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Wealth Preservation *Strategies*™

What's New in Trusts & Estates

Low Interest Rates Create Wealth Transfer Opportunities

By Kevin Lane

The current low-interest-rate environment creates powerful wealth transfer opportunities. Each month, the IRS issues minimum interest rates that can be applied to intra-family loans so that the IRS does not treat the transaction as a gift. These interest rates are known as the "applicable federal rates" (AFRs). The minimum AFR that must be paid to avoid having the loan treated as a gift varies depending on the length of the loan.

In addition, each month the IRS announces the minimum interest rate that can be used to measure the present value of annuities, income interests and remainder interests for estate and gift tax purposes (known as the Section 7520 rate, or hurdle rate). For August 2008, the Section 7520 rate is 4.2 percent.

Estate planning professionals can use these low rates to shift wealth, free of transfer taxes, from one generation to the next. Since low rates will not last forever, you may want to consider the following "wealth-shifting" techniques that are designed to capitalize on the low-interest-rate environment:

Intra-Family Loan

An effective, yet under-used, technique is the simple intra-family loan. Rather than making a gift of a particular asset to a child, a parent can loan assets to the child. If the child earns a rate of return on the borrowed assets that exceeds the AFR, the excess return (over the interest rate) is transferred to the child free of transfer taxes.

For example, assume that a parent during August 2008 loans $1 million to a child for nine years in return for an interest-only $1 million promissory note bearing interest at 3.55 percent (the August 2008 AFR for mid-term loans). If the child invests the $1 million in an asset that returns 10 percent annually, the asset, minus the annual $35,500 interest payment, will be worth $1,875,876 after nine years. Accordingly, upon termination of the note and repayment of the $1 million principal balance, the child would retain $875,876 free of transfer taxes.

continued on page 4

AUGUST 2008 AFR RATES	
Short-term (three years or less)	2.54%
Mid-term (more than three years, but not more than nine years)	3.55%
Long-term (more than nine years)	4.58%

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New Federal Rules Could Change Your Will or Trust

By Ralph Engel

On January 1, 2009, many existing wills and revocable trust agreements, especially those involving married couples, will, in effect, be rewritten, even if no one touches them. Who gets what may significantly change. Some couples will also see a substantial increase in state estate taxes, even though state estate tax brackets and exemptions generally have not changed. Some people can benefit from the changes by retitling a portion of their assets.

How can this happen?

Under the federal estate tax law now in effect, on January 1, 2009, the federal estate tax exemption (in addition to what one leaves to—or, in a permissible manner, for—one's spouse [the "marital deduction"] or charity [the "charitable deduction"]) increases from $2 million to $3.5 million. The same occurs as to the exemption from the federal tax on generation-skipping transfers (the "GST tax"). For many, that will be good news. For others, it will change who gets what, and for some, it will result in more estate tax being payable on a state level, even though less tax—or even no tax at all—was payable before.

For those whose net assets do not exceed $2 million in value and who have not used any of their exemptions in connection with lifetime gifts, these changes may be largely irrelevant. For others the effects may be significant.

Suppose that a married person has all of his or her net assets, worth $3.5 million or more, in his or her own name (with no surviving designated beneficiary), or in his or her revocable trust. Suppose that this person, like many others, has a will or trust agreement (hereinafter, collectively, a "testamentary instrument") that leaves the maximum amount free of federal estate tax to a trust (hereinafter, an "exemption trust") which does not qualify for the marital deduction or the charitable deduction, with the balance to pass to his or her spouse. If that person dies on or before December 31, 2008, the exemption trust potentially receives $2 million, and anything above that amount passes to the spouse. If that person dies on or after January 1, 2009, however, the exemption trust potentially receives $3.5 million, and only assets in excess of that amount pass to the spouse.

What if the same person has a testamentary instrument that leaves the maximum amount free of federal estate tax to his or her descendants, or to a trust for them, and the balance to his or her spouse? Starting on January 1, 2009, the descendants potentially receive $3.5 million, not $2 million, and the spouse potentially receives everything over $3.5 million, not everything over $2 million.

If, instead, the same person leaves the maximum amount free of GST tax to his or her descendants, to a trust for them or to a multi-generational or dynasty trust, with the balance going to his or her spouse, again the first portion grows by up to $1.5 million (potentially from $2 million to $3.5 million), and the second shrinks by an identical amount. All of this may occur without any change in that person's testamentary instruments.

continued on page 3

Although many will regard this change as positive, those for whom the change will skew who gets what in an undesirable manner need to amend or replace their testamentary instruments to ensure that they still carry out their wishes and that they will still do so in a tax-efficient manner.

If one spouse has assets worth appreciably more than $3.5 million, and the other has assets worth appreciably less, consideration should be given to transferring some assets from the wealthier spouse to the less wealthy spouse, outright or in an appropriate trust, so as to take advantage of the new $3.5 million federal estate/GST tax exemption, no matter which spouse dies first.

What does any of this have to do with state estate taxes?

Earlier this decade, most states had estate tax exemptions identical to the federal estate tax exemption, typically $1 million. An estate that paid no federal estate tax usually paid no state estate tax either. When the federal estate tax exemption increased, some states, such as New York, kept their exemptions at $1 million, and a few, such as New Jersey and Ohio, set theirs even lower. Others, such as Illinois and Connecticut, increased theirs to the 2008 federal exemption level of $2 million. Still others, such as California, Florida and Missouri, wound up with no state estate tax at all.

What does all of this mean if one lives in, or has real estate in, a state with an estate tax and with an exemption smaller than the new federal exemption? Absent updated planning and, in many cases, amended or new testamentary instruments, it means that one's estate may have to pay a state estate tax even if there is no federal estate tax to pay, and that tax may be hefty.

If a person with a testamentary instrument that governs all of his or her assets dies in 2009, leaves the maximum amount free of federal estate tax to an exemption trust and leaves everything else in a manner that will qualify for the marital deduction or the charitable deduction, in some jurisdictions there may be up to $250,000, or even a bit more, in state estate tax to pay. Jurisdictions in which this may be the case include Connecticut, the District of Columbia, Illinois, Kansas, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, North Carolina, Oregon, Rhode Island, Vermont, Virginia and Washington. In 2008, the state estate tax applicable to the estate of a person with such an estate plan who lives in a state with an estate tax exemption of $1 million or less may already be up to about $100,000, but, in 2009, the tax may increase by up to 250 percent, a huge increase. The additional state estate tax may also reduce the assets available to support the family, for the balance of the surviving spouse's lifetime, by up to about a quarter million dollars.

Those who have provisions in their testamentary instruments tied to the federal estate tax exemption or the GST exemption who do not want their estate plans adjusted by the changes in those exemptions that take effect on January 1, 2009, should consider making timely and appropriate modifications to their wills or trust agreements and, if appropriate, making inter-spousal transfers.

Low Interest Rates Create Wealth Transfer Opportunities

continued from page 1

A drawback to this transaction is that the IRS treats the interest payments to the lender (i.e., the parent) as taxable income. If, however, the loan is made to a trust created for the benefit of the child, and the trust is structured for income tax purposes as a "grantor trust" with respect to the parent, the parent's annual receipt of interest will not be treated as taxable income.

A "grantor trust" is simply a trust that is ignored for income tax purposes, so that the trust assets are treated for income tax purposes as if they are still owned by the parent. Income and gains attributable to the trust's assets are reported on the parent's income tax return, which allows the trust to grow without the burden of paying income taxes. The parent's income tax payment on assets that ultimately pass to the child is the equivalent of a tax-free gift to the child.

Grantor Retained Annuity Trust

A grantor retained annuity trust (GRAT) is an irrevocable trust that pays its creator (the grantor) an annual annuity for a fixed term of years. The annuity paid to the grantor is a percentage of the initial value of the GRAT's assets and could have a present value approximately equal to the value of the property transferred into the trust. There is little or no gift associated with the transaction because the grantor's retained interest in the GRAT is approximately equal to the property transferred to the GRAT. This type of GRAT is often called a "zeroed-out GRAT."

If the total annual return (income and/or appreciation) on the GRAT assets exceeds the Section 7520, or hurdle, rate, the excess will pass to the grantor's children, free of transfer taxes, upon termination of the trust (if the grantor survives the term). For that reason, GRATs work particularly well in a low-interest-rate environment. The transfer tax benefits of a zeroed-out GRAT can be illustrated by the following example:

Assume (i) a parent transfers $5 million to a GRAT with a five-year term, (ii) the GRAT assets will increase in value at a rate of 15 percent per year during the GRAT term, and (iii) the Section 7520 rate in effect at the creation of the GRAT is 4.2 percent. Based on these assumptions, the parent will receive an annual annuity payment of $1,129,459 from the GRAT during the five-year term. Because the GRAT annuity payments have a present value equal to the value of the property transferred, formation of the GRAT is not treated as a gift. The assets remaining in the GRAT at the end of five years will, based on these assumptions, equal $2,441,546 and be distributable to the children free of gift and estate tax.

Installment Sale to a Grantor Trust

Another strategy commonly recommended in a low-interest-rate environment is an installment sale to a grantor trust. This transaction is similar to the intra-family loan to a grantor trust, but, instead of loaning assets to the trust, a parent sells an existing high-performing asset to a grantor trust held for the benefit of the parent's descendants.

As discussed, a grantor trust is "ignored" for income tax purposes; the trust's assets are treated as if they are still owned by the grantor. This means that, if a parent sells assets to the grantor trust in return for a promissory note, no capital gain tax is triggered by the sale, and the annual interest paid by the trust to the parent is not taxable income to the parent.

continued on page 5

Although the trust is ignored for income tax purposes, it is respected for estate and gift tax purposes. Accordingly, the parent shifts the asset's future appreciation to the trust (where it will ultimately pass to the grantor's descendants) free of estate, gift and, if appropriately structured, generation-skipping transfer (GST) taxes.

The following example illustrates the benefits of this transaction: A parent sells $5 million of assets to an existing grantor trust that is held for the benefit of the parent's descendants in exchange for a five-year $5 million promissory note. The note requires interest to be paid annually at the August 2008 mid-term AFR of 3.55 percent and a balloon payment of principal to be paid at the end of the five-year term. For illustrative purposes it is assumed that the trust assets will grow at a rate of 15 percent per year during the trust term.

As discussed, no gain or loss is recognized on the sale of $5 million of assets to the trust, and the annual interest payments of $177,500 ($5 million x 3.55%) will not be treated as taxable income to the parent. After the re-payment of the $5 million note, $3,860,013 will be left in the trust and will pass to the beneficiaries free of gift, estate and GST taxes.

Charitable Lead Annuity Trust

A charitable lead annuity trust (CLAT) is another technique that works particularly well in a low-interest-rate environment. A CLAT should be considered by anyone who has significant charitable objectives. Like a GRAT, a CLAT pays a predetermined annuity amount to charity, with any remaining property passing to non-charitable remainder beneficiaries (typically the grantor's children). Also like a GRAT, the annuity is typically structured as a zeroed-out CLAT, so that it has a present value approximately equal to the value of the property transferred into the trust. Thus, a CLAT is virtually identical to a GRAT, except that the annuity is paid to charity rather than to the grantor. As with a GRAT, a CLAT's remainder beneficiaries are more likely to receive significant assets when interest rates are low.

For example, assume (i) a parent transfers $10 million of assets to a CLAT with a 20-year term, (ii) the annuity payable annually to the charity is 7.228 percent of the initial fair market value of the trust assets; (iii) the discount rate for the CLAT is 3.8 percent (the June 2008 rate); and (iv) the total annual return on the assets transferred to the CLAT is nine percent. Based on these assumptions, the charity would receive an annual annuity of $722,846 from the CLAT for 20 years, and $19,063,205 would pass free of tax to the parent's then-living children.

Thus, parents can use a CLAT in a low-interest-rate environment to transfer significant wealth to their children and simultaneously accomplish their charitable objectives.

Low Rates Will Not Last

The current low-interest-rate environment is unlikely to last, due to inflationary pressures facing our economy. Accordingly, parents and other donors who want to take advantage of low interest rates should act quickly. If you would like more information on one of these estate planning techniques, please contact your Sonnenschein Trusts & Estates attorney at your earliest convenience.

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