Proskauer

newsletter

June 2011

in this issue

A monthly report for wealth management professionals.

Edited by **Henry J. Leibowitz**

Contributor: **Jordana T. Berman**

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

The June applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.8%. That is down from the May rate of 3.0%. The rate for use with a sale to a defective grantor trust, self-cancelling installment note ("SCIN") or intra-family loan with a note of a 9-year duration (the mid-term rate, compounded annually) is also down, to 2.27%. 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 and real estate markets presents a potentially rewarding opportunity to fund GRATs in June with depressed assets you expect to perform better in the coming years. However, the Obama Administration, in its 2012 fiscal budget, has proposed to significantly curtail short-term and zeroed-out GRATs. Therefore, GRATs should be funded as soon as possible 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 0.46% for loans with a term of 3 years or less, 2.27% for loans with a term of 9 years or less and 4.05% 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 2.27%, the child will be able to keep any returns over 2.27%. These same rates are used in connection with sales to defective grantor trusts.

Trustees of self-directed IRAs are not liable for IRA losses from Madoff investments – *Mandelbaum v. Fiserv, Inc.,* 107 AFTR 2d 2011-1651 (Dist. Ct. of CO, 3/29/2011)

In *Mandelbaum*, the District Court of Colorado dismissed all of the claims brought in a class action suit by the owners of self-directed IRAs against the IRA Trustees for losses incurred by IRA assets invested with Bernard Madoff's firm. Pursuant to instructions given by the IRA owners, the IRA Trustees sent the IRA funds to be invested with Madoff. These funds were eventually lost in Madoff's ponzi scheme.

The IRA owners sought to hold the IRA Trustees responsible for their role in the losses. The IRA owners argued that the IRA Trustees, as fiduciaries of the IRAs, owed the duty to hold, preserve and keep safe the IRA assets and to avoid commingling them with other assets and that the Trustees failed to fulfill these duties. The IRA agreements clearly stated that the IRA owners were solely responsible for making investment decisions in connection with the funds in their IRAs and that the IRA Trustees would not provide any investment advice.

The Court dismissed all of the claims of the IRA owners. Specifically, the Court rejected the federal common law claims based on IRC Section 408, finding that it does not impose a specific duty of care on an IRA Trustee or create a private right of action for fiduciary breaches. The Court also rejected the negligence claim by finding that the IRA Trustees owed no duties to the IRA owners independent of those in the IRA agreements which explicitly indemnified the IRA administrators from liability resulting from any claims arising from the IRAs and made the IRA owners solely responsible for the investment of the IRA funds.

Tax Court excludes taxpayer's appraisal report and upholds the IRS's position in the valuation of a conservation easement – *Boltar, LLC v. Comm'r.,* 136 T.C. No. 14 (4/5/2011)

In *Boltar LLC,* the Tax Court completely barred the taxpayer's appraisal report from evidence. At issue was the correct value of an income tax charitable deduction for a conservation easement.

In 1996, Boltar LLC ("Boltar") acquired parcels of land in Indiana. In 2003, Boltar granted a conservation easement to a land trust on a portion of one of the parcels. On its 2003 partnership income tax return, Boltar claimed a charitable contribution deduction of $3,245,000, but only $42,400 was allowed by the IRS. The IRS filed a motion to exclude Boltar's expert report and testimony as neither reliable nor relevant under the Federal rules of evidence and under *Daubert v. Merrell Dow Pharm., Inc*., 509 U.S. 579 (1993). The entire Tax Court found significant problems with Boltar's appraisal including: (1) factual errors, such as ignoring a utility easement on the property; (2) errors in identifying the property's location; (3) errors in which zoning rules apply to the easement; (4) the expert continued to assert the appraised value was correct, even after admitting factual errors; and (5) the appraisal was based on a draft of the conservation easement, not on the final conservation easement.

The Tax Court expressed that it was not inclined to guess at how the valuation should be adjusted for the factual errors, and found the report as a whole to be too speculative and unreliable to be useful. The expert's report and opinion was so problematic that the Court granted the IRS's motion to exclude it. The taxpayer argued that the *Daubert* analysis should only apply in a jury trial and this case was a non-jury trial. The Tax Court rejected this argument and held that a *Daubert*-type exclusion can apply in a bench trial.

Valuation victory for taxpayer – IRS loses most of its proposed estate and gift tax deficiencies – *Estate of Mitchell v. Comm'r.,* T.C. Memo 2011-94 (4/28/2011)

This Tax Court Memo illustrates the benefits of good estate planning and valuations. The net result in this case was that the IRS lost most of its proposed $10 million estate and gift tax deficiencies.

James Mitchell, a widower, died a resident of California leaving substantial assets to his teenage sons in trust. This case involves disputes between the estate and the IRS on the valuation of two real property holdings and two paintings. The real property consisted of a beachfront residence and a ranch, both of which the decedent leased to third parties on a long term basis. The use of the relatively long-term leases for both properties was a method to insure keeping the properties in the family and having them be income producing. The paintings were by well known American western artists.

Six days before he died, the decedent gifted a 5% co-tenancy interest in the two real properties to his sons in trust. With respect to the beachfront residence, the estate took a 32% discount on the 5% gifted interest and 19% discount on the estate's 95% interest. With respect to the ranch, the estate took a 40% discount on the 5% gifted interest and a 35% discount on the estate's 95% interest. The Court reviewed the valuations of the real property and paintings and found in favor of the estate.

With respect to the real property valuations, the estate's appraiser used a standard “income capitalization” method (which estimates the present value of anticipated cash flows and the reversionary interest) while the IRS appraisers proposed a unique, never approved by the Courts, valuation approach called the “leased buyout” method (which takes the real property's fee simple value less the amount the landlord would have to pay to buyout a tenant). The Court accepted the estate's appraisals and pointed out that any property that generates income can be valued using the income capitalization approach. The Court rejected that leased buyout approach stating that it is “speculative at best”.

With respect to the painting valuations, the Court accepted the estate's values and determined that the estate's experts at trial were experienced, qualified and reasonable. Specifically, one of the estate's appraisers was well qualified to opine on American western art while the IRS experts had neither expertise nor extensive background in American western art. In addition, an IRS appraiser included private sales in his analysis together with the usual sales at public auctions. The use of private sales, presented without details of such sales, was rejected by the Court. The Tax Court accepted the estate's valuation of one painting at $1.2 million (valued by the IRS at $2.3 million) and the other painting at $750,000 (valued by the IRS at $2 million).

9th Circuit upholds finding that transfers to FLPs are includible in estate – *Estate of Jorgensen v. Comm'r.,* No. 09-7325 (9th Circuit 5/4/2011)

In *Jorgensen*, the 9th Circuit upheld the Tax Court's finding that certain transfers decedent made to two family limited partnerships were includible in the decedent's estate under IRC Section 2036(a).

Husband and Wife formed a family limited partnership with their sons. The partnership agreement stated that the parties desired to pool certain assets and capital for the purpose of investing in securities. Husband and Wife each contributed marketable securities valued at $227,000 in exchange for 50% limited partnership interests. During his lifetime, Husband made all decisions with respect to the family limited partnership. Husband died and his estate took a 35% discount on his interest in the family limited partnership which passed into a family trust. The family trust was funded with $600,000 of assets including the family limited partnership interests valued using minority interest and lack of marketability discounts. All other estate assets went to Wife outright.

Following Husband's death, Wife formed another family limited partnership into which she contributed $1.8 million in marketable securities in exchange for her initial limited partnership interest. She then contributed about $700,000 from the estate's brokerage account.

Both partnerships held only passive investments, primarily marketable securities. The assets of the partnerships were commingled and Wife wrote personal checks on the partnerships accounts and ultimately paid her estate tax with funds from the partnerships. Wife died and the IRS determined a federal estate tax deficiency of nearly $800,000. The Tax Court held that the values of the assets Wife transferred to the two partnerships were includible in her estate under IRC Section 2036(a).

On appeal to the 9th Circuit, the Wife's estate did not contest the Tax Court's determination that IRC Section 2036(a) applies. Wife's estate acknowledged that Wife retained some benefits in the transferred property since she wrote checks on partnership accounts to pay personal expenses and make family gifts. Wife's estate argued that these amounts should be considered di minimus or that the application of IRS Section 2036 should be limited to the actual amount accessed by Wife.

These arguments were made for the first time to the 9th Circuit and were rejected by the Court. The Court did not find it de minimus that Wife personally wrote checks over $90,000 and that the partnerships paid over $200,000 of her personal estate taxes from partnership funds. The 9th Circuit found that the Tax Court did not err by concluding that there was an implied agreement that Wife could have accessed any amount of the assets to the extent she desired them. Nor did the Tax Court err by concluding that Wife's transfer was not a bona fide sale for adequate and full consideration. Transfers to family limited partnerships such as these are subject to heightened scrutiny and to be bona fide, must objectively demonstrate a legitimate and significant nontax reason for the transfers.

Proposed regulations would treat the grantor of a grantor trust and the owner of disregarded entity as the taxpayer for some discharge of indebtedness purposes – *Proposed Reg. § 1.108-9, 76 FR 20593-01* (4/13/2011)

In general, income from the discharge of indebtedness is includible in gross income. A limited exception applies under IRC Section 108 which provides that an amount that normally would be includible in gross income by reason of the discharge of indebtedness of the taxpayer is excludible if the discharge occurs in (1) a Title 11 bankruptcy case or (2) to the extent the taxpayer is insolvent when the discharge occurs.

This proposed regulation would treat the grantor as the taxpayer with respect to amounts owed by a grantor trust, to determine whether the discharge of those debts is excluded from gross income because the debtor is bankrupt or insolvent. Under the proposed regulations, the grantor, rather than the grantor trust, would have to be bankrupt or insolvent in order to avoid current income. The proposed regulations would also treat the owner of a disregarded entity, such as a single member LLC, as the taxpayer for similar purposes.

District Court denies summary judgment and finds that a trial is necessary to determine whether the estate should be subject to a negligence penalty for its failure to disclose that the decedent made gifts during his life – *Estate of Haggar v. Comm'r,* 107 AFTR 2d 2011-974 (DC SD 2/23/2011)

In *Haggar*, the issue was whether an estate's admitted failure to disclose that the decedent made gifts during life should be subject to a negligence penalty. The Court rejected both the taxpayer's and the government's request for summary judgment and will determine the issue at trial.

Decedent made a gift to Daughter and told her that she didn't have to do anything with regard to the gift and that he would take care of the tax return. Decedent also made a gift to his Wife's children. Wife was aware of the gifts and signed a gift tax return consenting to gift split. The accountant did not give Decedent or Wife a copy of the gift tax return.

Decedent died and Daughter and Wife were appointed as Executors. They hired an attorney and accountant to prepare the Decedent's estate tax return. Wife turned over Decedent's tax records, which did not include any gift tax returns. Wife and Daughter were somewhat educated and experienced in the business world, but not familiar with tax law. When asked by the attorney whether Decedent had ever made any gifts, Wife and Daughter answered no. Accordingly, the estate tax return reported that no federal gift tax returns had ever been filed.

The IRS examined the estate tax return and determined the estate failed to disclose prior gifts and assessed a negligence penalty. The estate paid the additional federal estate tax and interest, but contended that the penalty was erroneously or illegally assessed because there was reasonable cause for the underpayment and that they acted in good faith.

Under IRC Section 6662, an accuracy penalty is imposed if any part of an underpayment of tax is due to either negligence or to disregard of rules or regulations but without intent to defraud. The penalty is 20% of the portion of the underpayment attributable to the negligence. The penalty doesn't apply to the portion of the underpayment for which the taxpayer shows reasonable cause and he acted in good faith.

The Court found that there was disputed evidence that Wife and Daughter acted in good faith when they incorrectly answered the questions about whether Decedent had previously filed gift tax returns. This evidence included the fact that (1) Daughter was not aware that a gift tax return was filed and (2) Wife did not understand that the gift was relevant for purposes of the estate tax return. The weight of the evidence depends heavily on the credibility of the individual making the statements and those determinations are best made after seeing and hearing the individual in person. Therefore, neither side was entitled to summary judgment.

IRS provides interim guidance on unbundling investment advisory fees for purposes of the 2% floor on miscellaneous itemized deductions – IRS Notice 2011-37, 2011-20 IRS (4/13/2011)

Previously, the IRS released notices in response to the 2008 *Knight* case that held that trust investment advisory fees are subject to the 2% floor on miscellaneous itemized deductions under IRC Section 67(e). The prior notices confirmed that fiduciaries preparing 2007, 2008 and 2009 income tax returns would not be required to unbundle a unitary fiduciary fee to separately state the components of the fee that are subject to the 2% floor.

This notice again extends the relief of trustees from the need to unbundle their fees. Unlike prior notices, this notice provides the extension to all taxable years that begin before the date the final regulations are published. In other words, when final regulations are issued, any unbundling requirement will not be applied retroactively to any year that has already begun. Therefore, Trustees may deduct the full amount of the bundled fiduciary fees for 2010 and 2011 without regard to the 2% floor.

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

Boca Raton | Boston | Chicago | Hong Kong | London | Los Angeles | New Orleans | New York | Newark | Paris | São Paulo | Washington, D.C.

www.proskauer.com