PROSKAUER ROSE LLP

Wealth Management Update

A monthly report for wealth management professionals.

September 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.

September Interest Rates Stay Steady for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split Interest Charitable Trusts

The September applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs remains at 3.4%, the same as last month. The rate for use with a sale to a defective grantor trust, SCIN or intra-family loan, with a note of a 9-year duration (the mid-term rate, compounded annually), is up very slightly to 2.87%. 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 a decline in the financial and real estate markets continues to present a potentially rewarding opportunity to fund GRATs in September with depressed assets you expect to perform better in the coming years.

Clients also should continue to consider "refinancing" existing intra-family loans. The AFRs (based on annual compounding) used in connection with intra-family loans are 0.84% for loans with a term of 3 years or less, 2.87% for loans with a term of 9 years or less and 4.38% for loans with a term of longer 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 2.87%, the child will be able to keep any returns over 2.87%. These same rates are used in connection with sales to defective grantor trusts.

Valuation Discounts for Gifts of Limited Liability Company Interests to Children's Trusts Denied Because Transfers of Mutual Funds to Limited Liability Company Were Indirect Gifts to Children's Trusts

In *Heckerman v. United States*, 2009-2 USTC ¶60,578 (W.D. Wash. July 31, 2009), the United States District Court of the Western District of Washington ruled that the transfers of mutual funds to a limited liability company ("LLC") were indirect gifts to their children's trusts, thereby denying the valuation discounts for the gifts of the LLC interests.

In November, 2001, the taxpayers formed three LLCs – a parent LLC and two subsidiary LLCs. On December 28, 2001, the taxpayers conveyed real property to the parent LLC, which then conveyed it to one of the subsidiary LLCs. On January 11, 2002, the taxpayers transferred $2.85 million in mutual funds to the other subsidiary LLC and, on the same date, gifted membership interests in the parent LLC to their children's trusts. The taxpayers took a 58% discount for the gifts of the parent LLC interest to the children's trusts.

The District Court held that the gifts of the membership interests were indirect gifts of the mutual funds to the children's trusts because the taxpayers were unable to show that they transferred the mutual funds to the subsidiary LLC before they gifted interests in the parent LLC to the children's trusts. As evidence, the District Court pointed to various documents, including (1) the documents assigning the interests in the parent LLC to the children's trusts, which stated that the assignments were effective on January 11, 2002 and that the children's trusts were admitted as LLC members on that date, (2) e-mails stating that the appraiser should use January 11, 2002 as the valuation date, and (3) the taxpayers' gift tax returns, reporting the date of the gifts as January 11, 2002.

The District Court also found that the step transaction doctrine applied because this transaction met two of the three factors, specifically the end result test and the interdependence test.

As a note, the IRS did not challenge the gift of the real property, for which there was a 14-day delay between the transfer of the real property to the subsidiary LLC and the gift of interests in the parent LLC to the children's trusts.

Valuation Discounts for Gifts of Limited Liability Company Interests to Children's Trusts Denied Because Transfers of Property to Limited Liability Company Were Indirect Gifts to Children's Trusts

In *Linton v. United States*, 2009-2 USTC ¶60,575 (W.D. Wash. July 1, 2009), the United States District Court of the Western District of Washington ruled that the transfers of property to a limited liability company ("LLC") were indirect gifts to their children's trusts, thereby denying the valuation discounts for the gifts of the LLC interests.

In November, 2002, the taxpayer formed the LLC.

On January 22, 2003, all of the following events took place:

- The taxpayer gifted a 50% interest in the LLC to his wife.
- The taxpayer signed a quit claim deed and an assignment of assets conveying such property to the LLC.
- The taxpayer signed a letter authorizing the transfer of securities to the LLC.

- The taxpayer and his wife signed the trust agreement creating trusts for their children and a separate document gifting the LLC interests to the children's trusts. Although they do not date the trust agreement or the gift document, their lawyer later inserts the date of January 22, 2003.

On January 24, 2003, the brokerage house confirmed the transfer of the securities to the LLC.

The taxpayer and his lawyer later testified that the lawyer made an error in dating the trust agreement and gift document; the lawyer intended to insert the date of January 31, 2003.

The court held that the taxpayers cannot by parol evidence contradict the express language of the documents, all of which showed that the gifts of the LLC interests were made either before or simultaneous with the transfer of the property to the LLC. Specifically, the trust agreement stated that it was effective upon contribution of property to the trust and that, at the time of its signing, the LLC interests had been transferred to the Trustee. In addition, the document gifting the LLC interests to the children's trusts stated that the trusts were dated the same date as the gift document.

The District Court also found that this transaction met all 3 tests under the step transaction doctrine.

Annual Exclusion Gifts Made by Son Pursuant to a Power of Attorney Were Includible in Decedent's Gross Estate

In *Barnett v. United States*, 2009-2 USTC ¶60,576 (W.D. Penn. May 27, 2009), the United States District Court of the Western District of Pennsylvania held that checks issued by the decedent's agent pursuant to a power of attorney were includible in the decedent's gross estate because the power of attorney did not authorize the agent to make gifts.

During the last few months of the decedent's life, his son, as agent under a power of attorney, issued seventeen checks, each in the amount of $11,000, on the decedent's behalf. The word "gift" was written in the memo line of each check.

The court held that since the power of attorney did not authorize the agent to make gifts, none of the checks effected a transfer out of the estate, therefore all of them were includible in the decedent's gross estate.

The decedent's son stated that he and his father discussed the gifts and his father consented to make the gifts. However, the court held that under Pennsylvania law the only method in which the principal may authorize an agent to make gifts is as provided in the statute governing gifts in a power of attorney. The statute has specific requirements for such an authorization to be effective. Furthermore, Pennsylvania state courts have construed the statute narrowly, ruling that a general power allowing the agent to otherwise dispose of assets or general language allowing the agent to make gifts without including the statutory language is insufficient to authorize an agent to make gifts.

Executor's Personal Liability for Estate Taxes Not Dischargeable in Bankruptcy

In *Carroll v. US*, 2009-2 USTC ¶60,577 (N.D. Ala. July 29, 2009), the United States District Court of the Northern District of Alabama affirmed the judgment of the Bankruptcy Court denying an executor discharge in bankruptcy of his personal liability for estate taxes owed.

Carroll and his siblings were appointed as executors of their father's estate. The executors and the Internal Revenue Service agreed that the estate would pay estate taxes in installments under Section 6166 of the Internal Revenue Code. The executors failed to make all of the installment payments. However, the executors distributed estate assets to themselves even though the estate tax debt remained unpaid.

Executors of an estate become personally liable for the estate's Federal taxes if they distribute property of the estate before fully satisfying the estate's taxes.

Carroll subsequently filed for bankruptcy and sought discharge of his personal liability for the unpaid estate taxes. The court denied the discharge, holding the tax debt was excepted from discharge since he willfully evaded payment of the estate tax debt.

Delaware Reinstates Estate Tax

The Governor of Delaware signed into law a statute reinstating the estate tax. The Delaware estate tax applies to estates of Delaware residents and certain Delaware nonresidents who own Delaware real property or tangible personal property and who die after June 30, 2009. Although the statute does not specify the exemption amount, the filing requirement is $3.5 million.

This statute is unlikely to have any impact on trusts created by Delaware nonresidents which do not own any Delaware real property or tangible personal property.

New Power of Attorney Statute for New York Effective September 1, 2009

As a reminder, the new Power of Attorney statute for New York is effective September 1, 2009. The new statute, which was enacted earlier this year, makes significant changes to New York's Statutory Short Form Power of Attorney, especially with respect to the addition of the Major Gifts Rider, which is now necessary to authorize the agent to make gifts on behalf of the principal. Statutory Short Form Powers of Attorney executed before September 1, 2009, continue to be valid until revoked.

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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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