The Estate Planner

July/August *2009*

It's time to make gifts

The struggling economy may allow you to save gift and estate taxes

Do-it-yourself estate planning can lead to costly mistakes

What are these assets worth?

Valuation is critical to your estate plan

Estate Planning Red Flag

You're planning required minimum distributions from your retirement accounts

It's time to make gifts

The struggling economy may allow you to save gift and estate taxes

Estate planning opportunities are a silver lining among today's dark economic clouds. Depressed asset values and low interest rates may allow you to gift more to your loved ones at a significant gift tax savings, removing substantial wealth from your taxable estate.

Shopping for gift tax bargains

Making lifetime gifts is particularly attractive for assets you expect will appreciate significantly in value in the future, such as stock, real estate or interests in a closely held business. By transferring these assets to family members (either outright or through an irrevocable trust) while values are low, you can minimize the amount of transfer tax while ensuring that all future appreciation is removed from your taxable estate.

The sluggish economy also allows you to make the most of your $1 million lifetime gift tax exemption and your $13,000-per-recipient annual gift tax exclusion ($26,000 if splitting gifts with your spouse). By using these estate planning strategies while asset values are low, you can transfer more wealth tax free.

But be sure to consider income taxes as well as gift and estate taxes. Under current law, when your heirs inherit assets their tax basis is generally "stepped up" to the assets' current fair market value, minimizing or eliminating capital gains taxes in the event of a sale. Gifted assets don't enjoy a stepped-up basis, which means the recipient may have significant income tax exposure if the assets have appreciated in value.

The economic reality may be that you have assets whose value is less than their basis. Transferring such assets may be a poor choice for income tax purposes. Instead, consider whether it would make sense to sell those assets to take advantage of the loss. Then you can gift the cash you receive from the sale.

Keeping it in the family

The current economic climate may be especially favorable for transferring interests in a family business or other closely held company using a family limited partnership (FLP) or a family limited liability company (FLLC). Be aware, however, that proposed legislation would make these entities less effective, at least from an estate planning perspective. (See "Will Congress weaken the FLP?" on page 3.)

In a typical FLP or FLLC arrangement, you form a limited partnership or LLC to own your business (or your interest in a business) and then transfer limited partnership interests or nonmanaging LLC interests to your children or other family members. By maintaining a small ownership interest

Will Congress weaken the FLP?

For years, some lawmakers have proposed eliminating or limiting the tax-planning advantages of family limited partnerships (FLPs), family limited liability companies (FLLCs) and similar vehicles. So far, these proposals haven't become a reality, but given the current economic crisis, it's possible that Congress will be more receptive.

As of this writing, at least one bill (H.R. 436) has been introduced that would make it harder to use FLPs and FLLCs to reduce gift taxes. Among other things, the bill would:

- Eliminate gift tax valuation discounts for transfers of minority interests in FLPs, FLLCs and other "nonactively traded" interests if the transferee and certain family members control the entity, and
- Disallow valuation discounts to the extent such entities own "nonbusiness assets," such as marketable securities.

These changes would be effective *prospectively*, so they wouldn't affect transfers to FLPs or FLLCs made before the bill is enacted. Check with your estate planning advisor for the latest information.

and acting as general partner or managing member, you retain the right to manage the business indefinitely.

FLPs and FLLCs offer several important benefits, including the ability to provide family members with an ownership stake without giving up managerial control, and some protection against creditors' claims against limited partners or nonmanaging members. In addition, valuation discounts for lack of control and lack of marketability allow you to minimize or even eliminate gift taxes when you transfer a minority interest in the business.

During the last several months, the value of many businesses has declined. So now may be a good time to transfer business interests to your family at the lowest possible tax cost.

Locking in a low interest rate

Some of the most effective gifting strategies involve the use of trusts, and many of these strategies are even more powerful when interest rates are low, as they are now. For example, the Section 7520 rate, an assumed rate of return the IRS uses to value certain interests for gift tax purposes, has been extremely favorable.

When you establish certain trusts — such as grantor retained annuity trusts (GRATs) and charitable lead annuity trusts (CLATs) — your children or other beneficiaries receive a "remainder interest." In other words, at the end of the trust term, after the annuity payments have ceased, whatever is left in the trust is distributed to your beneficiaries. When you establish and fund the trust, you make a taxable gift equal to the present value of this remainder interest.

To calculate the remainder interest, the IRS assumes that the trust assets will grow at the Sec. 7520 rate in effect during the month the trust is funded. The lower that rate, the smaller the remainder interest and, therefore, the smaller the gift. If, and to the extent, the trust's growth and earnings outperform the Sec. 7520 rate, your beneficiaries will reap the benefit of getting those assets without any additional gift tax cost to you.

Many trust strategies are even more powerful when interest rates are low, as they are now.

By setting up and funding these types of trusts now, you can lock in a low interest rate, making it possible to transfer a significant amount of wealth while minimizing gift taxes.

Looking ahead

As you consider these and other gifting techniques, keep an eye on congressional developments. Although the estate tax (but not the gift tax) is scheduled for repeal in 2010, that's unlikely to happen. As of this writing, the prevailing view seems to be that Congress will preserve the estate tax, freezing the estate tax exemption at its current level of $3.5 million or possibly raising it to as much as $5 million. Check with your estate planning advisor for the latest information.

Gift and estate tax law changes may affect the desirability of certain gifting strategies, so be sure to talk with your advisors about the impact on your plan. ✤

Do-it-yourself estate planning can lead to costly mistakes

If you're interested in preparing your own estate plan, there's no shortage of software, how-to books, preprinted forms and online services to assist you. Do-it-yourself (DIY) estate planning may save you a few hundred dollars, or even a few thousand dollars, up front. But except in the simplest cases, the risk of unintended results or costly disputes is too great to justify the initial savings.

In some cases, out-of-date software or forms fail to comply with current federal or state estate tax laws or regulations. But even if all the i's are dotted and t's crossed, many estate planning tools and strategies are complex, and people may not fully understand the consequences of the choices they make in wills and other documents.

In many cases, by the time you or your family realize you've made a mistake, it may be too late to do anything about it.

A mistake in deed

The case of *Clemons v. Thornton* provides a good example of DIY estate planning leading to unintended results. W.C. Clemons, Jr., a widowed father, remarried in 1993. He wanted to ensure that his second wife had the right to continue living in the home they shared after he died, but he also wanted the home ultimately to go to his daughter, Joyce Thornton, from his first marriage.

Clemons executed a preprinted form warranty deed that described the homestead property and named himself and "Ruth Clemons his wife" as grantees. The deed also contained a typewritten addition stating that the home would go to his daughter when his wife died.

Seven years later, Clemons died intestate (that is, without a will), survived by his wife, his daughter and certain other lineal descendants. In 2004, Clemons' wife attempted to convey the property to herself and her grandson, and Clemons' daughter sued to stop the transfer.

A Florida appellate court ruled that the deed successfully granted a life estate to Clemons and his wife, but that the attempt to convey a remainder interest to his daughter was ineffective because his wife never signed the deed. Florida's constitution, the court explained, "requires that both spouses join in alienating homestead property in favor of any third party."

So, what was the fate of the homestead? Instead of going to his daughter alone, as Clemons intended, under

Florida law the home would be divided among all of his lineal descendants. An estate planning advisor could have helped ensure the home would ultimately have gone to Clemons' daughter as desired.

A trust with a twist

The following situation, though probably not too unusual, pays homage to the old adage "penny wise and pound foolish." Howard and Beth are married and have roughly equal estates. With the help of an estate planning attorney, Howard establishes an irrevocable life insurance trust (ILIT), naming Beth as the sole current beneficiary and trustee. A properly structured ILIT shields the life insurance proceeds from taxation in the insured's estate.

Howard and Beth decide to set up an ILIT to hold an insurance policy on Beth's life as well. To save money on attorneys' fees, they simply copy the language of the first ILIT, transposing Howard's and Beth's names wherever they appear.

The problem with identical trusts is that the IRS may challenge the arrangement as a violation of the "reciprocal trust doctrine." Under this doctrine, a court can "uncross" interrelated trusts if it finds that the arrangement places the trust creators in approximately the same economic position they would have been in had they named themselves as beneficiaries.

If the IRS is successful, the proceeds of both Howard's and Beth's insurance policies will be included in their taxable estates, defeating the purpose of an ILIT. Had they consulted an estate planning advisor, he or she would have recommended that Beth's trust be designed in such a manner as to defeat the reciprocal trust doctrine.

For example, in Private Letter Ruling 200426008, the IRS held that the reciprocal trust doctrine didn't apply to ILITs created by a husband and wife in that particular situation because the two trusts contained somewhat different terms. For example, the husband's trust gave his wife the right to withdraw some of the trust principal after their son's death and granted her special powers of appointment exercisable during her life or at death, while the wife's trust didn't give these powers to the husband. Keep in mind that, while Private Letter Rulings aren't considered precedent, they can, as in this circumstance, provide guidance.

Invest in some peace of mind

DIY estate planning can be a risky proposition. And in many cases, by the time you or your family realize you've made a mistake, it likely will be too late to do anything about it.

If you do prepare your own estate planning documents, at the very least have an estate planning professional review them to be sure there aren't any ticking time bombs that could derail your plans. ✤

What are these assets worth?

Valuation is critical to your estate plan

If you make substantial noncash gifts or charitable donations, it's critical to have the property valued by a qualified appraiser. Unless you're transferring publicly traded stocks or other securities with a readily ascertainable market value, a professional valuation may be necessary to support the values you report on your gift or income tax returns.

A professional valuation can protect you against IRS challenges that could otherwise result in some unpleasant tax surprises.

Gain peace of mind

If your estate plan includes giving substantial noncash gifts — either outright or in trust — IRS regulations provide for a three-year statute of limitations during which the IRS can challenge the value you report on your gift tax return. After the three-year period expires, you can enjoy the peace of mind that comes with knowing that your estate plan will work as you intended.

Insufficient valuations expose you to the risk that the IRS will revalue property and assess additional taxes down the road.

There's one catch, though: The statute of limitations doesn't *begin* until your gift is "adequately disclosed" on a gift tax return. Under IRS regulations, to adequately disclose a gift, you must provide a detailed description of the nature of the gift, the relationship of the parties to the transaction and the basis for the valuation. You may also be required to furnish certain financial statements or other financial data and documents.

The regulations also provide that you can satisfy the adequate disclosure rule's information requirements by submitting an appraisal report by a qualified, independent appraiser that includes details about the property, the transaction and the appraisal process. In most cases, this is the most effective way to ensure that you have disclosed gifts adequately and triggered the statute of limitations.

Avoid penalties

Insufficient valuations expose you to the risk that the IRS will revalue property and assess additional taxes down the road. They can also result in significant penalties if the IRS finds that the value of property was substantially or grossly misstated.

In this context, a "substantial misstatement" occurs when you report a value that is 65% or less of the "correct" value. A "gross misstatement" occurs when you report a value that is 40% or less of the correct value. The penalty for a substantial misstatement is 20% of the amount by which your taxes are underpaid. Gross misstatements result in a 40% penalty.

Substantiate charitable donations

Generally, to substantiate noncash charitable donations of more than $5,000, a qualified appraisal is required.

As of this writing, proposed IRS regulations define a qualified appraisal as "an appraisal document that is prepared by a qualified appraiser … in accordance with generally accepted appraisal standards …."

The proposed regulations define a qualified appraiser as someone who, among other things, has "verifiable education and experience in valuing the relevant type of property for which the appraisal is performed …."

The proposed regulations go on to describe the required elements of a qualified appraisal.

Stand the test of time

The success of many estate planning techniques depends on accurate, supportable, well-documented valuations of assets. Obtaining a valuation by a qualified appraiser at the time of a transaction is the most effective way of ensuring that the values you report on your tax returns will hold up against an IRS challenge years or even decades later. ✤

Estate Planning Red Flag

You're planning required minimum distributions from your retirement accounts

If you're planning to take required minimum distributions (RMDs) at the end of this year from your IRA, 401(k) or other tax-deferred retirement-savings account, check with your tax and estate planning advisors first. Under a tax law passed late last year, you may be able to skip RMDs this year.

A good estate planning strategy can be to leave funds in your tax-deferred accounts as long as possible. Assuming you have other sources of income or assets to meet your living expenses, keeping money in these accounts allows them to continue growing on a tax-deferred basis, thus maximizing their value and ultimately allowing you to leave more for your family.

Ideally, you wouldn't touch these accounts at all unless you depleted your other funds, but the government has other ideas. To ensure that retirement funds don't escape taxation, federal law generally requires you to begin taking annual RMDs after you reach age 70½. Your first RMD, for the year in which you turn 70½, is due by April 1 of the following year. Subsequent distributions are due by the end of each calendar year.

RMDs are particularly onerous now, while the values of many stocks, mutual funds and other investments have sharply declined. Being forced to take funds out of a retirement account while asset values are depressed deprives you of the tax-deferred gains you might otherwise enjoy when the economy recovers.

To provide some relief, last year's Worker, Retiree and Employer Recovery Act of 2008 suspended most RMDs for 2009. If you're already taking RMDs, you can skip the 2009 distribution that otherwise would be required by Dec. 31. If you turn 70½ this year, you can skip your first RMD, which ordinarily would have been due by April 1, 2010. In either case, the next RMD would be due by Dec. 31, 2010. This relief is also available for people taking RMDs from inherited IRAs.

Before you skip an RMD, consult your advisors to be sure that you're eligible. If you miss an RMD, you could be hit with a penalty equal to 50% of the amount that you should have taken. Also, in certain circumstances it may be beneficial to take a distribution this year even if you aren't required to do so; your advisors can help you determine what is appropriate for your situation.