Hunton & Williams

Estate Planning Alert

November 2009

Contacts

Dallas
1445 Ross Avenue Suite 3700
Dallas, Texas 75202-2799
(214) 979-3000

Thomas H. Cantrill
tcantrill@hunton.com

Andrew W. Lawrence
alawrence@hunton.com

Margaret S. Alford
salford@hunton.com

Miami
1111 Brickell Avenue, Suite 2500
Miami, Florida 33131
(305) 810-2500

Michael A. Silva
msilva@hunton.com

New York
200 Park Avenue
New York, New York 10166-0091
(212) 309-1000

John T. Konther
jkonther@hunton.com

Raleigh
421 Fayetteville Street, Suite 1400
Raleigh, North Carolina 27601
(919) 899-3000

Jean Gordon Carter
jcarter@hunton.com

William S. Patterson
bpatterson@hunton.com

Richmond
951 East Byrd Street
Richmond, Virginia 23219-4074
(804) 788-8200

William L. S. Rowe
wrowe@hunton.com

J. William Gray, Jr.
billgray@hunton.com

Katherine E. Ramsey
kramsey@hunton.com

Thomas McN. Millhiser
tmillhiser@hunton.com

Timothy R. Mucha
tmucha@hunton.com

Lemonade, Anyone?

My mother used to have a number of old sayings I hated. One of them was, "When life gives you lemons, make lemonade." Well, the world has certainly thrown a load of lemons at us during the last year. Asset values are way down; interest rates and yields are still at historic lows. But these same lemons can provide you with a great opportunity to make lemonade for your family through your estate planning. In fact, thanks to current economic conditions, today may be one of the best times in recent memory to take advantage of a number of gifting techniques that can benefit your family after your death.

Gifted assets are valued for tax purposes at their fair market value on the date of gift — and with current values, that can be pretty low. Using temporarily depreciated assets to make gifts now will allow you effectively to shift any future appreciation to your beneficiaries free of gift or estate tax. There are several ways to make gifts:

- You can give away $13,000 per year to each recipient using the annual gift tax exclusion. If you are married and your spouse agrees to file a gift tax return to "split" your gifts, you can give away up to $26,000 per recipient.
- You can make lifetime gifts in excess of your annual exclusion of up to $1,000,000 (or $2,000,000, if splitting gifts with your spouse) without paying gift tax. However, these gifts will reduce your available estate tax exemption (currently $3,500,000) by an equal amount at death.
- In some cases, you may even save your family future estate taxes by making a larger gift and paying gift tax on the portion not covered by the annual exclusions or lifetime exemptions.

In each case, however, taking advantage of current economic conditions will allow you to leverage your exemptions so as to give away more today at a lower gift tax cost.

First, several gifting techniques benefit from low interest rates. For example, charging below-market interest on a loan to a family member will not be treated as a gift so long as the interest rate used is at least equal to the applicable federal rate. For loans made in November 2009, this rate is between 0.71% and 4.01%, depending on the term of the loan. If this rate is better than any commercial rate the child could find elsewhere, or if the child can earn a greater return on investment than the interest rate charged, the result will be to shift value to the child free of gift tax. Of course, it is always important to document any loan with a properly drafted promissory note.

A somewhat more complicated technique would be to sell highly appreciating or income-producing assets to a properly drafted irrevocable trust in exchange for a promissory note bearing interest at the current, relatively low federal rate. Once again, if the trust assets appreciate or earn income at a rate greater than the interest rate on the note, the trust beneficiaries will receive the excess free of gift or estate tax.

Similar strategies are available if you are interested in giving away only a future interest in property. For example, a charitable lead annuity trust or a grantor-retained annuity trust may pay a fixed annual amount to charity or you for a period of time, before the remainder passes to your beneficiaries. The present value of the remainder is treated as a current taxable gift, but low federal rates can be used to minimize (or even eliminate) that value. Thus, a charitable lead annuity trust or a grantor-retained annuity trust can be another very effective way to make a tax-leveraged gift to your children.

Oddly enough, a qualified personal residence trust (by which you give your personal residence to your beneficiaries today, while retaining the right to use it for a term) does not work as well in a low-interest rate environment. However, currently depressed property values may still make this technique worth considering for some.

I guess my mother's old expression about lemons and lemonade has never been more true than it is today.

GRATs: An Endangered Species?

A grantor-retained annuity trust ("GRAT") is an attractive wealth transfer planning vehicle because the taxable gift portion is limited to the present value of the trust remainder. There are essentially two ways to reduce this value: extending the length of the initial term and/or increasing the size of the annuity currently payable to the grantor. With the proper combination of these two variables, it is possible to reduce the gift tax value of the remainder to zero.

Of course, given this, it would be understandable if your first instinct was simply to create a GRAT with a very long initial term. However, the tax benefits of a GRAT (namely, the tax-free transfer of value to your beneficiaries) can be realized only if you survive the initial term. So, the longer the term, the more likely the GRAT's purpose will not be realized.

Consequently, most individuals choose to use a series of very short-term (two or three years) GRATs to minimize the risk that they will die during the initial term, while increasing the size of the annuity payment to still achieve a zero remainder value.

Unfortunately, Congress may be preparing to make it difficult, if not impossible, to use GRATs in this fashion.

Among the Treasury Department's proposals for the 2010 fiscal year was a requirement that all GRATs have an initial annuity term of at least 10 years. Other suggestions have included a required minimum remainder value equal to 5% of the initial value, which would eliminate the ability to create a GRAT with no gift tax cost.

Although similar proposals have been made in the past, the current budgetary climate in Washington, D.C., has led many to believe that an eventual change in the GRAT rules is almost inevitable. If you have been wondering whether a GRAT would be appropriate for you, it would be best to act sooner, rather than later.

Is There a Future for Valuation Discounts?

As was the case at the end of 2008, we do not yet know what changes Congress may make to the gift and estate tax laws next year. However, it is almost certain that change is coming. One area likely to be targeted specifically is valuation discounts.

Many practitioners expect Congress to enact legislation in 2010 that limits taxpayers' ability to claim certain discounts in valuing transfers of family-controlled entities for tax purposes. Although this change is not guaranteed, we do know that the Treasury Department's revenue proposals for the 2010 fiscal year included proposals for legislation that would disregard certain transfer restrictions when valuing an interest in a family-controlled entity. We also know that a bill (HR 436) has been introduced in the House of Representatives to (i) eliminate the application of valuation discounts for "nonbusiness assets" held by a business (e.g., cash and marketable securities in excess of the business's needs), (ii) eliminate additional discounts for any interest in a subsidiary if the parent entity owns 10% or more of that subsidiary, and (iii) eliminate minority discounts (i.e., those reflecting lack of control) for family-controlled entities.

While no one knows what Congress actually will do with estate tax reform, many informed sources (including John Buckley, Chief Tax Counsel for the House Ways and Means Committee, on October 2, 2009) have predicted that Congress will simply extend the 2009 tax rates and exemptions through 2010 without material modifications. If this occurs, then there is significantly less chance that any proposal to limit the application of discounts in valuing transfers of interests in family-controlled entities would have an effective date any earlier than January 1, 2010.

In this environment, if you have been considering a transfer of an interest in a family business, you may want to act by year-end to minimize the risk of being subject to new valuation limitations in 2010 that could make it more costly to transfer the business to the next generation.

A Trap for Employer-Owned Life Insurance

Does your business own a life insurance policy on an employee and have a direct or indirect interest in the policy proceeds? If so, recently published rules may require that you file an information report with the IRS relating to all such contracts.

In 2006 Congress, being concerned about the expansion in employer-owned life insurance ("EOLI"), enacted a new law to limit the income tax-free receipt of life insurance proceeds in certain situations involving EOLI contracts issued or materially modified after August 17, 2006. Congress also enacted a companion statute that imposed on employers annual information-reporting requirements pertaining to their EOLI contracts.

Recently, the IRS published new guidance concerning EOLI contracts and their associated reporting requirements (Notice 2009-48). These new rules apply only to a policy owner who is actually engaged in a trade or business. They do not apply to anyone else, even if the beneficiary of the contract is a business.

In addition, in order for the new rules to apply, the business owning the contract must directly or indirectly be a beneficiary of the contract on the date the contract is issued. So, for example, a policy owned by a business but payable in full to the employee would not be subject to the new reporting rules because the business is not a beneficiary of the policy.

The situation in which these rules most commonly will arise is with a buy-sell arrangement that is funded by life insurance owned by and payable to the business in order to fund the repurchase of employee ownership in the business. It also may arise in conjunction with EOLI purchased to help fund a promised death benefit or an employee's commitment under a nonqualified deferred compensation plan.

If you have an EOLI contract that is subject to the reporting requirements, then each applicable owner of the contract must file Form 8925 with the IRS for each year in which the policy qualifies as an EOLI contract. Failure to file this form may trigger penalties (generally $50 for each failure to file an information return, subject to some maximum penalty limitations).

The new rules are complex, and there are a number of other instances in which they do not apply. There may also be consent requirements for new EOLI policies being purchased on an employee's life, which, if not followed, could cost the employer the desired income tax-free treatment of proceeds.

So, if your business owns or is thinking of purchasing EOLI contracts, you should have them reviewed to determine whether you are required to file a report or obtain consent for them.

New for 2010: Expanded Roth IRA Rollovers

Contributing to a Roth IRA is a very attractive way to save for retirement. After all, unlike traditional IRAs, distributions from a Roth IRA are generally not subject to income tax. There is also no requirement that the owner take a minimum distribution from a Roth IRA each year, so the account may be allowed to accumulate tax-free during your life.

But not everyone has been able to take advantage of these benefits. Under current rules, high-income taxpayers may not contribute (directly or through a traditional IRA rollover) to a Roth IRA at all.

However, this is due to change in 2010. As of January 1, any taxpayer may convert a traditional IRA to a Roth IRA <u>without regard to income</u>. (Note, though, that the usual income limits for direct contributions to a Roth IRA will continue to apply.)

If you have previously been unable to convert your traditional IRA to a Roth IRA and do not mind paying income tax on the rollover amount (which can be recognized entirely in 2010 or averaged over 2011-2012), then 2010 may provide you with a great opportunity to lock in the future tax-free benefits of a Roth IRA. Current low stock market values also may make a taxable conversion in early 2010 attractive.

Of course, if income tax rates decline in the future, you may end up having paid more tax overall with a conversion. However, most planners do not forecast lower income tax rates anytime in the near future.

There may be significant planning options available when considering a conversion, including whether to split a single IRA into multiple IRAs and under what circumstances you might be well-advised to "undo" the conversion later in the year.

Trustees, Beware

So, your friend or brother has asked you to do him a favor and serve as a trustee for a trust he is creating. Of course, you are a nice guy, so why not? But agreeing to serve as a trustee is a serious decision and failing to take the proper steps once you begin to serve could mean personal liability for you.

Often friends or relatives ask others to serve as trustees for them. Sometimes, the trust will not be created or have any assets until after the grantor dies, which you assume will happen far into the future. Other times, the trust will exist currently and hold assets, but you believe that, while there may be a few annoying administrative details such as annual beneficiary notices, someone else will really handle all the details. In still other cases, the friend or relative has already died, and you think all you have to do as trustee is listen to what someone else tells you to do and sign whatever forms or tax returns they tell you to sign.

The preceding may sound a little silly, but individual trustees often remain uninvolved in the trust's administration when they are serving to accommodate someone else. After all, they reason, the trust must have a trustee for tax reasons, but someone else will be calling the real shots. Unfortunately, too often this "hands-off" attitude can lead to trouble for the well-meaning friend or relative.

First, the IRS takes the role of trustee very seriously. As with corporations and other entities, if the trust's formalities are not properly followed or the necessary tax elections are not made, the intended tax planning can fail. As trustee, you are also responsible for ensuring that all taxes are paid on a timely basis.

Second, individual trustees can face personal liability for their actions and inactions as trustee. While your friend or relative who asked you to be trustee would likely never sue you, the other beneficiaries are seldom that kind.

If something goes wrong in the trust's administration (for example, poor investment returns or a dispute with a beneficiary over distribution decisions), your primary defense as trustee is that you acted diligently and in accordance with what a reasonably prudent fiduciary would do under similar circumstances. This standard does not require you to outguess the experts as to what the market will do, but it does mean you must seek reasonable investment advice and diligently monitor the trust accounts. As trustee, you also have a duty of loyalty and impartiality to the trust beneficiaries. A trustee must put the beneficiaries' interests before all else and must not favor any one beneficiary (or group of beneficiaries) over another unless expressly permitted in the trust document.

Also, those who serve as trustees of irrevocable life insurance trusts must keep an eye on the performance of the insurance policies owned by those trusts. Often the policies and options were chosen by others, with little or no input from the trustee. But with the recent changes in the economy, many older policies are no longer financially sound. For example, universal life policies that have experienced unexpectedly low internal returns may no longer work as intended. Also, the features of many older policies may be less favorable than those currently available. A simple review of older policies might reveal better options or avoid disaster, such as a policy lapsing, just before it is needed, due to the inability of its internal rate of return to maintain premium payments.

Fortunately, state law does provide some protection for trustees. However, as a practical matter, the appropriateness of a trustee's decisions is a question of fact and explaining that you were serving as a trustee "just to help out a friend who gave you a wink and a nudge — you know, for tax reasons" is not going to play well with a jury. Also, remember that not all of the trust beneficiaries are friendly and on your side. They will not much care that you were doing someone a favor, but they will certainly care that you lost the money that was promised to them.

Trustees, beware.

Estate Tax Update

January 1, 2010, must have seemed like a long time away to Congress when it voted in 2001 to repeal the estate tax for people dying in 2010 and then reinstate it with a $1,000,000 exemption and maximum 55% rate for those dying in 2011 and later years. Almost everyone believed then that Congress would fix the "see-saw" problem well before 2010, either by making repeal permanent after 2009 or by eliminating the one-year repeal altogether. However, time is running short, and still no one really knows what Congress may do in the coming weeks. Although most experts believe the 2009 exemption ($3,500,000) and rate (45%) will be extended for at least another year, it is not certain how estate tax reform will factor into the various competing legislative priorities currently being addressed on Capitol Hill. The best advice for now is to stay tuned.