Proskauer

newsletter

July 2010
in this issue

A monthly report for wealth management professionals.

Edited by **Henry J. Leibowitz**
Contributor: **Jane Wang**

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.

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

The July applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.8%, the lowest rate so far this year. The rate for use with a sale to a defective grantor trust, SCIN or intra-family loan, with a note of 9-year duration (the mid-term rate, compounded annually), is also down to 2.35%. 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 still low AFR and a decline in the financial and real estate markets continues to present a potentially rewarding opportunity to fund GRATs in July with depressed assets you expect to perform better in the coming years. However, there is legislation currently pending in Congress which would significantly curtail short-term and zeroed-out GRATs. Therefore GRATs should be funded immediately in order to be grandfathered from the effective date of any new legislation that may be enacted.

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 0.61% for loans with a term of 3 years or less, 2.35% for loans with a term of 9 years or less and 3.94% for loans with a term of longer than 9 years.

Thus, for example, if a nine-year loan is made to a child and the child can invest the funds and obtain a return in excess of 2.35%, the child will be able to keep any returns over 2.35%. These same rates are used in connection with sales to defective grantor trusts.

No Estate Tax Apportionment against Payable on Death Accounts

In *Estate of Sheppard v. Schleis*, 2010 WI 32 (Wis. May 4, 2010), the Wisconsin Supreme Court ruled that, in the absence of any tax apportionment directions by the decedent, a beneficiary of a payable-on-death account is not liable for any estate tax imposed on the decedent's estate.

The decedent died without a Will. Other than the payable-on-death accounts which passed directly to the beneficiary, the decedent's estate passed by probate to his heirs at law.

The executors of the decedent's probate estate sought reimbursement from the beneficiary of the payable-on-death accounts for the portion of federal and state estate taxes attributable to those accounts.

The executor first argued that payable-on-death accounts fall under Internal Revenue Code ("IRC") Section 2036 because the decedent had a retained interest in those accounts. If the decedent had a retained interest under IRC § 2036, the executors could exercise their right to recover estate taxes under IRC § 2207B. However, the court rejected this argument, stating that payable-on-death accounts do not fall under IRC § 2036 because the decedent did not relinquish any rights to the accounts during his lifetime and the beneficiary did not possess a remainder interest during the decedent's lifetime.

The executor also argued that, since Wisconsin does not have an estate tax apportionment statute, there is a common-law right to equitable apportionment of estate tax. The court rejected this argument also, stating that in the absence of any tax apportionment directions by the decedent, estate taxes are to be paid from the residuary estate.

Spendthrift Provision of Trust Not Invalidated Despite Control by Beneficiary

In *Miller v. Kresser*, --- So.3d ---, 2010 WL 1779899 (Fla. 4th DCA May 5, 2010), the Florida Court of Appeal, Fourth District, ruled that a creditor cannot invalidate a trust's spendthrift provision to reach the trust assets so long as the language of the trust agreement meets statutory requirements.

In 2004, a fully discretionary trust was established for the beneficiary by his mother, and the beneficiary's brother was appointed as the trustee. The trust agreement contained both a spendthrift provision and a provision stating that the trustee had full discretion to determine the timing and amount of all distributions.

In 2007, a creditor obtained a judgment against the beneficiary, individually. The creditor was unable to collect on his judgment from the beneficiary, individually, so he sued to invalidate the trust.

During the trial it was shown that the trustee had completely turned over management of the trust's operations, including investment decisions, to the beneficiary. The trustee never independently investigated these decisions to determine if they were in the trust's best interests and merely rubber-stamped the beneficiary's decisions.

Despite those facts, the court held that Florida law requires the focus to be on the terms of the trust and not on the actions of the trustee or the beneficiary. While the court agreed that the facts were an egregious example of a trustee abdicating his responsibilities, the trust agreement grants the trustee the sole authority to manage and distribute the trust property. Florida law provides that with a fully discretionary trust, a creditor may only reach those distributions which the trustee chooses to make and that this law applies whether or not the trustee has abused his discretion in managing the trust. Furthermore, there is no law in Florida allowing a creditor to reach trust assets simply because the trustee allowed the beneficiary to exercise significant control over the trust.

Decedent Had No Ownership Interest in Companies Despite His Involvement in the Business

In *Estate of Fortunato v. Commissioner*, T.C. Memo 2010-105 (May 12, 2010), the Tax Court ruled that the decedent had no ownership interest in various companies despite his involvement in the operation of the companies.

The decedent's brothers started a group of warehouse companies. The decedent became involved in running some of those companies. During business dealings, the decedent held himself out as the owner or the CEO. However, he had no documented ownership interest in any of the companies, and he did not provide any of the initial or subsequent infusions of capital. As such, the executors did not report an ownership interest in the companies on the decedent's estate tax return.

The IRS determined a deficiency in the federal estate tax paid; it asserted that the decedent held an interest in the companies as a beneficial owner because he created the business strategies for the companies, controlled the companies' finances, had the companies' employees report to him, and held himself out as the business owner.

Although the applicable state laws allowed a legal owner of a corporation to be an uncertified shareholder, the Tax Court held that the facts showed the decedent did not exhibit any intent to become a shareholder nor did the corporation exhibit an intent to make the decedent an owner. The decedent never wanted to become a shareholder because he was afraid his creditors would attempt to collect on his debts and he was worried his past criminal convictions would stigmatize the companies. Furthermore, the decedent's brothers thought the decedent was irresponsible despite his business acumen.

Step Transaction Doctrine Applies to Aggregate Gifts and Sales to Trusts

In *Pierre v. Commissioner*, T.C. Memo 2010-106 (May 13, 2010), the Tax Court held that the step transaction doctrine applied to collapse the taxpayer's gifts and sales of LLC membership interests to trusts. This case addresses different issues related to the transaction involved in *Pierre v. Commissioner,* 133 T.C. No. 2 (August 24, 2009), whereby the Tax Court held that gifts and sales of membership interests in a single member LLC did not preclude valuation discounts because, for gift tax purposes, the single member LLC was not a disregarded entity.

Twelve days after funding a single member LLC, the taxpayer – on the same day – transferred her entire interest in the LLC to two trusts. The taxpayer gifted a 9.5% interest to each trust, and sold a 40.5% interest to each trust for a promissory note.

The Tax Court collapsed the gift and sale to each trust for valuation purposes and treated the transfers as an aggregate transfer of a 50% interest to each trust. The lack of control discount was decreased from 10% to 8%. The taxpayer's valuation expert admitted that the control discount would be lower for a 50% interest because, for example, it could block the appointment of a new LLC manager. The IRS did not contest the 30% lack of marketability discount.

The Tax Court stated that the main reasons for collapsing the gifts and sale were:

- The gifts and sales occurred on the same day.
- No time elapsed between the gifts and sales other than the time it took to sign four documents.
- The taxpayer intended to transfer her entire interest in the LLC without paying gift tax. There was no non-tax reason for splitting the transfer.

Each trust's capital account in the LLC ledger was labeled "gift transaction."

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

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