Proskauer

newsletter

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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.

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

The January applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 3.0%. 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 2.45%. These are decreases from December'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 January 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 .57% for loans less than 3 years, 2.45% for loans less than 9 years, and 4.11% 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 2.45%. These same rates are used in connection with sales to defective grantor trusts.

Eighth Circuit Upholds Formula Disclaimer Over Public Policy Objections - *Estate of Christiansen v. Commissioner*, 104 AFTR 2d 2009-7352 (8th Cir. 2009)

In a unanimous decision, the Eighth Circuit upheld over the IRS' public policy objections a formula disclaimer which passed property to charity. This is an important case, as its holding might be broadly applied not just to formula disclaimers passing property to charity, but to defined value clauses in general, including those used in conjunction with gifts or sales of business interests to intentionally defective grantor trusts.

In her will, a decedent left her entire estate to her daughter. The will provided that any disclaimed assets were to pass 75% to a CLAT and 25% to a private foundation. The daughter made a formula disclaimer, in effect disclaiming a fractional share of the decedent's estate exceeding $6.35 million. The decedent's estate tax return reported the estate's value at just over $6.5 million. Based on that value, about $120,000 was to pass to the CLAT and about $40,000 was to pass to the foundation. On audit, the IRS and the estate agreed to increase the gross estate from $6.5 million to $9.6 million (based largely on adjustments to discounts that the estate took on limited partnership interests). Pursuant to the disclaimer, the additional $3.1 million of estate tax was to pass to the CLAT and foundation as if there were no additional tax.

The Tax Court held that the 75% disclaimer to the CLAT was not a qualified disclaimer due to technical violations of the Disclaimer Regulations. That finding was not at issue in the appeal.

With respect to the 25% passing to the foundation, the IRS allowed the $40,000 charitable deduction for the pre-adjustment disclaimer amount, but not for the additional amount passing to the foundation as a result of the adjustment. The IRS made two arguments against the increased deduction. First, it argued that any increased amount passing to the foundation was not deductible because it was contingent on the determination of the final estate tax value, and the Regulations provide that a charitable deduction is not available where it is "dependent upon the performance of some act or happening." The court rejected that argument, finding that while the <u>transfer</u> must be complete at the date of the decedent's death, there does not necessarily need to be an agreement on the <u>value</u> of the transfer at that time. In this case, the foundation's right to receive 25% of the disclaimed amount was certain; the only thing that was uncertain was the value of that 25%.

The IRS's second argument was the same argument that the IRS made successfully in *Proctor v. Commissioner*, 142 F.2d 824 (4th Cir. 1944)—that is, that the transfer violated public policy because it reduced the IRS' incentive to audit the return. The court rejected this argument as well, even though the formula disclaimer "may marginally detract from the incentive to audit" and, in some situations, would permit a charitable deduction equal to the entire increase in the value of the estate. The court gave three reasons for its holding. First, it noted that the IRS' role is not merely to maximize tax receipts, but to enforce the tax laws. Second, there is no evidence of a clear Congressional intent suggesting a policy to maximize incentives for the IRS to audit returns; on the other hand, there is a clear policy of encouraging charitable donations by allowing charitable deductions. Third, there are other mechanisms that offset the decreased incentive to audit, including (a) the executor's fiduciary duty to accurately report estate values and (b) the contingent beneficiary (in this case the foundation) having an interest in ensuring that the executor does not underreport the value of the estate. Accordingly, the Eight Circuit affirmed the Tax Court's holding that the formula disclaimer clause was not against public policy, and that the estate was entitled to a deduction for the full amount passing to the foundation.

Tax Court Upholds Defined Value Gift in which LLC Interests Given to the Donor's Children and Charities. - *Estate of Petter v. Commissioner*, TC Memo 2009-280

On the heals of *Christiansen*, the Tax Court upheld a defined value clause over the IRS' public policy objections, this time in the context of a part-gift, part-sale of LLC interests. As with *Christiansen*, this is an important taxpayer victory in the defined value clause arena.

Anne Petter inherited a large amount of UPS stock from her uncle. She consulted an estate planner who recommended a number of techniques to meet her goals, including (a) involving her children in the management of her newly acquired wealth and (b) providing for local charities. One of those techniques involved having Anne contribute all of her UPS stock to an LLC. Anne also created two defective grantor trusts, one for each of her children. She transferred LLC units to each child's trust, partly as a gift and part as a sale. The gift portion was stated as amount equal to 10% of the trust's assets, and the sale portion was stated as 90% of the trust's assets. In addition, Anne donated LLC interests to two local charities.

A formula clause was used to divide the LLC interests between the trusts and charities. The transfer to each trust was stated as "the number of units that equals one-half of the maximum dollar amount that can pass free of federal gift tax." As part of the transfer documents, the trustees of the trusts agreed, as a condition of the gift, that if the value of the units it received was finally determined for gift tax purposes to exceed the originally determined amount, then it would transfer the excess to the charities. The sale to each trust was stated as "the number of units that equals a value of $4,085,190 as finally determined for Federal estate tax purposes," with any excess passing to the charities. Again, the trustees of the trusts agreed, as a condition of the sales, that if the value of the interests were adjusted upward, they would transfer additional LLC interests to the charities. Similarly, the charities agreed that, in the event of any downward adjustment, the charities would transfer a portion of the LLC interests to the trusts.

The LLC units were valued by a qualified appraiser who determined that a discount of over 50% was appropriate, and the LLC units were allocated among the trusts and charities accordingly. On audit, the IRS disallowed a significant portion of the discount, which had the result of increasing the amount passing to the charities based on the formula clauses. The IRS also disallowed any increase in the charitable deduction and asserted that the sales were for less than adequate and full consideration, resulting in gift tax.

Again, the IRS argued that the formula clause was void against public policy based on *Proctor*. The Tax Court did not agree, finding that this case was closer to *Christiansen* (in which a donor gave away a fixed set of rights with uncertain values) than *Proctor* (in which the donor tried to take property back). The plain language of the transfer documents showed that the taxpayer was making gifts of an ascertainable dollar value of LLC units, rather than a specified number of units. The facts also showed that the charities were advocating their own interests, not just passively helping the taxpayer reduce her tax bill. The charities conducted arm's-length negotiations, retained their own counsel, and won changes to the transfer documents to protect their interests. In addition, the directors of the charities owed fiduciary duties to their organizations to make sure that the appraisal was acceptable before signing off on the gift. Thus, the court held that (a) the formula clause was valid, (b) the sales did not result in additional gifts and (c) an additional charitable deduction was warranted for the reallocated amount passing to charity.

Life Insurance Proceeds Received by Limited Partnership Not Included in Gross Estate of Insured Limited Partner - PLR 200947006 (Nov. 20, 2009) & PLR 200948001 (Nov. 27, 2009)

In Private Letter Rulings 200947006 & 200948001, the IRS considered whether a series of transactions among a partnership, corporations and trusts which altered the ownership and beneficiary designations of two life insurance policies required inclusion of the policies in the insured's estate.

At the outset, the partnership's sole asset was life insurance on the taxpayer's life. The general partner of the partnership was a corporation that was wholly owned by the insured. The limited partners of the partnership included the insured and a second corporation. The second corporation was owned by a trust formed by the insured's parents. The trustees were the insured and his sister. The sole current beneficiary was the insured. The insured did not have any power of appointment. Upon the insured's death, the trust assets were to pass in trust for his descendants.

The insured, the partnership, the corporations and the trusts proposed entering into a multi-step transaction, which would result in the partnership still owning the life insurance; however, the partnership would be owned by the trust created by the insured's parents, plus another trust formed by the insured for the benefit of his wife and children. The insured would remain a co-trustee of the trust created by his parents, but he would release to his co-trustee/sister all powers to make decisions with respect to the insurance. The first trust would contribute cash to the partnership in an amount estimated to cover the premiums on the policies for the rest of the insured's life.

The IRS held that policies were not includible in the insured's estate because he would hold no incidents of ownership either before or after the transactions. The IRS relied on *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), in which a decedent was a 50% general partner in a partnership that owned and was the beneficiary of ten life insurance policies on the decedent's life. In *Knipp*, the Tax Court found that the partnership bought the policies in the ordinary course of business and that the decedent, in his individual capacity, had no incidents of ownership. Therefore, the policies were not includible in his estate. Prior to Private Letter Rulings 200947006 & 200948001, some practitioners believed that a partnership might not be able to benefit from *Knipp* unless there was a business purpose for holding the insurance. However, the partnerships in the Private Letter Rulings had no assets apart from the insurance, which suggests that a business purpose for ownership of the policies is not necessary.

California Appeals Court Holds That Fees Incurred Defending Trust Beneficiaries’ Bad Faith Claim Were Properly Charged Against Those Beneficiaries’ Shares of the Trust. - *Rudnick v. Rudnick*, 2009 SOS 6928 (Cal. App. 5th Dist.)

In this case, a California Appeals Court considered whether fees incurred by a trust in defending against certain trust beneficiaries’ bad faith claim to block the sale of trust property were properly chargeable against the entire trust or just the shares of the beneficiaries who brought the bad faith claim.

Under a trust agreement, any sale or disposition of certain trust property, once negotiated by the trustee, had to be approved by a majority of the trust beneficiaries for it to become effective. The trustee proposed the sale of a ranch, which was the trust’s primary asset. The sale was approved by a 60% majority of the beneficiaries, but the beneficiaries in the 40% minority continued to file pleadings to enjoin the sale of the ranch. Accordingly, the trustee filed a petition in the Probate Court to obtain instructions to complete the sale and to approve a distribution of the proceeds to the beneficiaries. The court approved the sale and distribution plan. Thereafter, the trustee filed a motion to recover the attorney’s fees and costs incurred in connection with the petition for instructions, and to charge that amount against the minority beneficiaries’ shares of the sales proceeds.

The Probate Court found that the minority beneficiaries’ opposition to the petition for instructions was not made in good faith; that their primary motivation was to disrupt the sale by preventing the trustee from closing by the due date that had been arranged with the buyer. Thus, the Probate Court held that, under the circumstances, it was not fair to burden all of the beneficiaries, including the majority beneficiaries, with the payment of the fees. Therefore, it ordered that the fees be paid only from the minority beneficiaries’ shares of the sales proceeds. The Court of Appeals found that the Probate Court did not abuse its discretion, in that the court did have the equitable power to order that the attorney’s fees be paid from the minority beneficiaries’ shares only.

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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