

## Breaking Developments in Trusts and Estates Law

### Year End Opportunities for Wealth Transfer and Tax Savings to Consider

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Many of the current income tax rates were enacted as part of comprehensive tax legislation enacted in 2001. This legislation is scheduled to expire at the end of 2010 and it is uncertain what path the new Congress will take in January 2011. However, if Congress does not act, individual income tax rates will rise in 2011, returning to the rates applicable in 2001. As with the gift planning opportunities identified in the next section below, the strong potential for an increase in individual income tax rates in 2011 creates incentives for 2010 year-end tax planning strategies.

1. Required Minimum Distributions from IRA or 401(k). If you turned the age of 70 ½ in 2010, you can elect to take your required minimum distribution in either 2010 or 2011. If you elect to take the minimum distribution in 2011, you will have to take two distributions in that year – the 2010 minimum distribution and the 2011 minimum distribution. Absent action by Congress, the income tax rates applicable to minimum distributions will also increase in 2011, which suggests that eligible IRA owners may prefer to take their required minimum distributions for 2010 in 2010.

2. Estimated Income Tax Payments. If you are faced with a penalty for underpayment of quarterly estimated income taxes and you cannot solve this problem through additional withholding, then (if permitted to do so by your Plan's rules) you may be able to address the problem by taking an eligible rollover distribution from your qualified retirement plan. By electing to have income taxes withheld from the distribution treated as applicable to your quarterly estimated payments throughout 2010, and then rolling the entire gross distribution (*i.e.*, the entire distribution including the amount of withheld income taxes) into an IRA, you may be able to avoid the penalty for underpayment of estimated taxes.

3. Convert a Traditional IRA into a Roth IRA. Beginning in 2010, any taxpayer can convert existing IRAs and certain other retirement plans into Roth IRAs. In a traditional IRA, the IRA investments grow tax free; however, distributions from the IRA are taxed as ordinary income. In contrast, investments in a Roth IRA also grow tax free *and* Roth IRA distributions are not taxed if the distribution is taken more than five years from the date of conversion. Another advantage of a Roth IRA is that the taxpayer no longer has to take required minimum distributions (although after the taxpayer's death, the designated beneficiary other than a surviving spouse must begin taking minimum required distributions). However, there are significant 2010 income tax consequences to converting a regular IRA to a Roth IRA, and incurring these immediate tax consequences makes the most economic sense for taxpayers, who

anticipate many years ahead of them, to take advantage of future tax-free growth. Consult your legal and tax advisers to determine if conversion to a Roth IRA is a good choice for you.

### **Taxable Gift Planning for 2010**

A number of factors make 2010 a particularly good time for affluent taxpayers to make year-end taxable gifts. These factors can result in a significantly reduced tax cost to transferring wealth during your lifetime, as compared to the estate taxes that would be imposed at death in 2011 and beyond. These factors include:

- Low asset values, particularly for real estate and businesses interests.
- Current gift tax rate of 35 percent and an even lower “effective” rate if the taxpayer survives the gift by three years.
- Risk that the federal estate and gift tax rates for high net worth taxpayers will be 55 percent or more after 2010.
- The ability to avoid Washington state estate tax, ranging from 10 to 19 percent, on property transferred by gift.
- Increasing likelihood of federal regulatory or statutory changes that would eliminate valuation discounts for transfer of interests in family-owned partnerships and other businesses.

1. Gifts to Grandchildren. Taxable gifts to grandchildren offer the same benefits as taxable gifts to children. In addition, for taxable gifts to grandchildren in 2010, there is no generation skipping transfer (“GST”) tax, which, except in 2010, is likely to apply to transfers between grandparents and grandchildren or more remote descendants. The anticipated individual exemption from GST in 2011 is approximately \$1.3 million. Beyond this GST exemption amount, the GST tax rate has historically been as high as 55 percent, an amount of additional tax that dissuades most taxpayers from making gifts or bequests directly to their grandchildren. The absence of GST tax for transfers completed in 2010 presents an incredible opportunity to transfer wealth directly to grandchildren at a much lower tax rate. Because the tax consequences of gifts in trust to grandchildren are different than the tax consequences of direct gifts, you should always consult your counsel or tax advisors regarding gifts to grandchildren.

2. Specific Types of Gifts to Consider.

a. Family Partnerships and other Family Business Entities. For a number of years, taxpayers have used family partnership transactions to transfer family business assets to family members at discounted values. Valuation discounts have typically ranged from 35 to 45 percent of market value. The Treasury Department has prepared new regulations that would preclude the use of “minority interest” and “lack of marketability” discounts when valuing interests in family-owned business interests for gift and estate tax purposes. At the same time, members of Congress have introduced several bills that, if enacted, would have the same negative effect on the use of valuation discounts. Although the future of comprehensive estate tax reform is hardly certain, it is very likely that existing law, with respect to valuation of family business interests, will change. Accordingly, owners of family business entities should consult their counsel and

financial advisors about making taxable gifts of minority interests of stock or partnership, or limited liability company membership interests this year, in order to take advantage of existing law that allows discounts for minority interests and lack of marketability of such interests.

b. Charitable Lead Trusts. Taxpayers who plan to make significant lifetime charitable gifts should consider making the gifts through a charitable lead annuity trust (“CLAT”). The annuity is designed to have a value equal to the proposed charitable contribution based on the current IRS interest rate. A CLAT pays an annuity to the charity each year for a designated number of years. After the annuity period, any remaining assets in the CLAT pass free of estate and gift tax to the taxpayer’s noncharitable beneficiaries. In order to capture the fullest potential wealth transfer, taxpayers can forego the income tax charitable deduction for the contribution (the “cost” of the CLAT to the taxpayer).

3. Grantor Retained Annuity Trusts. Taxpayers with a high net worth should also consider contributing assets to a grantor retained annuity trust (“GRAT”) during 2010. GRATs are an important tool to transfer future appreciation of trust assets to family members with little or no gift tax, particularly in light of the current all-time low IRS interest rate of 1.8 percent for December.

For example, a “zeroed-out” \$10 million GRAT established in December 2010 will repay \$10,270,630 to the taxpayer at the end of a two-year period. If the GRAT assets appreciate eight percent during the same two-year period, the additional appreciation of \$982,545 (that is, the amount of appreciation in excess of the IRS interest rate) will pass to the beneficiaries of the GRAT free of additional gift and estate tax.

Another reason to create a GRAT in 2010 is that the favorable treatment of GRATs may change in the future, as Congress may enact new rules that impose a significant gift tax on the creation of a GRAT.

4. Real Estate Values. The current depressed real estate market, in combination with the gift tax rate of 35 percent, creates additional planning opportunities to transfer commercial property and family vacation homes. For example, the IRS has ruled that, when a parent transfers 25 percent interest in a parcel of real property to each of his/her four children, the gifts are each valued as separate fractional interests even though the parent has given away 100 percent of the property. Although the IRS often disagrees with taxpayers about the appropriate amount of discount, courts have allowed discounts ranging from 18 to 45 percent for transfers of fractional interests in real property.

## **Sale Transactions**

Selling property offers many of the same tax advantages as transfers by gift:

- Transfer of family business interests at discounted prices in advance of possible estate tax reform.
- Transfer of family real estate at current, depressed values, including fractional interest discounts in advance of possible legislation prohibiting such discounts.

- Transfer of future appreciation of assets to your family.

Transferring property by sale may be preferred by taxpayers who want to retain cash flow from the property, or who do not want to pay gift tax. If the transaction is structured as an installment sale calling for regular payments, then the seller can receive regular cash payments on the purchase price. This is a particularly useful transaction for income-producing property. In addition, current historic low interest rates approved by the IRS for intra-family loans make installment sales particularly attractive. Your counsel and financial advisers can also assist you in evaluating strategies for minimizing recognition of gain on such installment sales.

### **Refinancing Existing Loans**

As noted above, the IRS approved interest rates for December 2010 will be at an all-time low. For example, in December 2010, the IRS approved rate for a loan with a term longer than nine years will be 3.53 percent; for a loan of three to nine years, the rate will be 1.53 percent; and for a loan of three years or less, the rate will be 0.32 percent. Accordingly, if you have loaned money to family members, you may want to consider allowing the borrowers to refinance at the current approved rates.

### **Summary**

Not all of the strategies identified above will be a good fit for all clients, but many of them are more attractive than ever, particularly in light of the possibility that some of these opportunities will disappear at the end of 2010. If you are interested in exploring these tax efficient wealth transfer strategies, contact your legal counsel or financial adviser as soon as possible so that there is time for meaningful evaluation and implementation of any strategies you want to include in your year-end tax and gift planning.

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