

Estate Planning in Turbulent Times: The Good, The Bad, and The Ugly.

We see the same headlines every day: the financial markets are collapsing, the real estate bubble has burst, and thousands are losing their jobs. Our clients—even our higher net-worth clients—are scared, and the last thing they want to do is come talk to us about their estate planning. Who, after all, needs an estate planner when the federal estate tax exemption has increased to \$3.5 million, and investments of all types have suffered double-digit declines? Despite the downturn, we can't ignore the very real effect that the current economic situation imposes on our clients. What follows are some of the good, the bad, and the ugly effects of the economic downturn on our practices.

1. The Good.

For those clients who still have taxable estates, the current economic climate provides some excellent tax-planning opportunities. Consider the following:

1.1. Gifts of Depreciated Stock. Usually, we're reluctant to advise our clients to make in-kind gifts of stock due to the adverse income tax consequences associated with such gifts. In today's market, however, it is not unusual for a client's portfolio to be comprised mostly of depreciated stock. Consider advising clients to make in-kind gifts of depreciated stock to younger generations. For donees of depreciated stock, gains are calculated based on the donor's original basis, while losses are only allowed to the extent that the loss occurred after the donee acquired the asset. So if Grandma bought her Google stock at \$500 and it's now worth \$350 per share, gifting the stock to her grandchildren means that the grandchildren won't recognize any gain unless the stock is sold above \$500 per share. If, however, a grandchild sells the stock at \$340, the grandchild's loss is only \$10 per share. Obviously Grandma could sell the stock now, take the losses herself, and then gift the cash to her grandchildren, but gifting the stock gives the grandchildren a chance to earn more in the long run and encourages them to hold on to long-term investments.

1.2. Qualified Personal Residence Trusts. The depressed real estate market means that more property can be given away with fewer gift tax implications than just a few years ago. Rather than gifting property outright, consider transferring real property to a qualified personal residence trust (QPRT). A QPRT is an irrevocable trust to which a grantor transfers ownership of her residence or vacation home for a term of years. During the term of the trust the grantor retains the right to use the property; after the term expires, the property is distributed to the named beneficiaries. The original transfer to the trust is a taxable gift to the named beneficiaries, but the gift amount is discounted based on the interest rate under IRC § 7520 (which for March 2009 was only 2.4%) and mortality tables. With property values in decline, any property transferred to a QPRT today can be gifted on an extremely discounted basis.

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1.3. Intentionally Defective Grantor Trusts. A sale to an intentionally defective grantor trust (IDGT) is an estate-freezing strategy that works particularly well in today's environment. The basics of such a transaction are: (1) your client creates an irrevocable trust that is "defective" for income tax purposes; and (2) the client sells an asset she expects to appreciate to the defective trust and in exchange receives a promissory note for the value of the transferred asset. Because the IDGT is defective no gain is recognized on the sale for income tax purposes, but the asset has been removed from the client's estate for estate tax purposes, thereby "freezing" the asset at today's value.

IDGTs are always an effective tool for our higher net-worth clients, but they are especially attractive in today's market. First, the depressed market has significantly decreased the value of assets that are good candidates to sell to IDGTs (income-producing real property and closely-held business interests). Second, the interest rate for the note is based on the applicable federal rate (AFR), which is hovering around historical lows. Finally, for an added bonus, consider adding a self-cancelling installment feature to the note so that, in the event the client dies before the note is paid in full, any balance owing on the note is not included in the client's estate.

1.4. Charitable Lead Trusts. For our clients with charitable intentions, a charitable lead annuity trust (CLAT) is another device that works particularly well in a low interest rate environment. A CLAT is a planning strategy whereby a charity or charities are paid a fixed amount every year from a trust for a period of years or for life, with the remainder to be distributed to children or other named beneficiaries at the end of the term. Because the annual payout is based in part on the AFR, a CLAT can be set up today with relatively small annual distributions required, resulting in more assets available for distribution to the client's non-charitable beneficiaries.

2. The Bad.

2.1. Value of Specific Bequests. Many of us have drafted estate plans which use specific bequests to equalize distributions among a client's intended beneficiaries. For example, if Daughter has been an integral part of a family business and Son has no involvement, we may have drafted a plan which gave the business to Daughter and perhaps the family vacation home to Son to equalize distributions between the children. In today's market, the family business (or the vacation home for that matter) may be worth much less than originally expected. These plans should be re-examined in light of drastic changes in asset values so that equality can be maintained.

2.2. Support of Surviving Spouse. Some estate plans provide that some (or all) of the client's exemption amount is to be distributed to non-spousal beneficiaries on the death of the first spouse. This plan may have been crafted at a time when, even after the bequest to non-spousal beneficiaries, the estate was anticipated to be large enough to adequately support the

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surviving spouse. These plans should be reevaluated with the client. Planners should consider using disclaimers to make the plan more flexible.

2.3. Advising Fiduciaries. In this market, and with the recent attention on the Uniform Prudent Management of Institutional Funds Act (UPMIFA), the actions of fiduciaries will be even more closely scrutinized by beneficiaries. In light of this, consider the following:

2.3.1. *Trust Protectors.* The appointment of a trust protector can provide increased flexibility by allowing the trust instrument to address almost every conceivable future circumstance. For this reason, the use of a trust protector is increasingly popular. Some powers commonly vested in a trust protector are: (1) to remove, add and replace trustees; (2) to eliminate or alter; (3) to control investment decisions; (4) to amend the trust with respect to administrative provisions; and (5) to terminate the trust. Although utilizing a trust protector may be considered somewhat of an administrative burden for the trustee, the ease of mind it creates for our clients may outweigh the negative effects to the trustee.

2.3.2. *Investment committees.* An investment committee's overall purpose is to work with the fiduciary to coordinate and oversee the client's investment portfolio. The committee will help the fiduciary determine the client's desired financial objectives and appropriate investment risk level. The committee is also responsible for monitoring investment performances. Having such an organization may not only help alleviate client concerns, but also creates peace of mind for the fiduciary and beneficiaries.

2.4. Preuptial Agreements. Prenuptial agreements should be reviewed in light of declining asset values. Has the client's financial situation changed so dramatically such that the prenuptial is no longer effective or even justified? Have one spouse's assets declined significantly while the other's have remained relatively unchanged? When drafting future prenuptial agreements consider building flexibility into the agreement by using formulas (e.g., a lump sum settlement in equal to the lesser of \$1,000,000 or twenty-five percent of the client's net worth) or by making asset division contingent on the value or status of assets at a future date.

3. The Ugly.

Generally, estate taxes must be paid in lump sum within nine months of a decedent's date of death. However, IRC § 6166 provides that payment of estate taxes may be made over a fourteen-year period provided that at least thirty-five percent of the decedent's adjusted gross estate was comprised of closely-held business interests. The primary benefit of § 6166 is obvious: it reduces the need for immediate liquidity which in turn reduces the potential for fire-sales. With declining values of closely-held businesses, however, some clients who may have qualified under § 6166 a few years ago may no longer be eligible. If liquidity is an issue, consider additional life insurance or an aggressive gifting program.

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There are two kinds of people in this world—those who run from tough situations and those who take advantage of them. In these tough economic times, we have an opportunity to assist our clients by first pointing out the good, the bad, and the ugly, and then making each work best to our client's advantage.

For further discussion of the good, the bad, and the ugly of estate planning, please contact John Christianson or Barry Rubenstein at (541) 484-2277 in Eugene, (541) 673-5528 in Roseburg, (541) 923-8767 in Redmond, or (541) 757-1365 in Corvallis.

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