

USHER IN 2009 WITH TRANSFER TAX RELIEF

February 4, 2009

To Our Clients and Friends:

While we all continue to be affected by difficult market conditions, we wanted to bring to your attention changes in the estate, gift and generation-skipping transfer tax areas that are effective for 2009, as well as other opportunities given the bruised markets.

This year the applicable exclusion amount for the Federal estate tax and the exemption from generation-skipping transfer (“GST”) tax were both increased to \$3.5 million per individual (or, with appropriate planning, \$7 million for a married couple). The comparable exemptions last year were \$2 million per individual (or \$4 million per couple). This means that, as of now, an additional \$1.5 million of estate value (or \$3 million of a couple’s combined estates) more than last year will be exempt from the Federal estate tax. Similarly, the first \$3.5 million of generation-skipping transfers will not be subject to the GST tax, although the GST exemption may be applied to lifetime gifts as well as legacies and trust distributions.

The top Federal estate tax rate is 45% for 2009 and the Federal gift tax exemption is frozen at \$1 million, both unchanged from 2008. Thus, even if one makes lifetime gifts up to the current exemption amount, individuals can still leave \$2.5 million of additional assets free of Federal estate tax at death.

It remains true that under current law both the estate and GST tax are scheduled to be repealed entirely for 2010, but it is unlikely that Congress will let that repeal become effective. We expect that there will be legislation in 2009 freezing this year’s exemptions and rates. It is possible that legislation will also seek to close perceived loopholes in the estate and gift tax area which may impair the usefulness of family limited partnerships or LLCs and grantor retained annuity trusts (GRATs), among other strategies.

Many married couples have Wills that leave the amount of each spouse’s available Federal estate tax exemption to a so-called “credit shelter trust” for the surviving spouse and descendants, with the balance of their assets passing to the surviving spouse (or to a marital trust for the spouse’s benefit). Older clients may leave the GST exemption amount to a trust for grandchildren and more remote descendants. In many Wills, such bequests adjust automatically to take into account changes in law, so there is no need to update your documents to take full advantage of the higher Federal exemption amounts. However, a larger bequest to a credit shelter or GST trust typically reduces a surviving spouse’s share of

an estate. Clients should consider whether this is appropriate in light of their current circumstances, or whether a cap should be imposed on the credit shelter or GST legacy.

The increase in the Federal exemption from estate tax also brings into sharper focus the impact of state estate taxes on overall estate tax liability. For individuals in a state that has “decoupled” from the Federal estate tax system and imposes a separate state estate tax, maximizing the use of the Federal estate tax exemption is likely to result in some state estate tax, even if the taxable estate is below the Federal estate tax exemption. For example, in New York, a taxable estate of \$3.5 million will owe New York State estate tax of \$229,200, even as no Federal estate tax will be due. While paying state estate taxes may seem counterintuitive, doing so will likely reduce the overall estate tax burden substantially by maximizing use of the Federal estate tax exemption even at the expense of paying some state tax.

Other changes of note for 2009 are:

- The annual gift tax exclusion amount has increased to \$13,000 from \$12,000. Clients may now give \$13,000 (doubled for married couples) annually to as many individuals as they wish free of gift tax consequences. The decline in asset values increases the leverage resulting from annual exclusion gifts of non-cash assets, assuming one believes that values eventually will recover.
- The exemption for annual gifts to spouses who are not U.S. citizens is now \$130,000. (There is no marital gift tax deduction if the donee spouse is not a U.S. citizen.)
- IRS interest rates applied to certain gift tax strategies, such as GRATs and charitable lead trusts, have reached historic lows (the February 2009 rate is 2%). The lower “hurdle” increases the likelihood that a GRAT or a charitable lead trust will pass appreciation to the family beneficiaries, even if market returns are less than stellar. (See our prior client update, dated June 26, 2007, titled “IRS Makes GRATs A Little Less Risky.”)
- Similarly, IRS interest rates for intra-family loans, including loans in installment sales, also are at historic lows, ranging from 0.60% to 2.96% per annum for loans originated in February 2009. These low rates are an opportunity not only to make new loans to family members but also to refinance existing loans that were made at higher interest rates. This is an often overlooked opportunity to improve the tax efficiency of wealth transfer arrangements already in place.

- Participants in retirement plans, such as 401(k)s and IRAs, are not required to take the required minimum distribution for 2009. Accordingly, clients may wish to consider suspending retirement account distributions this year in order to allow those accounts to recover some of their lost value if markets improve.

Please let us know if you wish to discuss any of the above described changes or any other estate or gift planning matters.

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