Proskauer

newsletter

Wealth Management Update

April 2010
in this issue

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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.

April Interest Rates Remain Steady for GRATs and Split Interest Charitable Trusts and Increase Slightly for Sales to Defective Grantor Trusts and Intra-Family Loans

The April applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 3.2%, the same as it was in March. 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 2.70%. This is a very 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 April 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 0.67% for loans less than 3 years, 2.70% for loans less than 9 years and 4.40% 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 2.70%. These same rates are used in connection with sales to defective grantor trusts.

Tax Court Finds that Value of Life Insurance Policy Sold from Profit-Sharing Plan to the Insured is Determined by Reference to the Policy's "Entire Cash Value," which Allows no Reduction for Surrender Charges, thereby Resulting in Taxable Income from Bargain Sale – *Matthies v. Commissioner*, 134 T.C. No. 6 (February 22, 2010)

At issue in *Matthies* was whether taxable income resulted from the sale of a second-to-die life insurance policy by the profit-sharing plan of the taxpayers' wholly owned subchapter S corporation to the taxpayers.

In October of 1998, the taxpayers incorporated their subchapter S corporation and formed its profit-sharing plan. In January of 1999. the plan purchased an $80 million second-to-die life insurance policy on the lives of the taxpayers. During 1999 and 2000, the taxpayers transferred over $2.5 million from an IRA to the profit-sharing plan. These contributions were used to pay the premiums on the life insurance policy. Then, in December of 2000, the profit-sharing plan sold the policy to the taxpayers for about $315,000. At the time of the sale, the "cash value" of the policy was about $306,000, but the "account value" was almost $1.4 million. The difference between the "cash value" and the "account value" was a result of a surrender charge that would be imposed upon the policy if surrendered within the three years after issuance.

The taxpayers then transferred the policy to a "family irrevocable trust." In January of 2001, the trust exchanged the policy for another survivor policy with a face amount of $19.5 million. As part of the exchange, the life insurance company waived the surrender charge and accepted the $1.4 million "account value" as full payment for the new policy.

Because the sale of the policy was not negotiated at arm's length, the Tax Court considered the proper method for valuing the policy for purposes of determining whether the taxpayer's realized taxable income from a bargain sale. In this regard, the essential question was whether the surrender charge should be taken into account in valuing the policy, or, in other words, whether fair market value of the policy was its "cash value" or its "account value." The court reviewed statutory and regulatory language from IRC Sections 72, 402 and 7702 and determined that for purposes of calculating the taxpayers' income from the bargain sale, the value of the policy should be determined without reference to the cash surrender value. Accordingly, the court held that the taxpayers recognized about $1.1 million of taxable income from the transaction. However, in light of ambiguity as to the proper tax treatment of the transaction, the court declined to assess a negligence penalty against the taxpayers.

Tax Court Finds that Termination of Variable Life Insurance Policy against which Taxpayer had Borrowed Did Not Result in Cancellation of Indebtedness Income, but rather in Taxable Distribution of the Policy's Cash Surrender Value – *McGowen v. Commissioner*, T.C. Memo 2009-285 (December 14, 2009)

In *McGowen v. Commissioner*, the Tax Court found that the termination of a variable life insurance policy resulted in a taxable distribution of the policy's cash surrender value. From 1989 until the termination of the policy in 2003, the taxpayer continually borrowed against the cash surrender value of her variable life insurance policy. As the debt against the policy grew, together with accrued interest, the life insurance company terminated the policy and used its cash surrender value to satisfy the taxpayer's debt. The insurance company issued the taxpayer a 1099 reporting about $565,000 in income

At issue was the characterization of the income. The taxpayer argued that the income was a result of cancellation of indebtedness. Characterization as such would have permitted the taxpayer to avail herself of the provisions of IRC Section 108 and exclude the amount from gross income. However, the Tax Court disagreed with this characterization. The court found that the debt was not extinguished; rather, the insurance company had applied the cash surrender value of the policy against the debt. This constituted an indirect distribution under IRC Section 72. Accordingly, the taxpayer was not entitled to an exclusion from gross income.

Federal District Court Finds Promoter of "Aegis" System of "Trusts" Guilty of Conspiracy to Defraud and Aiding the Filing of a False Tax Return – *United States v. Wasson*, C. Dist. Ill., No. 2:06-CR-20055 (December 4, 2009)

The defendant in *Wasson* was found guilty of conspiracy to defraud and of aiding in the filing of a false tax return. The defendant was a promoter of a system of "trusts" marketed under the name "Aegis." The scheme was designed to assign income to trusts and omit the assigned income from the taxpayers' individual income tax returns. The defendant also promoted so-called "charitable trusts" that actually failed to donate anything to charity or to be structured in accordance with federal tax law regarding charitable trusts. From 1994 until 2002, the defendant promoted this sham trust structure to assist taxpayers in fraudulently concealing over $17 million in income. Despite arguing that he acted in good faith belief, the defendant was convicted of conspiracy to defraud and aiding the filing of a false tax return.

Although these schemes are nothing new, they highlight an ongoing concern that some well-intentioned individuals may fall prey to these too-good-to-be true schemes. Some telling signs include schemes that have half-truths, often mixed with a touch of good law, packaged into a bigger sham transaction. Notwithstanding these half-truths, the promises are often – if not always — inconsistent with basic principles of taxation.

Federal Court of Claims Holds that Primary Executor of Estate Was Not Entitled to Reissuance of $10 Million Refund when Check Was Previously Issued to and Negotiated by an Ancillary Executor – *Curtin v. United States*, Fed. Cl. No. 09-109 T (February 26, 2010)

The Federal Court of Claims recently denied a U.S. executor's claim for a federal tax refund when the IRS had previously issued a refund check to a non-U.S. ancillary executor. At issue was the estate of a deceased U.S. citizen who died domiciled in France. Unrelated individuals, the Plaintiffs, administered her estate in the U.S. The decedent"s son served as an ancillary executor in France.

The U.S. executor initially paid from the estate about $17.5 million in federal estate taxes and requested an extension of time to file along with the payment of the tax. Subsequent to this, the son filed an estate tax return claiming a $10 million refund, which the IRS paid to him. The son's agent negotiated the check.

The U.S. executor subsequently filed for a $5 million refund, which was denied on the basis that the refund had already been paid. The U.S. executor filed suit, claiming that the check was forged or fraudulently negotiated and the IRS breached an implied in fact contract between it and the U.S. executor. The Court of Claims disagreed. Because the check was issued to the son and duly negotiated, no forgery or fraud was present. Moreover, the court held that the U.S. executor failed to establish a basis for an implied in fact contract.

IRS Announces Two-Year Renewal of Art Advisory Panel (February 23, 2010)

The IRS recently announced its decision to renew for an additional two years the charter for the Art Advisory Panel. The Art Advisory Panel assists the IRS by reviewing and evaluating the acceptability of appraisals submitted by taxpayers with respect to the fair market value of art. Membership on the Panel is comprised of museum directors, curators, art dealers and auction representatives.

The Art Advisory Panel has played an important role in the eye of many courts deciding issues of art valuation in federal tax cases. For example, in *Stone v. United States*, 99 AFTR.2d 2007-2992, aff'd, 103 AFTR.2d 2009-1379, the court emphasized that the Panel represented a "collection of experts" and found that on account of the fact that the members are not paid and are not told the purpose of the valuation (e.g., income tax valuation versus transfer tax valuation), the Panel is "extremely credible" and "unbiased." Critics point to the close-knit nature of the art community in questioning whether the Panel's evaluations are actually all that unbiased. Nonetheless, the Panel is here to stay, at least for the next two years.

IRS Announces Notice and Proposed Regulations Regarding Form TD F 90.22-1 Report of Foreign Bank and Financial Accounts (the FBAR) – *Notice 2010-23; Proposed Regulation 31 CFR Part 103* (February 26, 2010)

The IRS has recently announced further guidance in the area of reporting non-U.S. bank and financial accounts. Most notable among the Proposed Regulations is an attempt to define a "financial account." Additionally, the Notice announced that interests in hedge funds and private equity funds held in tax years 2009 and earlier do not have to be reported on the FBAR.

For more information, see Proskauer Client Alert, "The Foreign Bank and Financial Account Reporting Saga Continues: Further Relief for Prospective Filers," March 5. 2010, available at http://www.proskauer.com/publications/client-alerts/the-foreign-bank-and-financial-account-reporting-saga-continues/

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:

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