

TRIPLE WITCHING HOUR

What You Should Know About This Estate Planning Phenomenon BY GARY ALTMAN, ESQ.

Triple witching hour is the last hour of the stock market trading on the third Friday of every March, June, September, and December. Those days mark the expiration of three kinds of securities - stock index futures, stock market index options and stock options.

The result often increases the trading volume of options, futures and the underlying stocks, and, occasionally, increases volatility of prices of related securities.

Those of us in the estate planning community look out for a similar phenomenon commonly referred to as the "Estate Planning Witching Hour" - the convergence of three different events - favorable interest rates, depressed asset values, and a potentially limited timeframe to continue receiving higher valuation discounts - resulting in an exceptional opportunity to realize greater lifetime gifting/wealth transfer potential.

Favorable Interest Rates

Interest rates are at historic lows and all indications are that they will be this way for a while. These low rates make some loan-based estate planning practices extremely advantageous.

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 (Applicable Federal Rate) 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 assets sold to the IDIT appreciate at a rate greater than the interest

rate charged, there will 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 chance that loaned money (assuming it is invested) will outperform the interest rate on the loan.

Life Insurance Loan Arrangements

When money is loaned by an insured to an Irrevocable Life Insurance Trust (ILIT) to enable the ILIT to pay life insurance premiums, the adequacy of the interest rate charged is again determined by the appropriate AFR. The lower the AFR used, the lower the gift tax cost of loaning money to an ILIT to make life insurance premiums payments (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) which is used in certain estate freeze techniques (i.e. freezing the value of your estate). The 7520 Rate is 2.4% for May, 2009, which is considerably less than the average 7520 Rate of 6.4% over the past 18 year period starting January, 1991.

A low 7520 Rate also makes estate tax freeze techniques, such as grantor retained annuity trusts (GRATs) and charitable lead annuity and unitrusts (CLATs & CLUTs) more attractive. Just like the techniques discussed above, the lower the 7520 Rate, the easier it is for a GRAT, CLAT or CLUT to outperform the expected return and therefore pass more money to younger family members estate and gift tax free.

Depressed Asset Values

I recently blogged on the importance of reviewing your estate plan in light of declining asset values. Generally speaking, no one likes to see their assets lose value. However, the upside to

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such an occurrence is that gifting assets of lesser value lowers the amount of taxes that will be paid on the gift. In the future, the value of the gift may increase (outside of the client's estate) and benefit the heirs.

Potential Legislation Eliminating Valuation Discounts

If planning is done properly, current law generally permits as much as a 35% to 50% discount when clients transfer certain types of assets. 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 to family members, when family members, as a group, control the entity.

This bill also eliminates discounts for transfers of entities that hold non-business assets, such as bonds, stocks or cash.

Assuming H.R. 436 (or similar legislation) is enacted, the loss of the ability to take a discount for lack of control or lack of marketability will, in most cases, lead to higher valuation of assets, 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.

The Triple Opportunity

In combination, these three occurrences (lower interest rates, depressed asset values and possibly legislation limiting valuation discounts) can create great opportunities for wealthy individuals to make the most of estate planning techniques and maximize the potential of gifts.

Possibilities include:

- Contribute depressed assets to an FLP;
- Gift an interest in the FLP to a family member or trust for a family member; and
- Give the FLP interest to a long-term GRAT or sell the FLP interest in an IDIT

Bottom Line

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 hopefully will not remain depressed at their current level for too long, as a market upturn could be just around the corner.
- Legislation limiting valuation discounts may be passed before the end of 2009, though no one knows exactly what Congress will do.
- The "estate planning triple witching hour" is a reason to act now to transfer assets and wealth to younger family members.

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