Proskauer

newsletter

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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.

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

The May § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 1.6% (up slightly from the 1.4% rate in January, February, March and April). The applicable federal rate ("AFR") for use with a sale to a defective grantor trust, self-canceling installment note ("SCIN") or intra-family loan with a note of 9-year duration (the mid-term rate, compounded annually) is 1.30% (up slightly from the April rate of 1.15%). 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 § 7520 rate and a decline in the financial and real estate markets presents a potentially rewarding opportunity to fund GRATs in May 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 0.28% for loans with a term of 3 years or less, 1.30% for loans with a term of 9 years or less and 2.89% for loans with a term of longer than 9 years.

Thus, for example, if a 9-year loan is made to a child and the child can invest the funds and obtain a return in excess of 1.30%, the child will be able to keep any returns over 1.30%. These same rates are used in connection with sales to defective grantor trusts.

Wandry v. Commissioner, T.C. Memo 2012-88 (3/26/2012)

In *Wandry*, a groundbreaking Tax Court case, the court approved a donor's use of a defined value clause (a clause where the donee is entitled to a fixed dollar amount worth of property) which, upon an IRS revaluation of LLC membership interests, resulted in a reallocation of LLC interests to the original donor. *Wandry* is the latest in a series of recent cases that have approved of defined value clauses. What makes *Wandry* unique is that it is the first case to approve of a defined value clause where there was no charitable donee to receive part of the property.

The donors, Albert and Joanne Wandry, formed Norseman Capital, LLC (the "LLC") with their children in 2001. The family members contributed cash and marketable securities to the LLC. In 2004, the donors gifted specific dollar amounts of membership interests in the LLC. They gave $261,000 of interests to each of their four children and $11,000 of interests to each of their five grandchildren. The assignments provided that the donors were transferring a sufficient number of units in the LLC so that the fair market value of the units for federal gift tax purposes would be $261,000 per child and $11,000 per grandchild. The assignments provided further that the donors intended to have a good faith determination of the value of the units made by an independent appraiser, and that if the IRS challenged such valuation and a final determination of a different value were made by the IRS or a court of law, the number of gifted units would be adjusted accordingly, so that the value of the number of units gifted to the children and grandchildren equaled the amounts set forth above.

The donors then had an appraisal completed by an independent appraiser, which the donors' accountant used to prepare a ledger for the LLC capital accounts and the donors' gift tax returns. On the donors' gift tax returns, the donors reported a gift of $261,000 to each child and $11,000 to each grandchild. However, the schedule describing the gifts stated that each child received a 2.39% interest in the LLC and each grandchild received a .101% interest in the LLC. The accountant backed into the percentages based on the dollar amounts transferred and the LLC appraisal.

The IRS asserted that the appraisal undervalued the interests by more than 40%. In Tax Court, the IRS made three arguments.

First, the IRS argued that the descriptions of the gifts in the gift tax returns were admissions that the donors transferred fixed LLC percentage interests, rather than fixed dollar amounts. The IRS relied on *Knight v. Commissioner*, 115 T.C. 506 (2000). In *Knight*, the donors stated they had gifted a fixed dollar amount of partnership interests, but, at trial, the donors argued they had actually transferred less than the fixed dollar amount. This opened the door for the IRS to assert they had not transferred a fixed dollar amount, but rather a percentage interest. In *Wandry*, the Tax Court found that while the schedules to the donors' gift tax returns listed percentage interests, the gifts were still reported as fixed dollar gifts. Thus, the donors always intended to gift fixed dollar amounts.

The IRS next argued that the LLC capital accounts, which reflected gifts of fixed percentages interests, controlled the nature of the gifts. The IRS relied on case law that held that a completed gift occurred with respect to corporate stock when the corporate books were changed to reflect a change in ownership. The Tax Court rejected this argument as well, reasoning that the stock transfer cases were inapplicable, because, here, there was no dispute as to whether the gifts were completed. The Tax Court believed that the facts and circumstances of the gift determine the capital accounts of the donees, rather than the capital accounts determining the nature of the gift.

Lastly, the IRS reasoned that the assignment documents transferred fixed LLC percentage interests because the defined value clause used in the assignments was void against public policy. Relying on *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), the IRS argued that the donors' use of the defined value clause was contrary to public policy because (1) any attempt to collect the tax would defeat the gift, thereby discouraging efforts to collect tax, (2) the court would be required to pass judgment upon a moot case, and (3) the clause would reduce the court's judgment to a declaratory judgment.

The Tax Court rejected the public policy arguments by reconfirming the distinction between the type of savings clause used in *Procter* (which is void because it involves a "condition subsequent" in which the donor tries to "take property back" based on IRS redetermination) and the type of defined value clauses upheld in more recent cases such as *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), *Estate of Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009), *Estate of Petter v. Commissioner*, 653 F.3d 1012 (9th Cir. 2011), and *Hendrix v. Commissioner*, T.C. Memo 2011-133 (which relies on a "condition precedent" to transfer a "fixed set of rights with uncertain value").

The IRS claimed that the clause in *Wandry* differed from the types of clauses used in the more recent cases because the *Wandry* clause would operate to return property to the donors. In the recent cases, charitable beneficiaries were named as parties to the transactions, so that any revaluation by the IRS would result in business interests passing to the charities. On the other hand, revaluation in *Wandry* would merely reallocate percentage interests among the donors and their children and grandchildren.

The Tax Court dismissed this argument and held that there is no distinction between the *Wandry*-type clause and clauses that use a charitable donee. Thus, the court held for the donors, finding the defined value clause valid.

Estate of Kelly v. Commissioner, T.C. Memo 2012-73 (3/19/2012)

In *Kelly*, the Tax Court held that property of a family limited partnership should not be included in a decedent's estate, even though the decedent owned 100% of the stock of the corporate general partner, and a management fee was paid to the corporation which could have potentially been used to pay the decedent's living expenses.

The decedent, Beatrice Kelly, owned various real properties, including quarries, a post office and rental properties, which had been operated by her husband until his death. After her husband's death, the decedent's children helped her manage the properties as well as her financial investments. The decedent executed a Will, which included specific bequests of real estate, securities and personal items, and divided the residue of her estate equally among her children.

Several years later, the decedent's health began to decline and she was ultimately diagnosed with Alzheimer's. The decedent's children were appointed co-guardians. The children then read the decedent's Will and discovered that it would not actually divide her estate equally among them, primarily because of uneven appreciation in the decedent's assets since she executed the Will. Therefore, the children entered into a settlement agreement, agreeing to honor any specific bequests to individuals other than themselves and to divide the balance of the decedent's estate equally.

Thereafter, the children consulted an attorney, who advised them that if a child predeceased the decedent, and the child's heirs (the decedent's grandchildren) refused to sign disclaimers, the settlement agreement might not ensure an equal division of the decedent's residuary estate. Thus, the attorney proposed that the decedent create family limited partnerships, one to own the quarries and three others to own the non-quarry properties. The decedent would gift limited partnership interests in the non-quarry partnerships to her children, and would retain the entire 99% limited partnership interest in the quarry partnership. The decedent also would retain about $1.1 million of liquid assets in her guardianship account. The partnerships would be managed by a corporate general partner, to be owned entirely by the decedent. The children would be the directors and officers. The partnerships would pay the corporate general partner a management fee equal to approximately 1% of the values of the partnership assets.

The children liked the proposal and applied to a Georgia court to approve the plan. In the Georgia court petition, the children stated that the plan would save close to $3 million of estate taxes. They also stated in the petition that the management fees paid to the corporate general partner would be used to pay the operating expenses of the partnerships and to provide adequate income to the decedent to cover her living expenses. The court approved the plan and the children proceeded.

The children all provided regular services to the partnerships. The son did maintenance on the properties, one of the daughters prepared financial reports and communicated with the accountant for the companies, and the other daughter did administrative work and communicated with the attorneys for the companies. The children also held regular board meetings, at which they discussed needed repairs to the properties and approved budgets.

The decedent died less than two years after she funded the partnerships and gifted interests in the partnerships to her children. At the decedent's death, she owned 100% of the corporate general partner, the 99% limited partnership interest in the quarry partnership and a 33-35% limited partnership interest in two of the other three partnerships. The children, as executors, reported those interests on the decedent's estate tax return. The IRS assessed a deficiency of $2.2 million, asserting that the value of the assets contributed to the partnership were includible in the decedent's estate.

The Tax Court found that decedent's transfers of assets to the partnerships qualified for the bona fide sale exception, because the decedent had legitimate and significant nontax reasons for creating the partnerships, and she received partnership interests in proportion to the value of the assets transferred. The primary concern of the family was to ensure the equal distribution of the decedent's assets among the children, thereby avoiding litigation. In addition, the partnerships protected the family from legitimate liability concerns with respect to the real properties, as well as concerns regarding the effective management of the assets. The court noted that the Georgia court petition referenced estate tax savings, but found that there was no evidence that tax savings actually motivated the transaction.

The gifts of the partnership interests, on the other hand, did not qualify for the bona fide sale exception, and the IRS argued that the interests in the partnerships were includible in the decedent's estate because there was an agreement for her to retain income from the partnerships. The IRS pointed to the language of the Georgia court petition, which stated that the management fees were to be used to pay for the decedent's living expenses, in addition to the costs of operating the partnerships.

The court rejected the argument. First, it noted that the decedent and her children respected the partnerships as separate legal entities, observing their formalities, and sufficient assets were retained outside of the partnerships for the decedent's personal needs. Second, the decedent's personal expenses were never actually paid from the management fees. The language in the Georgia court petition suggesting that the fees would cover the decedent's expenses was not a legally binding directive. Moreover, for the general partner to permit the fees to be used in that manner would have violated the fiduciary duties imposed on the general partner. Thus, the court held in favor of the estate.

Estate of Turner v. Commissioner, 138 T.C. 14 (March 29, 2012)

This Tax Court case, referred to as "*Turner II*," is a follow-up to "*Turner I*," a 2011 Tax Court case, *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209, which held that property underlying certain family limited partnership interests that were gifted by a decedent to family members during his lifetime were includible in the decedent's estate. In *Turner I*, the Tax Court found that there was no legitimate nontax purpose of the partnership, which consisted entirely of cash and marketable securities.

In *Turner II*, the estate argued that, under the decedent's Will, his surviving spouse's right to a pecuniary marital bequest (coupled with the residual bypass trust) effectively reduced the estate tax to zero. The IRS contended that, even though the partnership interests were included in the decedent's estate, neither the partnership interests nor the underlying property actually passed to the surviving spouse and, therefore, it could not qualify for the marital deduction.

The court noted that the Treasury Regulations for Section 2056 provide that a "property interest is considered as passing to the surviving spouse only if it passes to the spouse as beneficial owner." Here, neither the partnership interest nor the underlying property passed or could pass to the surviving spouse as beneficial owner.

The court also noted that, if a decedent's estate claims a marital deduction, the marital deduction presupposes that the surviving spouse will include the value of the assets in his or her gross estate (provided that the surviving spouse does not consume the assets during his or her lifetime). Here, no Internal Revenue Code provision would require the surviving spouse's estate to include the partnership interests or the underlying property. Therefore, the court reasoned that allowing a marital deduction would allow the assets to leave the marital unit without being taxed. Accordingly, the court found that the estate was not entitled to a marital deduction.

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.

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