Proskauer

newsletter

Wealth Management Update

Edited by **Henry J. Leibowitz**
Contributor: **John F. Pokorny**

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in this issue

A monthly report for wealth management professionals.

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.

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

The June applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 3.2%, slightly lower 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 2.72%. This is also a slight decrease 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 June 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 0.74% for loans less than 3 years, 2.72% for loans less than 9 years and 4.30% 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 2.72%. These same rates are used in connection with sales to defective grantor trusts.

Adams v. Comm'r, T.C. Memo 2010-72 (April 13, 2010).

In this case, the Tax Court held that a beneficiary was permitted to claim a mortgage interest deduction for trust property.

Title to certain real property was transferred to a grantor trust for a 5-year period. Petitioner held a beneficial interest in that trust. Petitioner lived in the property held by the trust and paid the principal and interest on the loans secured by the property. Petitioner claimed mortgage interest deductions that the IRS disallowed.

In general, interest on a mortgage is deductible if the indebtedness is an obligation of the taxpayer and not an obligation of another. However, if the taxpayer is not directly liable on the mortgage, the mortgage interest paid by the taxpayer may still be deductible if the taxpayer is the legal or equitable owner of the property. Whether or not the taxpayer is the legal or equitable owner of property is a fact based inquiry and depends on certain factors (e.g., whether the taxpayer has the right to possess the property and to enjoy its use, rents and profits; whether the taxpayer has the duty to maintain and the right to improve the property).

Based on the facts presented, the Tax Court determined that the beneficiary was the equitable owner of the property and had assumed the benefits and burdens of its ownership. Specifically, (i) the beneficiary had a duty to maintain and repair the property; (ii) the beneficiary paid the taxes attributable to the property; and (iii) the beneficiary had a right of first refusal to purchase the property. Therefore, the Tax Court concluded that the beneficiary was entitled to claim the mortgage interest deduction.

PLR 201011036 (Dec. 14, 2009)

In this Private Letter Ruling request, the IRS held that the 10% early distribution penalty would not apply to taxpayer's withdrawals from his IRA because of taxpayer's disability.

Taxpayer was diagnosed with multiple sclerosis, which forced taxpayer to stop working and apply for Social Security disability benefits. Taxpayer was under age 59-1/2 and wanted to withdraw amounts from his IRA before attaining that age. A ruling was requested that the 10% early distribution penalty did not apply because of taxpayer's disability. (This ruling was requested because there is no specific definition of disabled under the applicable tax provisions.)

In general, the 10% early distribution penalty does not apply to distributions attributable to an employee being disabled within the meaning of IRC § 72(m)(7). That section provides that an individual shall be considered to be disabled if he or she is unable to engage in any substantial gainful activity by reason of any medically determined physical or mental impairment which can be expected to result in death or to be of long continued and indefinite duration.

Here, taxpayer demonstrated that he has multiple sclerosis and is unable to engage in any substantial gainful activity by reason of this physical impairment. Based on the documentation submitted, the IRS determined that the taxpayer is not expected to recover from this physical impairment in the foreseeable future. Accordingly, the IRS concluded that the taxpayer could make withdrawals from his IRA without being subject to the 10% early distribution penalty.

Ludwick v. Comm'r, T.C. Memo. 2010-104 (May 10, 2010)

In this case, the Tax Court held that a contribution of a tenancy-in-common interest in a personal residence to a qualified personal residence trust was entitled to a 17% marketability discount from its full fair market value.

Husband and wife purchased real property in Hawaii as tenants in common. Husband and wife then created separate qualified personal residence trusts and transferred their one-half undivided interests to the trusts. On their gift tax returns, husband and wife valued their separate one-half undivided interests in the property at a 30% discount. The IRS allowed discounts of only 15%.

In its decision, the Tax Court noted its dissatisfaction with the appraisals prepared by both the taxpayers and the IRS. The Tax Court ultimately decided to discount the tenancy in common interest to reflect the cost of partition and the lack of marketability caused by the buyer's inability to sell the property quickly for its full fair market value. Based on its calculations, the Tax Court determined that a discount of approximately 17% should apply.

Petition No. M090929A, NYS Dep't of Taxation & Finance Advisory Opinion, TSB-A-10(1)(M)

In this Advisory Opinion, New York State determined that a non-resident decedent's interest in a revocable trust that owned interests in several limited liability companies ("LLCs") that held New York real property was not subject to New York State estate tax.

The decedent was domiciled in and a resident of Florida. Through his revocable trust, the decedent owned various minority interests in several LLCs (classified as partnerships for Federal income tax purposes) organized under the laws of New York State. The LLCs held commercial and residential property located in New York. The business purpose of the LLCs is to rent these properties to tenants for a profit. The decedent never resided in or personally owned any of the properties. The decedent never participated in the management of the LLCs (the decedent was a limited partner) and did not provide any of services to the LLCs.

In general, a non-resident decedent's intangible property is not subject to New York State estate tax. (New York State estate tax is imposed on real or personal property owned by a non-resident decedent located in the State.) Because the LLCs are multi-member LLCs that elected to be treated as partnerships for Federal income tax purposes, the LLCs are considered to be separate from its owner. Thus, New York State concluded that the revocable trust's interest in the LLCs constituted an intangible asset that was not subject to New York State estate tax.

Estate of Schneider v. Finmann, 2009 NY Slip Op 2319 (App. Div. Mar. 24, 2009) (appeal pending before Court of Appeals)

This case was argued before the Court of Appeals on May 4, 2010, and has not yet been decided by the Court. The issue before the Court is the applicability of New York's strict privity defense in an estate planning malpractice claim. (Under the privity rule, lawyers owe no duty of care to non-clients, and only a client may sue a lawyer for legal malpractice.)

Decedent retained the services of an attorney for estate planning advice. Prior to decedent's death, it is alleged that, on the attorney's advice, ownership of a life insurance policy was transferred from a family limited partnership controlled by decedent to decedent individually. When decedent died, the insurance proceeds became subject to estate tax.

The estate brought a legal malpractice action for negligent estate planning against the attorney. The trial court dismissed the suit and the Appellate Division affirmed based on New York's strict privity defense.

In its brief filed with the Court of Appeals, the estate argues that decedent had a cause of action for malpractice at the time when the attorney gave decedent erroneous estate planning advice. Had decedent discovered it, decedent would have had a claim for the damages then accruing, specifically, for the cost of hiring another attorney to correct the issue pertaining to ownership of the insurance and to recover fees paid to the attorney who initially advised decedent. Thus, a cause of action had accrued and was viable when decedent died. Furthermore, the estate argues that this is not a privity case as a beneficiary of the estate is not suing for any reduction or omission of his or her bequest. Rather, it is the estate that is bringing the action to seek damages that were done to decedent when the estate plan was negligently implemented.

We will be monitoring this case and will summarize the Court's holding in a future edition of Wealth Management Update.

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