Proskauer

newsletter

Wealth Management Update

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in this issue

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.

PLR 200944002 (October 30, 2009) – Self-settled Spendthrift Trust Assets Not Includible in Grantor's Estate under IRC §2036

In this very important private letter ruling, the IRS held that the assets of the self-settled spendthrift trust in question would not be includible in the Grantor's estate under Section 2036 even though the Grantor was a discretionary beneficiary of the trust. This ruling appears to be the first of its kind and should provide practitioners with additional comfort in an area in which there has been some uncertainty.

Under the terms of the trust, the trustee has discretionary authority to distribute income and principal for the benefit of the Grantor, his spouse, or his descendants. The trustee cannot, however, pay the Grantor any amounts to discharge his income tax liability. Further, upon the termination of the trust, no income or principal can be transferred to the Grantor, his estate, his creditors or the creditors of his estate. A trust company was to serve as the trustee and none of the following people could ever be trustee: the Grantor, his spouse, a beneficiary under the trust, the spouse of a beneficiary, or anyone related or subordinate to the Grantor.

The Grantor retained a power to substitute assets of equivalent value with trust assets. Also, the state in which the Grantor resides (Alaska) has a statute that provides that a person who transfers property to a trust may provide that the interest of a beneficiary, including the grantor, may not be voluntarily or involuntarily transferred. If the trust contains this restriction, then a creditor cannot satisfy a claim out of the beneficiary's interest unless certain exceptions apply, none of which applied in this case.

The IRS ruled, first, that a contribution to the trust by the Grantor will be a completed gift because he did not retain the power to revest beneficial title in himself or reserve the right to change the interests of the beneficiaries.

The IRS also ruled that the assets will not be included in the Grantor's estate under Section 2036 because:

(i) the Grantor's substitution power will not by itself cause inclusion in the Grantor's estate;

(ii) the trustee is prohibited from paying the Grantor any amounts to discharge his income tax liability. (Note, however, that the IRS stated that the assets may be includable in the Grantor's gross estate if the trustee had the discretion to reimburse the Grantor for tax liability, and other factors were present, such as a pre-existing arrangement, the power of the Grantor to name himself as trustee, or if local law subjected the assets to the claims of the Grantor's creditors); and

(iii) the trustee's discretionary authority to distribute income and principal to the Grantor did not, by itself, cause inclusion in the Grantor's gross estate. The PLR, however, specifically did not rule on whether or not the trustee's discretionary authority, combined with other factors (such as a pre-existing arrangement), would cause inclusion in the Grantor's gross estate.

December Interest Rates Rise for Sales to Defective Grantor Trusts and Intra-family Loans

The December 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 for a 9-year duration (the mid-term rate, compounded annually), is 2.64%. The 2.64% is an increase from November's rate. While this rate has gone up, the rates 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 still-low AFR and a decline in the financial markets continues to present a potentially rewarding opportunity to fund GRATs in December with depressed assets expected to perform better in 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 .69% for loans 3 years or less, 2.64% for loans 9 years or less and 4.17% for loans 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 2.64%. These same rates are used in connection with sales to defective grantors trusts.

T.D. 9468 and Related IRS Notice 2009-84 – Final Regulations on Deductions under IRS § 2053

The IRS issued final regulations on deductions from a decedent's gross estate under § 2053 for (a) funeral expenses, (b) administration expenses, (c) claims against the estate, and (d) unpaid debt on property, where the value of the asset is included in the estate undiminished by such debt. The final regulations are applicable to decedents dying after Oct 20, 2009 and primarily affect estates against which there are outstanding claims.

The final regulations provide, generally, that any deduction for a claim or expense under § 2053 is limited to the amount actually paid on the claim or expense.

The regulations provide a general exception for “ascertainable amounts.” More specifically, a claim or expense that is “ascertainable with reasonable certainty and will be paid” is deductible. No deduction is allowed for a “vague or uncertain” estimate. If the claim or expense is *contested* or *contingent*, then it is not considered “ascertainable with reasonable certainty.” Note, however, if a decedent has a recurring obligation that is subject to a contingency, the executor may deduct the amount of a commercial annuity purchased to satisfy the obligation.

The Regulations also provide two additional exceptions that specifically relate to claims against an estate under § 2053(a)(3). The first is for “related claims.” More specifically, if there are one or more substantially related claims or integrally related assets included in the gross estate that are related to a claim against the estate, then that claim is deductible as long as certain factors are met, including (but not limited to) (i) the claim represents a personal obligation of the decedent, (ii) the claim is enforceable against the decedent’s estate, (iii) the value of the claim is determined from a “qualified appraisal,” and (iv) the related claim or assets includable in the estate constitute more than 10% of the gross estate. The deduction is limited to the value of the claim or asset that is includable in the estate.

Secondly, claims that do not exceed $500,000 in the aggregate can be deducted as long as certain factors are met, including (but not limited to) (i) the claims represent personal obligations of the decedent; (ii) the claims are enforceable against the decedent’s estate; (iii) the value of the claims are determined by qualified appraisals; and (iv) the full value of all deducted claims, rather than just a portion of those claims, equals $500,000 or less.

Note, the $500,000 exception can be combined with the other exceptions for ascertainable amounts and related claims. For example, if an estate has an outstanding claim of $1,000,000 against it that is related to a $750,000 asset that is included in the estate, the executor can deduct $750,000 of the $1,000,000 claim under the first exception for “related claims” and the remaining $250,000 can be deducted under the exception for claims that do not exceed $500,000.

Note, further, that all exceptions are subject to adjustment to reflect post-death events.

Protective claims can be made to preserve the right to make a greater deduction based on post-death events. Notice 2009-84 provides that the IRS will limit the review of a return to the evidence relating to the 2053 deduction if the protective claim ripens after the expiration of the statute of limitations on assessment. Protective claims will not reduce marital or charitable deductions.

Further, claims and expenses must be bona fide. The regulations set forth factors to determine whether a claim by a family member or related entity are bona fide.

Prudential Insurance Co. of America v. Giacobbe, D.N.J., No. 3:07-cv-04113-AET-TJB, *unpublished* 10/30/09) – Decedent did not "substantially comply" with benefit plan's requirements because he failed to include beneficiaries' Social Security numbers on designation form

The decedent attempted to change the beneficiary of a Prudential life insurance policy held in a welfare benefit plan from his wife to his parents and brother, but omitted their Social Security numbers; Prudential therefore rejected the designation. The court found that the insurance plan was governed by ERISA, which requires that plans be administered in accordance with plan documents. The decedent's attempt to change the beneficiary designation would only be honored if he was deemed to have "substantially complied" with the plan's requirements.

The court found that the decedent did not "substantially comply" with the plan requirements because he had not made all reasonable efforts to ensure that the designation form met the plan's requirements and, therefore, Prudential did not have to honor his attempt to change the beneficiaries.

In re Estate of Max Feinberg, Docket No. 106982 (Ill. Sup. Ct., 9/24/09) – Illinois Supreme Court upholds trust's restriction of benefits to descendants who married Jewish individuals

The Illinois Supreme Court upheld a provision in a trust that treated a lineal descendant who married outside of Judaism as predeceased for purposes of defining the class of beneficiaries.

The decedent, Max, created a trust in which he directed that one-half of his assets should be held in trust for the lives of his grandchildren upon his wife's death. If, however, any grandchild marries outside of the Jewish faith, and his or her spouse does not convert within one year of the marriage, then the grandchild will be deemed deceased, as will that grandchildren's descendants, and they will all lose interests in the trust. The trust also granted Max's wife, Erla, a limited power of appointment in favor of their issue that allowed her to change Max's dispositive plan.

After Max's death, Erla exercised the power of appointment and directed that, at her death, each of her two children and any grandchildren not deemed deceased under Max's beneficiary restriction clause would receive $250,000. At her death, this gift depleted the trust corpus, so no assets were subject to Max's original plan to keep assets in trust for the beneficiaries.

The Supreme Court upheld the provision, emphasizing the fact that the distributions were ultimately made under Erla's power of appointment, which only defined the class at her death. The court found it significant that Erla's disposition only provided a condition precedent to becoming a beneficiary. A condition precedent, the court stated, would be given effect because, until the condition was met, the beneficiary's interest was a mere expectancy. On the other hand, under Max's plan, a person who was already a beneficiary would lose his or her interest if he or she later married a non-Jew. This was a condition subsequent that would cause a vested interest to divest and may be impermissible.

A key aspect of the ruling, therefore, was that the provision that took effect only defined who would be members of the class and had no impact on the beneficiaries' choices with respect to marriage. The court seemed to suggest (but specifically declined to rule) that if Max's plan had, in fact, taken effect, then it may have violated public policy. The court stated that "Max and Erla were free to distribute their bounty as they saw fit… so long as they did not convey a vested interest that was subject to divestment by a condition subsequent that tended to unreasonably restrict marriage or encourage divorce."

Note also that the court rejected various constitutional arguments raised by the petitioner because the decedent was a private party and, therefore, the court found that there are no constitutional dimensions to his choice of beneficiaries.

Estate of Murphy v. United States, U.S. Dist. Ct. W.D. Ark., Case No. 07-CV-1013 (10/2/09) – Taxpayer FLP victory

The court held that the transfer to a family limited partnership (FLP) of certain of decedent's assets was a bona fide sale for full consideration under section 2036 of the Code.

The court found that the transfer was a bona fide sale because, first, the FLP had legitimate non-tax purposes. One of the main purposes was to pool together what the Court referred to as the family's "legacy assets" into one entity to be centrally managed in a manner consistent with the decedent's long-term business and investment philosophy. Other purposes included: (i) enabling decedent to make lifetime gifts of interests in the assets while ensuring the voting of the underlying assets remained in one place; (ii) enabling decedent to educate his descendants about wealth acquisition, management and preservation; and (iii) to protect the assets from creditors and from being dissipated by future generations.

Secondly, the court found the transfer was a bona fide sale because two of the decedent's children were actively involved in the management of the legacy assets. For example, one child served on the board of directors of the businesses comprising the legacy assets. Also, the partners met 6-8 times a year to discuss the partnership.

Third, the decedent retained $130 million of assets for his personal support. Fourth, the decedent did not commingle the FLP assets with his own. Finally, the two children involved in the FLP took an active role in forming it, and one child even was represented by her own attorney.

The court found that the transfer was for full consideration because (i) the interests in the FLP were proportionate to each individual's contributions; (ii) the value of each partner's contribution was credited to his or her capital account; and (iii) on termination or dissolution, the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

The court also upheld substantial discounts to the decedent's interests. The decedent's interest in the FLP at death consisted of an approximately 95% limited partner interest and a 49% interest in an LLC that owned the approximately 2.3% general partnership interest. The court upheld a combined control and marketability discount of 41% for the 95% limited partnership interest. Also, the court allowed tiered discounts in valuing the decedent's 49% interest in the LLC that owned the 2.3% general partnership interest. The overall discount for the LLC interest was 52%.

Finally, the court allowed a deduction of all the interest on an $11 million "Graegin" loan that the estate borrowed from the FLP to pay estate taxes.

2004 Stuart Moldaw Trust v. XE L.I.F.E., LLC, 2009 U.S. Dist. LEXIS 64658 – Stranger-owned life insurance policy case

A group of investors purchased $78 million of life insurance on the life of the decedent in exchange for paying him $4 million during his life. The decedent's widow, estate, and living trust sued the investors to recover the insurance payments. The issue was whether or not the widow, estate and living trust had standing to sue for the recovery of the funds. The decision turned on whether or not the law of California or New York was applicable.

Both California and New York prohibit the purchase of a life insurance policy on the life of another person without having an "insurable interest" in that person's life. An "insurable interest" is an interest in having the life continue, as distinguished from an interest which would arise by or be enhanced by the death of the insured. In New York, the executor of the insured's estate has a right to recover the benefits of the policy. In California, however, only the insurer has the right to sue.

The court concluded that California law applies because the plaintiffs were domiciled in California, the decedent was domiciled in California at the time of his death, the initial negotiations occurred in California, and at least two of the policies contained a California choice of law provision. Therefore, only the insurer had standing to sue to recover the payments.

IRS Notice 2009-75 – Roth IRA Conversions from Non-IRA Accounts Will Be Taxed at Ordinary Income Tax Rates

Roth IRA conversions made directly from non-IRA accounts will be treated as though they first passed through a traditional IRA and, therefore, special tax rules, such as those applicable to net unrealized appreciation on employer securities, will not apply.

Net unrealized appreciation relates to eligible retirement accounts that hold employer securities. The "net unrealized appreciation" is the unrealized gain on the employer securities in the hands of the plan trustee as of the date it is distributed to the participant. Distributions from plans with employer securities with net unrealized appreciation only require the payment of current income tax on the amount of the stock cost basis and not on the net unrealized appreciation, which is taxed later as the participant sells it. A Roth IRA conversion is supposed to be taxed as if the non-IRA account was distributed. With respect to employer stock accounts with net unrealized appreciation, that means that only the basis would be taxed at the time of conversion. Further, since Roth IRA distributions are not taxed, the participant potentially could avoid paying any tax on the net unrealized appreciation.

The Notice, however, provides that the conversion will be treated as if it passed through a traditional IRA first and, therefore, the participant will be required to pay income tax on the entire amount and the benefit is lost.

IRS Internal Memo re Procedures for Implementing the Penalty for the Substantial and Gross Valuation Misstatements Attributable to Incorrect Appraisals under IRC § 6695A (August 18, 2009)

In this internal memo, the IRS permits IRS agents and examiners (even those lacking appraisal experience) to issue a penalty citation to an appraiser *without* consulting the appraiser or a Field Specialist Engineer. The penalties may be issued to an appraiser who prepares an appraisal who knew (or should have known) that the appraisal would be used in connection with a return or claim for a refund that results in certain valuation misstatements or understatements. The penalties do not apply if it is "more likely than not" that the appraisal value is correct, but the applicable statute does not define "more likely than not," and the IRS stated that forthcoming regulations will provide guidance on the standard.

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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