

Financial Planning

THE VIEW FROM LOWRY HILL

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REGAINING CONTROL IN TURBULENT TIMES

Volatile stock prices, decreasing home values, tightening credit, rising unemployment... At almost every turn, it seems we are plagued by more discouraging news. In these tumultuous times, it is only natural to feel a lack of control. None of us can predict with certainty when the economy will improve. Still, there is no need to sit idle, just waiting for things to happen. There are many things you can do and situations you can manage. This issue of *Financial Planning: The View From Lowry Hill* provides proactive steps to help you regain a greater sense of control while positioning you for better times ahead.

REASSESS SPENDING LEVELS

An area where you can exercise significant impact lies within your spending habits. Ask yourself: Where do I spend my money? How much do I spend? Creating a budget is the best way to track this information. Separate your budget into two categories: fixed expenses (e.g., mortgage payments, real estate taxes, household bills, income taxes, etc.) and discretionary expenses (e.g., dining out, entertainment, clothes, travel, toys, club memberships, landscaping, etc.). Over a period of time, track these expenses on a spreadsheet. Focus on expenses that can be trimmed or completely eliminated. For example, could you eat at home more often? Could you do a family vacation for less? Could you eliminate your gym membership or downgrade a level? Could you put off buying an item until next year or buy that item in used but good condition? Although many of the items may fall under the discretionary category, don't overlook fixed costs such as mortgage payments. With mortgage rates falling to historic lows, now may be a good time to consider refinancing. If the budget method seems too cumbersome, commit to only spending a set amount over your fixed expenses each month. This approach still requires both discipline and pacing.

In tandem with building or revising your budget, it may be worthwhile for your advisors to run new spending projections and forecasts. It is much easier to make cuts when you can see how long your money will last. In addition, you want to avoid the "forced seller" situation, whereby you are involuntarily placed in a position requiring you to liquidate assets to raise needed cash. Paying particularly close attention to your budget and spending levels, in addition to analyzing updated cash flow projections, will help prevent this unwelcome situation.

REVIEW YOUR ESTATE PLAN

Along with the changes and opportunities associated with the economy, there are changes and opportunities presented by estate tax laws and wealth transfer strategies. On January 1, 2009, two important changes went into effect that could significantly impact your estate plan.

First, the annual gift tax exclusion was increased from \$12,000 to \$13,000. This change allows individuals the ability to increase annual gifts to family members and other donees without paying a tax on such transfers. While these annual gifts are often made with cash, now may be an opportune time (given the depressed market values) to consider using stock. As the stock price rises, the donee receives the benefit of the appreciation with no gift or estate tax consequences. Be sure to check your current powers of attorney to determine if they permit the full use of the increased amount or if they are limited to the older, lower amount.

Second, and more importantly, the estate tax exemption was increased from \$2,000,000 per person to \$3,500,000—effectively allowing a married couple to shelter up to \$7,000,000 in combined assets from the estate tax. In order to take advantage of this increased exemption, each spouse must have sufficient assets titled in his or her individual name. Therefore, it may be necessary to transfer assets between spouses in order to take full advantage of this tax benefit.

It is also quite common for a typical estate plan to contain “formula clauses” which are used to maximize the allowable estate tax exemption. However, with nearly every asset class having depreciated in value, those formula clauses may have unintended consequences that could negatively affect your plan. Let’s take a look at an example:

	<i>Sam</i>	<i>Mary</i>	<i>Joint</i>
Cash	\$750,000		
Investment Accounts	\$3,000,000	\$250,000	
Home			\$1,750,000

As detailed above, Sam and Mary have a combined estate currently valued at \$5.75 million. Their estate planning documents were drafted in early 2008 (before the market downturn) when their estate was valued at approximately \$10 million. The documents were structured to take full advantage of the estate tax exemption. If Sam dies in 2009, \$3.5 million of his \$3.75 million assets will pass into a credit shelter trust (taking advantage of the increased \$3.5 million estate tax exemption). It is likely that the \$3 million of Sam’s investment account and \$500,000 of Sam’s cash would be used to fund the credit shelter trust. Thus, Mary will have direct control over the remaining \$250,000 of Sam’s cash, \$250,000 in her own investment accounts and the home. Is this enough to support her lifestyle for the rest of her life? As noted above, the majority of the liquid assets will be held in the credit shelter trust, where Mary most likely will have limited access to them. Is this what was originally intended?*

**This allocation may differ in a community property state.*

Don’t overlook any applicable state estate tax. Those exemptions could be significantly lower than the federal exemption, requiring you to pay estate tax to your state of residency.

In addition to being an opportune time to review your existing estate plan and update existing documents, this economic environment has also created an opportunity to consider certain estate planning strategies. These strategies include: grantor retained annuity trusts (GRATs), intentionally defective grantor trusts (IDGTs), charitable lead trusts (CLTs) and intra-family loans. Historically low interest rates, coupled with depressed asset values, have fueled the growing use of these strategies. This combination offers the opportunity to move potential appreciation out of your estate while passing investment gains to heirs. A detailed discussion of each of these strategies is beyond the scope of this article. However, we’ll briefly describe each strategy, including timely benefits.

GRANTOR RETAINED ANNUITY TRUSTS

With a GRAT, a trust is established for a period of years, the “trust term,” and funded with assets you expect to appreciate over that term. As the “grantor,” you would receive an annuity during the trust term. At the end of the trust term, any assets remaining in the trust would be distributed to your beneficiaries. Because it is a grantor trust, you would be taxed on any income generated by the trust during its term. In calculating the value of assets gifted to the trust, an applicable federal rate (AFR) is used. The AFR is published monthly and is often referred to as the “7520 rate.” Currently, the AFR is very low (at 2.4 percent for May 2009). If the assets you place into the trust appreciate at a rate higher than the AFR used when the GRAT was established, you could essentially pass all additional appreciation to your beneficiaries at a discounted gift tax value and free of estate tax. In the past, GRATs have been effectively used in conjunction with concentrated stock holdings or closely held business interests. While those assets remain good candidates, a depressed “basket” of marketable securities may also be used. As the market improves and those assets appreciate, substantial value can be passed along to future generations. One caveat on the GRAT strategy: There are indications that the new administration may revise the tax rules applicable to GRATs. These revisions could detrimentally impact GRATs’ usefulness as a wealth transfer strategy. As such, time may be of the essence.

The following illustrates the benefits of this strategy, utilizing the lower AFR rate currently available. This example assumes that \$1 million of assets was originally transferred into the GRAT and that those assets appreciated 6 percent per year over a three-year GRAT term.

<i>AFR</i>	<i>Beginning Principal</i>	<i>Total Annuity Payments Made to Grantor</i>	<i>Remainder to Beneficiaries</i>
4.2% (July 2008)	\$1,000,000	\$1,085,147	\$39,457
2.4% (May 2009)	\$1,000,000	\$1,048,364	\$78,492
Additional Amount to Beneficiaries (due to lower AFR)			\$39,035

INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

The intentionally defective grantor trust (IDGT) is another leveraging strategy that can be used to pass assets to children or grandchildren. It involves first establishing a trust and subsequently lending the trust money to purchase an asset from you that has the potential for

significant appreciation. There are no taxes due upon the sale of the asset. Closely held or family businesses can be good assets to use for IDGTs. The trust is called “intentionally defective” because it is drafted with an intentional flaw that ensures the individual continues to personally pay income taxes. The note can be structured using the very low interest rates currently in effect. For this technique to work effectively, the assets in the trust must generate sufficient cash flow to cover the interest payments on the note, with any excess appreciation being passed on to the children or grandchildren. The IDGT needs to be structured carefully, and there are certain risks involved. (For instance, what happens if the trust assets decline in value and there is insufficient cash to pay back the note?) It is highly recommended to seek legal counsel if considering this strategy.

INTRA-FAMILY LOANS

Tightened credit and stricter underwriting standards have made commercial loans of all types much more difficult to obtain. The present economic downturn seems to have spared no one, and many families have turned to each other for financial assistance. The good news is that this low-interest-rate environment makes techniques such as intra-family loans an attractive option for those in need of an “economic stimulus.” Current allowable interest rates are as low as 1.0 percent and may offer family members in need the affordable financial assistance they require, whether it be to purchase a new home, endure a job loss, fund college expenses or pay for unexpected health care costs. These loans can be made and gradually forgiven using the annual gift tax exclusion. Keep in mind that there are a number of legal requirements and ramifications associated with lending money to family and friends—not to mention the emotional stress of becoming a lender. It’s best to enter into these kinds of transactions after receiving good financial and legal advice.

CHARITABLE LEAD TRUSTS

For clients who are philanthropically inclined yet still want to provide for their respective families, a charitable lead trust (CLT) might be worth considering. The trust can be set up during your lifetime or funded upon your death through specific provisions in your estate plan. This vehicle provides for an annual annuity payment to one or more charities for a specific term. At the end of that term, the remaining assets in the trust are distributed to family members. Depending upon how the CLT is originally established, you could receive a significant upfront charitable deduction. Alternatively, if you forgo the current income tax deduction, the trust can be drafted as a non-grantor trust. This approach would relieve you of having to pay income taxes on the income and capital gains that the trust earns. The present low-interest-rate environment also makes this strategy advantageous. Similar to a GRAT, the IRS uses the 7520 rate as a baseline for the trust’s projected investment returns. An added benefit to a charitable transfer is that you are allowed to use the current month’s AFR or the AFR of either of the two preceding

months. This affords some additional planning flexibility to take into account unexpected rate fluctuations. Any appreciation over and above the applicable rate will inure to the benefit of the charity, and ultimately, to the family members.

OTHER ISSUES TO CONSIDER

While challenging in many respects, the current economic environment presents some valuable planning opportunities. There are still other questions to consider and additional steps you can take to exert more control over your financial circumstances. Here are some to consider:

- ◆ *Do you have a residence or vacation home that has significantly depreciated in value? Perhaps a qualified personal residence trust (QPRT) may be beneficial. This strategy typically is used when interest rates are high. However, with the significant decline in real estate values, it may be a timely consideration.*
- ◆ *Are you currently receiving required minimum distributions (RMDs) from an IRA? New federal legislation passed before the end of last year suspended RMDs for 2009. Individuals who don't need the RMD to support their lifestyle should consider postponing distributions for 2009. Alternatively, it may make sense to take the RMD "in kind" and hold on to the stock if it has growth potential and is consistent with your overall plan.*
- ◆ *Do you own universal or variable life insurance policies? These types of policies include an investment component. Consequently, they are affected by market conditions. It is imperative to review the performance and sustainability of these policies, as well as the current financial status of the carriers. If you've utilized insurance as part of a buy-sell strategy, it is worth reviewing the policy in light of new business valuations to ensure that the strategy remains effective. Be sure to review any applicable shareholder agreements as well.*

CONCLUSION

Our economic environment need not render anyone paralyzed from taking action. There are a number of things you can and should do to adjust your personal financial situation and position yourself for the upswing that will inevitably occur. Hopefully, this issue of the *View* will get you started down that path. Of course, you will want to consult your financial advisors to ensure that any potential tax or estate planning strategies will work with your specific circumstances.

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