The individual must be over 70 1/2. Thus, if the person reaches age 70 on March 31, 2009, the withdrawal cannot occur until after October 1, 2009.) The provision does not apply to withdrawals from qualified retirement plans, such as 401(k) accounts. However, an individual may convert a 401(k) account to an IRA to take advantage of this provision. *This provision now expires on December 31, 2009, so individuals should plan accordingly. Please note, for individuals required to take minimum distributions under an IRA or 401(k), under new legislation, there is no required distribution for 2009.*

Back to top

Planning to Take Advantage of Lower Interest Rates

When interest rates are historically low, as they are now, the potential for success of certain estate planning techniques increases. One such technique is a Grantor Retained Annuity Trust (GRAT).

A GRAT is an estate planning tool that allows an individual to transfer interests in appreciating assets to an irrevocable trust at a lower transfer tax cost and retain an annuity interest for a trust term of a specified number of years. At the end of this trust term, the property remaining passes to the remainder beneficiaries of the trust. Because of the retained annuity interest, the value of the gift is "discounted".

To illustrate, assume that a 60-year old individual transfers $1,000,000 to a GRAT and retains a 10% annuity for 10 years. The value of the gift of the remainder interest is approximately $120,000. Generally, a GRAT succeeds (that is, property remains in the trust for benefit of the remainder beneficiaries) when the investment return on the property exceeds the IRS established interest rate for valuing the annuity. The IRS established interest rate for March of 2009 is 2.4%. Therefore, if the investments perform at a rate greater than 2.4%, the GRAT is likely to succeed as a wealth transfer tool. Thus, in the example above, if the principal in the GRAT grows at 5% per year, there will be $371,000 for the remainder beneficiaries at the end of 10 years. As a result, in this example the remainder beneficiary will receive $371,000 even though the gift tax was based on a gift of only $120,000.

A GRAT also can be structured with virtually no taxable gift. This technique is referred to as a "zeroed-out GRAT". The reason there is no taxable gift is that the donor's retained annuity causes the donor to receive back the entire amount contributed to the GRAT, plus interest thereon. Any appreciation on such property above the annuity payments then passes to the remainder beneficiaries of the trust, free of gift tax.

A similar technique that is beneficial in a low interest rate environment for individuals with current charitable giving goals and significant liquidity is a charitable lead annuity trust (CLAT). In a CLAT, the annual annuity is distributed to charity, rather than to the donor. The donor receives a gift tax deduction for the value of the interest passing to charity. This deduction reduces the value of the remainder interest passing to the donor's children at the end of the CLAT term.

Another technique often used to take advantage of the lower interest rates is a sale of assets to family members (or an entity or trust comprised of family members) for a promissory note. Capital gains rates currently are still low and may increase in the future. Thus, now is a good time to sell assets and recognize capital gain. In some cases, the sale may even be structured to defer capital gain recognition. Such assets can be sold to family members at fair market value, subject to any appropriate discounts, for an adequate down payment and a promissory note. The IRS established interest rate for March 2009 is 1.94% for loans that remain in place for more than 3 years but not more than 9 years. For loans in excess of 9 years, the March 2009 interest rate is 3.52%. If the assets' investment return is higher than the IRS established interest rate, the leveraged purchase will result in greater economic value to the trust beneficiaries.

Please let us know if you would like to learn more about how to take advantage of low interest rates to accomplish gifting and other strategies.

Back to top

GRAT Swaps

Given the decline in market values, we expect that many of the GRATs that were funded last year are "under water". That is, the assets remaining in the GRAT will not be sufficient to meet the GRAT's annuity obligations to the grantor, let alone leave any assets in the GRAT for the benefit of the GRAT remainder beneficiaries. However, given depressed asset values and the low current interest rates, it is possible that the GRAT's assets, going forward, will increase in value at a rate greater than the current "hurdle rate" of 2.4% for March.

There is a way you might take advantage of low interest rates to improve the chances of having a successful GRAT. Assume that you expect the assets in the current GRAT ("GRAT One") to increase in value in the future at a rate greater than the current "hurdle rate". If so, you could withdraw the assets from GRAT One (the "Acquired Assets") and contribute these assets to a new GRAT ("GRAT Two"). So long as you replace the assets withdrawn from GRAT One with assets equal in value to the Acquired Assets (the "Substitute Assets"), this exchange should be ignored for income, gift and estate tax purposes.

Knowing that GRAT One will fail simply will mean that the grantor will reacquire all of the Substitute Assets. If GRAT Two succeeds (after all, it only needs to beat the current "hurdle rate" starting from a low asset value), the excess over the "hurdle rate" will pass to the GRAT Two beneficiaries free of gift and estate tax (assuming the grantor survives the GRAT Two term). In other words, the GRAT "swap" is one way to turn a failing GRAT into a successful one.

Please let us know if you would like to learn more about how to take advantage of a GRAT swap.

Back to top

State Estate Tax for Maryland and DC Taxpayers

As we noted in our October 2008 newsletter, individuals living in Maryland and DC should review their estate plans this year. With the increase in the Federal estate tax exemption to $3,500,000 in 2009, Maryland and DC residents could be faced with a much larger state estate tax bill of up to $229,200 on the death of a first spouse. *Please let us know if you would like us to send you a copy of the October 2008 newsletter discussing this issue.*

Back to top

CALIFORNIA   MARYLAND   NEW YORK   VIRGINIA   WASHINGTON, DC

1.888.VENABLE | www.Venable.com