

# THE BERNSTEIN REPORT

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Published By: Richard S. Bernstein and Associates, Inc.

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DECEMBER 2010

Dear Reader,

At the time this was written, President Obama had reached an agreement with the Republican Congressional leaders to compromise on the expiring tax cuts. We haven't seen the bill language yet and it is possible that House and Senate Democrats will change or thwart some or all of the provisions by the time this agreement comes up for a vote. Most likely, something close to the terms of the compromise will become law before the end of the year. The early reports indicate that this will be a two-year compromise, although it is possible that some individual elements could selectively be made permanent.

Key components of the compromise are:

- An extension of the income-tax rate reductions from the Bush-era tax cuts that were about to expire leaving the maximum rate at 35 percent.
- An extension of the lower 15 percent rate for capital gains and qualified dividends.
- An extension of the alternative minimum tax (AMT) relief that will keep approximately 21 million taxpayers from becoming subject to an AMT.
- The re-instatement of the federal estate tax with a 35 percent rate and an exemption for estates up to \$5 million.
- A two percent break on payroll taxes for one year up to the Social Security wage base.
- An extension of emergency unemployment benefits for 13 months.

Until the final bill is passed and all the language is available, we as practitioners will have more questions than answers. The estate tax details need to be clarified. Will the GST return? What about 2010? The disparate treatment of taxpayers dying in 2010 versus 2011 is very difficult to justify. Major newspapers have chronicled the "fortunate" billionaires to pass away in 2010 without an estate tax. If the effective date of the compromise is January 1, 2011, the wealth transfer tax will come back beginning next year, which burdens those with estates greater than \$5 million with the "misfortune" to survive 2010.

The National Commission on Fiscal Responsibility and Reform released its report about reducing the unsustainable deficit earlier this month. The report has many moving parts and the committee certainly did not unanimously support every detail. Fundamental to the report is the goal to cap federal revenues at 21 percent of GDP and to limit expenditures to 22 percent of GDP. The report contains details about reducing discretionary spending, making adjustments to Social Security, and serious tax reform.

Next month we can hopefully provide the important details of the new tax law.

Cordially,

*Happy Holiday*

*Richard S. Bernstein*

**A Second Opinion Costs You NOTHING,  
But Could Save You MILLIONS!**

**WHEN IT COMES TO YOUR HEALTH, YOU GET A SECOND OPINION,  
SHOULD YOUR FINANCIAL WEALTH BE ANY DIFFERENT?**

*Happy Hanukkah*

*Merry Christmas*

## HISTORICALLY LOW INTEREST RATES PROVIDE UNIQUE ESTATE PLANNING POSSIBILITIES

The slow economic recovery has continued to challenge asset values in the United States, particularly in the real estate and small business sectors. The real estate market has turned in some locations, but continues to decline in others. It's safe to conclude that most locations remain well below their peaks in 2006 or 2007. At the time this was written, the Dow Jones Industrial Average was just under 80 percent of its fall 2007 peak. The Federal Reserve has lowered interest rates to attempt to stimulate the economy and create liquidity in the commercial lending market.

There are some government-established interest rates that are relevant for the purposes of valuing certain gifts or sales to family members for gift tax purposes. One rate, known as the Sec. 7520 rate, is the lowest in history for December 2010 at 1.8 percent. The applicable federal rates for the purposes of calculating understated interest in sales or loans are extremely low also. For example, the short-term rate (up to 3-year loan or installment period) is .32 percent for December 2010 ([www.irs.gov/pub/irs-drop/rr-10-29.pdf](http://www.irs.gov/pub/irs-drop/rr-10-29.pdf)). What does all this have to do with estate planning? There are some unique opportunities created by these circumstances for individuals who have the resources to consider making lifetime transfers to family members to effectuate estate-freezing or tax-reduction possibilities.

### ASSET VALUATION AND INTEREST RATES

What do the historically low interest rates and the reduction in asset values have to do with estate planning techniques? First, it is generally best to transfer assets with the greatest appreciation potential. Second, the interest rate used in actuarial valuation methodology can have a profound impact on charitable giving and other estate planning techniques. The interest rate is adjusted every month and certainly could go up in the not too distant future. However, a transaction completed within the month of the published interest rate will be locked in for wealth transfer tax purposes at the current interest rate.

The interest rate and mortality tables (where necessary) are used for valuing partial interests in property for tax purposes. For example, the interest and mortality tables (prescribed by Sec. 7520) are used to determine (1) the income, gift, and/or estate tax deductions for charitable lead or remainder trusts, (2) the gift tax value of transfers to qualified personal residence trusts, grantor-retained annuity trusts, and (3) the annual payment for a private annuity transaction. The applicable federal rates (short-term, mid-term or long-term) are used to determine the interest rates that apply to installment sales or loans. Since the interest rate is at its all-time low, this discussion is to provide you with basic guidance for selecting planning techniques that benefit from low interest rates.

### WHAT TECHNIQUES BENEFIT?

**Installment Sales to Junior-Generation Family Members.** One type of family estate-freezing transaction is the installment sale of property to next-generation heirs. This is an excellent technique to transfer wealth when interest rates are low. The transaction results in the senior-generation seller holding value that is limited to the value of the note. The junior-generation buyer will be enriched by all post-sale appreciation in the property. For estate tax purposes, the only possible value to be included in the seller's gross estate is the remaining value of the note at the time of death. For family transactions, all components of the sale will be evaluated by the IRS to determine if a gift has occurred. Hence, the sale price for the property should be full and adequate consideration and the other terms of the installment note should meet with reasonable commercial standards. Fortunately, the currently low applicable federal rates discussed above are all that the senior-generation seller must receive on the unpaid balance. Hence, any post-sale appreciation and property above the applicable interest rate will enrich the junior-generation buyer without the burden of wealth transfer taxes.

*Example:* Suppose Paul Patton owns a small apartment building holding several rental units. This apartment building is currently valued at \$1 million. Perhaps his building might have been valued at \$1.25 million in 2006. Paul proposes to sell the building to his daughter Patty for an installment note. The installment sale has a principal balance of \$1 million and will be paid over the next eight years. The applicable federal midterm rate for this month is 1.52 percent. This rate would've been 4.68 percent in 2006. Any appreciation above the interest rate Patty must pay will accrue to her benefit. Note the perfect timing of this transaction. The property should have greater appreciation potential now than in 2006 yet the economic threshold to provide gift-tax-free benefits to Patty has dropped dramatically over four years. The installment sale transaction is often used between the seller and an intentionally defective grantor trust created by the seller for next-generation family members. The benefit of the sale to the defective trust is that the seller receives the estate-freezing benefits from the transaction but will not incur capital gains taxes.

**Grantor-Retained Annuity Trusts (GRATs).** A grantor-retained annuity trust is an irrevocable trust that is funded with any appropriate investment by the grantor, who will retain a temporary fixed annual annuity followed by a gift of the remainder interest to the GRAT's remainder beneficiaries. The GRAT is a very interest-rate-sensitive planning technique and performs well in an environment of low interest rates, as the example below indicates.

*Example:* Ernest Estateplanner, aged 60, transfers \$1 million in marketable securities to a GRAT. The same portfolio might have been worth \$1.25 million about 3 years ago. He retains the right to an annual annuity payment of \$50,000 for 10 years, and the remainder will be distributed to a trust for his children. The size of his taxable gift is the actuarial value of the remainder, allowing for his 10-year annuity. Under the current 1.8 percent Sec. 7520 rate (the lowest in history), he will make a taxable gift of \$546,135, well under his \$1 million lifetime exemption for taxable gifts. For comparison, under an 11.6 percent rate (the highest in history), his taxable gift would have been \$712,800. What's more, if the trust principal grows at 6 percent (1 percent higher than the 5 percent required annual annuity payment to Ernest), the remainder beneficiaries will receive a principal sum of \$1,131,808 when the trust terminates. This sum was transferred by using only \$546,135 of Ernest's unified credit! Again the greater the actual return on the GRAT's invested principal, the larger the wealth transfer. Although Congress has talked about limiting short-term GRATs, this type of ten-year GRAT would be unaffected by the proposed change.

**Charitable Lead Annuity Trusts (CLATs).** Charitable lead trusts (CLTs) are the reverse of the more commonly known charitable remainder trusts (CRTs). That is, the donor creates a trust and the charity receives a donation of a temporary annual annuity (a fixed amount) or unitrust (a stated percentage of the annual value of principal) payments from the CLT. The remaining principal is distributed to a noncharitable beneficiary at the termination of the trust term. Any appreciation that occurs after the property is contributed to the CLT is transferred to the remainder beneficiaries without gift or estate taxes. Thus, the charitable income, gift, and/or estate tax deductions are based on the actuarial value of the temporary annuity or unitrust rights donated to the charity. Due to the nature of the actuarial calculation, the lead unitrust donation is not significantly affected by changes to the interest rate. However, the charitable lead annuity trust will perform significantly better in a period of low interest rates.

*Example:* Suppose Phil Enthropic creates a CLAT and places \$1 million of principal in the trust. The trust will pay his favorite charity \$80,000 per year for 10 years with the remainder distributable to his children. Under the current 1.8 percent interest rate, his charitable deduction is \$726,184, and the gift tax value of the remainder given to his children is only \$273,816. The charitable deduction can be used in the year of the donation and any excess deduction unused due to current-year's deduction limitations can be carried forward 5 years. This gift tax cost is fixed, regardless of how the assets held by the trust perform. The greater the return, the more that will be available to the beneficiaries after the charitable lead interest ends. Just for comparison, under an 11.6 interest rate, the tax deduction would have been limited to \$459,520, and the size of the taxable gift would have been \$540,480.

**Private Annuities.** The typical private annuity could be described as a sale of property between family members. In accordance with estate planning goals, a parent (or grandparent) sells family property to a child (or grandchild). Instead of paying a purchase price today, the buyer promises to make annual payments to the seller for the rest of the seller's life (i.e., a life annuity). The payments are fixed in amount at the time of the sale. The size of the annual payments is based on the seller's life expectancy, the current valuation interest rates, and the amount of the purchase price. The estate planning goal of a private annuity often is to sell property to the next generation for as little as possible. Thus, it is usually desirable to hold down the size of the required annuity payments. IRS regulations removed some of the advantages of the private annuity. The impact of the regulations is the immediate imposition of the capital gains tax at the time the property is transferred. Here again, timing is everything. Currently reduced asset valuations in some property could have reduced or eliminated built-in capital gains. Second, the lowest Sec. 7520 rate in history creates a unique advantage for private annuities. It might be preferable to incur some capital gains tax at the current 15 percent rate and allow the future appreciation to benefit the next generation.

*Example:* Suppose Mary Matriarch is 60 years old and owns investment real estate (a duplex apartment) worth \$500,000, 20 percent below its value in 2006. The two rental units currently generate \$3,500 per month (\$42,000 annually) in rental income. Mary would like to reduce her otherwise substantial estate and eventual estate taxes. Under the current 1.8 percent interest rate, she can sell the real estate to her child for a private annual annuity payment of only \$29,181. These annuity payments will continue for the rest of Mary's life. If Mary is unhealthy, but she has a greater than 50 percent likelihood of surviving one year, the regulations will still allow the use of these valuation methods to determine the required annual annuity payment. If Mary dies before her life expectancy determined by the tables, the technique will have greater wealth transfer leverage. In addition, the appreciation on the real estate benefits her child. Again for comparison, under the highest (11.6 percent) interest rate in effect under these rules, the required payment would have been \$70,690, an amount well in excess of the property's current income and certainly a less favorable estate planning scenario for Mary and her child.

## SUMMARY

Although the federal estate tax is inapplicable in 2010, most believe that the tax will be re-instated at the beginning of 2011 and lifetime transfers by gift or sale to family members remain important estate-planning techniques. As the examples above clearly demonstrate, interest rate swings can have a profound effect on many estate planning techniques. When interest rates are low, charitable lead annuity trusts, private annuities, and grantor-retained annuity trusts are more favorable. The benefits of these techniques are markedly enhanced when the property appreciates in value after the gift or sale is completed.

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This Tax Letter is intended to assist you to conserve your estate and to protect the interests of your family and business associates. Estate planning involves the joint services of a competent Trust Officer, Attorney, Accountant, and Life Underwriter. The experience and advice of each is generally essential.

*This tax letter, prepared by a nationally recognized tax authority, is published monthly by*

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