REISH LUFTMAN REICHER & COHEN
A PROFESSIONAL CORPORATION
ATTORNEYS AT LAW

TRUST & ESTATE ADVISOR REPORT

November 2008 Vol. 11, No. 1

Message From The Firm

Times are changing; families are no longer the traditional one set of parents and their children, but often consist of blended families. We see a lot of multiple marriages and children from multiple marriages which can complicate creating an estate plan or altering an existing plan. David's article touches on the dynamics of blended families and the rising popularity of terminating irrevocable trusts. An oxymoron for sure, but due to family issues, money and taxes, terminating or altering an irrevocable trust is possible.

While most of the country is feeling the psychological effects of the economy, many people are taking advantage of today's low interest rate. Richard's article focuses on various opportunities for high net worth clients to transfer wealth to the next generation. He discusses several strategies for reducing taxable estates.

The new year is around the corner along with the promise of change. On January 1st, the annual gift tax exclusion will be $13,000. This can mean considerable tax savings, over a period of time if used properly. As congress and the president start to act, we will be vigilant. However, we are relatively confident that there will not be repeal of the estate tax law. Rather, we feel that the exemption will be $3,500,000 or more. We may finally see portability where a spouse can give their exemption to their spouse for future use. Ultimately, the tax rate will probably be close to 45%. We will have to see what the future holds.

Michael B. Luftman
MichaelLuftman@Reish.com

Unintended Consequences of Terminating an Irrevocable Trust Early

By David Schwartz, Esq. (DavidSchwartz@Reish.com)

A combination of tremendous wealth generation and changing family dynamics in this country (*i.e.*, multiple marriages and children by multiple marriages) have resulted in more care being required to be taken when creating an estate plan. Although it is prudent to consider the impact of putting a current spouse in the same plan with the grantor's children by prior marriages prior to preparing the plan, many practitioners do not advise appropriately in this regard. As a result, it is often part and parcel of an estate plan to provide for the surviving spouse immediately after the death of a grantor, with the children, with whom the surviving spouse might not have a good relationship, receiving assets only after the death of the surviving spouse. The end result is often tension between the children, who will not receive assets until the surviving spouse dies, and the surviving spouse, who the children believe is "overusing" their future inheritance, is not investing the assets prudently (if the survivor is acting as trustee), or both. One potential consideration is to terminate the trust early, distribute a portion of the assets to the children and a portion to the surviving spouse, and allow all parties to go their separate ways. While this is a simple concept, the gift and income tax laws may provide a punitive result.

Gift Tax

Even in the context of settling a dispute, the Internal Revenue Service generally concludes that a beneficiary's release of an income interest in a trust for a consideration that is less than the present value of the interest likely constitutes a gift equal to the present value of the relinquished income interest. This can produce a substantial adverse tax result, given that the income beneficiary might be inclined to cause the trust to be distributed in equal shares to the spouse and children, rather than based on an actuarial calculation. The adverse result is compounded if the surviving spouse is still young, because the right to the survivor's interest in the trust (and thus the gift tax consequence on making a gift of that interest) is determined based on the survivor's actuarial life expectancy.

For example, assume the surviving spouse is age 50, has an income interest in the trust for the remainder of his or her lifetime, and the balance of the trust consists of $5,000,000 of assets. Assume further that the deceased grantor has three living children by a prior marriage, and the survivor desires to divide the trust in equal shares among the survivor and all beneficiaries ($1,250,000 each). The present value of the survivor's lifetime interest in the trust, based on an actuarial calculation, is approximately $3,050,000. Because the proposed

Continued on page 3

Opportunities in Today's Low Interest Rate Environment

By Richard Luftman, Esq. (RichardLuftman@Reish.com)

Why Now?

During this time of historically low interest rates and generally depressed economy (and resulting decline in value of assets), our high net worth clients have taken this opportunity to implement tax-efficient plans to transfer their wealth to the next generation. Because low interest rates may not be around for long, and the likely improvement in the economy over time, the time to implement transfer-tax strategies is now.

The "Freebies"

It should first be noted that there are certain techniques that should be implemented on an annual basis regardless of the state of the economy and/or interest rates. These techniques including annual exclusion gifting, the direct payment of medical expenses and educational tuition, and Section 529 college savings plans. By utilizing these techniques on an annual basis, our clients incrementally reduce their taxable estates without a gift tax cost and, at the same time, transfer wealth to, or for the benefit of, the next generation.

Every year, each person may gift up to $12,000 per donor per donee ($13,000 beginning in 2009) without payment of gift tax (commonly referred to as the "annual gift tax exclusion"). Although this amount may not seem significant, when it is accumulated over several donees over many years, and compounds outside the donor's estate, it can make a significant impact in reducing the taxable estate. In order to qualify for the annual gift tax exclusion, the donee must have the ability to use the gift presently.

In addition to the annual gift tax exclusion, each person may pay another person's medical expenses and educational tuition without using any portion of the annual gift tax exclusion. This too can be a powerful technique to slowly but surely reduce a person's taxable estate since there is no limit on the amount of expenses that can be paid in this way. All that is required is that the person paying the expenses pay them directly to the provider of the services or educational institution.

Many of our clients are aware of Section 529 college savings plans, which are specific accounts that are funded with gifts, and ultimately used toward qualified higher educational expenses such as tuition, fees, books, supplies, equipment and room and board. The assets held in a Section 529 plan grow income-tax free, and when distributions are made toward qualified expenses, those distributions will not be income taxable to the beneficiary. Contributions to a Section 529 plan qualify for the annual gift tax exclusion. Also, up to five year's worth of annual exclusion amounts may be "prepaid" when setting up a Section 529 plan. That is, several years' worth of annual exclusion gifts may be made in one year, and the additional compound effect could be substantial.

Who are the "Players"?

In order to understand the benefit of planning with low interest rates, one first needs to know the "players." The Internal Revenue Service ("IRS") publishes two significant interest rates on a monthly basis: the "applicable federal rate" or "AFR" and the "Section 7520 rate" or "7520" rate. The AFR is the minimum rate that must be charged on loans. One of the uses of the 7520 rate is to value certain interests (charitable and non-charitable) within the context of a "split interest trust." A split interest trust is a trust that benefits two different beneficiaries at two different periods of time.

A good time to implement effective wealth planning strategies is when the AFR and 7520 rates are low, as they are now, by use of such tools as charitable lead trusts, grantor retained annuity trusts, and loans to intentionally defective grantor trusts. A thorough summary of each of these techniques is beyond the scope of this article. The following paragraphs will, however, briefly describe the way in which these techniques are particularly efficient when the AFR and 7520 rates are low, as they are now.

Charitable Lead Trusts

A charitable lead trust ("CLT") is an irrevocable trust that provides for a charitable beneficiary for a term of years

Continued on page 4

New Attorney Joins Reish Luftman Reicher & Cohen

We are constantly striving for ways to better serve our clients and referral sources. To that end, we are pleased to announce that Meena P. Kotak has joined the firm. Meena's practice areas include estate planning, probate, trust administration and tax. From the point of establishing an estate plan through closing the estate and distributing the assets, Meena provides thoughtful guidance, handling sensitive probate and trust administration matters and assisting with the preparation and filing of federal estate tax returns. She focuses on helping clients minimize adverse tax consequences related to estate, income and property taxes. She also has experience in representing non-profit organizations, assisting them with formation, the application for tax-exempt status and ongoing compliance. Meena's in-depth experience greatly expands our growing Tax, Estate Planning and Probate practice. If you would like to know more about our tax, estate planning and probate practice, please see our website at www.reish.com or contact any of our attorneys at (310) 478-5656.

Irrevocable Trust

continued from page 1

gifts ($3,750,000) exceed the actuarial value of the remainder interests in the trust ($1,950,000) by $1,800,000, the surviving spouse would be treated as making a gift of that amount to the remainder beneficiaries. Assuming the surviving spouse has not used any portion of his or her $1,000,000 lifetime gifting exemption, the above generosity results in $270,000 of gift tax to the surviving spouse.

Income Tax

While the above gift consequence may be eliminated by causing the trust assets to be distributed based on the actuarial interests of the surviving spouse and the remainder beneficiaries, there is an income tax consequence to be considered. The Internal Revenue Service has consistently taken the position that, where the form of a transaction is a distribution of the present values of interests in a trust, it is in substance a sale of the current term beneficiary's interest to the remainder beneficiaries. The resulting amount is treated as received by the current beneficiary in connection with the sale of a capital asset, therefore subjecting the proceeds to tax at capital gains rates. To make matters worse, the term interestholder is unable to use any tax basis in such interest in determining his or her capital gain.

This means that, in the above transaction, the surviving spouse would be subject to capital gains tax on the amount distributed to her ($1,250,000), or approximately $250,000. To make matters worse, even if the surviving spouse agreed with the remainder beneficiaries that the remainder beneficiaries would pay any resulting gift tax, the Internal Revenue Service takes the position that, while the gift tax paid by the remainder beneficiaries would reduce the amount of the gift to them, it would increase the "amount realized" (and therefore the amount subject to income tax) by the surviving spouse in connection with the termination.

Conclusion

Any proposed early distribution of an irrevocable trust by the surviving spouse needs to be carefully considered, as there can be both income and gift tax consequences to the term interestholder that can substantially reduce the assets that the surviving spouse ends up with after gift tax and income tax is paid. ❖

IRS Shortens Extension Period to Help K-1 Recipients Meet Their Filing Deadlines

On June 30, 2008, the IRS issued temporary and proposed regulations that will reduce the extension of time to file tax returns from six months to five months for partnerships, estates and trusts, making the new due date September 15.

Currently, the extended due date for individuals and certain businesses is generally October 15. As such, individual taxpayers who rely on the information from Schedules K-1 and other similar statements to prepare and file their personal tax returns often find it difficult to file in a timely manner. The IRS is hoping that an earlier due date for filing extensions for partnerships, estates and trusts will help ease the burden on taxpayers who must report information from Schedules K-1 and similar documents generated by these entities on their individual tax returns.

The new filing due date will be effective for extension requests with respect to tax returns due on or after January 1, 2009, and will apply to entities that file the following returns and forms with a tax year ending on or after September 30, 2008:

1. Form 1065, U.S. Return of Partnership Income
2. Form 1041, U.S. Income Tax Return for Estates and Trusts
3. Form 8804, Annual Return for Partnership Withholding Tax

It is important to note that the regulations will not change the original due date (generally, April 15, for the above forms), the process for requesting an extension of time to file, nor will it affect extensions of time to file of other types of business returns, such as those used by S corporations. This is because the filing due date for other types of business returns, like those used by S corporations, are generally due on March 15, and under a regular 6-month extension of time to file, their extended due date already falls on September 15.

Interest Rate

continued from page 2

with the remainder going to non-charitable beneficiaries. The CLT operates for a term during which annual payments are made to a charitable beneficiary. At the end of the term, the remaining CLT property can be distributed to or held for the benefit of the next generation. However, in addition to the potential substantial up-front income tax deduction, it is possible to drastically reduce or even eliminate the gift tax cost associated with the transfer of the remainder to the next generation. This is because, due to the passage of time, the right to receive the remainder at some point in the future is worth far less than the proposed amount of money or property contributed to the trust. The particular benefits of a CLT will depend on the way in which the CLT is structured after addressing income, estate, and gift tax considerations.

The key to a CLT and, for that matter, each of the techniques described in this article, is to "outperform" the IRS's applicable interest rate. The 7520 rate determines the amount of the annual payment that must be made to the charitable beneficiary in the charitable lead trust. Therefore, when the 7520 rate is 3.6% as it is for November 2008, if the assets inside the trust generate a return (income and appreciation) exceeding 3.6%, it will be beneficial to both the creator, and the non-charitable remainder beneficiaries, of the CLT.

Grantor Retained Annuity Trusts

A grantor retained annuity trust ("GRAT") operates on a similar principle as the CLT. A GRAT is an irrevocable trust to which a grantor transfers property in return for the right to receive fixed payments on at least an annual basis, based upon the initial value of property transferred. Although the assets of the GRAT may increase in value during the term of the GRAT, the fixed amount payable to the grantor will not change. As a result, to the extent that the growth in the GRAT (income and appreciation) outperforms the 7520 rate applicable to the distributions to the grantor, that excess will be treated as additional tax-free gifts for the remainder beneficiaries. As with the CLT, the particular benefits of a GRAT will depend on the way in which the GRAT is structured after addressing income, estate, and gift tax considerations.

Loans/Installment Sales to Defective Grantor Trusts

A similar principle is involved with a loan to an intentionally defective grantor trust. In such a transaction, the loan is made to an irrevocable trust which accrues interest at the then existing AFR or perhaps a slightly higher rate. The trust may then use the loan proceeds to invest in income-producing property. To the extent that the interest payments on the loan are less than the return (income and appreciation) generated by the trust, the excess will benefit the beneficiaries on a gift-tax free basis.

The Time to Act is Now!

The AFR and 7520 rates recently went up slightly, but have come back down. The November 2008 mid-term AFR is 2.97% and, as stated above, the November 7520 rate is 3.6%. When the economy is in distress as it is now, asset values are almost certainly decreased. This provides an excellent opportunity to transfer property to the next generation on a tax-efficient basis.

If you have questions concerning ways in which you can transfer wealth in a tax efficient manner, please contact me or the attorney at the firm with whom you regularly work. ❖

Around the Firm

Robin Gilden will teach a spring semester of "Partnership Tax II" at Loyola School of Law. Jonathan Karp will present "Profile of Your Deal" at the California CPA Education Foundation's Succession Planning Conference in Burbank on November 4th and in San Francisco on November 11th. He will also present "Pass Through Entity Update" at the California Education Foundation's Tax Update and Planning Conference in San Francisco on November 24th and in Burbank on November 25th. In addition, he presented "Succession Planning and Exit Strategies for the Closely Held Business" at the AICPA National Tax Conference in Washing D.C., on October 28th. Robin and Charles Kolstad co-presented a webcast of "Use of Limited Liability Companies in Mergers & Acquisitions" at the California CPA Education Foundation on September 25th. Jon also presented "Buy-Sell Agreements for Owners of Closely Held Businesses" at the CPA Law Forum in West Los Angeles, on September 24th.

Any tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed herein.

©2008 Reish Luftman Reicher & Cohen, A Professional Corporation. All rights reserved. The *Trust & Estate Advisor Report* is published as a general informational source. Articles are general in nature and are not intended to constitute legal advice in any particular matter. Transmission of this report does not create an attorney-client relationship. Reish Luftman Reicher & Cohen does not warrant and is not responsible for errors or omissions in the content of this report.