

GOODSON WACHTEL AND PETRULIS

A PROFESSIONAL CORPORATION

MEMORANDUM

TO: Selected Clients and Friends

FROM: Edward W. Wachtel, Kenneth G. Petrulis, and Lemoine Skinner III

DATE: July 10, 2009

RE: Administration's Fiscal Year 2010 Revenue Proposals With Respect To Estate And Gift Tax

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The Administration proposes to freeze the estate tax and to make changes to the estate and gift tax that would have a profound effect on estate planning.<sup>1</sup> The current maximum gift and estate tax rate is 45%.<sup>2</sup> The current applicable exclusion amount for gift tax is \$1,000,000 and for estate tax is \$3,500,000.

The Administration proposes to restrict valuation discounts for transfers of interests in family-controlled entities. Valuation discounts for family-controlled entities are a significant method of reducing estate and gift taxes. These discounts under current law are, generally speaking, determined by professional appraisal of the fair market value of the interests. These discounts can range from 35% to over 50% of the value of the assets held by an entity. **The proposal would apply to transfers after the date of enactment** of interests in family-controlled entities created (or subject to restrictions created) after October 8, 1990.

The proposal might be expanded to include undivided interests in real estate owned by family members as joint tenants or tenants in common. Valuation discounts for such interests range from 15% to over 33.33%.

The Administration also proposes to eliminate short term grantor retained annuity trusts ("GRATs") by requiring GRATs to have a minimum term of 10 years. A GRAT is an irrevocable trust that pays an annuity to the grantor for a fixed number of years. The remainder of the GRAT is distributed to or held in further trust for other beneficiaries (usually descendants of the grantor). For gift tax purposes, the value of the remainder equals the value of the assets contributed to the GRAT by the grantor less the present value of the annuity retained by the grantor. The present value of the annuity is determined by the amount of the annuity, the term of years for which it is retained, and a discount rate (or interest rate) published by the IRS that is based on current Treasury rates. If the GRAT is funded with assets that yield a total return (i.e., current income and appreciation) greater than the interest rate used to value the retained annuity, and the grantor survives the term of years for which the annuity was retained, at the end of that

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<sup>1</sup> General Explanation of the Administration's Fiscal Year 2010 Revenue Proposals released on May 11, 2009 ("General Explanation"). The 2010 fiscal year of the United States runs from October 1, 2009 to September 30, 2010.

<sup>2</sup> Applicable to taxable transfers of over \$1,500,000.

term, the assets then remaining in the GRAT including appreciation are transferred to (or held in further trust for) the beneficiaries without additional gift tax.

"If the grantor dies during the GRAT term, however, the trust assets (at least the portion needed to produce the retained annuity) are included in the grantor's gross estate for estate tax purposes. In this event, although the beneficiaries will own the remaining trust assets, the estate tax benefit of creating the GRAT (specifically, the tax-free transfer of the appreciation during the GRAT term in excess of the annuity payments) is not realized."<sup>3</sup> The Administration's proposal would increase the risk that the grantor might die during the term of the GRAT and lose the anticipated tax benefit of the GRAT. **The proposal would apply to GRATs created after the date of enactment.** The current interest rate for valuing a retained annuity in a GRAT is 3.4% per year.

The Administration's proposal to disallow valuation discounts for interests in family-controlled entities would increase the cost of transferring an interest in a family-controlled entity to a grantor's descendants using a GRAT or an installment sale.

One widely used method for transferring an interest in a family-controlled entity to a grantor's descendants is an installment sale by the grantor of an interest in the entity to an irrevocable trust created by the grantor for their benefit. The purchasing trust is often a grantor trust that is ignored for income tax purposes but recognized for estate and gift tax purposes. Because the trust is ignored for income tax purposes, income tax is not due on the sale.<sup>4</sup> Because the grantor pays the taxes on the trust income, the sale results in a tax free gift by the grantor to his or her descendants of the income taxes paid. The current interest rate required for installment notes used as consideration for such transfers is 2.76% per year for notes with a term of between 3 and 9 years.

Given the currently depressed state of property values and low interest rates that would be used to determine whether the contribution of property to a GRAT, the installment sale of an interest in a family-controlled entity, or the transfer of an undivided interest in real estate has resulted in a gift, now is a good time to make such transfers.<sup>5</sup> This combination of depressed values and interest rates is historically rare and is unlikely to last. When and if the Administration's fiscal year 2010 revenue proposals with respect to gift and estate tax are enacted, the risk or cost of such transfers will probably be greatly increased.

Please contact us if you wish to discuss creating family-controlled entities, transferring interests in family-controlled entities to your descendants, transferring undivided interests in real estate held by family members as co-owners, or using a GRAT in your estate plan.

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<sup>3</sup> General Explanation at p. 123.

<sup>4</sup> Whether income tax is due if the unpaid balance of the note exceeds the basis of the assets in the trust on the grantor's death is not settled.

<sup>5</sup> The value of the annuity retained by a grantor in a GRAT is higher when the discount rate used to value it is low.