PROSKAUER ROSE LLP

# Wealth Management Update

A monthly report for wealth management professionals.

March 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.

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

The March applicable federal rate (AFR) for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.4%. 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 1.94%. These are increases from February's historic lows. Remember that 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. It makes sense to fund a grantor type CLAT by the end of April of 2009 to take advantage of the historically low February AFR. (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 March with depressed assets you expect to perform better in the coming years.

Clients should also continue to consider "refinancing" existing intra-family loans. The AFRs (based on annual compounding) used in connection with intra-family loans are .72% for loans less than 3 years, 1.94% for loans less than 9 years and 3.52% 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 1.94%. These same rates are used in connection with sales to defective grantor trusts.

### Dramatic Changes Made to New York's Power of Attorney Legislation And Form

On January 27, 2009, Governor Patterson signed new power of attorney legislation as Chapter 644 of the New York General Obligations Law. The new law makes dramatic changes, including a new statutory short form power of attorney. The new form includes new optional provisions such as the designation of a monitor and compensation of the agent. Another major change is that if a principal wants to authorize gifts, a new "Statutory Major Gifts Rider" must be completed, signed and witnessed. As enacted, the new law is effective March 1, 2009, however, the effective date has been extended until September 1, 2009. Powers of attorney executed before September 1, 2009 will continue to be valid under the new law.

### IRS Urged to Issue Pre-April 15 Guidance for Madoff Victims

Pressure is building for the IRS to issue tax guidance to victims of the Madoff Ponzi scheme. During a recent Senate Banking Committee hearing on the scandal, committee members discussed ways to help victims of the Ponzi scheme who paid income taxes on "phantom income interest" generated by the funds supposedly invested by Madoff and his firm. A proposal was made to establish a special unit specifically tasked with providing guidance on how to aid Madoff victims.

Additionally, former New York State Governor George Pataki requested the IRS to issue pre-April 15 guidance for Madoff victims about the ability of individuals who invested in the Madoff fund to claim fraud losses on their 2008 income tax returns.

### Estate Victorious to the Extent of Over 85% of Claimed Discounts - *Litchfield v.Comm'r*, T.C. Memo 2009-21 (Jan. 29, 2009)

The Tax Court determined for estate tax purposes the percentage discounts that should be used for built-in capital gains taxes, lack of control and lack of marketability relating to the estate's minority interest in two closely held family corporations. One corporation was formed in 1921 to invest in and manage farmland and other assets of the decedent's family in Iowa and was converted from a C Corporation to an S Corporation in 2000. The other corporation was formed as a C Corporation in 1924 to invest in marketable securities. Family members contributed securities they owned to the investment corporation in return for shares of stock in the corporation.

The Tax Court determined discounts that were over 85% of the discounts sought by the estate. The Judge noted that the estate's appraiser diligently considered documentation and input from the officers and directors of the corporation and considered plans for future sales whereas the IRS's appraiser used only historical data to calculate built-in gain tax liabilities and did not discuss future asset sale plans with corporate management.

Considering the overall evidence and that the burden of proof had shifted to the IRS, the Tax Court found that a hypothetical buyer-seller would incorporate significant discounts for substantial built-in gains taxes and accepted the estate's expert's estimates (a 17.4% discount with respect to the S Corporation and a 23.6% discount with respect to the investment corporation) as such estimates were based on more accurate data than the lowball estimates of the IRS's expert.

The Tax Court also accepted the estate's expert's estimates of 14.8% and 11.9% lack of control discounts which reflected realities of the companies' respective asset holdings and sizes of the estate's stock interests in each company. The Tax Court rejected the estate's expert's estimated 36% and 29.7% marketability discounts as too high, noting that they were based in part on old data relating to restricted stock discounts and exceeded marketability discounts contained in benchmark studies. The Tax Court re-determined those discounts to be 25% and 20%, respectively.

### Sixth Circuit Permits Use of IRS's Annuity Tables to Determine Estate Tax Value of Lottery Payments - *Negron v. U.S.*, 103 AFTR 2d 2009-408, Ct. App., 6th Cir. (Jan. 28, 2009)

Reversing a district court decision and balancing the circuit split on the issue, the Sixth Circuit held that the IRS properly used its annuity tables to value the decedents' remaining lottery payments for estate tax purposes. The Court found that using the IRS tables did not result in an unrealistic or unreasonable valuation, and departure from the tables was not justified or required.

In 1991, three individuals jointly won a lottery in Ohio. Two of the winners died in 2001 (one in October and the other in November) at which time fifteen payments were due to each of them. Each of the estates elected to receive a lump sum distribution of approximately $2.3 million from the Ohio Lottery Commission and each estate reported that value on the decedent's estate tax return. The Ohio Lottery Commission used a 9.0% discount rate in calculating the lump sum.

Subsequently, the IRS audited the estate tax returns and determined a higher value of the fifteen remaining payments based on the IRC Section 7520 rates in effect at each of the decedent's deaths (roughly $2.8 million for one estate and $2.7 million for the other). The estates paid the additional tax and filed refund claims which were denied. The interest factor for valuing annuities under IRS Section 7520 was 5.6% for October 2001 and 5% for November 2001 which produced a substantially higher value than the lump sum received by each estate, which was computed using the higher rate of 9%.

The Court pointed out that although it didn't seem fair for an estate to be taxed on a lottery annuity amount that it did not receive, the difference in the amount received and the value for federal estate tax purposes occurred because of the interaction between the state and federal discount rates. While Ohio used a discount rate in effect on the date the lottery was won, the IRS used a discount rate in effect on the date of death. The two discount rates yielded different results because they served different purposes: Ohio's method approximated the value of the unpaid annuity as if it had been a lump sum from the beginning, while the IRS's method valued the annuity as an ongoing annuity or a continuing stream of periodic payments. The lump sum calculation was an alternate method of valuing lottery winnings and did not make IRS's method unreasonable. The Court noted that it was the estates' choice to take the lump sum payments rather than to continue the annuities. Had the estates chosen to continue the annuities, the Ohio discount rate would not have been part of the calculation.

### Trustee who failed to Make the Section 663(b) 65 Day Rule Election Granted an Extension of Time Under § 301.9100-3 - PLR 200904020 (Sept. 29, 2008)

The IRS granted an extension of time under IRC Section 9100 to allow a Trust to file an election under IRC Section 663(b). The Trust filed its federal income tax return on a calendar year basis. The Trustee made a distribution within the first 65 days of year two. The Trust included the distribution on its return for year one as permitted under IRC

Section 663(b), but failed to make an election under that Section. The IRS granted the Trust an extension of sixty days from the date of the ruling to make the election.

### Use of Alternate Valuation for the New York State Estate Tax Return When a Federal Estate Tax Return is Not Required to be Filed - NYT-G-09(1)M (Jan. 14, 2009)

On January 14, 2009, the Office of Counsel of the New York State Department of Taxation and Finance issued an informational statement which provides that an executor may elect to use alternate valuation as provided in IRC Section 2032 for purposes of calculating the New York gross estate when the decedent's date of death is after 2003 and no federal estate tax return is required to be filed.

### Guidance Relaxes Investment Restriction Under Qualified Tuition Accounts for 2009 - IRS Notice 2009-1, 2009-2 IRB 250 (Dec. 23, 2008)

In response to comments raised regarding market uncertainty and value preservation during the review process for proposed IRC Section 529 regulations, the IRS issued this new notice which states that a 529 plan may permit a change in the investment strategy twice in the 2009 calendar year and on a change in the designated beneficiary of the account. The IRS also stated that the Treasury and the IRS intend to include this special rule in the final regulations under IRC Section 529. (The originally proposed regulations provided that investment strategies can be selected only at the time of the initial contribution establishing the account.)

### Man Entitled to Inherit Estate of His Same-Sex Partner - *Estate of H. Kenneth Ranftle*, 4585-2008 (Surr. Ct. New York County, Jan. 26, 2009)

In this New York County probate proceeding, the Surrogate's Court held that the decedent's same-sex partner is his surviving spouse and sole distributee. The decedent married his same-sex partner in Canada on June 7, 2008. The decedent died on November 1, 2008, survived by his partner and by three siblings. His parents predeceased him, as did another sibling who left no children. The opinion states that marriages which are valid where solemnized have long been recognized in New York. Exceptions exist only for marriages affirmatively prohibited by New York law or proscribed by "natural law." Surrogate Glen determined that the decedent's marriage is entitled to recognition in New York because it is valid under the laws of Canada and does not fall under either of the exceptions. The opinion cites *Martinez v. County of Monroe* (4th Dept. 2008) which recognized Canadian same-sex marriages for purposes of entitlement to spousal health care benefits. This decision comes approximately four months after the Queens County Surrogate took a more cautious approach in a probate proceeding holding that the validity of gay marriage had not been "definitely determined".

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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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