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Tough Times Are Good Times to Trim Estates

By Tom Herman and Mike Spector | January 20, 2009

Investors have taken a huge hit as the prices of stocks, bonds, real estate and most other assets have tumbled. But sharply lower prices, combined with rock-bottom interest rates, make this an unusually attractive time for many people to transfer wealth to the next generation.

Among the tax-smart strategies advisers are recommending are low-interest loans to other family members and "grantor-retained annuity trusts," or GRATs -- which are designed to transfer assets to family members while minimizing gift and estate taxes. These and other interest-rate sensitive techniques are likely to look even more attractive next month, thanks to even lower rates.

Many estate planners say they've structured more family loans and GRATs in recent months amid these historically low rates, which allow lenders to charge less to family members and to shelter the potential growth of certain assets. Gary Pittsford, the owner and founder of Castle Wealth Advisors LLC in Indianapolis, expects he'll more than double the amount of these transactions this year, compared with 2008. Strategists also are urging more clients who can afford it to take advantage of a recent increase in the annual gift-tax exclusion to \$13,000.

Beaten-down prices and sagging interest rates provide opportunities to move potential appreciation out of your estate, while passing investment gains to heirs. "What we're looking at is a perfect combination of conditions for GRATs, at least for people who have some degree of optimism about the economy," says Carlyn McCaffrey, a partner at Weil, Gotshal & Manges LLP.

Many financial advisers are urging their clients to take action quickly, pointing to rumors that Congress may soon take action, as part of a major estate-tax overhaul, to make GRATs less attractive. "When you toss in the possibility of legislative changes that would negatively impact some of these techniques, it becomes more compelling," says Joseph Toce, a managing director at WTAS LLC, a tax-planning and consulting firm. "It's almost a call to arms."

Estate-tax changes appear inevitable. Under current law, the basic federal estate-tax exemption for 2009 is \$3.5 million, and the top estate-tax rate is 45%. (Transfers between spouses typically are tax-free.) Next year, the tax is scheduled to disappear entirely -- only to reappear in 2011 with a \$1 million exemption and a top rate of 55% on the largest estates.

But don't bet on a total repeal. While that was the Bush administration's oft-stated dream, President Obama, who was sworn in Tuesday, has said he is opposed to that idea. Instead, he said during the presidential campaign that he favors extending this year's \$3.5 million per-person exemption level and the 45% top rate into future years. Another factor to consider: Many states impose their own death-related taxes.

Here is a summary of a few techniques that financial planners say look especially attractive:

Direct gifts. Under current law, you can give away as much as \$13,000 a year to anyone you want -- and to as many people as you wish -- without any tax consequences and without even having to report it to the IRS. You can give away even more by paying directly for someone's tuition or medical expenses. Those payments don't count toward the annual limit. Financial advisers say more people should consider taking advantage of this provision to reduce their taxable estates and help heirs.

The stock market's deep slump makes this provision even more attractive as an estate-planning vehicle. "With prices as depressed as they are, in many cases blocks of stock can be transferred completely free of gift tax

under the umbrella of the \$13,000 annual exclusion," says William E. Massey, senior tax analyst at the tax and accounting business of Thomson Reuters in New York.

For 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," Mr. Massey says. "If the stock bounces back to its earlier highs or beyond, the post-transfer appreciation will escape transfer-tax costs."

Intra-family loans. Suppose you want to help a child take advantage of an investment opportunity. You don't want to make a direct gift, and the child is having difficulty qualifying for a bank loan, or is facing a painfully high interest rate. You can lend money to the child at rates well below bank rates.

The IRS sets minimum rates for such loans; the rates for January range from 0.81% to 3.57%, depending on the maturity of the loan. For February, those rates will range from 0.60% to 2.96%, says Catherine Grevers Schmidt, a partner at Patterson Belknap Webb & Tyler in New York.

Another idea: Make a low-interest loan to a child but forgive part of that loan each year through the annual gift-tax exclusion. But just make sure your loan is structured properly and fully documented, says Ms. Schmidt.

Parents often use family loans to help children buy a home. Mark Bookman, a 60-year-old resident of Agoura Hills, Calif., wants to help his son relocate to a larger home so that he and his wife have more room for their three children. Brett Ellen, the president and chief executive of American Financial Network, a Calabasas, Calif.-based firm that advises clients nationwide, suggested Mr. Bookman explore a family loan.

Mr. Bookman, senior vice president and chief operating officer at American Jewish University in Los Angeles, is currently mulling a loan of \$100,000 to help his son's family relocate to a better neighborhood closer to the son's law firm. For Mr. Bookman, lower interest rates mean he'll be receiving less money back into his estate than if he had made a conventional loan. What's more, he can reduce that amount further by making annual gifts to his son to lower the loan's principal.

"This way we're moving a significant amount of money now at a low cost factor versus significantly more -- probably three times more -- at our demise," Mr. Bookman says.

Grantor-retained annuity trusts. These vehicles are especially popular among wealthy investors who own a valuable asset, such as a family business or deeply depressed stock that they expect to increase sharply in value in coming years. A well-constructed GRAT can help them pass on most of that increased value to their heirs tax-free.

In a typical GRAT, you put assets into a trust set to expire within a specified time -- often as little as two years -- name your children as beneficiaries, and get annuity payments from the trust. Assuming all goes well and the asset values increase, most of the appreciation can pass to your heirs tax-free when the trust expires.

These trusts have grown in popularity as the applicable IRS interest rate has fallen. The rate, known as the "hurdle rate," is set monthly by the IRS. If the assets in the trust appreciate beyond this rate, the excess amount will eventually pass to the beneficiaries tax-free. The January hurdle rate is 2.4%, down from 4.4% a year ago. In February, the IRS rate will drop to only 2% -- "an all-time low," says Mr. Massey of Thomson Reuters.

If you're considering setting one up, "I wouldn't wait much longer," says Nadine Gordon Lee, president of Prosper Advisors LLC, an Armonk, N.Y., wealth-management firm. She is working right now on a GRAT for one client and a low-interest loan for another.