Once in a Generation Opportunity to Engage in Estate Tax Planning

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Abstract: *Legislation has been proposed to set the estate tax rate at 45% and the lifetime exclusion at $3.5 million per person. The bill will also limit the valuation discounts for transfers of interests in closely held entities such as family limited partnerships. The potential new law is only one reason why financial service professionals must educate clients and estate planning team members about this historic opportunity to engage in estate tax planning. Other reasons include asset values reduced by the current troubled economy, the lowest interest rates ever required by the IRS, and high valuation discounts for appraisals of limited partnerships and similar interests.*

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Introduction

Financial service professionals must use the confluence of factors that make this a once-in-a-generation[1] opportunity to help clients engage in estate tax planning. By making clients aware of this opportunity, and helping other members of the estate planning team[2] in this process, financial service professionals will enhance their services to clients and their standing in the professional community.

Four factors have occurred at the same time to cause this opportunity: (1) dramatically decreased asset values, (2) the lowest interest rates since the IRS started requiring rates for certain purposes, (3) large valuation discounts, and (4) the introduction of legislation that threatens to eliminate some valuation discounts for transfers of interests in family entities.

Reduced Asset Values

The asset classes normally encountered in estate tax planning have undergone dramatic reductions in value since early 2008. Following are several examples.

Investment Real Estate

When the owner of a 14-unit apartment building in Beverly Hills died in February 2008, the unit was appraised at $9 million. The trustee ordered an appraisal for the alternate valuation date[3] six months later—August 2008—and the value had dropped to $6 million. By the time the deceased's daughter was ready to do her own estate tax planning in February 2009, the property had dropped still further to $5million. In other words, the appraisal one year after the owner's death reflected a

44% reduction in value for a building in a prime residential neighborhood. In this situation, the daughter had no interest in selling the property. However, the dramatic reduction in appraised value made it easier for her to transfer a larger percentage of the building to an irrevocable trust for the benefit of her heirs.[4]

Closely Held Businesses

A family retail furniture business employing father, mother, son, daughter, and 30 rank-and-file employees had gross revenue of $30 million out of two locations, with a net[5] of $3 million in 2006 and in 2007. In connection with their estate tax planning, the parents in late 2007 hired a business appraiser. The parents' goal was to transfer nonvoting stock in this S corporation to an irrevocable trust for the benefit of their children. The business was, at that time, valued at $20 million.[6] With combined lack of control and lack of marketability discounts of 30%, the parents were able to transfer 20% of the nonvoting stock to the trust for their children with an initial value of $2.8 million [$20,000,000 x 20% = $4,000,000 x 70% (to allow for a 30% combined valuation discount)]. A grantor retained annuity trust[7] (GRAT) was constructed using assumptions that seemed conservative at the time,[8] and the gift was $573,496.[9] Thus, each parent reported a gift of one-half that amount, or $286,478. No tax was due since both parents had their entire $1 million lifetime transfer tax exclusion available.

By mid-2008, sales were down 30% and profits were down 50% as the customer base was hit hard by layoffs and foreclosures. By early 2009, sales were down 60% and profits had disappeared. The family members were able to take a modest salary; happily, they own the building in which the main sales office is located. In early 2009, the parents decided to take another step in estate tax planning, so they hired the same business appraiser who valued the business at $6 million.[10] As a result, the parents were able to transfer another 20% of the nonvoting stock to the trust for their children with an initial value of $720,000 ($6,000,000 x 20% = $1,200,000 x 60%[11]). Again using a GRAT, this time with greatly reduced expectations about the corporation's profitability, the parents made a combined gift of $73,253.[12]

Now consider a family business that continues to be profitable despite the flagging economy. This business has seen its profits increase over the past three years: $1 million in 2006; $2.5 million in 2007; $3.8 million in 2008, and is on track to net $4.5 million in 2009. One business appraiser viewed the value as continuing to increase, reflecting the rising profits.[13] A different business appraiser viewed the value as dropping, since the gross revenue multiplier,[14] one factor used in valuing this type of business, has dropped from a 2007 range of 4 to 6 to a 2009 range of to 2 to 4.[15] As a result, despite increasing profits, the valuation of this business has also dropped, providing an encouraging environment in which to engage in estate tax planning.

Publicly Traded Securities

Many clients have accumulated wealth in the form of publicly traded securities. Even the best of these securities have been hammered since early 2008.[16] For example, General Electric, one of the bluest of the Blue Chips,[17] traded at $33.55 per share on February 25, 2008, and one year later it closed at $9.38 per share. Pfizer, another Big Board[18] stalwart, was $22.50 on February 25, 2008, and one year later closed at $13.71. These reductions of 72% and 40%, respectively, are not unusual for the best of public companies but are less than the 91.5%, 92%, and 99% reductions in value for such formerly solid companies as Bank of America, AIG, and GM.[19] Assume that the client is convinced that the high quality, publicly traded securities will, at some point in the next several years, regain a great deal of their prior value, and the client would like to transfer that value to the next generation. The financial service professional must encourage the client to consult with the other members of the estate planning team to consider implementing that transfer program now. There are many ways to transfer the wealth, and the manner selected must reflect the client's goals and objectives. The approach that works best for the client might include one or more of the following, several of which take advantage of the low interest rates discussed below: (1) simple direct gift, (2) a transfer using a grantor-retained annuity trust (GRAT), (3) a sale for a regular installment note, (4) a sale for a private annuity,[20] (5) a sale for a self-canceling installment note (SCIN),[21] (6) a

part-gift, part-sale, or (7) some other transfer technique, e.g., a charitable lead trust.[22]

Low Interest Rates

Applicable Federal Rate

In 1984 Congress added a section to the Internal Revenue Code[23] to block certain loopholes such as:[24] gift loans, e.g., interest-free loans from parents to their children; compensation loans, e.g., interest-free loans from corporations to employees; and shareholder loans, e.g., interest-free loans from corporations to shareholders. The new law allowed the IRS to impute interest if none—or inadequate interest—was stated in the loan. Congress also gave the IRS authority to prescribe the interest rate, the so-called applicable federal rate (AFR).[25] There are actually three categories of AFR: (1) short-term, for debt instruments with a term of not over three years; (2) mid-term, for debt instruments with a term of over three years but not more than nine years; and (3) long-term, for debt instruments with a term over nine years. In turn, each category is calculated based on four payment types: annual, semiannual, quarterly, and monthly. In other words, there are at *least* 12 AFRs.[26] For a comparison at a glance, Table 1 shows just the short-term AFR for annual payments for January of each year.

This interest rate provides a safe harbor that is extremely useful in planning and simple to implement. The parents merely have to make a loan to an irrevocable trust of the children to transfer wealth. A loan with a term of less than three years could have borne, in January 2009, an interest rate of 0.81% and not resulted in imputed interest. As long as the children's trust earns more than 0.81%, wealth will be transferred from the parents to the children. How might the loan proceeds be used? To buy (1) life insurance on the parents, (2) nonvoting stock in a closely held corporation, or (3) limited partnership interests in a family limited partnership (FLP). There are many possibilities. What if the goal was to make a long-term, more-than-nine-year loan? In other words, the parents believe that the current trillion-dollar federal government deficits will lead to hyperinflation some time in the next decade. The parents could have charged the children's trust—in February 2009—for a 20-year loan with an interest rate of 2.96% and annual payments without the fear of imputed interest. That is a startling example of an opportunity to take advantage of future inflation to transfer wealth to the heirs with a simple structure.

IRC Sec. 7520 Rate

In 1988 Congress prescribed an interest rate to be used in calculating annuities.[27] Rounded to the nearest two-tenths of 1%, this rate is 120% of the federal mid-term AFR in effect for the month in which the valuation date occurs.[28] The rate reached a high of 11.6% in May 1989 and a low of 2% in February 2009.[29] How might this be used to transfer wealth to future generations?

Consider the situation of parents wanting to transfer 10% of the nonvoting stock in their S corporation to an irrevocable trust for the benefit of their children. The corporation is appraised for $10 million. The appraiser determines that 10% of the stock consisting only of nonvoting stock is subject to a 30% discount for lack of control and lack of marketability, giving it a value of $700,000. The parents decide that the corpo-

TABLE 1

Year	AFR Annual Payments
1985	9.79
1985	8.32
1987	6.13
1988	7.56
1989	9.01
1990	7.90
1991	7.53
1992	5.12
1994	3.98
1995	7.19
1996	5.50
1997	5.63
1998	5.70
1999	4.57
2000	5.88
2002	2.73
2003	1.81
2004	1.71
2005	2.78
2006	4.38
2007	4.88
2008	3.18
2009	0.81

[AU: YEARS 1993 AND 2001 ARE MISSING. OK?]

ration can afford to distribute a dividend of $700,000 per year, which is 7% of the corporation's value but 10% of the discounted value. They decide to establish a GRAT and retain the dividend stream, in the form of an annuity payment from the GRAT, for a 10-year period. The resulting gift is $71,218 if made in February 2009 due to the 2% Sec. 7520 rate. What if they had made the same gift in February 2008? The gift would have been more than twice as much ($137,851) because the February 2008 Sec. 7520 rate was more than twice as much at 4.2%. The financial service professional needs to urge clients and other team members to recognize that the Sec. 7520 rates can only increase, and the upward trend will make many sophisticated gifting techniques more expensive.

There are, of course, exceptions. In the GRAT example, the actual dollar amount paid as an annuity and retained by the parents is more valuable in a lower-interest-rate environment, and that retained interest makes the gift to the children smaller. By contrast, with a qualified personal residence trust (QPRT),[30] no actual dollar amount is paid to the parents. The parents have a retained value that is based on the Sec. 7520 rate.[31] Therefore, the higher the rate, the more valuable the asset (the retained right to live rent free in the residence for the term) retained by the parent. A 70-year-old retaining a 10-year term in a QPRT in February 2008 has made a $437,280 gift to his children. By contrast, the same 70-year-old retaining the same 10-year term interest in February 2009 has made a $541,300 gift to his children. The difference is due to the reduction of the Sec. 7520 rate from 4.2% to 2%. Since interest rates have dropped, why should the financial service professional still urge this parent to engage in this type of estate tax planning? Because the chances are that the residence, which was valued in February 2008 at $1 million, is, in February 2009, valued at $800,000. As a result, despite the reduced interest rate, the gift will still be less at $433,040.[32]

The Problem of Lagging Data

In one case the decedent died on February 23, 2008. A prominent national company was hired to provide the real estate appraisals for the properties located in five different states as of the date of death. As the economy deteriorated throughout 2008, it became apparent that the alternate valuation date might provide a lower valuation and, therefore, a lower estate tax. However, the national appraisal company, when asked to provide a new appraisal as of August 23, 2008, demurred. The company indicated that a new appraisal would not show a decline in value from February. When pressed, the company indicated that although it, too, felt that the economy had softened, there was no objective data to support a reduced valuation. The trustee consulted with another, more sympathetic, real estate appraiser who elaborated that the declining economy and lack of financing had caused buyers to list but not sell their properties. As a result, there were no sales that could be used as "comparables" to allow the appraisers to reach a conclusion of reduced values for August 2008.

By the time this discussion occurred it was February 2009, at which point the stock market's near collapse was all too apparent, as was the cascading effect on investment real estate. Also, in early 2009, there were some sales at reduced prices for investment real estate. The question then became: With data in February 2008 (point A) and data in February 2009 (point C), could the appraisers draw a line from point A to point C and interpolate the results for point B (August 23, 2008)? At this same time, the IRS issued "interim guidance on obtaining additional review of real property valuations in offer in compromise cases…."[33] Although "offer in compromise cases" are a different field from estate tax planning, this announcement was an IRS acknowledgment of the difficulty of real property valuations during turbulent markets:

> During these current economic times the value of real property may be difficult to determine in specific markets…. [¶] All employees should be sensitive to the current economic conditions that may be affecting taxpayers while investigating the acceptability of an offer. Employees should continue to utilize all available resources to arrive at the most accurate property valuation possible, including a discussion with the taxpayer and/or their representative on the methods used to value the taxpayer's property.[34]

A prominent national business appraiser reporting

on this IRS announcement pointed to the same factors that underpin this article: "This is just another indication that now may be the time to gift. Other reasons include: (a) higher market volatility has resulted in substantially higher discounts for lack of marketability, (b) AFR rates are at historical lows, (c) asset values are considerably lower than they were just six months ago, and (d) the threat (while apparently low) of the elimination of valuation discounts (see H.R. 436)."[35]

Large Valuation Discounts

In February 2008, a business appraiser opined that the gift of a 20% limited partnership interest was entitled to a 30% combined discount for lack of control and lack of marketability. That same business appraiser, one year later, opined that the gift of another 20% limited partnership interest in the same FLP was entitled to a combined discount for lack of control and lack of marketability of 40%. This reflects the fact that, in general, the valuation discounts are inversely related to the stock market: the stronger the stock market, the lower the discounts; the weaker the stock market, the higher the discounts. Of course, this increase in discounts facilitates the transfer of greater wealth at lower gift values. Assume that the building had remained at the same value and the only factor that changed was the valuation discount. The gift would have changed as follows:

	February 2008	February 2009
Building value	$9,000,000	$9,000,000
20% limited partnership interest value	$1,260,000	$1,080,000

However, the building's value dropped precipitously, as indicated above, so the gift actually changed as follows:

	February 2008	February 2009
Building value	$9,000,000	$5,000,000
20% limited partnership interest value	$1,260,000	$600,000

Pending Legislation: H.R. 436

On January 9, 2009, U.S. Rep. Earl Pomeroy (D-ND) introduced House Resolution 436. If enacted into law, H.R. 436 will accomplish four major goals, three of which have long been expected. First, it will repeal the 2010 repeal of the estate tax. This is, of course, not a surprise. The federal government's trillion-dollar 2009 deficit, and a likely similar deficit at least in the next year, means that the government can ill afford the loss of revenue, even from a source as small as the estate tax.[36] Second and third, it will freeze the lifetime transfer tax exclusion at $3.5 million per person and make the 45% estate tax bracket permanent. Again, it has long been anticipated that the exclusion and bracket effective in 2009 would be made permanent. Finally, the one proposal that has been largely unanticipated is the limitation on valuation discounts.[37] One new provision will require the appraiser to look inside any closely held entity and separately value any nonbusiness assets without considering any valuation discounts.[38] The other new provision will eliminate the lack of control discount for transfers of interests in family entities.[39] The proposed new restrictions on valuation discounts can be illustrated as follows.

Example. Mother and father have an FLP. The FLP owns a residential hotel[40] worth $8 million and has a securities account worth $2 million. The parents decide to make a gift of a 20% limited partnership interest to an irrevocable trust for their children. If H.R. 436 does not become law, the appraiser might determine that there is a combined 40% discount for lack of control and lack of marketability.[41] As a result, the gift would be valued as follows: $10,000,000 x 20% x 60% (to allow for the combined 40% discount) = $1,200,000. By contrast, if H.R. 436 becomes law, the gift would be valued by first removing the $2 million of securities from the FLP valuation. The gift of an interest in the securities would be valued as follows: $2,000,000 x 20% = $400,000. Then the FLP would be valued as follows: $8,000,000 x 75% (to allow for the 25% lack of marketability discount) = $2,000,000. As a result, the total gift would be valued at $2.4 million. So the impact of H.R. 436's restriction on valuation discounts, in this example, would be to raise the gift from $1.2 million to $2.4 million, a 100% increase.

Connection with Income Tax Planning

Some estate tax planning structures also have positive income tax planning consequences. For example, an

FLP is often formed with a corporation as the general partner.[42] Assume that the FLP has $50 million in limited partnership interests generating $2 million per year. Can the father, as president of the corporate general partner, take a modest salary? Can the corporate general partner adopt a retirement plan and make deductible contributions based on the father's modest salary? Can the son be paid a modest salary for helping with this family business[43] and also be covered by the retirement plan? Normally we would assume that owning limited partnership interests is a passive activity that would not provide the basis for taking compensation, whether current or deferred.[44] However, what if the family's $50 million investment was scattered among 50 different partnerships? At some point, the complexity alone probably requires a level of business activity that justifies some level of compensation.

Connection with Asset Protection Planning

One advantage of encouraging clients to engage in estate tax planning is that there is often a collateral benefit in terms of asset protection planning. That is because many of the same structures used to reduce the value of assets for estate tax planning purposes also reduce the attractiveness of those same assets to an unforeseeable creditor.[45] For example, a QPRT is an excellent way for parents to pass the equity in their residence to the children at a low transfer tax cost. However, once the transfer has been completed, and the parents have retained nothing but the right to live in the residence rent free for a term of years, what can a creditor of the parents seize? In theory, perhaps, the judgment creditor can seize the parents' right to use or reside in the residence, or the creditor can put its own tenant in the residence, which causes the QPRT to convert to a GRAT and then attach the annuity payments when made to the parents.[46] However, as a practical matter, the end result is likely to be a negotiated settlement for pennies on the dollar. There was a case in which, despite strong evidence of bad intent, the bankruptcy court denied a suggestion that the transfer of a residence to a QPRT was a fraudulent transfer.[47] Similarly, once stock in a closely held business is transferred to a GRAT, the parents have only retained annuity payments for a fixed term of years. With each passing year, the parents' retained interest becomes less valuable. Therefore, as long as the initial transfer to a GRAT is not a fraudulent transfer, the parents should be put in a strong negotiating position vis a vis a judgment creditor.

Conclusion

In November 2008, then President-Elect Obama's chief of staff, Rahm Emanuel, said, "You never want a serious crisis to go to waste. And what I mean by that is an opportunity to do things you think you could not do before." **[AU: DO YOU HAVE REFERENCE INFORMATION FOR THIS QUOTE?]** Emanuel—using a phrase coined by Stanford economist Paul Romer—was talking about how governments must take advantage of our current economic crisis. However, the same idea applies to financial service professionals and their role as members of the estate planning team. Leadership in this difficult time will bear fruit in their professional lives for years, if not decades, to come. ■

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(1) Compare: Mark Zandi, chief economist at Moody's Economy.com labeled the Fed's reduction of its benchmark interest rate by three-quarters of a percentage point from 4.25% to 3.5% "a once-in-a-generation event." *International Herald Tribune* (January 22, 2008).

(2) The professionals involved in tax planning in general, and estate tax planning in particular, are often said to include "the life underwriter, trust officer, attorney, accountant, and any other party or parties having to do with estate planning…." From the home page of the San Fernando Valley (Los Angeles, California) Estate Planning Council, http://councils.naepc.org/_cgi-bin/splashpage.web?CouncilID=16: "San Fernando Valley Estate Planning Council is an interdisciplinary organization for professionals involved in estate planning. San Fernando Valley

Estate Planning Council strives to foster understanding of the proper relationship between the functions of the Life Underwriter, Trust Officer, Attorney, Accountant, and any other party or parties having to do with estate planning, and to encourage cooperation of persons acting under those disciplines."

(3) IRC §2032, entitled "Alternate Valuation" provides, in relevant part, as follows: "The value of the gross estate may be determined, if the executor so elects, by valuing all the property included in the gross estate as follows: …(2) in the case of property not distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death, such property shall be valued as of the date 6 months after the decedent's death…."

(4) We strongly encourage clients to make transfers to irrevocable trusts rather than to heirs directly. Heirs can prove to be unpredictable during the parent's remaining life expectancy. The children may be influenced by spouses or by greed or both. By contrast, the parent is able to select a trustee who is more likely to be accommodating to the parent's interests. Also, if the trustee is a child the parent can (1) retain the right to remove the trustee under Rev. Rul. 85-58, 1995-2 C.B. 191, and (2) encourage cooperation due to the threat of disinheritance which, to a rational child, is a significant motivator.

(5) After compensation to family members.

(6) In approximate terms, the appraisal was based on $3,000,000 EBITDA (earnings before interest, taxes, depreciation and amortization) x 6 (a not uncommon multiplier) = $18,000,000 plus $2,000,000 of "hard" assets.

(7) IRC §2702, entitled "Special valuation rules in case of transfers of interests in trusts," provides in relevant part as follows: "(a) Valuation rules. (1) In general. Solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member (as defined in §2701(e)(2)) shall be determined as provided in ¶2. (2) Valuation of retained interest. (A) In general. The value of any retained interest which is not a qualified interest shall be treated as being zero. (B) Valuation of qualified interest. The value of any retained interest which is a qualified interest shall be determined under §7520. …(b) Qualified interest. For purpose of this section, the term `qualified interest' means (1) any interest which consists of the right to receive fixed amount payable not less frequently than annually, (2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and (3) any noncontingent remainder interest if all of the other interest in the trust consist of interest described in ¶(1) or (2)."

(8) It is beyond the scope of this article to address what happens when a GRAT is based on a certain annuity rate, in this case $280,000 for a 20% interest, and that annuity cannot—in a later year—be made. The short answer is that the failure to make the payment will cause a gift. That is why conservative assumptions are appropriate in this type of planning.

(9) $2.8 million, using the January, 2008, IRC §7520 rate of 4.4%, with a 10% annuity rate for 10 years, results in a $573,496 taxable gift based on the term interest, as the value of the grantor's retained interest is $2,226,504. All calculations in this article have been prepared using Estate Planning Tools 2008.03, published by Brentmark Software, Inc., Leimberg & LeClair, Inc. (www.brentmark.com).

(10) Despite the falling profits, the appraiser did not fully discount the recent highly profitable years.

(11) As discussed later in this article, the lack of marketability and lack of control discounts have increased in the past year.

(12) Using the February 2009 §7520 rate of 2%, a $720,000 GRAT for 10 years with a 10% payout results in a $73,252.80 taxable gift based on the term interest, with a $646,747.20 value of the grantor's retained interest.

(13) One method of valuing a business is the income approach. The income approach requires the appraiser to determine a discount rate, which has two elements: (1) a risk-free rate and (2) a premium for risk. Even though the risk-free rate is currently at an historic low, the systematic risk (that risk that relates to movements in returns on the investment market in general) is quite high due to uncertainties in the U.S. and world economies. Therefore, the two may be balancing each other out, explaining why the appraisal of the business discussed in the text has continued to climb. See Pratt, Reilly and Schweihs, Chapter 9, "Income Approach: Discounted Economic Income Methods," *Valuing a Business,* 3rd Edition (New York: McGraw-Hill): 162.

(14) "The value of the company may be determined based on the revenue-generating capacity of the company. For example, many Internet stocks that lose money in the short run and yet have great future earnings potential tend to derive their value from their revenue-generating capacity or registered member subscriptions. The formula for this method is as follows: Value of the Business = Revenue x Gross Revenue Multiplier." Shim and Siegel, *Handbook of Financial Analysis: Forecasting and Modeling* (CCH Incorporated, 2001): 443.

(15) See "Valuation (EBITDA) Multiples Where Companies Trade. Smaller companies tend to trade at lower valuation (EBITDA) multiples, because they are more risky (i.e. less diversified) than larger companies. * Small businesses with revenues under $5 million typically trade 2 to 3 times earnings (EBITDA). * Companies with revenues under $150 million typically trade 4 to 7 times EBITDA. * Companies with revenues under $500 million typically trade 8 to 9 times EBITDA. * Companies with revenues under $1 billion typically trade 10 to 12 times EBITDA. * Growing companies with revenues greater than a $1 billion earnings often trade at multiples greater than 12 times EBITDA," www.OracleOfNewYork.com (December 17, 2008).

Compare the October 23, 2007 article in www.CFO.com entitled "Cap Gains Vote Could Spark Small Biz Selloff," which included the following: "For example, consider a company with $5 million in EBITDA (earnings before interest, taxes, depreciation, and amortization) that is sold for $42.5 million, or 8.5 times its EBITDA. An EBITDA multiple of 8.5 is considered typical for companies with less than $25 million in revenues, according to a recent report in Piper Jaffray's *M&A Monitor* " with the 2009 "Confidential Evaluation Report" at www.transactint.com which included the following: "An EBITDA multiple of 4 is considered

'typical' for companies with $8-20 million in revenues."

(16) Many of our clients holding these securities have also gotten hammered, in the slang sense of the word.

(17) "Stock of a large, national company with a solid record of stable earnings and/or dividend growth and a reputation for high quality management and/or products. More generally, anything of very high quality"; http://www.investorwords.com/505/Blue_Chip.html. Similarly, see http://www.investopedia.com/terms/b/bluechip.asp.

(18) "A nickname for the New York Stock Exchange"; http://www.investopedia.com/terms/b/ bigboard.asp.

(19) On February 25, 2008, Bank of America, AIG and GM were $42.27, $48.64, and $23.60, respectively. One year later they were $3.61, 56 cents, and $1.90, respectively. The losses in value were 91.5%, 99.9%, and 92%, respectively.

(20) A private annuity involves the transfer of property from the transferor in exchange for the transferee's unsecured promise to make a periodic stream of fixed payments. The transferor may be an individual or a revocable living trust; the transferee may be an individual or an entity such as a trust, a partnership, or a corporation. When properly structured, private annuities eliminate federal estate tax and state death tax on the value of the transferred property. Wojnaroski, 805-2nd T.M., *Private Annuities and Self-Canceling Installment Notes.*

(21) A self-canceling installment note (SCIN) involves a sale of property to a buyer in exchange for an installment note that expires upon a certain cancellation event, typically the seller's death. A SCIN involves a sale of property to a buyer in exchange for an installment note that expires upon a certain cancellation event, typically the seller's death. Wojnaroski, 805-2nd T.M., *Private Annuities and Self-Canceling Installment Notes.*

(22) "A charitable lead trust (also called a charitable income trust) is a trust in which an income (or lead) interest is paid to one or more charitable beneficiaries and the remainder interest either reverts to the grantor or is paid to one or more noncharitable beneficiaries at the termination of the trust. Conceptually, a charitable lead trust is the opposite of a charitable remainder trust or pooled income fund where the noncharitable beneficiary receives an income interest and the charitable beneficiary receives the remainder interest." Etheridge, 866 T.M., *Charitable Income Trusts,* ¶I.A.

(23) IRC §7872, entitled " Treatment of loans with below-market interest rates."

(24) McCawley, 535 T.M., *Time Value of Money: OID and Imputed Interest,* ¶VII.A, entitled "Background of §7872."

(25) IRC §1274, entitled "Determination of issue price in the case of certain debt instruments issued for property," subsection (d) of which is entitled "Determination of applicable federal rate." As originally enacted as part of the Tax Reform Act of 1984 (P.L. 98-369), §1274 provided for AFRs to be determined every six months. This was amended by the Imputed Interest Rules Amendments Act of 1985 (P.L. 99-121) to require that rates be redetermined every month. In accordance with §1274 as originally enacted, the IRS published AFRs for 1984 and the first half of 1985 in Rev. Rul. 84-163, 1984-2 C.B. 179, and those rates for the first half of 1985 were as follows:

	Annual	**Semiannual**	**Quarterly**	**Monthly**
Short-term	12.37%	12.01%	11.83%	11.72%
Mid-term	13.37%	12.95%	12.75%	12.61%
Long-term	13.43%	13.01%	12.81%	12.67%

An excellent source for historical applicable federal rates is http://evans-legal.com/dan/afr. html.

(26) There are actually many more than 12 AFRs. For various purposes, each of the 12 are kept at 110%, 120%, and 130%, and the mid-term is also kept at 150% and 175%. For example, in accordance with §1274(e), the regulations provide for a test rate of 110% of the three–month rate for sale-leaseback transactions. Regs. §1.1274-4(a)(2). Also, 175% of the federal mid-term rate has been relevant in connection with §412(m), the quarterly contributions required to fund a defined-benefit plan.

(27) The enactment of §7520 by the 1988 Technical and Miscellaneous Revenue Act, P.L. 100-647, §5031, brought a new approach to the valuation of annuities, interests for life or a term of years, and remainder or reversionary interests, effective for the estates of decedents dying or gifts made after April 30, 1989. §7520 requires the Secretary to prescribe valuation tables based on (1) an interest rate (rounded to the nearest 2/10 of 1%) equal to 120% of the "federal mid-term rate" applicable under §1274(d)(1) for the month in which the valuation date falls, and (2) the most recent mortality experience. The tables are to be revised at least every 10 years to take into account the most recent mortality experience at the time of the revision. See Hood and Beausang, 830-2nd T.M., *Valuation: General and Real Estate,* ¶V.F.2.

(28) "If an income, estate, or gift tax charitable contribution is allowable for any part of the property transferred, the taxpayer may elect to use such federal mid-term rate for either of the two months preceding the month in which the valuation date falls for purposes of ¶(2)." IRC §7520(a), the flush language, first sentence.

(29) Transfers made in January through April were made at the 10% discount rate that applied before the effective date of §7520. See Reg. §20.2031-7A(d). The following table appears at http://evans-legal.com/dan/s7520.html:

	Jan.	**Feb.**	**Mar.**	**Apr.**	**May**	**Jun.**	**Jul.**	**Aug.**	**Sep.**	**Oct.**	**Nov.**	**Dec.**
1989	NA	NA	11.2%	11.6%	11.6%	11.2%	10.6%	10.0%	9.6%	10.2%	10.0%	9.8%
1990	9.6%	9.8%	10.2%	10.6%	10.6%	11.0%	10.6%	10.4%	10.2%	10.6%	10.6%	10.2%
1991	9.8%	9.6%	9.4%	9.6%	9.6%	9.6%	9.6%	9.8%	9.6%	9.0%	8.6%	8.4%
1992	8.2%	7.6%	8.0%	8.4%	8.6%	8.4%	8.2%	7.8%	7.2%	7.0%	6.8%	7.4%
1993	7.6%	7.6%	7.0%	6.6%	6.6%	6.4%	6.6%	6.4%	6.4%	6.0%	6.0%	6.2%
1994	6.4%	6.4%	6.4%	7.0%	7.8%	8.4%	8.2%	8.4%	8.4%	8.6%	9.0%	9.4%
1995	9.6%	9.6%	9.4%	8.8%	8.6%	8.2%	7.6%	7.2%	7.6%	7.6%	7.4%	7.2%
1996	6.8%	6.8%	6.6%	7.0%	7.6%	8.0%	8.2%	8.2%	8.0%	8.0%	8.0%	7.6%
1997	7.4%	7.6%	7.8%	7.8%	8.2%	8.2%	8.0%	7.6%	7.6%	7.6%	7.4%	7.2%
1998	7.2%	6.8%	6.8%	6.8%	6.8%	7.0%	6.8%	6.8%	6.6%	6.2%	5.4%	5.4%
1999	5.6%	5.6%	5.8%	6.4%	6.2%	6.4%	7.0%	7.2%	7.2%	7.2%	7.4%	7.4%
2000	7.4%	8.0%	8.2%	8.0%	7.8%	8.0%	8.0%	7.6%	7.6%	7.4%	7.2%	7.0%
2001	6.8%	6.2%	6.2%	6.0%	5.8%	6.0%	6.2%	6.0%	5.8%	5.6%	5.0%	4.8%
2002	5.4%	5.6%	5.4%	5.6%	6.0%	5.8%	5.6%	5.2%	4.6%	4.2%	3.6%	4.0%
2003	4.2%	4.0%	3.8%	3.6%	3.8%	3.6%	3.0%	3.2%	4.2%	4.4%	4.0%	4.2%
2004	4.2%	4.2%	4.0%	3.8%	3.8%	4.6%	5.0%	4.8%	4.6%	4.4%	4.2%	4.2%
2005	4.6%	4.6%	4.6%	5.0%	5.2%	4.8%	4.6%	4.8%	5.0%	5.0%	5.0%	5.4%
2006	5.4%	5.2%	5.4%	5.6%	5.8%	6.0%	6.0%	6.2%	6.0%	5.8%	5.6%	5.8%
2007	5.6%	5.6%	5.8%	5.6%	5.6%	5.6%	6.0%	6.2%	5.8%	5.2%	5.2%	5.0%
2008	4.4%	4.2%	3.6%	3.4%	3.2%	3.8%	4.2%	4.2%	4.2%	3.8%	3.6%	3.4%
2009	2.4%	2.0%										

(30) IRC §2702(a)(3)(A)(ii).

(31) What Natalie B. Choate refers to as "The §7520 fiction." *The QPRT Manual* (Boston, MA: Ataxplan Publications, 2004): 34.

(32) There are other ways to reduce the gift value of a residence when using a QPRT. For example, the parent may first transfer an undivided interest to the children's trust and enter into a written lease for the fair rental value of that portion of the residence. Then the parent can transfer an undivided interest in the residence to a QPRT. That will entitle the parent to a tenancy in common discount for the interest transferred to the QPRT. See Choate, *supra,* §2.3, titled "Gifts of Fractional Interests in Residence."

(33) SBSE-05-0209-006.

(34) *Ibid.*

(35) Carsten Hoffman of FMV Opinions, Inc., in a February 11, 2009, e-mail alert.

(36) "In 2003, the estate tax is estimated to have raised $20 billion," http://www.faireconomy.org/ news/estate_tax_faqs. The Tax Policy Center of the Urban Institute and Brookings Institution listed the estate tax liability (in billions) as follows: 2007 - $21.2; 2008 $23.0; http://www.taxpolicycenter.org/briefing-book/key-elements/estate/how-many.cfm.

(37) President Clinton's 1999 budget proposal would have limited valuation discounts to active businesses. Kalinka, "President's Proposals Would Affect the Use of Limited Partnerships or LLCs in an Estate Plan," *Taxes: The Tax Magazine* 7 (August 1998), CCH, Inc.

(38) Proposed IRC §2031(d)(1): "In General. In the case of the transfer of any interest in an entity other than an interest which is actively traded…(A) the value of any nonbusiness assets held by the entity shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed as to such nonbusiness assets), and (B) the nonbusiness assets shall not be taken into account in determining the value of the interest in the entity."

(39) Proposed IRC §2031(e), titled "Limitation on Minority Discounts," reads as follows: "For purposes of this chapter and chapter 12 [Gift Tax], in the case of the transfer of any interest in an entity other than an interest which is actively traded…no discount shall be allowed by reason of the fact that the transferee does not have control of such entity if the transferee and members of the family…of the transferee have control of such entity."

(40) The example uses a residential hotel rather than other types of investment real estate, e.g., an apartment building, to avoid having to address other issues raised by H.R. 436. The bill has detailed definitions of what types of assets will qualify as nonbusiness assets.

(41) A 20% lack of control discount plus a 25% lack of marketability discount amounts to a 40% combined discount as follows: 100 x 80% (to allow for a 20% lack of control discount) = 80; then 80 x 75% (to allow for a 25% lack of marketability discount) = 60.

(42) The parents should not own the corporation. The corporation should be owned by an irrevocable trust for the benefit of the children and later heirs. The reason the parents should not own the corporate general partner is creditor protection. If the parents own the corporation, then a judgment creditor of the parents can obtain control of the FLP. The irrevocable trust that owns the corporate general partner should be different from the trust to which the parents are going to be transferring the limited partnership interests. The reason for using two different irrevocable trusts is to avoid a loss of the lack of control discount. If the same irrevocable trust both (1) owns the corporate general partner and (2) receives gifts of limited partnership interests, the IRS will argue that the lack of control discount is inappropriate in valuing the gifts of limited partnership interests. After all, the donee is clearly in control. Although that argument is technically incorrect, it is better to use two irrevocable trusts so as to avoid having to negotiate with the IRS during the estate or gift tax audit. In the words of Kenny Rogers, "You have to know when to hold 'em, and know when to fold 'em."

(43) The argument being made is that the plethora of limited partnership interests requires so much work that the FLP is itself a family business. That is, of course, a determination to be made by the lawyer and the CPA by asking: Do the activities arise to the level of a business?

(44) A tax-qualified employee retirement plan is a form of deferred compensation.

(45) The phrase "unforeseeable creditor" is an attempt to describe a person who is not a "creditor" since that term is used in the Uniform Fraudulent Transfer Act (UFTA) §1, titled "Definitions." It defines a "creditor" as a "person who has a claim." A "claim" means "a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." The UFTA was drafted by the National Conference of Commissioners on Uniform State Laws and recommended for enactment at its July 27–August 3, 1984, annual conference. California has adopted it as Civil Code §§3439.01–3439.09. UFTA has been adopted by at least 39 states and the District of Columbia in response to perceived deficiencies in the predecessor statute, the Uniform Fraudulent Conveyance Act. See Rattner, "The Statute of Limitations under the Uniform Fraudulent Transfer Act: New Jersey's View," *The Banking Journal* (September 2001); http://www.riker.com/articles/index.php?id=3447.

(46) See Choate, *supra,* at ¶4.5.03.

(47) *In re: Thomas J. Earle, Jr. et al.,* 307 B.R. 276 (2002).