Proskauer

newsletter

May 2010

in this issue

A monthly report for wealth management professionals.

Edited by **Henry J. Leibowitz**
Contributor: **Stephanie D. Zaffos**

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.

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

The May applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 3.4%, slightly higher than the March rate. 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 2.87%. This is also a slight increase from March's rate. 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 May 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 0.79% for loans less than 3 years, 2.87% for loans less than 9 years and 4.47% 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 2.87%. These same rates are used in connection with sales to defective grantor trusts.

Federal District Court Finds Transfer of Interests in LLC to Children Does Not Qualify for the Annual Gift Tax Exclusion – *Fisher v. Commissioner*, No. 1:08-CV-00908 (March 11, 2010)

A U.S. District Court in Indiana found the transfer of interests in a LLC to children did not qualify for the annual gift tax exclusion because the interests were considered "future" rather than "present" interests in property due to operating agreement restrictions on the children's rights relating to the property.

The Fisher parents transferred an LLC, in its entirety, to their 7 children over the course of 3 years using annual exclusion gifts. The LLC owned undeveloped land in Michigan. The Fishers presented three arguments in support of their claim that these were present interest gifts, all of which were rejected by the court. First, the children had the unrestricted right to receive distributions from the LLC. The court said since the timing and amount of any distributions were within the exclusive discretion of the Manager of the LLC, the right to such distributions was not a "substantial present economic benefit." Second, the children had the unrestricted right to use the land which was the primary asset of the LLC. The court said there was no indication that the right to use the land was transferred with the LLC interests, and, even if it was, "the right to possess, use, and enjoy property, without more, is not a right to a, "substantial present economic benefit." And third, the children had the unrestricted right to transfer their LLC interests. The court noted that the operating agreement contained a right of first refusal, allowing the LLC to match any offer and to pay with a promissory note of up to 15 years. Consequently, the court concluded that this effectively prevented the children from transferring their interests in exchange for immediate value.

This case sheds light on what sort of "use" constitutes present economic benefit (it appears a right to use the real property held by an entity does not) and how to treat a right of first refusal. A right of first refusal appears to be a sufficient transfer restriction to cause a partnership or LLC interest to fail the property test, but it is unclear what role the payment terms play.

8th Circuit Finds Limited Partnership's Transfer Restrictions Disregarded when Valuing Stock for Gift Tax Purposes – *Holman v. Commissioner*, 2010 WL 1331270 (April 7, 2010)

The 8th Circuit, in affirming the Tax Court, found that a limited partnership created by a couple to hold Dell stock in trust for their children could not claim that the partnership's transfer restrictions constituted a bona fide business arrangement. Therefore, under §2703, the restrictions could be disregarded when valuing the stock for gift tax purposes and applying smaller lack of marketability and minority interest discounts than claimed by the donors.

The Tax Court had held that the transfer restrictions were designed principally to discourage the children's dissipation of the wealth transferred to them by way of gift, and said restrictions did not constitute a bona fide business arrangement within the meaning of §2703(b)(1).

The Holmans argued that the Tax Court applied an overly restrictive definition of the phrase "business arrangement" and effectively imposed an "operating business nexus." In affirming the Tax Court decision, the 8th Circuit rejected the Holmans' claims and reasoned that "context" matters when analyzing whether a restriction constitutes a bona fide business arrangement; in this case, there was no "business," active or otherwise.

6th Circuit Finds Regulation Reasonable on Generation-Skipping Transfer Tax – *Estate of Timken*, 2010 WL 1253627 (April 2, 2010)

The 6th Circuit found that Treasury Regulation §26.2601-1(b)(1)(v)(A), stipulating that the grandfathering exemption to the generation-skipping transfer tax ("GST") does not apply when there is a post-statute exercise of lapse of a general power of appointment, is reasonable.

The Timken estate trust became irrevocable in 1968, before passage of the GST, with the death of the Settlor ("Timken"). The trust granted Timken's widow a general power of appointment over trust assets, and, provided that if the power lapsed, the remaining assets would be divided for Timken's nieces and nephews. The widow died in 1998 without appointing successors and, consequently, her general power lapsed. The trust assets passed to Timken's nieces, nephews, grandnieces and grandnephews.

The court noted that §2601 is ambiguous as to whether the grandfathering exemption applies to an irrevocable trust that does not mandate a generation-skip, but permits a beneficiary to use a discretionary power of appointment to make a generation-skipping transfer. Treasury Regulation §26.2601-1(b)(1)(v)(A) permits application of the GST to post-statute exercises and lapses of general powers of appointment.

The court found that the regulation resolves the statutory ambiguity in the same way as other regulatory amendments and is therefore reasonable.

The Tax Court Disallows Charitable Deductions and Imposes Accuracy-Related Penalties for Failure To Substantiate Equipment Donations

The Tax Court disallowed a couple's charitable deductions and imposed accuracy-related penalties after finding they did not properly substantiate the contributions or provide contemporaneous written acknowledgements of their medical equipment donations. The couple failed to comply with the strict substantiation requirements because they: (1) did not provide adequate descriptions of the equipment and (2) did not identify the valuation methods used, the manner of acquisition, or the cost basis of the equipment.

On their 2001 and 2002 returns, the Friedmans claimed $217,500 in noncash charitable deductions for donations of diagnostic and laboratory equipment to two charitable organizations. Their tax returns included Forms 8283 and appraisals of only certain items.

For any noncash contribution exceeding $5,000, the regulations require the donor to: (1) obtain a qualified appraisal, (2) attach a fully completed appraisal summary (Form 8283), and (3) maintain records pertaining to the claimed deduction. A qualified appraisal must include: (a) a sufficiently detailed description of the property, (b) the valuation method used to determine fair market value, and (c) the specific basis for the valuation. Further, a qualified appraisal must be made no earlier than 60 days before the date of the contribution and no later than the date of the return, including extensions. The appraisal summary must include: (i) a sufficiently detailed description of the property, (ii) the manner of acquisition, and (iii) the cost or other basis of the property. In addition, a taxpayer must obtain a contemporaneous written acknowledgement from the donee organization.

The Friedmans argued that they "substantially complied" with the regulations. While the Tax Court acknowledged that the regulations are "directory" and therefore only require substantial compliance, and not absolute adherence, the court held that the donors did not substantially comply with the regulatory procedures.

Further, the Friedmans argued that they should be excused from penalties because they relied on the advice of their C.P.A. However, a taxpayer relying on professional advice must show: (1) the adviser was a competent professional, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment. In this case, the Tax Court found the donors liable for the penalties because they did not provide full and accurate information to their C.P.A. and therefore they could not have relied *in good faith* on his advice.

The ultimate lesson of this case is simple: strict compliance with both the letter and spirit of the law is essential. Obtain a qualified and timely appraisal; ensure the appraisal contains all the proper elements; attach a fully completed appraisal summary; maintain meticulous records; and obtain a contemporaneous written acknowledgement from the donee.

IRS Extends Interim Relief to Trusts and Estates on Investment Advisory Costs - *Notice 2010-32*

The IRS recently issued Notice 2010-32, which extends for another year interim relief for trusts and estates on the treatment of investment advisory costs subject to the 2% floor under §67(a), so that taxpayers will not be required to determine the portion of a bundled fiduciary fee that is subject to the 2% floor for any taxable year beginning before January 1, 2010. Instead, taxpayers may deduct the full amount of the bundled fiduciary fee without regard to the 2% floor.

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.

If you have any questions regarding the matters discussed in this newsletter, please contact any of the lawyers listed below:

BOCA RATON

Elaine M. Bucher
561.995.4768 — ebucher@proskauer.com

Albert W. Gortz
561.995.4700 — agortz@proskauer.com

George D. Karibjanian
561.995.4780 — gkaribjanian@proskauer.com

David Pratt
561.995.4777 — dpratt@proskauer.com

LOS ANGELES

Mitchell M. Gaswirth
310.284.5693 — mgaswirth@proskauer.com

Andrew M. Katzenstein
310.284.4553 — akatzenstein@proskauer.com

NEW YORK

Henry J. Leibowitz
212.969.3602 — hleibowitz@proskauer.com

Lawrence J. Rothenberg
212.969.3615 — lrothenberg@proskauer.com

Lisa M. Stern
212.969.3968 — lstern@proskauer.com

Philip M. Susswein
212.969.3625 — psusswein@proskauer.com

Ivan Taback
212.969.3662 — itaback@proskauer.com

Jay D. Waxenberg
212.969.3606 — jwaxenberg@proskauer.com

Boca Raton | Boston | Chicago | Hong Kong | London | Los Angeles | New Orleans | New York | Newark | Paris | São Paulo | Washington, D.C.

www.proskauer.com