PROSKAUER ROSE LLP

Wealth Management Update

A monthly report for wealth management professionals.

October 2009

As part of our ongoing efforts to keep wealth management professionals informed of recent developments related to our practice area, we have summarized below some items we think would be of interest. Please let us know if you have any questions.

October Interest Rates Down Slightly for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split Interest Charitable Trusts

The October applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 3.2%, down slightly from September. The rate for a sale to a defective grantor trust, SCIN or intra-family loan, with a note of 9-year duration (the mid-term rate, compounded annually), also is down slightly at 2.66%. Remember that lower rates work best with GRATs, CLATs, sales to defective grantor trusts, private annuities, SCINs and intra-family loans. The combination of a still low AFR and financial and real estate markets that have yet to recover continues to present a potentially rewarding opportunity to fund GRATs in October with depressed assets you expect to perform better in the coming years.

Clients also should continue to consider "refinancing" existing intra-family loans and notes. The AFRs (based on annual compounding) used in connection with intra-family loans and notes are .75% for notes with a duration of less than 3 years, 2.66% for notes with a duration of less than 9 years and 4.10% for notes with a duration of more than 9 years. Thus, for example, if a nine-year loan is made to a child and the child can invest the funds and obtain a return in excess of 2.66%, the child will be able to keep any returns over 2.66%. These same rates are used in connection with sales to defective grantor trusts.

Tax Court Checks Commissioner's Take on Check-the-Box Regulations

In the narrowly decided *Pierre v. Commissioner*, 133 T.C. No. 2, 8/24/09, the Tax Court found that the Federal "check-the-box" regulations merely classify a business enterprise for income tax purposes and do not define the property right being transferred for gift tax purposes. Thus, transfers of interests in a limited liability company ("LLC") are not valued as transfers of the LLC's underlying property merely because a single-member LLC is a disregarded entity under the check-the-box regulations.

On July 13, 2000, the taxpayer formed a New York single-member LLC. Shortly thereafter, she established two irrevocable trusts to which she later transferred $4.25 million. On September 27, 2000, the taxpayer donated a 9.5% LLC interest to each of the trusts and thereafter sold the remainder of her LLC interests to those same trusts in exchange for promissory notes. The appraisal of the LLC indicated that the sale and gift valuations should reflect a 30% discount.

The IRS audited the taxpayer's gift tax return and challenged the discount on three grounds: (1) that the taxpayer had made indirect gifts, (2) that the step-transaction doctrine applied and (3) that the gifts were of the LLC's assets since the taxpayer did not elect to have the LLC taxed as a corporation under the check-the-box regulations. With respect to the third argument, the taxpayer responded that local law, not Federal, defines the nature of one's property, and that under New York State LLC laws, LLC membership interests, themselves, are personal property, and no member has any direct interest in an LLC's assets.

In a decision that coincided with the taxpayer's stance, the majority rendered a lesson in "The Historical Gift Tax Valuation Regime . . . . (1) the determination under State law of the property interest that the donor transferred, (2) the determination of the fair market value of the transferred property and the amount of the transfer to be taxed, and (3) the calculation of the Federal gift tax due on the transfer . . . ." The court then rejected the IRS position that the check–the-box regulations alter that regime, stating that "While we accept that the check-the-box regulations govern how a <u>single-member LLC</u> will be taxed for Federal tax purposes . . . we do not agree that the check-the-box regulations apply to disregard the LLC in determining how a <u>donor</u> must be taxed under the Federal gift tax provisions . . . ."

The Tax Court reserved judgment on the indirect gift and step-transaction arguments. We will report on those decisions and the outcome of the likely appeal of this decision when they occur.

Texas District Court Permits $40M Estate Tax Refund for "Partnership Assets" that Decedent Intended To, But Did Not Actually, Transfer Prior to Death

In *Keller, et. al. v. United States,* S.D. Tex., No. V-02-62, 8/20/09, the Texas District Court approved a 47% fair market valuation discount of interests in a decedent's limited partnership that was formed days before she died without having actually transferred the partnership's assets to the partnership.

The decedent and her husband held approximately $300M in a joint revocable trust that they created in 1998. When her husband died in 1999, the assets, then worth approximately $350M, were split into two trusts for the benefit of the decedent, of which she was the Trustee. Despite her advanced age of 89, the decedent remained fully aware of the extent and nature of her assets and engaged in numerous discussions with her advisers about how to protect them, particularly against future loss to the potential divorces of her heirs.

As a result of those discussions, the decedent formed a limited liability company ("LLC") and a limited partnership ("LP"). The LLC owned a 0.1% general partnership in the LP, and the two trusts created under the revocable trust owned 49.95% limited partnership interests. The decedent expected to sell her LLC interest to three family members soon after the LLC was formed.

The underlying agreements were signed while the decedent was hospitalized with terminal cancer. Although the decedent had determined to transfer approximately $250M in assets to the LP, the partnership agreement did not indicate the amount of any capital contributions that were to be made. On the following day, the decedent's accountant applied for taxpayer identification numbers and spoke with a brokerage firm about establishing LP and LLC accounts. He also wrote a $300,000 check payable to the LLC which was to serve as the corporate general partner's capital contribution to the LP. The next day, the accountant filed the Articles of Incorporation and Certificate of Limited Partnership with the Texas Secretary of State, which issued a Certificate of Incorporation. Thus, under Texas law, the entities were deemed formed. Four days later, the decedent died without having signed the $300,000 check and without having actually transferred any of the property intended to be owned by the partnership to it.

The decedent's advisers did not believe that the LP had been properly formed or funded at the time of the decedent's death. As a result, the estate tax return did not disclose its existence and the estate paid $147,800,245 in estate tax.

After the estate paid the tax, the accountant attended an estate planning conference which gave him reason to believe that the LP had, in fact, been formed before the decedent's death. The advisers thereafter resumed where they had left off when the decedent died and funded the LP. The estate then filed a Claim for Refund in the amount of $40,455,332, plus interest, based on the discounted value of the LP interests owned by the decedent, rather than direct ownership of the assets that were transferred to the LP. The IRS did not respond to the refund request, so the estate filed a complaint in the Texas District Court seeking the refund.

The court determined that, despite the fact that the LP remained formally unfunded at the decedent's death, "well-established principles of Texas law provide that the intent of an owner to make an asset partnership property will cause the asset to be property of the partnership." The court found sufficient evidence on record to establish the decedent's intent to fund the LP. It also held that, under Texas law, her executors had a duty to complete the transactions because the decedent's intention to capitalize the LLC and sell it to her family members had created a binding agreement.

The government then argued that Internal Revenue Code Section 2036(a) should apply to the LP transfer because it was not a bona fide sale. The court disagreed, stating that the decedent had a "significant and legitimate non-tax business purpose" of protecting and managing family assets, and that the resulting estate tax savings were incidental to the decedent's primary goals. As a result, that incidental savings amounted to a refund of over $40M.

Despite Fears and Debates, New York Statutory Short Form Power of Attorney Effective Date Arrives

New York General Obligations Law Article 5, Title 15 contains extensive revisions to New York's power of attorney laws. Effective September 1, 2009, any power of attorney executed on or after that date in the State of New York must comply with the new law in order to be effective. Pre-existing powers of attorney will not be invalid until they are revoked.

The law includes a new statutory form and permits a non-conforming form, but neither will be valid unless:

1. it is legibly written or typed in at least a twelve-point typeface;
2. it is signed and dated by the principal and the agent (no longer statutorily referred to as attorney-in-fact) in the manner prescribed for the conveyance of real property; and
3. it contains verbatim disclosure statements addressed to both the principal, with respect to the powers he or she is granting, and the agent, with respect to his or her fiduciary obligations and limitations.

In addition, if the principal intends to enable the agent to make gifts on his or her behalf, the principal must simultaneously execute a statutory major gifts rider which must be witnessed by two individuals and notarized.

The statutory form arguably is more confusing and certainly is more cumbersome than its predecessor, despite the legislative intent to protect principals. However, the more pressing concerns about the law include the expansive definition of a power of attorney and the fact that any newly executed power of attorney automatically revokes an existing one unless the new form specifically states otherwise.

Under the new law, a power of attorney is defined as "any written document by which a principal with capacity designates an agent to act on his or her behalf" executed in New York by an individual after September 1, 2009. Thus, for example, a power of attorney in a limited partnership agreement, a power of attorney executed in connection with a brokerage account and even the appointment of a transfer agent in an ordinary stock power all can be construed as powers of attorney. However, none of them would be deemed valid if they did not conform to the statute.

The broad definition of a power of attorney also could serve to inadvertently revoke a client's existing, and desired, power of attorney. For instance, if a stock power in which an agent was appointed only to transfer shares of stock was drafted to conform with the statute, but did not specifically state that an existing durable power of attorney was not being revoked, a client's spouse could suddenly find him- or herself unable to legally handle the client's affairs.

The debates among professionals are continuing, and the Legislature may act to amend the law next year, but, for now, you should proceed with extreme caution when acting upon or advising any individual about a power of attorney.

Father who Was Jailed for Non-Payment of Child Support Has No Interest in Fully Discretionary Trust for his Benefit that Creditor-Mother Can Reach

In *Lerman v. Lerman,* ___ N.J. Super. ___, Docket No. A-1953-07T3, 8/4/09, a New Jersey appellate court decided that a discretionary trust could not be reached by the beneficiary's creditor despite the fact that her claim was for unpaid child support, alimony and equitable distribution.

The beneficiary's mother restated her Florida revocable trust after his ex-wife had obtained a $300,000 New Jersey judgment against him. Upon her 2004 death, his siblings received shares of their mother's estate outright, but the beneficiary's $500,000 share was placed in a fully discretionary trust that also contained spendthrift provisions. In October 2007, because the beneficiary owed his ex-wife almost $660,000, including child support, he was arrested. By then, his trust owned two Florida bank accounts: a $508,000 account that was pledged as security for a letter of credit and an unencumbered $67,000 account.

The New Jersey Probation Division obtained a writ of execution that it served on a New Jersey branch of the bank, and a New Jersey trial court hearing was held at which it was determined that the beneficiary would not be released from jail until the trustees gave the unencumbered account assets to his ex-wife. The trustees, who had made a special voluntary appearance in New Jersey without waiving their objections to jurisdiction, appealed the order arguing that the court did not have jurisdiction over a Florida trust and that the court could not attach the assets of a fully discretionary trust.

The appellate court determined that (1) the trust is governed by Florida law, (2) Florida law recognizes validity of spendthrift trusts under which a creditor can only garnish distributions and (3) if trust distributions are wholly within a trustee's discretion, the court may not order the trustee to make distributions. The court also stated that the ex-wife's claim of quasi in rem jurisdiction failed since the beneficiary of a fully discretionary trust did not actually have any interest in the trust res.

Despite the holding in this case, it should be noted that several states are carving out family claim exceptions to creditor protections that were once thought to be inherent to all fully discretionary, spendthrift trusts.

Florida Bankruptcy Court Finds that Rebuttable Presumption of Exemption of IRAs from Bankruptcy Estate Is Defeated by Disqualified Person Engaging in Prohibited Transaction

In Re: Willis, 104 AFTR 2d 2009-5669 (Bktcy Ct FL 2009) serves as a reminder that there is no statute of limitations applicable to the review of an IRA owner's actions with respect to determining whether the IRA is exempt from bankruptcy proceedings.

During bankruptcy proceedings, the bankruptcy trustee and a creditor objected to the exemption of three self-directed IRAs having a combined value of approximately $1,500,000. Under most circumstances, IRA funds are presumed exempt from bankruptcy proceedings, and the IRA owner argued that the presumption is irrebuttable. However, the Bankruptcy Court disagreed, and stated that the presumption fails if the IRA owner is a disqualified person who engages in a prohibited transaction with respect to the IRA funds under Internal Revenue Code Section 4975.

In this case, the court determined that the self-directed IRA account owner is a disqualified person under Section 4975 since he exercised discretionary authority with respect to the management and disposition of the account assets. The court also found that fourteen years earlier the IRA owner had borrowed against one of the IRAs to purchase a mortgage owned by one of his companies, and that ten years earlier he had engaged in a check swapping process between one of the IRA accounts and his personal brokerage account. Those actions amounted to using the IRA assets for his personal purposes, a listed prohibited transaction, and, therefore, subjected them to creditor claims in the bankruptcy proceeding.

Offshore Voluntary Compliance Deadline Arrives

October 15, 2009 is the last date by which taxpayers who have failed to report offshore accounts and transactions may reveal their offshore activities under the IRS's voluntary disclosure program. Those taxpayers who do not comply with the program are likely to face criminal prosecution and penalties.

Connecticut Attorney General Seeks Disclosure of UBS Account Holder Names

Richard Blumenthal, Connecticut's Attorney General, has written to the United States Attorney General and the Commissioner of Internal Revenue asking that they provide him with the list of United States account holders that Swiss bank UBS has agreed to disclose. Mr. Blumenthal seeks the names in order to recover income taxes due from Connecticut residents who failed to report their UBS accounts on their Connecticut income tax returns. It seems probable that other state Attorneys General will follow suit.

Connecticut Tax and Budget Bill Effective as of September 6, 2009 without Governor's Signature

Last month we reported that Connecticut's Governor vetoed Senate Bill 1801, a state budget bill designed to remedy Connecticut's $1.5 billion budget deficit. Now, budget bill No. 6802 has taken effect without the Governor's signature. With respect to gifts made and deaths occurring on or after January 1, 2010, the bill amends Connecticut General Statutes Section 2-39 to (1) raise the estate and gift threshold from $2,000,000 to $3,500,000, (2) reduce by 25% the marginal tax rates on gifts and bequests valued between $3,500,000 and $20,000,000, and (3) eliminate the tax "cliff" under which an estate with a value of $2,000,000 had owed no tax, but an estate with a value of $2,000,001 owed $101,700. The bill also reduces the estate tax return filing deadline from nine to six months after date of death. It also includes increases in individual income tax rates retroactive to January 1, 2009 and imposes a corporate income tax surcharge, among other things.

IRS Form 708 To Be Issued to Report Gifts Made by Expatriates

Pursuant to the Heroes Assistance and Relief Act of 2008 (P.L. 110-245), "covered gifts or bequests" made by certain individuals who expatriated after June 17, 2008 to United States citizens or residents will be taxed at the highest rate in effect under Internal Revenue Code ("IRC") Section 2001(c). The IRS has announced that it will be issuing Form 708 on which the recipients of those gifts or bequests must report them. The IRS also announced that it will be issuing IRC Section 2801 guidance that will set forth the due date by which donees must file those returns and pay the tax.

IRS Provides its Examiners with Procedures for Assessing Preparer Penalty in Estate and Gift Tax Cases

Estate and gift tax return preparers are now potentially subject to return preparer penalties under Internal Revenue Code Sections 6694 and 6695 if an understatement of liability on the return is based on an unreasonable position that the preparer knew (or reasonably should have known) about. Now, during every estate and gift tax audit, IRS examiners are to determine whether they should pursue the imposition of preparer penalties. The new IRS Interim Guidance Memorandum SBSE-04-0509-009 provides estate and gift tax examiners with a step-by-step outline of how to prepare a penalty case. It also states that the estate or gift tax examination must proceed without regard to potential preparer penalties which should not be proposed until after the tax examination is complete.

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The Personal Planning Department at Proskauer Rose LLP is one of the largest private wealth management teams in the country and works with high net worth individuals and families to design customized estate and wealth transfer plans, and with individuals and institutions to assist in the administration of trusts and estates.

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