

Steve Leimberg's Estate Planning Newsletter: The Estate Planning Triple Witching Hour is Upon Us!

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The "triple witching hour" refers to a phenomenon in the financial markets that occurs once every three months: the simultaneous expiration of three financing instruments: stock index futures, stock market index options, and stock options.

For high net worth clients and their advisors, their own estate planning version of the "triple witching hour" has arrived!

Keith Buck, JD, LLM, Advanced Designs director, and **Fred Chang**, JD, Advanced designs consultant for **Pacific Life Insurance Company**, Newport Beach, CA, provide **LISI** members with their fascinating analysis of what they see as the "estate planning triple witching hour."

EXECUTIVE SUMMARY:

The "estate planning triple witching hour" refers to the rare convergence of three events that have created one of the best opportunities for wealthy clients to make the most of their estate planning.

The three events are:

- 1) A favorable interest rate environment;
- 2) Depressed asset values; and,
- 3) A potentially limited timeframe to continue receiving higher valuation discounts.

FACTS:

Clients face immense challenges when transferring wealth during their lifetime. This is due primarily to the limits placed on lifetime gifting.^[1] Individually, each of the three events makes it easier for wealthy clients to overcome their gifting challenges. Taken together, however, they create a unique opportunity to maximize wealth transfer.

EVENT NUMBER 1: FAVORABLE INTEREST RATE ENVIRONMENT

Current interest rates, when compared to historical ones, reveal a very favorable interest rate environment. The short-term Applicable Federal Rate ("AFR") for March 2009 was .72% (and has risen only slightly to .84% in September). These are some of the lowest short-term AFRs in the 11 year period starting in January 1998.^[2]

In addition, these short-term AFRs are considerably less than the average short-term AFR (3.77%) over that same 11 year period.^[3] The current mid-term and long-term AFRs are also low in comparison to historical mid-term and long-term AFRs.^[4]

Since the AFRs are used to determine the adequacy of interest for certain non-commercial loans, today's lower AFRs make the following loan based estate planning arrangements more attractive:

- Installment sales to intentionally defective irrevocable trusts (IDITs) – When assets are sold to an IDIT in exchange for an installment note, the interest rate on the note is based upon the appropriate AFR in effect at the time the note is created. The lower the AFR used, the greater the likelihood that rate of return on the assets owned by the IDIT will outperform the interest rate charged. In other words, if the growth of the assets sold to the IDIT exceeds the interest rate charged, there may be more assets left in the IDIT after the note is repaid.
- Intra-family loan arrangements – When funds are loaned by one family member to another, the adequacy of the interest rate charged on the loan is determined by the appropriate AFR. The lower the AFR used, the greater the probability that the rate earned on the loaned money (assuming it is invested) will outperform the interest rate on the loan.
- Split dollar loan regime arrangements – When life insurance premiums are loaned by an insured to an Irrevocable Life Insurance Trust (ILIT), the adequacy of the interest rate charged is determined by the appropriate AFR. The lower the AFR used, the lower the gift tax cost of loaning life insurance premiums to an ILIT (assuming the interest is imputed or gifted directly to the ILIT).

The favorable interest rate environment also benefits the Internal Revenue Code Section 7520 rate (7520 Rate) [\[5\]](#) which is used in certain estate freeze techniques. The 7520 Rate was 2.4% in March 2009 (and remains low now at 3.4%), which is considerably less than the average 7520 Rate of 6.4% over the 18 year period beginning in January 1991. [\[6\]](#)

A low 7520 Rate makes estate freeze techniques like grantor retained annuity and unitrusts (GRATs & GRUTs) and charitable lead annuity and unitrusts (CLATs & CLUTs) more attractive. The IRS uses the 7520 rate (at the time these trusts are created) to determine the present value of the annuity or unitrust payments.

That present value amount is deducted from the fair market value of the property contributed to the trust to determine the value of the remainder interest and the resulting taxable gift. Generally, the lower the 7520 rate, the smaller the taxable gift.

EVENT NUMBER 2: DEPRESSED ASSET VALUES

Many clients suffered a significant loss in real estate and stock values due to the recent economic downturn. For example: The S&P 500 dropped more than 50% between October 2007 and February 2009 (and is still down about 33% as of late August). [\[7\]](#)

In late February and early March 2009, the major market indices fell to their lowest levels since 1997. [\[8\]](#) (While the market is now starting to stabilize, the major market indices remain substantially depressed.) The S&P/Case Schiller U.S. National Home Price Index was, as of December 2008, at its lowest level since the third quarter of 2003. [\[9\]](#)

This decline in asset values may be both a blessing and a curse. On a positive note, gifting assets now that declined in value translates into a reduced taxable gift. If the gifted value rebounds in the future, the increased value occurs outside the client's taxable estate and may ultimately benefit the client's heirs.

EVENT NUMBER 3: POTENTIALLY LIMITED LIFETIME TIMEFRAME FOR HIGHER VALUATION DISCOUNTS

Current law permits as much as a 35% to 50% discount when clients transfer certain types of assets. [10] These discounts are generally applicable to transfers of interests in Family Limited Partnerships (FLPs), Limited Liability Companies (LLCs), etc., due to the lack of control and/or lack of marketability.

There is a looming threat to the ability to take sizable valuation discounts. House bill H.R. 436, introduced in early 2009 by Congressman Earl Pomeroy (D-ND), would eliminate the minority discount for transfers in which the transferee does not have control of the entity, if the transferee and members of his or her family have control of the entity.

This bill also eliminates discounts for transfers of entities that hold non-business assets (any asset not used in the active conduct of one or more trades or business). Because these proposals are tied to a bill that also addresses estate tax reform, the chance they may become law increases.

Assuming H.R. 436 (or similar legislation) is enacted, the loss of the ability to take a discount for lack of control may lead to lower overall valuation discounts, and thus higher estate and gift tax consequences. Clients who do not want to risk losing the benefit of higher valuation discounts might consider transferring their FLP interests, LLC interests, etc. prior to the potential enactment of any legislation. Of course, no transfer should be undertaken without the advice of counsel.

THE PERFECT STORM

The simultaneous occurrence of these three events creates one of the best opportunities for wealthy clients to maximize their estate planning. Each event enhances certain estate planning techniques. By combining techniques, clients can make more of their limited gifting capacity. For example, a client could:

- Contribute depressed assets to an FLP – Lower asset values help to reduce the value of the FLP (as compared to the value of the FLP had the assets not decreased in value);
- Gift the FLP interests subject to a valuation discount – Taking advantage of the ability to still receive discounts for both lack of control and lack of marketability to reduce the taxable gift; and
- Enter into a long-term GRAT or IDIT sale arrangement funded with the FLP interests – Taking advantage of today's favorable interest rate environment for the entire term of the GRAT or IDIT sale to even further reduce the taxable gift.

ENHANCED LIFE INSURANCE PLANNING OPPORTUNITIES

Clients taking advantage of these three events can reduce their estate taxes significantly; however, they may not fully eliminate their estate tax liability. [11] Liquidity may still be needed to pay estate taxes and other estate expenses – including state death taxes. Purchasing life insurance inside an irrevocable life insurance trust (ILIT) may provide the liquidity and preserve the pre-transfer tax value of the estate at death.

Wealthy clients paying large premiums for their ILIT-owned life insurance may struggle with gifting limitations. The "estate planning triple witching hour" may provide some relief. For example, they can benefit from the favorable AFR environment by loaning the premiums to their ILIT. They may also use a GRAT or IDIT arrangement funded with depressed and/or discountable assets to create a gift-tax leveraged exit strategy for premium financing, split dollar, or private loan arrangements.

COMMENT:

The opportunity for clients to take advantage of this "estate planning triple witching hour" may be short-lived.

- There is no telling how long this favorable interest rate environment will last.
- Asset values may not remain depressed at their current level for too long, as a market upturn could be just around the corner.
- If legislation limiting valuation discounts continues to be attached to estate tax reform measures, there is a high likelihood that it could be passed by the end of 2009.

The "estate planning triple witching hour" is a reason to contact your wealthy clients today and impress upon them the need to act, and act soon!

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE.

Keith Buck
Fred Chang

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CITES:

[¹] The annual gift tax exclusion amount in 2009 is \$13,000, and the lifetime gift tax exemption amount is currently \$1 million.

[²] See Short-Term Rates listed at www.leimberg.com/freeResources/keyRates.asp. This source only dates back to January 1998. The only lower short-term AFR rate was in February 2009 (.60%).

[³] *Id.* The average was computed by taking all the short-term monthly AFRs going back to January 1998 and dividing by the number of months involved.

[⁴] See Mid-Term and Long-Term Rates listed at www.leimberg.com/freeResources/keyRates.asp.

[⁵] The Section 7520 Rate is equal to 120% of the applicable federal mid-term rate (rounded to the nearest two-tenths of one percent).

[⁶] See Section 7520 Rates listed at www.leimberg.com/freeResources/keyRates.asp. This source only goes back as far as January 1991. The average was computed by taking all the monthly 7520 rates going back to January 1991 and dividing by the number of months involved.

[⁷] See <http://finance.yahoo.com/q/hp?s=%5EGSPC>. The October 2007 month end value for the S&P 500 index was 1549.38 and the February 2009 month end value was 735.09.

^[8] See http://en.wikinews.org/wiki/US_stock_markets_fall_to_lowest_levels_since_1997.

^[9] See http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_Release_022445.pdf.

^[10] See, e.g., *Jane Z. Astleford v. Comm'r*, U.S. Tax Court, T.C. Memo 2008-128, (May 5, 2008); *Huber v. Comm'r*, 2006 Tax Ct. Memo LEXIS 97 (May 9, 2006).

^[11] The federal estate tax exemption amount is \$3,500,000 in 2009. The highest federal estate tax rate is 45% in 2009. The federal estate tax will be repealed on 1/1/10 until 12/31/10. Beginning 2011, the federal estate tax will be reinstated with a federal estate tax exemption amount of \$1,000,000 and a maximum estate tax rate of 55%. Congress continues to discuss and consider legislation that, if passed, would permanently repeal or otherwise lessen the impact of the federal estate tax.