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Counsellors at Law

A Silver Lining? Recent Market Declines May Present Estate Planning Opportunities

In recent months, many of our clients have suffered declines in the value of their assets. While it can be difficult to open a monthly brokerage statement in this environment, decreases in asset values actually can present a significant opportunity for estate tax reduction planning. In this edition of the *Advisory* we discuss ways you can take advantage of currently depressed asset values to reduce estate taxes that would otherwise be owed at your death.

LIFETIME GIFTS

Gifts of Present Interests. If you have a large estate, the most effective way to reduce estate taxes is to reduce the size of your estate by giving assets away during your lifetime. Gifts made during your lifetime may be subject to federal and, in some cases, state gift tax. However, there are several exclusions from the federal gift tax, and most are also generally applicable to state gift as well. One is the *annual exclusion*. Through the use of the annual exclusion, each of us is permitted to give away up to \$13,000 per year to as many different individuals as desired. Another exclusion is the *lifetime exemption*. Using the lifetime exemption, each of us is entitled to give away a total of \$1,000,000 without incurring gift tax. (Significantly, gifts made using the annual exclusion do not reduce the amount of your lifetime exemption.) A third exclusion from the gift tax is the *med-ed exclusion*. The med-ed exclusion allows a donor to give unlimited amounts for certain medical and tuition expenses, provided the donor pays the expenses directly to the provider of services.

SERTs. One way of using the annual exclusion is a *Spousal Estate Reduction Trust* or *SERT*. For example, assume a

married couple with 3 children and 7 grandchildren. One spouse (the “grantor”) could set up a SERT naming the other spouse, the children and the grandchildren as beneficiaries. Each of the children and grandchildren would be given the right to withdraw the amount of any gifts made to the trust, up to two times the annual exclusion amount (e.g., \$26,000 per beneficiary in 2009). These withdrawal rights, sometimes referred to as “Crummey powers,” qualify gifts to the trust for the annual exclusion (provided the spouses agree to “split gifts” for the year). Therefore, in our example, the grantor could make gifts of assets worth up to \$260,000 per year to the trust free of gift tax and without using any of either spouse’s \$1,000,000 lifetime exemption. This removes from both spouses’ taxable estates the \$260,000 in gifted assets, together with any future growth on those assets as well.

A SERT offers a number of benefits over simple outright gifts. First, the grantor’s spouse can be a beneficiary of the trust in addition to the children and grandchildren. Many of our clients find this feature comforting. The spouse can receive distributions from the trust and, if desirable, can share them with the grantor. Second, the trust can be designed to be “generation skipping,” meaning that the assets in the trust can pass free of tax not only at the deaths of the spouses, but at the children’s deaths as well.

The SERT could also be a recipient of a gift using your \$1,000,000 lifetime exemption. Although gifts made using the \$1,000,000 lifetime exemption do not remove the gifted property from your estate (i.e., your estate tax exclusion amount is reduced by the \$1,000,000 gift), such gifts are effective to remove any

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appreciation in value from your estate. Therefore, the best assets to use in making a gift of the \$1,000,000 lifetime exemption are those which have a low value now but which are expected to have a much higher value over the long term. With today's diminished values in much of the stock and real estate markets, now may be a good time to review your portfolio to determine if there are any assets which have low values but which you believe will appreciate in the future. Such assets can be good candidates for lifetime gifting.

OTHER TRUST TECHNIQUES

The above are the relatively simple lifetime transfer techniques. For clients with even larger estates, there is an alphabet soup of advanced transfer strategies that may be attractive in today's market. Among these are the *Qualified Personal Residence Trust (QPRT)* and *Grantor Retained Annuity Trust (GRAT)*.

QPRTs. A QPRT is an irrevocable trust designed to own all or a portion of a personal residence (either a primary residence or a vacation home). You retain the right to live in your residence for a set term of years. At the expiration of the term, ownership of the residence passes to your children or to a trust for their benefit. The QPRT produces two main tax benefits. First, the gift tax value of the transfer is fixed and is based on the value of the property at the time the trust is established, even though the transfer to the children takes place in the future when the market value of the residence may be higher. (Some planners call this "freezing" the value of the residence for gift tax purposes.) Second, the gift tax value of the residence is discounted from fair market value to reflect both (a) the value of your retained use of the property during the QPRT term, and (b) the risk that the residence will revert back to your estate if you do not survive the term.

These discounts are calculated using an interest rate and actuarial factors published by the IRS.

For example, suppose a 70 year old individual transfers a \$1,000,000 residence to a QPRT, retaining the right to live in the property for 10 years, after which time the property passes to the individual's children. Assuming a 4% interest rate factor, the value of the taxable gift to the children is only about \$445,000. In effect, the individual has removed \$555,000 from his or her taxable estate. Assuming a 45% federal estate tax rate, the benefit of establishing the QPRT is to save the individual's family \$249,750 in federal estate tax (i.e., \$555,000 removed from estate multiplied by a 45% estate tax rate). These savings are increased when you consider the imposition of state estate tax. Assuming a combined state and federal estate tax rate of 53% (which is not uncommon for residents of Connecticut and New York), a QPRT would save \$294,150 in estate taxes. In addition, if the property appreciates between the date the QPRT is established and the date the individual dies, all of the appreciation escapes estate tax as well.

If the individual wishes to continue to reside in the residence after the expiration of the QPRT term, he or she can rent it from the children. The rent should be for fair market value with a written lease. The payment of rent enhances the estate tax benefits of a QPRT in that the rental payments reduce the individual's taxable estate without constituting taxable gifts to the children. The rent would constitute taxable income to the children, however, unless special features are designed into the trust to avoid this result.

Please note that, in order for a QPRT to work as intended, you must survive the term of years for which the QPRT is established. If you do not, the trust assets are brought back into your taxable estate.

GRATs. In addition to a SERT and a QPRT, depressed asset values are good news for clients wishing to create a third type of gifting trust known as a Grantor Retained Annuity Trust or GRAT. The main purpose of a GRAT is to allow you to give property with appreciation potential to a trust and retain a set annual payment (an annuity) for a set term of years. At the end of the term, ownership of the property passes to your children or other beneficiaries, or to a trust for their benefit. The value of your taxable gift is the value of the property contributed to the GRAT minus the value of your right to receive the annuity for the trust term. The value of your retained annuity is calculated using an interest rate factor published by the IRS. The GRAT can be structured such that the value of your retained annuity interest is more or less equal to the value of the assets contributed to the GRAT, with the result that your taxable gift is minimal. (These are sometimes referred to as “zeroed-out GRATs.”)

The benefit to the ultimate trust beneficiaries depends on the investment performance of the property placed in the GRAT. If the property appreciates and/or produces income at exactly the same rate as the IRS interest rate factor, the ultimate trust beneficiaries do not benefit, because the property contributed to the Trust will be just sufficient to pay the annuity for the trust term. However, if the property contributed to the trust appreciates and/or produces income at a rate greater than the IRS interest rate factor, there will be assets remaining in the trust at the end of the trust term, and the ultimate trust beneficiaries will receive those assets free of gift tax.

The benefit of a GRAT in an environment of depressed value can be seen in the following example. Suppose an individual owns a stock portfolio worth \$10,000,000 and he or she believes the portfolio has “bottomed out” and is poised for average

income and/or appreciation of, say, 7% per year over the next 10 years. Assume that the IRS interest rate factor for the month in which the GRAT is established is 4%. The individual could place the portfolio in a GRAT and retain the right to an annuity payment of \$1,233,000 per year for 10 years. At the end of 10 years, the assets remaining in the GRAT would pass to a trust for the individual’s children. The value of the gift is the initial value of the assets contributed to the GRAT (\$10,000,000) minus the discounted

present value of the individual’s right to receive \$1,233,000 per year for 10 years. At a 4% discount rate, the present value of that payment stream is about \$10,000,000. Accordingly, the taxable gift the individual would be required to report to the IRS is \$0. However, at the end of the GRAT term, the trust for the children would receive about \$2,636,000, as shown in the chart below.

For the GRAT to work, you must outlive the GRAT term. If not, all or a portion of

YEAR	BEGINNING BALANCE	GROWTH/ INCOME	ANNUITY PAYMENT	ENDING BALANCE
1	\$10,000,000	\$700,000	(\$1,233,000)	\$9,467,000
2	\$9,467,000	\$662,690	(\$1,233,000)	\$8,896,690
3	\$8,896,690	\$622,768	(\$1,233,000)	\$8,286,458
4	\$8,286,458	\$580,052	(\$1,233,000)	\$7,633,510
5	\$7,633,510	\$534,346	(\$1,233,000)	\$6,934,856
6	\$6,934,856	\$485,440	(\$1,233,000)	\$6,187,296
7	\$6,187,296	\$433,111	(\$1,233,000)	\$5,387,407
8	\$5,387,407	\$377,118	(\$1,233,000)	\$4,531,525
9	\$4,531,525	\$317,207	(\$1,233,000)	\$3,615,732
10	\$3,615,732	\$253,101	(\$1,233,000)	\$2,635,833

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the GRAT assets are brought back into your taxable estate. Of course, this places you in no worse position than you would have been in had the GRAT not been created, but it is still important to select a GRAT term that you believe you have a reasonable possibility of surviving.

Concluding Thoughts. No one can be certain what the future holds for the prices of stocks, real estate and other property. However, for those who believe that values are at or near their lows, and that the long-term outlook for valuations is positive, now is an excellent time to engage in asset transfer planning. Working with your attorney and financial advisor, you may be able to turn current market challenges into a substantial advantage by efficiently transferring wealth through multiple generations at today's discounted values.

Attorneys in Wiggin and Dana's Trusts and Estates Department would be happy to discuss these and other estate planning techniques with you. Please feel free to call us. Our names and telephone numbers are listed right.

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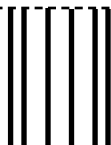
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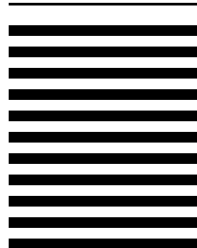
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