Proskauer

newsletter

November 2011
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.

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

The November applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 1.4%. There was no change from the October rate. 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 9-year duration (the mid-term rate, compounded annually) increased slightly to 1.20% (as compared to the October rate of 1.19%). 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 November 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 0.19% for loans with a term of 3 years or less, 1.20% for loans with a term of 9 years or less, and 2.67% for loans with a term 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 1.20%, the child will be able to keep any returns over that amount. These same rates are used in connection with sales to defective grantor trusts.

Estate of Turner v. Comm'r, T.C. Memo 2011-209 (Aug. 30, 2011)

The Tax Court has held that (a) assets contributed to a family limited partnership ("FLP") were includable in a decedent's gross estate under section 2036(a) of the Internal Revenue Code of 1986, as amended ("I.R.C."), and (b) premiums paid directly to a carrier on behalf of an insurance trust qualified for the annual gift tax exclusion as present interest gifts.

Decedent and his wife formed a FLP, each taking a 0.5% general partnership interest and a 49.5% limited partnership interest. The assets contributed to the FLP were a mix of cash and marketable securities and included a concentration of one stock, which accounted for nearly 60% of the partnership's assets. Decedent and his wife subsequently gifted limited partnership interests to children and grandchildren and retained their general partnership interests.

Apart from the FLP, decedent also established an insurance trust for the benefit of his children and grandchildren. The beneficiaries of the trust had a right to withdraw any "direct or indirect" contribution that was made to the trust. Decedent paid insurance premiums on trust policies directly from a joint checking account he maintained with his wife.

After decedent's death, the IRS argued that the assets decedent contributed to the FLP should be included in his gross estate under I.R.C. § 2036(a), and the Tax Court agreed. The IRS also sought to treat the insurance premiums paid by decedent as adjusted taxable gifts. Here, the Tax Court sided with decedent's estate and concluded that those premium payments qualified as present interest gifts.

With respect to the estate tax inclusion of FLP assets, the Tax Court first concluded that the bona fide sale for adequate and full consideration exception to I.R.C. § 2036(a) did not apply. In reaching this conclusion, the Tax Court noted that there was not a legitimate nontax reason for forming the partnership. For example, the Tax Court did not find compelling or credible that the FLP was intended (a) to consolidate assets for management purposes, since the property contributed to the partnership was passive investments and included one concentrated stock holding that did not materially change; or (b) to facilitate resolution of family disputes, given that the purported ill will among family members appeared not to be about money or its management but rather conflicts in personality. In addition, the Tax Court found that decedent stood on both sides of the transaction and that decedent created the FLP without any meaningful bargaining or negotiating with his wife or with any other anticipated limited partner. For these and certain other reasons set forth in the opinion, the Tax Court determined that there was not a bona fide sale for adequate and full consideration.

The Tax Court then examined whether decedent retained possession or enjoyment over the transferred property, or had the right to designate the persons who could possess or enjoy that property. Here, the Tax Court concluded that decedent had retained possession and enjoyment over the transferred property because decedent (a) was being paid a management fee from the FLP without any apparent regard for the scope of the management duties being performed and (b) used FLP funds for nonpartnership-related matters. The Tax Court also found that decedent retained the right to designate the persons who could possess or enjoy the property transferred to the FLP, since decedent held a general partnership interest that gave him broad authority to the managed partnership property.

As a result, the Tax Court held that the property decedent contributed to the FLP was includable in his gross estate under I.R.C. § 2036(a) and that such property was not subject to any discount for lack of control or lack of marketability.

As to the premiums paid by decedent for trust-owned policies, the Tax Court noted that the trust agreement gave each of the beneficiaries a right to withdraw "direct or indirect" transfers made to the trust. Thus, the Tax Court determined that it was irrelevant that decedent did not make his contributions directly to the trust. Likewise, the Tax Court found that the fact that some or even all of the beneficiaries may not have known that they had the right to demand withdrawals from the trust did not affect their legal right to do so. The court indicated that lack of such notice was not an impediment to present interest gift treatment. Accordingly, the court concluded that the premium payments made by decedent qualified as gifts of present interests and were not includable as adjusted taxable gifts.

McGowen v. Comm'r, 2011 U.S. App. LEXIS 18407 (10th Cir., Sept. 2, 2011)

The Tenth Circuit has affirmed a Tax Court decision finding that a taxpayer who borrowed against the cash value of an insurance policy must realize income under I.R.C. § 72 when the policy was terminated by the carrier.

Taxpayer bought a single-premium variable insurance policy on her life for $500,000, and taxpayer repeatedly borrowed from the policy. The carrier subsequently notified taxpayer that the outstanding policy debt had exceeded the policy's cash value and that the policy would be terminated unless she remitted a minimum loan repayment. Taxpayer failed to do so and the carrier canceled the policy. The carrier then sent taxpayer a Form 1099-R reporting a gross distribution from the policy of approximately $1,065,000 with a taxable amount of around $565,000 (i.e., the gross distribution less the premium paid).

Before the Tax Court, taxpayer attempted to argue that the $565,000 was not income attributable to the termination of a life insurance contract but a discharge of indebtedness excludable from gross income due to taxpayer's insolvency. (Apparently taxpayer's net worth on the date of cancellation, apart from the policy, was less than $4,000.)

The Tax Court disagreed. The Tax Court explained that the carrier did not discharge the debt (which occurs when the debtor is no longer legally required to satisfy the debt) but instead extinguished it after the carrier had applied the cash value of the policy towards the debt owed. According to the Tax Court, when the policy terminated, the loan was charged against the available proceeds. This satisfaction of the loan had the effect of an indirect payment of the policy proceeds to the taxpayer and constituted income to her at that time.

The Tenth Circuit affirmed this decision.

PLR 201131006 (Apr. 13, 2011)

The IRS has ruled that an amendment of a qualified personal residence trust ("QPRT") did not cause the trust to lose its special valuation status under I.R.C. § 2702.

Taxpayer transferred her entire interest in a residence to the QPRT. Under the terms of the trust, upon expiration of the QPRT term, if taxpayer is then living, the residence passes to taxpayer's four children.

Taxpayer, with consent of her children, modified the trust to provide that upon expiration of the QPRT term, the children are granted a power of appointment over the trust and the power to direct the trustee to extend the QPRT term. It was represented to the IRS that the children intended to exercise their right to extend the term of the QPRT.

The IRS held that the trust amendment did not affect the status of the QPRT so long as the language of the amendment followed the model QPRT form issued by the IRS. In addition, the IRS ruled that any extension of the QPRT term would result in a gift from the children to taxpayer.

In the Matter of Ranftle, 2008-4585, NYLJ 1202515287643, at *1 (N.Y. Surr. Ct., N.Y. County, Sept. 14, 2011)

The New York County Surrogate's Court has held that a decedent reestablished his domicile in New York.

In 2003, decedent changed his domicile from New York to Florida. The parties did not contest this fact. Instead, the issue before the Surrogate's Court was whether decedent later abandoned that domicile and reestablished it in New York.

There were certain facts evidencing that decedent maintained his domicile in Florida. Those facts included the following: (a) decedent only had a Florida's driver's license; (b) decedent had his car registered in Florida; (c) decedent voted in Florida by absentee ballot; (d) decedent declared his Fort Lauderdale residence as his homestead; and (e) decedent executed five separate Wills in which he declared Florida as his domicile.

There were, however, also facts indicating that decedent changed his domicile to New York. Those facts included the following: (a) although decedent owned a home in Florida, he co-owned an apartment in New York City with his domestic partner; (b) decedent maintained connections with New York where, for example, he had concert and theatre subscriptions, made his charitable contributions, and had his financial advisors, and all his doctors and other health care professionals were located; (c) in 2008, when decedent was diagnosed with cancer, decedent remained in New York for medical treatment and did not return to Florida; (d) papers completed in connection with decedent's marriage to his domestic partner referred to New York as his domicile; and (e) decedent met with, and then retained, a New York accountant to prepare his tax returns, with the clear intention of filing as a New York resident.

Based on all facts and circumstances, the Surrogate's Court determined that decedent reestablished his domicile in New York where his friends, family and spouse where located.

Estate of Beybom, 2011-839/E, NYLJ 1202516821017, at *1 (N.Y. Surr. Ct., Suffolk County, Aug. 26, 2011)

The Suffolk County Surrogate's Court has found that a witness to an SCPA 2307-a disclosure form may be affiliated with the nominated attorney/fiduciary.

By way of background, under SCPA 2307-a, when an attorney prepares a Will and the attorney is nominated in the Will as an Executor, the attorney will receive only one-half of an Executor statutory commission unless the testator signs a form acknowledging the disclosures required by the statute.

In this case, the attorney who was nominated as an Executor under the Will had the disclosure form witnessed by an attorney who was affiliated with him. The question was raised as to whether that document was tainted by that affiliation.

The Surrogate's Court reviewed the statute, which merely requires for the witness to be someone "other than the executor-designee." According to the Surrogate's Court, the statute sets forth no standard of relationship or affiliation that would define at what point a witness is no longer disinterested and therefore precluded from serving as a witness. Accordingly, the Surrogate's Court concluded that nothing in the statute would disqualify an affiliated attorney from acting as a witness.

Besides looking at the face of the statute, the court also took a practical approach in reaching its conclusion and found that to hold otherwise would force a law firm to seek a stranger to the firm for purposes of witnessing the form.

The Surrogate's Court did note that a better course of action may be to use someone other than a person affiliated with the nominated attorney/fiduciary.

Proposed Treas. Reg. § 1.67-4

Treasury has issued new proposed Regulations in connection with what costs incurred by estates or non-grantor trusts are subject to the 2% floor for miscellaneous deductions under I.R.C. § 67(a).

By way of background, I.R.C. § 67(a) provides that miscellaneous itemized deductions are allowed only to the extent that the aggregate of those deductions exceeds 2% of adjusted gross income.

I.R.C. § 67(e)(1) provides that the deductions for costs paid or incurred in connection with the administration of an estate or non-grantor trust that would not have been incurred if the property were not held in the estate or trust are not subject to this limitation and are fully deductible.

In 2007, proposed Regulations were issued, but these rules came into conflict with the Supreme Court's decision in Knight v. Comm'r. The IRS has now withdrawn these earlier proposed Regulations and re-issued new proposed Regulations.

In Knight, the Supreme Court held that the deductibility of an expense under I.R.C. § 67(e)(1) depends upon whether the cost is "commonly" or "customarily" incurred when such property is held instead by an individual. That is, the only costs that are excluded from the 2% floor are those that would be uncommon or unusual for an individual holding the same property to incur.

In applying this interpretation to investment advisory fees incurred by a trust, the Supreme Court held that such fees are commonly incurred by individual investors and thus are subject to the 2% floor. The Supreme Court noted, however, that it is conceivable that a trust may have an unusual investment objective or may require

specialized balancing of the interests of various parties, such that a reasonable comparison with an individual investor would be improper. In those cases, the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor.

The new proposed Regulations reflect the Supreme Court's holding in Knight.

As a result, under the proposed Regulations, to the extent that a portion of an investment advisory fee exceeds the fee generally charged to an individual investor, and that excess is attributable to an unusual investment objective of the estate or non-grantor trust or to a specialized balancing of interests of various parties such that a reasonable comparison with individual investors would be improper, that excess is not subject to the 2% floor.

However, where the costs charged to an estate or non-grantor trust do not exceed the costs charged to an individual investor, the cost attributable to taking into account the varying interests of current beneficiaries and remainderman is included in the usual investment advisory fees and is not the type of cost that is excluded from the 2% floor.

Under the proposed Regulations, in determining whether a cost would be commonly or customarily incurred by an individual owning the same property (and thus subject to the 2% floor), it is the type of product or service rendered in exchange for the cost, rather than the description of that product or service, that is determinative. Therefore, if a fiduciary is performing services that are commonly or customarily performed by an investment advisor retained by an individual investor, then the costs attributable to those services are subject to the 2% floor.

As to bundled fees, if a trust or estate pays a single fee, commission or other expense (such as a fiduciary's commission, attorney's fee or accountant's fee) for both costs that are subject to the 2% floor and costs that are not, then the single fee, commission or other expense (the bundled fee) must be allocated between the costs subject to the 2% floor and those that are not. The proposed Regulations allow the fiduciary and/or return preparer to use any reasonable method to make this allocation.

There is an exception to this general rule on bundled fees. If a bundled fee is not computed on an hourly basis, only the portion of that fee that is attributable to investment advice is subject to the 2% floor. The remaining portion is not subject to that floor.

In addition, payments made from the bundled fee to third parties that would have been subject to the 2% floor if they had been paid directly by the trust or estate are subject to the 2% floor, as are any fees or expenses separately assessed by the fiduciary or other payee of the bundled fee for services rendered to the trust or estate that are commonly or customarily incurred by an individual owner of such property (e.g., an additional fee charged by the fiduciary for managing rental real estate owned by the trust or estate).

IRS Notice 2011-82

The IRS has issued guidance on the portability election pursuant to this Notice.

Estates of decedents who die in 2011 and 2012 that want to elect portability must timely file a properly prepared estate tax return (Form 706) even if there is no estate tax liability. Failure to file a Form 706 will prohibit the surviving spouse's use of the pre-deceased spouse's unused estate and gift tax exclusion amount.

According to the IRS, there are no special boxes to check or statements to make on Form 706 in order to make the election. The Form 706 that is filed will be deemed to contain the computation of the unused exclusion amount.

If the estate files a Form 706 and does not wish to make the portability election, the Executor must attach a statement to that effect or write across the top of the estate tax return "NO ELECTION UNDER SECTION 2010(c)(5)."

The IRS intends to issue Regulations to implement the portability provisions of I.R.C. § 2010(c).

IRS Form 8939 and Instructions Released

The IRS has released Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent.

Estates of decedents dying in 2010 that wish to elect out of the estate tax regime and into the carry-over basis regime must file this Form by **January 17, 2012**.

In general, under the form, the Executor must name each beneficiary who receives property from the estate, supply information about that beneficiary, and provide information concerning the property being distributed from the estate.

Within 30 days after the date the form is filed, the Executor also must furnish to each beneficiary a separate copy of the Schedule A that reports tax information about the property being transferred to that beneficiary.

The Form and its instructions can be located on the IRS Web site at http://www.irs.gov/form8939.

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:

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