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OPPORTUNITIES IN A DOWN ECONOMY

The down economy presents some rare tax planning opportunities for individuals and business owners. This presentation will describe techniques that leverage our historically low interest rates in the context of wealth migration and business succession planning and identify techniques that should not be abandoned, despite the current economy.

Prepared and Presented by:

Heather A. Kmetz
1000 SW Broadway, Suite 1400
Portland, OR 97205
phone: (503) 227-1111
fax: (503) 248-0130
HeatherK@SussmanShank.com
www.SussmanShank.com

SUSSMAN SHANK LLP
ATTORNEYS AT LAW

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Family Loans

Many family members will be helping other family members out with increasing frequency during these tough economic times. Consider the gift tax implications of simply giving or "loaning" with no documentation. Written documents are essential to prove the transfer was a loan – not a gift. Further, if no interest rate is stated with respect to the loan, the interest will be imputed (at the applicable federal rate ("AFR") under the below market interest rules. Therefore, a "no interest" loan will likely result in a part loan / part gift transaction. (There are two exceptions to the imputation of interest rules: (1) If the loan is not invested by the borrower and is not more than $10,000, interest does not have to be imputed. (2) Similarly, if the loan is not more than $100,000 and the borrower's net investment income is not more than $1,000, the below market interest rules won't apply.)

Also, consider the opportunities of extending long-term, low-interest loans to family members. If the investment for which the loan is extended appreciates at a rate greater than the interest rate on the loan, value can be transferred without imposition of transfer taxes…and the AFR has never been lower!

Short Term AFRs (Term 3 Years or Less)				
	Compounding Period			
	Annual	**Semi-Annual**	**Quarterly**	**Monthly**
February 2009 Rev.Rul. 2009-5	0.60%	0.60%	0.60%	0.60%
January 2009 Rev.Rul. 2009-1	0.81%	0.81%	0.81%	0.81%
December 2008 Rev.Rul. 2008-53	1.36%	1.36%	1.36%	1.36%
November 2008 Rev.Rul. 2008-50	1.63%	1.62%	1.62%	1.61%

Mid Term AFRs (Term More Than 3 Years and 9 Years or Less)				
	Compounding Period			
	Annual	**Semi-Annual**	**Quarterly**	**Monthly**

February 2009 Rev.Rul. 2009-5	1.65%	1.64%	1.64%	1.63%
January 2009 Rev.Rul. 2009-1	2.06%	2.05%	2.04%	2.04%
December 2008 Rev.Rul. 2008-53	2.85%	2.83%	2.82%	2.81%
November 2008 Rev.Rul. 2008-50	2.97%	2.95%	2.94%	2.93%

Long Term AFRs (Term More Than 9 Years)				
	Compounding Period			
	Annual	**Semi-Annual**	**Quarterly**	**Monthly**
February 2009 Rev.Rul. 2009-5	2.96%	2.94%	2.93%	2.92%
January 2009 Rev.Rul. 2009-1	3.57%	3.54%	3.52%	3.51%
December 2008 Rev.Rul. 2008-53	4.45%	4.40%	4.38%	4.36%
November 2008 Rev.Rul. 2008-50	4.24%	4.20%	4.18%	4.16%

Direct Gifts

The economy has pushed down the value of many assets. As gift and estate taxes are imposed on the fair market value (FMV) of the asset (property) transferred, the depressed value unto itself offers a rare opportunity to transfer value to the next generation. It is important to stay with annual gifting plans that transfer the annual gift tax exemption amount ($13,000 in 2009) to children. The stock market's slump can be added value to your children.

> *Example* – 1,000 shares of stock previously worth $50 a share and now trading at $13 a share can be transferred to a single individual at no gift-tax cost (and with no reporting obligation).

If the stock market bounces back to its earlier highs or beyond, the post-transfer appreciation will escape transfer taxes.

Valuation Discounts

FMV of publicly traded stock is easily determined. However, FMV of a closely-held business interest or of real property is much more difficult – as both are unique assets for which there is no market that defines its value absolutely. FMV is defined as: "the net amount which a willing purchaser, whether an individual or corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts" *26 CFR 25.2512-3(a), and 20.2031-3(a).*

With respect to fractional interests in property, FMV generally includes the application of marketability and minority discounts – which generally reduces the value of property subject to transfer taxes.

Lack of Marketability Discount. Like any other asset, the FMV of an LP or an LLC interest is determined by what an uninterested third party would freely pay for the interest. Because most interests in closely held businesses or family owned businesses, including LPs and LLCs, are not freely transferable, a hypothetical third party purchaser would demand a discount below the Net Asset Value (NAV) of the LP or LLC for any fractional interest in the entity. The marketability discounts are often substantial.

In one of the landmark cases in this area, Mandelbaum v. Comr., 69 T.C.M. 2852 (1995), aff'd 91 F.3d 124 (3rd Cir. 1996), Tax Court Judge Davis Laro created quite a stir when he raised key issues regarding marketability discounts and set forth ten factors to be considered in determining an appropriate discount for lack of marketability:

1. Private vs. public sales of stock
2. Financial statement analysis
3. The Company's dividend policy
4. Nature of the Company, its history, position in the industry and its economic outlook
5. Strength of Company management
6. Amount of control transferred
7. Restrictions on transferability of stock
8. Holding period required in the stock
9. The Company's redemption policy
10. Costs associated with making a public offering

The Court considered the above ten factors and determined – on its own – that a 30 % marketability discount was appropriate.

In some instances, the Tax Court has allowed for lack of marketability discounts both for the underlying assets of the entity and the interest in the entity itself. *See Maxcy Est. v. Comr., 28 T.C.M. 783 (1969), rev'd on other grounds 441 F.2d 192 (5th Cir. 1971) and Bennett Est. v. Comr., 65 T.C.M. 1816 (1993), each of which valued the entity with a 15 percent discount from NAV due to the unique nature of the underlying assets.* Additional marketability discounts were allowed for the interests in the entity. Finally, a marketability discount may be allowed even if the interest at issue is a controlling interest. In Ford Est. v. Comr., 66 T.C.M. 1507 (1993), aff'd 53 F.3d 924 (8th Cir. 1995), the Tax Court's decision included a 10 percent marketability discount for a controlling interest in a corporation.

Lack of Control Discount. Further, if the fractional interest represents a minority control interest, the third party purchaser would pay less per unit or share than if purchasing a controlling interest. In general, according to BNA, courts have approved of minority discounts in the range of 20 percent to 30 percent.

> *Example – Application of Valuation Discounts.* Suppose an individual owns a commercial building worth $1,000,000. If the individual simply holds the building until death, the entire $1,000,000 is subject to tax. Instead, suppose the individual contributes the property to an LP or LLC and then makes a gift to each of his or her two children of a 1/3 interest in the partnership. At first glance, the value of the gift to each child is $333,333. However, because a disinterested third party would want a discount for a minority interest in an entity controlled by strangers with no readily available market for the interest, the discounted value of each 1/3 interest may be $200,000. In addition, the 1/3 interest retained by the transferor is now a minority interest with no readily available market. Thus, that interest may also be discounted to $200,000. By the use of an LLC or LP and discounts, the individual has just reduced the value of property subject to transfer taxes by $400,000.

Discounts are Distinct. Although often discussed in tandem, the lack of control discount (also referred to as a minority discount) and the lack of marketability discounts are actually distinct and separate concepts. Qualification for one discount does not per se result in qualification for the other. As noted by the Tax Court in Andrews Est. v. Comr. 79 T.C. 938, 952-953 (1982), the minority discount reflects a lack of control. The marketability discount reflects the lack of a readily available market for interests in the entity, whether minority or controlling. Nonetheless, the court in Andrews Est. recognized that a lack of control may affect marketability.

Calculation of Discounted Value. Technically the two discounts should be applied one after the other rather than being summed and applied to the partnership interest.

> *Example* – Assume that the total assets in the partnership are $1 million and that the valuation expert is assessing a 1 percent limited partnership interest. The valuation expert determines that for this investment there should be a 25 percent discount for lack of control and a 25 percent discount for lack of marketability.

According to Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs in their book, Valuing A Business: The Analysis and Appraisal of Closely Held Companies, Third Edition (Irwin Professional Publishing, 1996), the proper way to value the interest is sequentially, as follows: $10,000 per unit before discount (1% times $1,000,000), Less 25% (lack of control discount) = $7,500, Less 25% (lack of marketability discount) = $5,625 per unit.

ESTATE PLANNING PERSPECTIVE: Obtain a qualified appraisal to validate discounts. A number of different issues come into play in valuing an interest based in lack of or entitlement to control over an entity. In particular, questions of attribution, swing votes and actual or effective control must be considered. An advisor should not simply rely on historical results. The courts are careful to point out that the question of valuation is a question of fact. *See Andrews Est. v. Comr. 79 T.C. 938, 952-953 (1982); see also Wildman Est., T.C. Memo 1989-667, citing Propstra v. United States 680 F.d 1248 (9th Cir. 1982) and Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981).* In fact, in at least one case, the court ruled against the taxpayer for relying solely on the average of decided cases rather than presenting evidence or expert opinion. *Berg Est. v. Comr., 976 F.2d 1163 (8th Cir. 1992).* Thus, it is prudent to obtain an appraisal in support of the position to be taken on the return. Certainly, if litigation is pursued, expert testimony will be essential.

Sale to an Intentionally Defective Trust

An intentionally defective grantor trust (IDGT) is a trust that is treated as owned by the grantor for income tax purposes, but not for transfer tax purposes. A sale of property to an IDGT in exchange for a note is an estate freeze technique. This technique is maximized when the property sold is subject to valuation discounts – such as a limited partner interest.

Why bother? For one thing, the pay-off is potentially greater than with other strategies. Moreover, these give you a tax-advantaged way to pass assets to grandchildren while keeping the value of what's in the trust outside of their estates, as well as yours.

While IDGTs can be complex, on a basic level the arrangement involves setting up a trust and then lending it money to buy an asset from you that has the potential to appreciate significantly. Many people use these to purchase family businesses or homes.

To buy the assets, the trust will need some cash. So, to start with, you transfer cash funds to the IDGT. The most you typically want to transfer $1 million. Why $1 million? That's the amount each person is allowed to give away free of gift tax during that person's lifetime. Since you typically want this trust to endure for generations, you will typically apply some of the $3.5 million (in 2009) generation-skipping transfer tax exemption amount to shelter the amount transferred from that tax. Gifts of more than

$3.5 million (in 2009) to grandchildren or their descendants are subject to a generation-skipping transfer tax of as much as 45 %.

With that $1 million in cash, plus a $10 million loan from the grantor, the trust will purchase assets valued at $11 million. (To ensure that the note qualifies as bona fide debt – insulating it from IRS attack under IRC §§ 2036(a), 2701 and 2702 – it is important that the trust's debt / equity ratio is not too high. A 10/1 ratio is generally perceived as the highest ratio advisable; any greater and it is generally perceived that the debt may start to look like a retained income or equity interest instead.) *See Private Letter Ruling 9535026*, in which the IRS ruled that IRC §§ 2036(a), 2701 and 2702 did not apply to an IDGT sale, assuming that the note retained by the seller was bona fide debt.

IRC §671 the seller is treated as the owner of the trust for income tax purposes. Further, under Revenue Rule 85-13, the seller and the IDGT are treated as the same taxpayer. Thus, it is a sale to yourself! This means that no gain is recognized on the sale and that the interest payments received on the note are not income to the seller.

The trust can use the Applicable Federal Rate, which for loans of 10 or more years is 2.96 % if the trust is established in February 2009. However, if a self-canceling installment note ("SCIN") is used, an interest rate premium or a principal premium must be applied to the note to avoid re-characterization by the IRS as a taxable gift from the seller to the buyer. The premium also legitimizes the sale for a SCIN because it applies adequate and bargained-for consideration for the cancellation feature. Generally, the older the seller, the larger the premium that must be used to avoid a gift. To provide the greatest amount of mortality leverage, the SCIN's term should be as long as possible within the seller's life expectancy (determined using the IRS mortality tables).

Of course, the goal is for the IDGT's assets to gain enough to cover the loan, while leaving something more for the grantor's children and grandchildren. Over the next 20 years, typical market conditions could allow that initial $11 million to grow to around $20 million. While we are not in typical market conditions, the exceptionally low interest rates should still make this an attractive option for many.

Also, since the seller is treated as the owner of the IDGT and must pay the tax on the IDGT's income, this provides an additional opportunity. Payment of the IDGT's income tax by the seller is – in effect – an additional tax-free transfer from the seller to the IDGT. This also leaves more value to accumulate in the IDGT for eventual distribution to the seller's children.

Grantor Retained Interest Annuity Trusts

In many ways, GRATs resemble loans. As with a loan, they mature within a specified number of years. Moreover, any money you put in will be returned to you by the time the trust expires. So, what's in it for your heirs? Assuming all goes well, a big chunk of the earnings will go to them, free of gift and estate taxes.

With these trusts, heirs won't receive quite as much as they would with a sale to an IDGT. However, GRATs are also less risky, mostly because you can completely avoid any gift-tax consequences and because they are authorized vehicles under the Tax Code.

A successful GRAT is one that appreciates a lot. Thus, it's best to select an asset you think is on the verge of a rapid run-up. For example, shares in a privately held company that's likely to go public. However, in today's market, beaten-down shares are also good candidates.

The rate used to value annuities, life interests or interests for terms of years and remainder or reversionary interests is the "7520 rate". Like interest rates, the 7520 rate is at an historic low:

Section 7520 Rate	
February 2009 Rev.Rul. 2009-5	2.0%
January 2009 Rev.Rul. 2009-1	2.4%

If the asset transferred into the GRAT appreciates annually by more than the 7520 rate, the excess profits will remain in the trust and eventually go to the grantor's children. With the 7520 rate where it is, that is a pretty low hurdle!

Even if the asset were to decline, there's little downside – the GRAT will simply pay the grantor back what's left of the investment by the time it expires. (No one is required to make up for a shortfall.)

Many advisers favor limiting GRAT terms to as few as two years – the minimum allowed. That way, if a particular investment soars, you'll be able to get the gains out of the GRAT before your luck changes.

As with IDGTs, GRATS are grantor trusts. As such, they allow you to pay capital-gains and income taxes on the investments in the GRAT on behalf of your heirs. Because the IRS doesn't consider such tax payments a gift, they are another way to transfer wealth to the next generation free of gift and estate taxes.

But there are drawbacks. Because GRATs have to pay you higher rates than short-term and medium-term family loans, they pass along slightly less to your heirs. The biggest risk is that you might die before your trust ends. In that situation, it's as if the GRAT

never existed: Its entire value – including returns – is generally included in your estate and subject to tax.

ROLLING GRATS: A common strategy is to set up a short term, typically two year, GRAT designed to capture upside (not downside!) market volatility. The annuity paid to the grantor would be set high enough so that the GRAT would have a nominal value for gift tax purposes (the so-called post-Walton zeroed out GRAT). The result of this approach is that a substantial portion of the assets of the GRAT (the grantor's principal plus the 7520 mandated return) would be paid back to the grantor setting up the GRAT. Any market returns above the mandated federal interest rate, would inure to the benefit of the grantor's children (or a trust for them under the GRAT). This would result in the grantor having to re-GRAT the large distribution the grantor receives in each year of the GRAT to a new GRAT. This is why the technique of using repetitive short term GRATs is referred to as "rolling" GRATs. If the GRAT is worth less than what the grantor initially transferred to it, the GRAT will "bust" -- all the assets will be distributed to the grantor with nothing left for the grantor's children. In this situation, when the final GRAT assets are repaid to the grantor, the trustees should sign a short acknowledgement that the GRAT has been terminated with a final payment to the grantor (so that there is a record in the files of what happened should a question arise in future years). Next, continue the plan. Set up a new GRAT and re-gift the assets to the new GRAT.

Comparison Between Sale to a IDGT and GRAT.

(a) *Estate Tax.* The donor must survive the term to have the GRAT property out of the estate, whereas the IDGT property is out of the estate immediately.

(b) *Gift Tax.* No gift is made if the sale to the IDGT is for fair market value and interest is payable at (at least) the AFR, although there will be gift tax liability associated with the "seed money" given an IDGT. The GRAT has almost no (or no) gift if the annuity is high enough [the IRS will not rule on a GRAT if the amount of the annuity is more than 50 percent of the initial fair market value of the property transferred to the trust or the present value of the remainder interest is less than 10 percent of the initial net fair market value. Rev. Proc. 2002-3, 2002-1].

Generation-Skipping Transfer Tax. The exemption can be immediately allocated to the IDGT, but the GRAT allocation can not happen until the end of the estate tax inclusion period (usually the GRAT term).

The best of both worlds: Rolling GRATS to transfer property to an IDGT

With this strategy, the trustee of the IDGT uses the "seed money" (the $1 million in the above example) to buy a fractional interest in property from the grantor. The grantor

then takes that "seed money" received as payment from the purchase to fund rolling GRATs.

Hedging against the SCIN: Employing a "Bet to Live" Strategy

Alternatively, the economic value of the promissory note can be transferred to a GRAT in year one. (This also helps hedge against the SCIN option returning more wealth to the estate than the amount that would be paid to the estate using a traditional non-SCIN promissory note.) The best way to structure the transfer of promissory note in year one would be to have the seller / grantor contribute the SCIN (together with other assets) to an LLC in exchange for 1 % voting and 99 % non-voting interests. Then the seller / grantor would assign the 99 % non-voting interest in the LLC to a grantor retained annuity trust. The GRAT term should be as short as possible. This pits a "bet to live" strategy against the SCIN's "bet to die" strategy.

- If the seller / grantor dies before the GRAT term ends and before the SCIN term ends, this is the best economic outcome for the IDGT because the balance of the interest payments and the SCIN balloon payment are cancelled pursuant to the SCIN's terms. It doesn't matter that the GRAT "fails" because all the GRAT owns is an LLC in which the primary asset is a canceled note.

- If the seller / grantor dies after the GRAT term ends but before the SCIN term ends, the IDGT and the LLC each have some economic benefit because the remaining interest payments and SCIN balloon payment cancel and the trust asset (the LLC interest) passes outside the seller / grantor's estate.

- If the seller / grantor dies after the GRAT term ends and after the SCIN term ends, the GRAT receives a huge amount of value (it receives the SCIN interest payments plus the large SCIN balloon payment because that payment is when the seller / grantor survives the SCIN term).

IDGT / GRAT Strategies, Generally

Whether funding rolling GRATS with the promissory note payments or transferring the economic value of a promissory note to a GRAT in year one, the sale to an IDGT strategy is an attractive one. However, it should be noted that it is a relatively aggressive strategy for two reasons:

1) Neither the tax code nor case law specifically addresses IDGTs – and the IRS has been known to challenge them on occasion. To steer clear of problems, it would be prudent to establish the trust some time before selling it an asset.

2) Perhaps the biggest risk is that of the trust going bust. If its assets decline in value, it will have to come up with the cash to pay back the grantor. It can always use the money the grantor gave it – the $1 million plus

interest, in this example. But if it exhausts that sum, the grantor will have to pay gift tax, and possibly generation-skipping tax, on the rest of the debt.

Of course, any installment sale can be useful as an estate freeze. But by using the IDGT, the are the additional benefits of (1) avoiding the gain on the intra-family sale and income tax on the interest and (2) allowing the grantor / seller to pay income tax on the IDGT's income without gift tax consequences.

Charitable Lead Annuity Trusts

Similar to GRATs, charitable lead annuity trusts ("CLATs") are most attractive when the 7520 rate is down – as a low 7520 rate reduces the value of the remainder interest to the grantor's children (reducing or eliminating gift and estate taxes). However, whereas a GRAT returns interest and principal to the grantor, a CLAT gives away all of the income to charity. The remainder goes the grantor's children.

Of course, it makes little sense to set one up unless you are charitably inclined. Calculate the annual gift over the term – many clients may already be making charitable contributions in that amount on an annual basis. If the numbers make sense to the grantor, the CLAT can be better a better option than an outright gift to charity.

There are many ways to structure a CLAT. The tax treatment, for example, can vary, depending on whether you elect to receive an upfront charitable deduction on your income tax. If the grantor takes a charitable income tax deduction up front, that grantor will be responsible for the trust's income over the term. Alternatively, if the grantor chooses to forgo the income-tax deduction, they are relieved of the responsibility for covering the income taxes these trusts (incurred with respect to income or capital gains they earn).

DON'Ts For Business Owners

Don't Use Business Assets to Pay Personal Expenses. When faced with cash needs, dramatic portfolio declines, or a family member's job loss, it may be tempting for individuals to draw funds out of family-controlled entities. Consider the dangers of simply paying for personal expenses from entities, or making undocumented distributions. Such transactions can have a myriad of negative consequences. Most significantly, the integrity of the entity can be compromised (subverting any asset protection benefits the entity provided and exposing remaining personal assets to risk). Distributions from entities for which equity interests have been given to children or other heirs may support an IRS argument that the gifted equity interests should be included in the donor's estate since the payment of personal expenses, or loans/distributions that mirror personal cash flow needs, demonstrates a significant retained interest.

Don't Allow Entity Maintenance to Become a Low Priority. Many business owners are looking to cut expenses – including legal fees. However, do not allow annual meeting

minutes to lapse or delay needed revisions of shareholders' agreements and other governing documents. Evaluate the long-term appropriateness of these steps and let your legal counsel help advise as to those projects that may be avoided or delayed to minimize current costs.

Life Insurance Considerations

Even in rosy financial environments it is advisable every couple of years to review the financial status of the insurance company, obtain an in-force illustration and so on. Whether you've done this in the last year or two, the current turmoil should motivate you to do a review now. Don't assume your insurance company is safe, AIG changed all that. Query how that changes the fiduciary responsibility of trustees? If the policy is a variable policy, how badly have the underlying mutual funds been hammered? What does that do to future plans and the viability of the policy? If the variable policy is held inside a trust, what about the impact on the need for future gifts? What if the grantor has made other plans for her annual gifts? Just because your brother in law asked you to be a trustee doesn't mean you can ignore your responsibilities as trustee! Action Steps: Review and document the current status of the insurance company. If new insurance is purchased diversify – use a different carrier. Re-evaluate whether the lower rate from a less secure insurer is a bargain or a problem waiting to happen. Obtain an in-force illustration and review steps you might take to shore up the policy. If you're a trustee, meet with counsel and review the benefits or obligations to communicate these matters with trust beneficiaries.

Insurance may need to be evaluated from another perspective. If your other income sources have been reduced, can you reduce or even delay insurance premiums for a couple of years until your financial situation turns around? Recent market shockwaves may have altered the fundamental reasons you purchased the insurance (to pay estate tax on your now defunct mortgage lending business). Re-evaluate what your needs are. You may want to freeze what had been an aggressive gift plan so that your insurance needs may increase. Perhaps you are now convinced that economic developments will force Congress to strengthen the estate tax, not repeal it. Perhaps increasing insurance in spite of economic conditions is the right move for you.