PROSKAUER ROSE LLP

Wealth Management Update

A monthly report for wealth management professionals.

July 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.

July Interest Rates Rise for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split Interest Charitable Trusts

The July applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 3.4%. The rate for use with a sale to a defective grantor trust, SCIN or intra-family loan, with a note for a 9-year duration (the mid-term rate, compounded annually), is 2.76%. These are fairly significant increases from June's rates and may be a sign of things to come. While the rates have gone up, they are still very low and lower rates work best with GRATs, CLATs, sales to defective grantor trusts, private annuities, SCINs and intra-family loans. The combination of a relatively-low AFR and a decline in the financial markets continues to present a potentially rewarding opportunity to fund GRATs in July with depressed assets you expect to perform better in coming years.

Clients should also continue to consider "refinancing" existing intra-family loans. The AFRs (based on annual compounding) used in connection with intra-family loans are .82% for loans with a term of 3 years or less, 2.76% for loans with a term longer than 3 years but not longer than 9 years and 4.36% for loans with a term longer than 9 years. Thus, if a $1 million loan is made to a child and the child can invest the funds and obtain a 5% return, the child will be able to keep any returns over the mid-term AFR of 2.76%. These same rates are used in connection with sales to defective grantors trusts.

Ninth Circuit Affirms Disclaimer Not a Transfer of Property – I*n Re John M. Costas and Rachelle M. Costas, debtors, Chapter & Bankruptcy Trustee v. The Edward Ditloff Revocable Trust and Rachelle M. Costas*, 555 F.3d 790 (February 6, 2009)

The Ninth Circuit Court of Appeals affirmed the Bankruptcy Court's ruling in favor of the disclaiming party, holding that an execution of a qualified disclaimer by the debtor prior to filing for Chapter 7 bankruptcy was not a transfer of property under the bankruptcy laws.

Under the decedent's living trust, the debtor, Rachelle Costas, would receive a portion of her father's estate. However, she executed a qualified disclaimer under Arizona law thus renouncing her claim to the trust property. Shortly thereafter, she filed for Chapter 7 bankruptcy. The bankruptcy Trustee attempted to void the disclaimer under 11 U. S. C.

548 as a "transfer" on the basis of actual or constructive fraud by arguing that the Supreme Court's decision in *Drye v. United States*, 528 U. S. 49 (1999) (holding that a disclaimer was not effective with respect to federal tax liens against the disclaimant) required the Bankruptcy Court to void the disclaimer thus making the property available for the Trustee in bankruptcy. The primary question in *Costas* was whether a disclaimer qualified as a "transfer of an interest of the debtor in property" under bankruptcy law. The Ninth Circuit declined to apply the *Drye* holding primarily because the disclaimer was made after the tax lien had attached to the disclaimed assets while in this case the disclaimer occurred before the bankruptcy petition was filed. Accordingly, the retroactive divestment of property occurred prior to the bankruptcy estate gaining any interests in the right to disclaim.

Gift and GST Tax Consequences to Modification of Trust – PLR 2009127004 (December 16, 2008)

In Private Letter Ruling 2009127004, the Service ruled that a modification to a trust which expressly excluded adopted children as a beneficiary's "issue" would not affect the GST tax exempt status of the trust, but would cause a taxable gift for purposes of IRC §2501 of the interests given up by the beneficiaries of the trust who consented to the modification.

The Settlor created a revocable trust which, upon his death, would be held for the benefit of his siblings and their living lawful issue, which the trust defined as not including legally adopted issue. There were 6 total *natural* issue of the sole surviving sibling – 2 children, 2 grandchildren, and 2 great-grandchildren. In addition, there were 3 total *adopted* issue of that sibling – 1 grandchild and 2 great-grandchildren. The Trustee filed a petition in local court requesting a reformation of the trust to permit legally adopted children to receive distributions and each beneficiary who was a natural issue consented to the modification. The Service ruled that since the natural issue had consented to the modification, each had given up a portion of their future interest in the trust that otherwise would be paid to him or her. Consequently, each natural issue made a taxable gift of the interest given up for purposes of §2501. However, since the modification did not shift a beneficial interest to a lower generation beneficiary, it merely shifted an interest to persons who were members of the same generation or to a higher generation, and did not extend the time for vesting of any beneficial interest in the trust beyond the time provided for in the original trust, the trust would not be subject to the GST tax.

Recognition of Gain on Use of Appreciated Securities for Annuity Payments from CLAT – PLR 200920031 (January 26, 2009)

In Private Letter Ruling 200920031, the Service ruled that a grantor of a charitable lead annuity trust ("CLAT") would recognize gain on the use of appreciated securities to make the annuity payments to a private foundation. The Grantor created a CLAT and transferred a partial interest in a family limited liability company. The CLAT was a grantor trust which provided for an annuity payment of an "x" percentage of the fair market value of the initial assets to a private foundation for a term of 20 years. The Trustees wanted to make a disbursement to the private foundation of appreciated securities rather than from the income and requested a ruling that if the annuity payment was made with the appreciated securities that such payment would not trigger a gain or loss to the Grantor or the trust under *Revenue Ruling 55-410* (where a pledge does not constitute a debt, satisfaction of a pledge to a charity with property that has appreciated or depreciated in value does not give rise to a taxable gain or deductible loss). The Service ruled that *Revenue Ruling 55-410* was inapplicable since the private foundation has a claim against the CLAT assets which would be satisfied by the transfer of the appreciated securities. In addition, IRC §170(f)(2)(B) permits a charitable deduction for the present value of the annuity interest given to the charity even though payments are not made until the future, while a pledge to a charity does not result in an income tax deduction until the pledge is satisfied. Thus, there are no income tax consequences on the creation of a pledge agreement as there is upon creation of a CLAT and the Grantor is required to recognize gain on a distribution of appreciated assets as payment of the annuity.

Government Denied Summary Judgment in Estate Tax Valuation Case – *Alan Baer Revocable Trust dated February 9, 1996 V. United States*, D. Neb., No. 8:06-cv-00774, (May 18, 2009)

The U.S. District Court for the District of Nebraska denied summary judgment to the government finding that the estate presented issues of material fact with respect to the value of the decedent's stock at the time of his death. The matter was before the Court on a motion for summary judgment by the government. The estate filed an action seeking a refund of taxes paid, plus interest, after the Service assessed a deficiency upon its determination that the marital deduction taken by the estate on its federal Form 706 should have been reduced, thereby increasing the taxable estate.

The decedent died owning stock in ComoreTel Ltd. ("Stock") which was not publicly traded. The decedent's trust provided for certain bequests of money to several individuals which were contingent on the stock being sold and a profit realized. After the payment of such specific bequests, a residuary trust would be established for the decedent's surviving spouse funded with the remainder of the trust estate. The estate filed the 706 and listed the contingent bequests as specific gifts to "contingent beneficiaries" noting that the bequests may never be paid, or if they were it would take almost six years before completed. Even though the estate did not claim the value of the contingent bequests as part of the marital deduction property under Schedule M of the 706, the Service nonetheless adjusted the taxable estate by reducing the marital deduction calculation through excluding the value of the contingent bequests.

In its claim for refund, the estate asserted that the proper issue was the value of the stock – which was the basis for whether the contingent bequests would lapse under Nebraska law. It argued that the assumption that the contingent bequests would be fulfilled was premised on a speculative valuation of the stock at the time of the decedent's death, and since the value attributed to the bequests was a "phantom value," the contingency could not be fulfilled and the bequests could not vest. The government, on the other hand, argued that the stock's value was irrelevant since the trust provided for a possibility that the bequests would be funded to beneficiaries other than the surviving spouse; therefore, it could not be claimed in the marital deduction and must be part of the taxable estate.

Agreeing with the estate, the Court acknowledged that the issue was not whether the contingent bequests were part of the marital deduction (nor was the estate making that argument it said) but whether the stock's value could be ascertained with fair certainty, and if so, what that value was. It then held that the estate had presented evidence showing that there were issues of material fact with respect to the stock's value and denied summary judgment.

IRS Releases Memorandum to Small Business/Self Employed Division Regarding Tax Preparer Penalties – SBSE-04-0509-009

The IRS Small Business/Self Employed Division on June 3 released a memorandum instructing IRS exam agents to look for the possibility of tax preparer penalties for the understatement of tax liabilities in the preparation of every estate or gift tax return examination they undertake. SBSE-04-0509-009 deals with the responsibilities of IRS agents in reviewing gift and estate tax returns to make sure IRC §§6694 and 6695 are followed and states that its purpose is to provide interim guidance to their estate tax attorneys about the procedures they should follow in the assertions of the §§6694 and 6695 penalties. While the memorandum notes that no return preparer penalty will be proposed until the estate or gift tax examination is completed at the group level, it instructs that any determination and settlement of the examination will proceed without regard to the return preparer penalty issue. However, it cautions that §6694(d) provides that the §6694 penalty must be abated where there is a final administrative or judicial determination that there was no understatement of liability.

Tax Court Rules on Estate's Deductions and Discounts – *Estate of Miller v. Commissioner*, T.C. Memo 2009-119 (May 27, 2009)

The Tax Court ruled that the value of the gross estate of the decedent included an amount which funded a QTIP trust for the benefit of the decedent (as the surviving spouse) at her predeceased husband's death, and that the first transfer by the decedent of a majority of her securities to a family limited partnership in 2002 qualified for the discount while a second transfer by the decedent of all of her remaining securities in 2003 did not.

Mr. Miller ("Miller") and his wife Valeria Miller (the decedent in this case) had four children. Their oldest son became the successor manager of the family's securities portfolio after Mr. Miller's death. Mr. Miller died in 2002 and his estate consisted almost entirely of marketable securities. Shortly thereafter, the decedent established a family limited partnership ("MFLP") and transferred a majority of the securities to the MFLP which constituted 77% of the decedent's estate at the time of the transfer. The decedent received 920 MFLP units while her four children received the remaining 80 units. The MFLP was managed by Virgil as the general partner who continued his father's methodology of "charting stocks" approach which the court opined did qualify the MFLP as involved in an "active securities trading operation" and not just a "passive holder of securities." A year after the 2002 transfers, the decedent fell and broke her hip and contributed all of her remaining securities to the MFLP but received no additional partnership units in return. From then on, the decedent suffered several health problems which lead to her death. The estate filed a Form 706 and reported the value for the gross estate as consisting primarily of the net discounted value of the 920 MFLP units, but excluded the assets in the QTIP trust of which the decedent was a beneficiary. The IRS issued a notice of deficiency and included the QTIP trust assets and the date of death values for both the 2002 and 2003 transfers of securities.

Even though the estate argued that the decedent never received any income from the QTIP trust, the court made it clear that Mr. Miller's estate made the QTIP election, thus it was irrelevant whether or not she needed or actually received any income. With respect to the 2002 transfers of securities, the court concluded that the decedent had legitimate and nontax business reasons for forming the FLP – that being her desire to continue the management of the family assets pursuant to her husband's investment strategy; and further, that she had retained sufficient assets outside the partnership, needing no partnership distributions for her living needs after the first transfer. With respect to the 2003 transfers, however, the court noted that it consisted entirely of all of her remaining property during a time when her health was rapidly deteriorating. Moreover, after the estate filed the Form 706, a pro rata cash distribution was made to the partners, 92% of which went to the estate, for payment of the Federal estate tax liability. Consequently, the court determined that the decedent had retained an economic benefit of the securities transferred in 2003 just days prior to her death.

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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 adminsitration of trusts and estates.

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