Proskauer

newsletter


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*A monthly report for wealth management professionals.*




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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.

## March Interest Rates Decrease Slightly for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split Interest Charitable Trusts

The March applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 3.2%. 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 2.69%. These are slight decreases from February's rates. 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 low AFR and a decline in the financial markets continues to present a potentially rewarding opportunity to fund GRATs in March with depressed assets you expect to perform better in the 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 .64% for loans less than 3 years, 2.69% for loans less than 9 years and 4.35% for long-term loans. 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 2.69%. These same rates are used in connection with sales to defective grantor trusts.

## IRS Alerts Taxpayers that it Intends to Issue Guidance under Section 2511(c) – IRS Notice 2010-19 (February 16, 2010)

Section 2511(c) provides that, notwithstanding any other provision of Section 2511 and except as provided in the regulations, a transfer in trust is treated as a transfer of property by gift unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions.

Some advisors interpreted 2511(c) to mean transfers to wholly-owned grantor trusts during 2010 will not be treated as completed gifts for gift tax purposes. IRS Notice 2010-19 clarifies that such an interpretation is incorrect and that gifts to grantor trusts during 2010 may be completed gifts using the same criteria as was in effect on December 31, 2009.

The Notice clarifies that transfers in trust, which would otherwise be subject to gift tax are not excluded from the tax merely because the transfers would not be taxed under Section 2511(c). Section 2511(c) broadens the types of transfers subject to transfer tax to include certain transfers to trusts that, before 2010, would have been considered incomplete and, thus, not subject to the gift tax.

Therefore, a transfer made in 2010 to a trust that is not treated as wholly owned by the donor or the donor's spouse under the grantor trust rules is considered to be a transfer by gift of the entire interest in the property under Section 2511(c). The gift tax provisions in effect on December 31, 2009 continue to apply during 2010 to all transfers made to any other trust to determine whether the transfer is subject to gift tax.

## Tax Court Finds Transfer of an Interest in a Limited Partnership and Timberland to an FLP Was Not Includible in the Decedent's Gross Estate Under Section 2036(a) Because the Transfer Was a Bona Fide Sale For Adequate And Full Consideration – *Estate of Shurtz v. Commissioner*, TC Memo 2010-21 (February 3, 2010)

This Tax Court decision provides another Section 2036 victory for the taxpayer by holding that assets transferred to an FLP were not includible in the decedent's gross estate under Section 2036(a) because the transfer was a bona fide sale for adequate and full consideration. This case is particularly taxpayer friendly because the Tax Court focused on the non-tax purposes for forming the FLP and was able to overcome several bad facts.

The Decedent, Mrs. Shurtz, died in California in 2002. She was survived by her husband and children. The Decedent and her siblings grew up in Mississippi where their family owned and operated a timberland business.

By 1993, many family members held separate interests in the business. On the advice of counsel, the family formed a limited partnership, Timberlands LP, to manage and operate the business. A corporation was formed which owned a 2% GP interest in Timberlands LP. The Decedent and her two siblings each owned one-third of the stock of the GP and the Decedent owned a 16% LP interest.

After Timberlands LP was formed, the Decedent and her siblings raised concerns about protecting the family business from "Jackpot Justice" in Mississippi. They were concerned that they could be sued and a judgment entered against them and they could lose control of the business. To avoid this problem, their attorney recommended that each family hold its Timberland LP interest in a separate limited partnership. This recommendation was followed so that the active timber business was held in Timberland LP and the equity ownership was held in several new FLPs, one of which the FLP created by the Decedent.

The Decedent also wanted to give her children and grandchildren interests in 750 acres of timberland that she acquired from her parents.

In 1996, The Decedent and her husband formed an FLP. The purposes of the FLP were (1) to reduce the estate (2) provide asset protection and (3) provide for heirs. The Decedent transferred a 6.6% interest in the 750 acres to her husband who in turn received a 1% GP interest in the FLP. The Decedent contributed the balance of her interest in the 750 acres and her 16% LP interest to the FLP for a 1% GP interest and a 98% LP interest in the FLP.

The FLP agreement had substantial restrictions designed to keep persons outside the family from acquiring interests in the FLP.

Between 1996-2000, the Decedent made 26 gifts of .4% LP interests to her children and grandchildren. When the Decedent died in 2002, she held a 1% GP interest and a 87.6% LP interest in the FLP.

The IRS contended that the value of the assets the Decedent contributed to the FLP were includible in the value of her gross estate under Section 2036.

The “bad facts” in this case included the following: (1) the FLP did not maintain books of account as specifically required in the partnership agreement; (2) the partnership bank account was not set up until almost four months after formation of the FLP, and after two months as a checking account, it was changed into a money market account; (3) the Decedent and her husband paid some of the FLP’s expenses from their personal bank accounts, being reimbursed by the FLP for some payments and having others credited to their capital accounts; and (4) there were not always proportional distributions from the FLP to its partners.

The Tax Court reviewed the management style and operations of the LPs and the Judge noted that the entire family was conscientious about managing the family timber business, had a mission statement and held annual meetings in Mississippi.

The Tax Court found that transfer to the FLP was a bona fide sale because protecting the assets from potential litigants and using the FLP to facilitate the active management of the assets were legitimate and significant non-tax reasons for its creation. The Court acknowledged that reducing the estate tax was a motivating factor, but went on to say there were valid and significant non-tax reasons for establishing the partnership – therefore, the bona fide sale element was satisfied.

The Court found that the Decedent received an interest in the FLP that represented adequate and full consideration because (1) the participants in the FLP received interests proportionate to the value of the property each contributed; (2) the respective contributed assets were properly credited to the transferors’ capital accounts; (3) distributions required negative adjustments to distributee capital accounts; and (4) there was a legitimate and non-tax reason for forming the FLP. Therefore, the FMV value of the Decedent’s interest in the FLP, rather than the FMV of the assets she contributed to the FLP was includible in her estate.

Since the Tax Court found that a bona fide sale for adequate and full consideration occurred, the FMV of the property the Decedent contributed to the FLP was not includible in her gross estate under Section 2036.

## Haiti Earthquake Relief Donations Made Before March 1, 2010 May Be Deducted on 2009 Returns. IR News Release 2010-12 (January 25, 2010)

On January 22, 2010, President Obama signed into law a provision which allows taxpayers to claim a charitable deduction in tax year 2009 for donations made after January 11, 2010 and before March 1, 2010 for the relief of victims of the Haiti earthquake.

This option is only available if the contribution is made in cash and otherwise meets the requirements of Section 170 for charitable contribution deductions.

## The Ninth Circuit Holds That an IRA's Named Beneficiaries, Rather Than the Decedent's Wife, Were Entitled to the IRA Funds After His Death, Even Though Some of the Funds in the IRA Had Been Rolled Over From a 401(k) Plan Subject to ERISA's Surviving Spouse Provisions – *Charles Schwab & Co. v. Debickero*, 105 AFTR 2d (9th Cir., January 22, 2010)

The Ninth Circuit held that the named beneficiaries of an IRA, rather than the IRA owner's wife, were entitled to the IRA funds after his death, even though some of the funds in the IRA had been rolled over from a 401(k) plan subject to ERISA's surviving spouse provisions.

Wayne Wilson was a participant of his employer's 401(k) plan until 1992. In 1994, while employed with another company, Wilson elected to close his 401(k) plan and take a lump sum distribution which he rolled over into an IRA with Smith Barney.

After having lived together since 1990, Wilson married Katherine in 2000. In June 2002, Wilson opened another IRA with Charles Schwab, which he funded by transferring one-half of the proceeds from the Smith Barney IRA. Despite his marriage to Katherine, Wilson told Schwab that he was divorced and named his four adult children from a prior marriage as the primary beneficiaries of his IRA.

In 2005, Wilson died unexpectedly in a flash flood. He was survived by Katherine and his four adult children who asserted competing rights to the funds. Schwab filed an action naming Katherine and the children as defendants. Katherine argued that she was entitled to the funds as the surviving spouse under either ERISA or the Code.

The district court granted summary judgment in favor of the children and Katherine appealed to the Ninth Circuit. Katherine argued that ERISA excludes from coverage only self-funded IRAs and not IRAs containing funds that originated as employer contributions to an ERISA covered plan.

The Ninth Circuit rejected Katherine's arguments and affirmed the district court's grant of summary judgment and held that ERISA's surviving spouse protections apply only when an ERISA-qualified plan is involved. In this case, ERISA ceased to apply when, long before his marriage to Katherine, Wilson terminated his participation in the 401(k) plan and transferred the proceeds to the IRA.

## Surviving Spouse is not Treated as the Payee of the Decedent's IRA and Therefore Could Not Take the IRA and Roll It Over Into an IRA in Her Own Name – PLR 200944059 (August 3, 2009)

In this PLR, the IRS found that the Decedent's surviving spouse was not treated as the payee of the Decedent's IRA, and therefore she could not take the IRA and roll it over into an IRA in her own name.

The Decedent died in 2004 survived by his wife and son. The Decedent named a trust as the beneficiary of his IRA. The IRA was the only asset of the trust and the Decedent's wife was named as the sole trustee. The trustee is authorized to pay discretionary income and principal to the Decedent's wife for her maintenance, support and health. Any income not distributed is to be added to principal. Upon the Decedent' wife's death, the remaining principal is to be distributed to the Decedent's son, if he survives the wife, or, if he predeceases her, to his then living descendents, per stirpes, or, in default thereof, to the Decedent's nephews and nieces.

After the Decedent's death, a controversy arose among the Decedent's wife, son and nieces and nephews. The Decedent's wife petitioned the state court for a declaratory judgment that she has the discretion, as trustee, to withdraw the balance from the IRA and distribute it to herself, individually, in order for her to rollover the IRA into an IRA in her own name. The court granted the declaratory judgment.

In this ruling request, the Decedent's wife represented that she will roll the IRA into an IRA in her own name and will then make an irrevocable beneficiary designation consistent with the trust terms on her death.

The IRS noted that "generally, under certain conditions, if either a decedent's plan or IRA proceeds pass through a third party, e.g., a trust, and then are distributed to the decedent's surviving spouse who is entitled to receive the distribution, said spouse will be treated as acquiring them directly from the decedent." In those cases, the spouse could take the distribution and roll it into her own name.

However, the IRS determined that the Decedent's wife did not have the power to withdraw the entire balance of the IRA either under state law or pursuant to the trust terms because she was limited to distributions subject to an ascertainable standard.

The IRS stated that it is not bound by the state court order because it is not the highest court in the state, and is contrary to prior decisions by the highest court in the state. Accordingly, the court order is not controlling for federal tax purposes, and any withdrawal by the Decedent's wife of the IRA would be unauthorized for federal tax purposes. In addition, if the remainder beneficiaries agreed with such withdrawal, they may be treated as having made a taxable gift under Section 2501.

In making its ruling, the IRS concluded that (1) the Decedent's IRA will be considered an inherited IRA, since the beneficiary of the IRA is not the spouse; (2) the Decedent's wife is not the beneficiary and therefore cannot withdraw the IRA and roll it over into her own name; and (3) any amounts paid out of the IRA to the Decedent's wife will be taxed to her in the year distributed.

The IRS pointed out that the Decedent's wife is entitled to so much of the income and principal as determined under the ascertainable standard. If the amount so distributed to her exceeds the minimum required distribution for any year, then she, as the surviving spouse of the Decedent, would be entitled to roll such excess over into her own IRA.

## Estate is Not Entitled to an Estate Tax Charitable Deduction for the Amount Received by a Charitable Trust Pursuant to a Settlement Agreement — PLR 201004022 (September 15, 2009)

The IRS held that an estate was not entitled to an estate tax charitable deduction for the amount paid to a charitable trust pursuant to a settlement agreement.

The Decedent's Will made a number of specific bequests and created trusts for his son and other relatives which provide that the remainder interest in the trusts are distributable to a charitable trust which he created. However, the Will contained no residuary estate provision.

The Decedent's sole heir was his son who argued that he was entitled to the Decedent's residuary estate. The charitable trust argued that the omission of the residuary clause from the Will was a scrivener's error and that the Decedent's intent was to leave his residuary estate to the charitable trust. The attorney who drafted the Will confirmed this in an affidavit. After months of negotiations, the son and the charitable trust settled the dispute and executed a settlement agreement.

The issue presented in this ruling was whether the estate could take an estate tax deduction for the amount payable to the charitable trust under the settlement agreement.

The IRS determined that it has been established that the parties to a settlement agreement are only entitled to federal estate tax deductions to the extent that they have an enforceable right under properly applied state law. Therefore, the question was whether the charitable trust had an enforceable right under state law to receive the payment under the settlement agreement.

Although there is a preference under the applicable state law not to allow the passing of an estate through intestacy, when there is a valid Will, there is also a presumption that heirs of an estate are not to be disinherited unless it is through the plain language in the Will. Additionally, although a court is allowed to consider external evidence when interpreting a Will, that evidence is only allowed when the Will is ambiguous.

Since the Decedent's Will did not conflict with the distribution of the residuary clause through intestacy, there was no reason under state law for the court to examine extrinsic evidence such as the attorney's affidavit.

Therefore, the IRS held that the charitable trust was not entitled to the settlement proceeds under applicable state law and the estate was not entitled to the charitable deduction for the settlement amount.

The Personal Planning Department at Proskauer 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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