

Estate Planning Bulletin

***Carpe Diem:* Prompt Action Required to Take Advantage of Estate and Financial Planning Opportunities**

Due to impending changes in the law and the economy, several estate and financial planning opportunities and techniques may soon disappear or be drastically curtailed. Other changes are in legislation that is currently pending. We recommend prompt action by all persons who may be affected by these changes, starting with a call to a member of the Estate Planning Group of Vedder Price P.C.

Executive Summary

The following is an executive summary of the key changes; a more detailed discussion of each can be found inside this Bulletin:

- **GRATs May Soon Have Their Wings Clipped.** Pending legislation would greatly reduce the effectiveness and tax benefits of a grantor retained annuity trust (GRAT), which is one of the best wealth transfer techniques. The proposed legislation would not be retroactive, so there is still time to set up one or more GRATs using the current favorable rules. The time to create a GRAT is now.
- **Estate Taxes May Not Be Reinstated in 2010.** As discussed in our most recent Estate Planning Bulletin, the federal estate tax has been repealed for 2010. Many estate plans for married couples may not work as intended if the estate tax does not apply at the death of the first spouse. Married persons who have not done so should have their estate plans reviewed as soon as possible.
- **Low Interest Rates May Not Last Much Longer.** With the economy improving, it appears that the current period of low interest rates may be coming to an end. **This year could be the best opportunity for the foreseeable future to use leveraged techniques such as GRATs, installment sales to grantor trusts, intra-family loans and charitable lead annuity trusts.**
- **Increased Tax Rates on Investment Income May Affect Decisions on Converting to Roth IRAs, Retaining Assets Until Death.** The recently passed health care reform bill includes a 3.8% surtax on the investment income of wealthier taxpayers beginning in 2013. This will increase the relative advantages of (1) converting regular IRAs to Roth IRAs in 2010 and (2) either selling capital gain assets in 2010 or holding them until death to receive a step-up in basis.

GRATs May Soon Have Their Wings Clipped

In our *Estate Planning Bulletin, GRATs: Going, Going, Gone?* (May 2009), we described Treasury proposals to greatly restrict the effectiveness of GRATs. Those proposals, along with some others, have been adopted in the Small Business and Infrastructure Jobs Tax Act, which was recently passed by the House of Representatives. This legislation in its current form would not be retroactive, so there is still time to create one or more GRATs under the current favorable rules if action is taken promptly before the Senate acts.

The Small Business and Infrastructure Jobs Tax Act contains the following changes for GRATs:

Current Law for GRATs	Changes Proposed in Small Business and Infrastructure Jobs Act	Effects of Proposed Changes on GRATs
No minimum term; 2-year and 3-year GRATs are common and are generally preferred Volatility favors short-term GRATs as donees receive most of the upside but the grantor keeps the downside investment risk	Imposes minimum 10-year term for GRATs	<ul style="list-style-type: none"> ■ Increased risk of grantor's death during term, with possibility of greater amounts subject to estate tax ■ Reduced ability of GRATs to use volatility to transfer wealth
GRATs are commonly "zeroed-out" to have no taxable gift by structuring annuity payments to have a present value equal to the value of the property contributed	Requires GRATs to have at least some taxable gift	<ul style="list-style-type: none"> ■ Some taxable gift will be required, resulting in either use of lifetime exemption or gift tax ■ Removes a potential argument against having greater amounts subjected to estate tax if grantor dies during GRAT term
GRAT payments may change from one year to the next, increasing by up to 20% per year or decreasing by any amount	Prohibits GRAT payments from declining from one year to the next	<ul style="list-style-type: none"> ■ Removes a possible way to mitigate the effects of the 10-year minimum term by locking in most of the GRAT benefit after 2 or 3 years, with only nominal payments after that

Multiple studies have demonstrated that short-term GRATs are generally more effective, especially with volatile assets. Persons with assets that have good appreciation potential and who desire to shift some of that appreciation to family members with little or no gift tax should **create and fund GRATs soon, while the favorable current law is still in effect.**

Estate and Generation-Skipping Transfer Taxes May Not Be Reinstated in 2010

Estate and generation-skipping transfer taxes have been temporarily repealed, for 2010 only, under the Economic Growth and Tax Relief Reconciliation Act of 2001. In our preceding Bulletin, *Who Would Have Thought...? 2010 Arrives Without an Estate Tax* (January 2010), we described how repeal came to pass despite almost all predictions. The Senate failed to adopt legislation passed by the House of Representatives in December 2009 that would have extended the 2009 estate and gift tax rates and exemptions permanently. Now that we are well into the second quarter of 2010, with no perceptible movement in Congress to reinstate the estate tax for 2010, it is increasingly unlikely that Congress will attempt to retroactively impose the estate tax in 2010.

In our January 2010 Estate Planning Bulletin we described how many estate plans for married couples may not work as intended if the estate tax does not apply at the death of the first spouse. Congress does not appear to be close to addressing the one-year suspension of the estate tax. **Married couples and other persons with significant wealth should have their estate plans reviewed immediately, if they**

have not already done so. A limited review focused on the effect of the 2010 estate tax suspension does not take long and may identify how the estate plan can be revised to reduce the risk that assets will not pass as intended.

Low Interest Rates May Not Last Much Longer

2010 continues a multi-year trend of interest rates below historical averages. However, this respite from high interest rates may be coming to an end, and a change to a higher interest rate environment could come rapidly if history is any guide. Recent auctions of Treasury securities at the current low interest rates failed to meet expectations. Rating agencies such as Moody's and Standard & Poors have suggested that Treasury securities could lose their AAA rating within a few years.

These factors, along with the potential to return to significant inflation rates, suggest that the current trend of low interest rates may not last much longer. Treasury rates are used to calculate the rates used in wealth transfer techniques. Once those rates increase, the techniques that perform best with low interest rates will lose much of their luster. This would affect some of the most attractive wealth transfer techniques, including:

- **GRATs**—Discussed above.
- **Installment Sales to Grantor Trusts**—A transferor can sell growth assets to a grantor trust created by the transferor for beneficiaries in a manner that avoids current capital gains taxes and reduces or eliminates gift taxes by having the transferor take back an installment note. The “spread” between the growth assets’ rate of return and the low interest rate on the installment note is retained in the trust for the beneficiaries. This technique was addressed in our Estate Planning Bulletin, *Bad Economic Times Create Great Estate Planning Opportunities* (November 2008).
- **Intra-Family Loans**—One of the simplest wealth transfer techniques involving leverage is a loan to family members, or trusts for their benefit, at the lowest allowable rates that will not result in gift taxes. These minimum allowable rates are often substantially lower than the family member could obtain from a commercial lender. Over time, the interest rate savings and cash flow benefits for the family member can be substantial.
- **Charitable Lead Annuity Trusts (CLATs)**—Charitably inclined donors can benefit family members as well as charity using a CLAT, which is similar to a GRAT but with the annuity paid to charity. If the investments in the CLAT outperform the interest rate used to calculate the present value of the annuity at the start of the CLAT, assets will usually remain in the trust after the last annuity payment and will pass to the donor’s family members without gift taxes.

Because these leveraged techniques will be far more powerful while interest rates remain low—**now is the time to put these techniques to work for you.**

Increased Tax Rates on Investment Income May Affect Decisions on Converting to Roth IRAs or Retaining Assets Until Death

The Patient Protection and Affordable Care Act and its companion, the Health Care and Education Reconciliation Act of 2010 (together, the “Health Care Reform Act”), impose a 3.8% Medicare surtax on all investment income for married taxpayers with adjusted gross income of \$250,000 or more, and single taxpayers with adjusted gross income (“AGI”) of \$200,000 or more. This new surtax will begin in 2013 and will apply to capital gains, investment portfolio income (such as dividends and interest), and passive income. Although the tax does not technically apply to qualified plan and regular IRA distributions, those distributions (but not Roth IRA distributions) will increase AGI and may cause the surtax to apply when it would not otherwise apply. This surtax will come on top of the increases in capital gains and dividend tax rates already scheduled for 2011 when the current low rates expire.

Those considering whether to take advantage of the current, relatively low income tax rates to convert all or part of a regular IRA to a Roth IRA should take this new surtax into account. In a close case, the new surtax will improve the relative performance of a Roth IRA over a regular IRA.

Those considering whether to sell or retain investment assets for the long term should take this new surtax into account when determining projected capital gains taxes. The new surtax will improve the relative performance of a two-pronged investment strategy consisting of (1) identifying assets likely to be sold in the short- to mid-term and selling them in 2010 for a lower capital gains tax rate, while (2) retaining other assets until death to achieve the step-up in basis that under current law will return in 2011.

The Health Care Reform Act also includes a codification of a tax law principle known as the “economic substance doctrine.” With this doctrine becoming a part of the Internal Revenue Code, instead of merely being applied by courts in appropriate cases, taxpayers can expect the Internal Revenue Service to seek to apply it in more situations. The new law as enacted applies to income tax, not estate and gift taxes, but may still affect some estate planning transactions.

Time to Act

In this volatile economic and legislative environment, there are many potential opportunities that may be lost if not acted upon quickly. We can identify which opportunities are most relevant to your situation, prioritize them, and implement them for you while the opportunities remain more valuable.

FEDERAL TAX NOTICE: Treasury Regulations require us to inform you that any federal tax advice contained herein is not intended or written to be used, and cannot be used, by any person or entity for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code.

VEDDERPRICE®

222 NORTH LASALLE STREET
CHICAGO, ILLINOIS 60601
312-609-7500 FAX: 312-609-5005

1633 BROADWAY, 47th FLOOR
NEW YORK, NEW YORK 10019
212-407-7700 FAX: 212-407-7799

875 15th STREET NW, SUITE 725
WASHINGTON, D.C. 20005
202-312-3320 FAX: 202-312-3322

www.vedderprice.com

For questions about estate planning opportunities created by the current economic environment, please contact any member of the estate planning group.

About Vedder Price

Vedder Price P.C. is a national business-oriented law firm with more than 250 attorneys in Chicago, New York and Washington, D.C.

The Estate Planning Group

Vedder Price P.C. has long recognized the importance of estate planning and has been at the forefront of this ever-changing area of the law. The firm's practice has both a national and an international scope. Vedder Price attorneys combine technical experience in all aspects of estate and financial planning with a strong appreciation of personal objectives and concerns in servicing clients in this uniquely personal area.

The firm represents clients with diverse personal objectives and financial interests, including individuals with large estates, individuals with personal situations requiring special planning, owners of closely held businesses, corporate executives and professionals. Vedder Price estate planning attorneys also represent executors, administrators, trustees and guardians. In addition, the firm provides estate and financial planning counsel to businesses and not-for-profit organizations, as well as other professionals who consult Vedder Price with respect to their own clients.

The ESTATE PLANNING BULLETIN is published by the law firm of Vedder Price P.C. It is intended to keep our clients and interested parties generally informed on estate planning developments. The discussion in this Bulletin

is general in nature and is not a substitute for professional advice. For purposes of the New York State Bar Rules, this bulletin may be considered ATTORNEY ADVERTISING.

© Copyright 2010 Vedder Price P.C. Reproduction of this Bulletin is permitted only with credit to Vedder Price. For additional copies, an electronic copy of this Bulletin, or address changes, please contact us at info@vedderprice.com.

If you have any questions regarding material in this issue of the ESTATE PLANNING BULLETIN or suggestions for a specific topic you would like addressed in a future issue, please contact the executive editor, Igor Potym (group leader), at 312-609-7542 or at ipotym@vedderprice.com.

Contributing Author: Michael D. Whitty

Principal Members of the Estate Planning Group

Igor Potym	312-609-7542
Michael G. Beemer.....	312-609-7630
Charles H. Wiggins, Jr.....	312-609-7525
Christine M. Rhode.....	312-609-7575
Michael D. Whitty.....	312-609-7812
Robert F. Simon.....	312-609-7550
Amy E. Lewis.....	312-609-7837
Tara V. Baker	312-609-7834