PROSKAUER ROSE LLP

Wealth Management Update

A monthly report for wealth management professionals.

February 2009

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.

H.R. 436: Certain Estate Tax Relief Act of 2009 (Introduced in House) (Jan. 9, 2009)

Congressman Earl Pomeroy (D-ND) introduced a bill to amend the Internal Revenue Code to repeal the carryover basis rules, which would otherwise take effect next year, to retain the estate tax with a $3,500,000 exemption and a maximum rate of 45% and to impose certain valuation rules with respect to transfers of nonbusiness assets which limit the availability of minority discounts. The bill provides that in the case of a transfer of an interest in an entity other than an interest which is actively traded, the value of any nonbusiness assets held by the entity will be determined as if the transferor had transferred the assets directly to the transferee (and no valuation discount is allowed). Furthermore, there will be no discount even if the transferee does not control the entity if the transferee and the transferee's family control the entity. According to the bill, these amendments would apply to transfers made after the enactment of the Act. Estate planning professionals should therefore monitor H.R. 436 and consider implementing estate planning techniques that take advantage of minority and lack of marketability discounts (such as family limited partnerships) before the bill becomes law. (It should be noted that this bill is in the first step in the legislative process. Introduced bills and resolutions first go to committees that deliberate, investigate and revise them before they go to general debate. The majority of bills and resolutions never make it out of committee.)

February Interest Rates at All-Time Historic Low for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split Interest Charitable Trusts

The interest rates for estate planning techniques such as GRATs, CLATs and SCINs, to name a few, are at an all-time low! The rate for use with CRTs, CLTs, QPRTs, GRATs and private annuities is 2.0%. 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), is 1.64%. These are declines from January's rates and set another all-time low. As we have explained in past Updates, lower rates work best with GRATs, CLATs, sales to defective grantor trusts, private annuities, SCINs and intra-family loans. And, because of a special rule in the Internal Revenue Code, a taxpayer can elect to use the most favorable rate for a three-month period with respect to a CLAT. Thus, given the strong possibility that wealthy individuals will face higher income tax rates in 2009, it makes sense to fund a grantor-type CLAT in the first quarter of 2009 to obtain a 2009 income tax deduction and take advantage of the historically low February AFR and higher income tax rates. (If rates rise after February, an election may be made in March or April that will allow you to use the February rate.) In addition, the combination of a low AFR and a decline in the financial markets presents a potentially rewarding opportunity to fund GRATs in February with depressed assets that you expect to perform better in the coming years. Though it is possible that rates will continue to drop, substantial declines seem unlikely given the current 2.0% rate.

Clients also should consider "refinancing" existing intra-family loans. The AFRs used in connection with intra-family loans are .60% for loans less than 3 years, 1.64% for loans less than 9 years and 2.94% 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 1.64%. These same rates are used in connection with sales to defective grantor trusts.

Final Version of New Form 990 (Return of Organization Exempt from Income Tax) and Related Instructions Released (Dec. 23, 2008)

The IRS finalized a revised version of Form 990, which is effective for 2008 tax years (returns filed beginning in 2009). Form 990 had not previously seen major revisions since 1979. Any charitable organization filing Form 990 should carefully review the new form and instructions to make sure it satisfies the new reporting requirements, as some information previously required from only certain types of organizations completing the form is now required from *all* types of organizations. Examples of major changes in reporting requirements include Part VI of the new Form 990, which asks questions about the organization's governance structure, policies and disclosure practices, and Part VII, which contains new definitions of "officer" and "key employee" and extends the practice of reporting compensation paid to the five highest-compensated employees to all organizations. Other areas of significant change include determination of public charity status and public support; supplemental financial statement reporting; and fundraising, special events and gaming.

Final Regulations Issued on Tax Return Preparer Penalties under Sections 6694 and 6695, T.D. 9436; and Additional Guidance Related to Preparer Penalties Issued, Notice 2009-5 (Dec. 15, 2008)

The IRS issued final regulations setting forth tax return preparer penalties under Sections 6694 and 6695. The regulations are effective for returns filed after December 31, 2008 and apply to tax return preparers, including those who prepare estate, gift and GST tax returns. The final regulations adopt most of the changes in the proposed regulations, with some modifications. The regulations clarify that only one person within a firm will be subject to a penalty for each position giving rise to an understatement of tax liability, and the determination will be based on which individual within a firm was primarily responsible. Similar to the proposed regulations, the final rules allow a return preparer to rely in good faith on information provided by another adviser or preparer without verification (absent circumstances that would suggest a duty of further inquiry), though the regulations clarify that a return preparer may rely on advice given by other preparers. In addition, the preparer can rely on legal conclusions furnished by taxpayers, subject to applicable due diligence standards. (Note that different rules may apply with respect to positions taken on tax shelters.)

The IRS simultaneously issued interim guidance related to certain aspects of the final rules. Section 6694(a) imposes a penalty on a tax return preparer who prepares a return or claim for refund reflecting an understatement of liability due to an "unreasonable position" if the tax return preparer knew (or reasonably should have known) of the position. No penalty is imposed, however, if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith. A position will be treated as "unreasonable" unless there is or was "substantial authority" for the position, or the position was properly disclosed and had a reasonable basis. In Notice 2009-5, the IRS adopted the analysis under Section 6662's existing "substantial authority" regulations. Thus, "substantial authority" exists for a position if the taxpayer is the subject of a "written determination" or if there is controlling precedent from a U.S. Court of Appeals to which the taxpayer could appeal. There is substantial authority for a position only if there is substantial authority on the date the return or refund claim is deemed prepared, or there was substantial authority on the last day of the tax year to which the return relates. Notice 2009-5 clarifies that conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority.

FLP Assets Transferred in Exchange for Annuity Includible in Estate – *Estate of Hurford v. Comm'r*, T.C. Memo 2008-278 (Dec. 11, 2008)

The full value of assets transferred to three family limited partnerships (FLPs) was includible in a decedent's gross estate because the asset transfer and subsequent exchange of FLP interests for a private annuity were not bona fide sales for adequate and full consideration. The decedent contributed nearly all of her own assets and the assets from trusts created under her husband's will to the FLPs. The decedent then purported to sell FLP interests to two of her three children through a private annuity agreement. (The decedent's third child was not a party to the agreement because the decedent did not want him to have decision-making authority.) On audit, the IRS asserted gift and estate tax deficiencies.

The court held that the transfer of property for FLP interests was not a bona fide sale for adequate and full consideration under Section 2036. The court concluded that the non-tax reasons of asset protection and asset management offered by the estate as justification for the creation of the FLPs were not significant and legitimate. Dismissing the estate's position, the court explained that the partners' relationship to the assets did not change after the transfer to the FLPs and no greater asset protection was afforded. The court also found that the partners did not receive interests proportionate to the assets they contributed to the FLPs. Accordingly, the transfers to the FLPs were not bona fide sales for adequate and full consideration. Holding that the decedent retained the possession or enjoyment of the transferred assets, the court determined that an implied agreement existed that the decedent would be able to continue to enjoy the property after the transfers. Thus, even if the decedent had sold her FLP interests, the value of the transferred assets would still be includible in her estate pursuant to Sections 2035(a) and 2036(a)(1).

The court also held that the exchange of FLP interests in the private annuity arrangement was not bona fide but was a "disguised gift or sham transaction." The court noted that (i) the two children who were parties to the agreement intended to follow their mother's wishes and provide for their sibling; and (ii) the annuity payments that were made consisted of the very assets the decedent transferred to the FLPs. The purported sale was not for adequate and full consideration because the value of each FLP interest was computed from out-of-date values and incorporated discounts which were "conjured out of thin air." The court concluded that the Estate failed to show under Section 2036(a)(1) that the decedent did not keep possession or enjoyment of the property after the purported sale to her children. In addition, the court held that under Sections 2036(a)(2) and 2038(a)(1), the decedent exercised her power to designate who would enjoy the property and the power to alter or amend the transfer of the property, respectively, because the children intended to follow their mother's wishes regarding the distribution of her property with respect to the child not named in the annuity agreement.

Exception to Special Use Valuation Rule Applied to Joint Venture Interest – PLR 200852029 (Dec. 26, 2008)

In Private Letter Ruling 200852029, the IRS ruled that Section 2703 did not apply to the valuation of an interest in a joint venture that was transferred to a trust. Section 2703(a) provides that the value of any property for estate, gift and GST tax purposes is determined without regard to any option, agreement, or other right to acquire or use the property at a price less than fair market value, or any restriction on the right to sell or use such property. The Taxpayer planned to sell his interest in a joint venture, which is subject to mandatory redemption upon death at book value and other restrictions on transferability, to an irrevocable grantor trust for the benefit of his children.

The IRS concluded that the transfer of the Taxpayer's interest to the trust would be a substantial modification of the agreements that created the transfer restrictions, but that since more than fifty percent of the joint venture was owned by members who were not members of the Taxpayer's family, and because their interests would be subject to the transfer restrictions to the same extent as the Taxpayer's interest, the exception under Section 25.2703-(b)(3) applies to the transfer of the Taxpayer's interest in the joint venture to the trust, and therefore Section 2703 does not apply to the valuation of the Taxpayer's interest on the date of the transfer.

Nonqualified Disclaimers Reduce GST Taxes – PLR 200901013 (Jan. 2, 2009)

In Private Letter Ruling 200901013, the IRS held that the use of nonqualified disclaimers by beneficiaries of a generation-skipping trust could render the beneficiaries the new transferors for GST tax purposes, thereby reducing GST taxes on further taxable distributions and terminations. Married settlors established an irrevocable trust for the benefit of their issue. Upon the death of the survivor of the settlors the trust is to be divided into separate shares for the then living children, or for a predeceased child's spouse and/or issue.

The settlors' children and their spouses proposed to execute nonqualified disclaimers of their entire interests in the trust. The IRS ruled that the disclaimers would be transfers subject to federal gift tax under Section 2501, and the disclaimed property would be treated for federal gift, estate and GST tax purposes as passing from the disclaimant to the person entitled to receive the property as a result of the disclaimer. Because the disclaimants are not a generation that is two or more generations above a grandchild of the settlors, after the proposed disclaimers, a grandchild of the settlors would not be a skip person, as defined in Section 2613, with respect to such portions of the trust. The trust will be subject to GST tax only as to interests held by the settlors' grandchildren at the time of the disclaimers.

Wealth Management Update Newsletter
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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 individuals and institutions to assist in the adminsitration of trusts and estates.

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