KAYE SCHOLER LLP

TRUSTS & ESTATES DEPARTMENT

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UPCOMING CHANGES IN FEDERAL ESTATE TAX-APPLICABLE EXCLUSION AMOUNT AND GIFT TAX ANNUAL EXCLUSION AMOUNT

As the end of 2008 approaches, we note that as of January 1, 2009 the federal estate tax applicable exclusion amount — the amount that is shielded from federal estate tax (reduced by certain lifetime gifts) — increases to $3,500,000, up from the current $2,000,000. Many states have separate limitations on the amount that can pass free of state estate tax. For example, the New York exemption is $1,000,000, the New Jersey exemption is $675,000, and the Connecticut exemption is $2,000,000. In planning for married couples, the disconnect between the federal and state systems can result in the imposition of state estate tax. It is important to review your current estate plan to ensure that it meets with your expectations vis-à-vis the payment of estate taxes, as well as the disposition of your property in light of the increase in the applicable exclusion amount, *e.g.*, in 2003 when the federal estate tax exemption was $1,000,000, you may have decided to leave this amount to your children and the balance of your estate to your spouse. That might not be appropriate now that the amount exempt from federal estate tax will be $3,500,000 and that a New York State resident will incur $229,200 in state estate tax for such a bequest.

Without legislative action, the federal estate tax will be repealed in 2010, and when it returns in 2011, the estate tax exemption will be $1,000,000 and the top estate tax rate will again be 55% (it is currently 45%).

The amount exempt from federal gift tax (in excess of annual exclusion and other nontaxable gifts) remains at $1,000,000. However, the gift tax annual exclusion will increase from $12,000 in 2008 to $13,000 in 2009. For gifts to noncitizen spouses, the gift tax annual exclusion will increase from $128,000 in 2008 to $133,000 in 2009.

OCTOBER 2008 FEDERAL INTEREST RATES

The annual short-term, mid-term and long-term applicable federal rates for October are 2.19%, 3.16% and 4.32%, respectively. These are the minimum required interest rates used for loans in order to avoid below-market loans that have income and gift tax consequences related to the forgone interest. The Internal Revenue Code Section 7520 rate for October is 3.8%; this is the interest rate used to calculate the value of a transfer of certain interests in property, *e.g.*, transfers to grantor retained annuity trusts ("GRATs") and charitable lead annuity trusts ("CLATs"). These low rates provide very attractive estate planning opportunities given that the goal of many estate planning structures, such as those described below, is to outperform these rates over time.

ESTATE PLANNING STRUCTURES APPROPRIATE IN TODAY'S ENVIRONMENT

Grantor Retained Annuity Trust

A GRAT is a statutorily sanctioned form for gifting a remainder interest. In a GRAT, a fixed dollar amount is paid to the grantor annually for a stated period. At the end of the period, any property remaining in the trust passes to the remaindermen, generally trusts for the grantor's descendants.

When the GRAT is created, the present value of the remainder interest, which passes to the beneficiaries at the end of the trust term, is subject to gift tax. However, the annuity payments are usually fixed, based on the term of the GRAT and the Section 7520 rate in effect when the GRAT is created (the "hurdle rate"), so that the present value of the remainder interest is very low (and sometimes zero).

If the GRAT assets appreciate over the term of the GRAT at no more than the hurdle rate, *i.e.*, 3.8% for October 2008, the grantor will receive back all of the assets of the GRAT over time in the form of annuity payments, and there will be no assets left at the end of the GRAT term to pass gift tax-free to the remaindermen. However, to the extent the GRAT assets appreciate in excess of the hurdle rate and if the grantor is living at the end of the term, assets will remain in the GRAT at the expiration of the term and pass gift and estate tax-free to the remaindermen.

For income tax purposes, a GRAT is a "grantor" trust, *i.e.*, owned by the grantor for income tax purposes, and there is no income tax consequence to transactions between the grantor and the GRAT so that, for example, the distribution of the annuity amount to the grantor is not a recognition event for income tax purposes.

If the grantor dies during the term of the GRAT, so much of the GRAT property as would be required to fund the remaining annuity payments is includible in the grantor's estate for estate tax purposes.

In the low interest rate environment we are currently experiencing, the GRAT is particularly attractive because a low Section 7520 rate increases the value of the retained annuity interest, therefore decreasing the value of the gift. For example, if a grantor transfers assets worth $1,000,000 to a five-year virtually zeroed-out GRAT in October 2008 when the prescribed interest rate is 3.8%, the grantor would receive an annual annuity of $223,300 for five years, resulting in a very nominal taxable gift. If the GRAT produced a 10% annual return, it would have $247,241 left at the end of the GRAT term that would pass to the ultimate beneficiaries free of gift tax. In a higher interest rate environment, the hurdle rate and annuity amounts would be higher.

Sale to a Grantor Trust

The removal of future appreciation from an estate, or an estate tax freeze, can also be accomplished tax-efficiently by selling property to a trust created by the transferor that is treated as a "grantor" trust for income tax purposes.

Generally, an irrevocable trust is created for the benefit of family members. The trust is structured so that its value is excluded from the grantor's estate for estate tax purposes, but treated as owned by the grantor for income tax purposes, as described above. In other respects the trust provisions can be quite flexible in providing for children or other family members.

The trust purchases assets from the grantor in exchange for a note. The note should bear interest at the applicable federal rate as provided under Internal Revenue Code Section 7872. For income tax purposes, the transaction should be viewed as if the grantor was both the buyer and the seller under the grantor trust rules. As a result:

- No taxable gain or loss is recognized on the sale to the trust.
- The grantor is not taxed on the interest payments on the note during the grantor's lifetime.
- The grantor bears the income taxes on all of the earnings of the trust, resulting essentially in a gift tax-free "gift" of the income tax by the grantor to the trust.
- The trust is an eligible S corporation shareholder.
- The trust has the same income tax basis in the assets as the grantor.

All of the appreciation and earnings on the assets sold to the trust in excess of the prescribed interest rate on the note will pass to the trust for descendants free of transfer taxes. (If the assets underperform the interest rate on the notes, the result is reverse estate planning, *i.e.*, transfers of wealth from the trust to the grantor.)

The trust must have some measure of economic significance independent of the sale, and it is recommended that the trust be funded with at least 10% of the value of the property anticipated to be purchased by the trust. This amount transferred to the trust will generally be a gift requiring the filing of a gift tax return and, if in excess of the amount that can pass free of gift tax, payment of gift tax will be required.

As with a GRAT, when interest rates are low, the sale to a grantor trust is attractive, as the lower interest rate reduces the overall cost of the purchase.

Each of the GRAT and sale to a grantor trust structures has certain advantages and disadvantages compared with the other structure. The question of which structure is most appropriate in a given situation depends on the nature of the assets, your goals, and risk tolerance.

Charitable Lead Trust

The low interest rate environment also lends itself to incorporating charitable planning in the estate plan. This may be accomplished through the use of a split-interest trust, *i.e.*, a trust which benefits both charitable and non-charitable beneficiaries.

A CLAT provides for an annuity to be paid to one or more charitable beneficiaries for a period of years and at the end of the period the property remaining in the trust passes to the remaindermen. A CLAT is similar to a GRAT except that the annuity interest is paid to charity instead of the grantor. An income tax charitable deduction is available up-front for charity's interest in the CLAT, in the case of a CLAT that is a grantor trust for income tax purposes, or for payments made by the CLAT to charity, in the case of a CLAT that is a separate income taxpayer, *i.e.*, a nongrantor trust. In the case of a trust that is a grantor trust, the grantor remains taxable on the trust's income received during the charitable term.

The present value of the annuity interest to be paid to charity is not subject to gift tax, because of the gift tax charitable deduction available for the value of the charity's interest in the trust. While the present value of the remainder interest is subject to gift tax at the time of the creation of the CLAT, the annuity is generally set so that the present value of the remainder interest is nominal or zero. Unlike the GRAT, there is no adverse estate tax consequence if the grantor dies during the term of the CLAT. Like the GRAT, to the extent the CLAT investments outperform the hurdle rate, assets will remain in the CLAT at the end of the trust term to pass gift tax-free to a trust for descendants.

RECENT GUIDANCE FROM THE INTERNAL REVENUE SERVICE

Restricted Management Accounts

In Revenue Ruling 2008-35, the IRS held that the fair market value of an interest in a restricted management account for gift and estate tax purposes is determined based on the fair market value of the assets in the account without any discount to reflect the restrictions on the transfer or use of the account.

A restricted management account is an investment account where the depositor agrees that the bank or investment company can (1) keep assets on deposit for an extended period, (2) reinvest income, (3) make no distributions out of the account, and (4) have full discretion with respect to the investment of the assets, all of these restrictions being designed to enhance the investment performance of the portfolio by maximizing its long-term performance without the risk of withdrawal of any of the assets. Transfers to members of the depositor's family may be permitted, with the consent of the investment company, and the transferee is bound by all of the restrictions applicable to the original depositor.

The restrictions on the account were thought to produce a discount on the value of the assets for gift and estate tax purposes, but the IRS in this Revenue Ruling has announced that they do not. The IRS found that the agreement governing the restricted management account does not reduce the fair market value of the underlying property, and that, notwithstanding the restrictions, the depositor remained the sole and outright owner of the assets in the account. Accordingly, it is the assets held in the account that constitute the property to be valued for gift and estate tax purposes. The IRS stated that the agreement did not place substantive restrictions on the assets in the account and that the agreement does not impact the price at which those assets would change hands between a willing buyer and a willing seller — the test for determining fair market value for gift and estate tax purposes — and thus does not affect the value of the assets in the restricted management account.

Private Trust Company

The IRS issued Notice 2008-63, in which it is seeking comment on a proposed Revenue Ruling addressing the use of a private trust company to act as trustee of trusts whose grantors and beneficiaries are owners of the trust company. The proposed Ruling would provide that the use of a private trust company as a trustee will not, by itself, cause the value of the trust assets to be included in the grantor's estate or in a beneficiary's estate, nor will it affect the exempt status of a trust if it is otherwise exempt from the generation-skipping transfer tax or will cause the grantor or beneficiary to be treated as the owner of the trust for income tax purposes. The goal of the IRS is to confirm that tax consequences of using a private trust company are no more restrictive than what would have been achieved by the taxpayer acting directly as a trustee.

In the proposed Ruling, the private trust company is formed by a family that owns all of its stock and whose family members serve as officers and directors of the private trust company. The governing documents of the trust company provide for the creation of a discretionary distribution committee that is delegated the exclusive authority to make all decisions regarding discretionary distributions from each trust for which it serves as trustee, *i.e.*, permissible distributions not mandated in the trust instrument. No member of the discretionary distribution committee may participate in the activities of the committee with regard to any trust of which that member or his or her spouse is a grantor, or any trust of which that member or his or her spouse is a beneficiary. In addition, a discretionary distribution committee member may not participate in the activities of the committee with respect to any trust with a beneficiary to whom that member, or his or her spouse, owes a legal obligation of support.

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Please contact any member of the Trusts and Estates Department with any questions about the information contained in this Update.

Chicago Office
+1 312.583.2300

Frankfurt Office
+49.69.25494.0

London Office
+44.20.7105.0500

Los Angeles Office
+1 310.788.1000

New York Office
+1 212.836.8000

Shanghai Office
+86.21.2208.3600

Washington, DC Office
+1 202.682.3500

West Palm Beach Office
+1 561.802.3230