Proskauer

newsletter

Wealth Management Update

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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 1.2%, which is a slight decrease from April's rate of 1.4%. 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 a 9-year duration (the mid-term rate, compounded annually) is 1.00%, which is down slightly from the April rate of 1.09%, and still relatively low. 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 financial and real estate markets which remain undervalued presents a potentially rewarding opportunity to fund GRATs in May with depressed assets you expect to perform better in the relatively near future.

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 0.20% for loans with a term of 3 years or less, 1.00% for loans with a term of 9 years or less and 2.60% 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 1.00%, the child will be able to keep any returns over 1.00%. These same rates are used in connection with sales to defective grantor trusts.

Favorable "DING Trust" Rulings – PLRs 201310002 – 201310006

In five related rulings, the IRS issued favorable holdings addressing the income and gift tax consequences of so-called "DING trusts." The acronym stands for "Delaware Incomplete Non-Grantor" trusts, but the trust does not need to be established in Delaware. In fact, the trusts at issue in the rulings are believed to be Nevada trusts.

DING trusts primarily are used to avoid state income tax by having the trust created in a jurisdiction that will not tax the accumulated earnings of a nongrantor trust. At the same time, the Grantor's initial contribution of property to the trust is not deemed to be a completed gift subject to federal gift tax.

The Grantor had created an irrevocable trust for the benefit of himself and his issue. A corporate trustee was the sole trustee, but that corporate trustee was required to make distributions at the direction of the Grantor and/or a distribution committee composed of the Grantor and each of his four sons. The trust provided that income and principal could be distributed under three alternative methods:

> *Grantor's Consent Power* – The trustee must distribute income or principal to the Grantor or the Grantor's issue upon direction of a majority of the distribution committee members and the written consent of the Grantor.

> *Unanimous Member Power* – The trustee must distribute income or principal to the Grantor or the Grantor's issue upon direction by all distribution committee members other than the Grantor.

> *Grantor's Sole Power* – The Grantor may distribute principal (but not income) to the Grantor's issue as the Grantor deems advisable to provide for their health, education, maintenance and support.

Under the terms of the trust, the Grantor has a testamentary limited power of appointment. If that power of appointment is not exercised, the assets pass to the Grantor's issue.

The IRS gave five important rulings based on these facts:

> None of the circumstances existed that would cause the Grantor to be treated as the owner of any portion of the trust under the grantor trust rules.

> The Grantor did not make a completed gift subject to federal gift tax upon the initial contribution of property to the trust.

> The distribution committee members did not make a completed gift subject to federal gift tax upon making a distribution to the Grantor because any distribution from the trust to the Grantor was merely a return of the Grantor's property.

> The distribution committee members likewise did not make a completed gift subject to federal gift tax upon making a distribution to beneficiaries other than the Grantor.

> Upon the Grantor's death, the fair market value of the property in the trust would be includible in the Grantor's gross estate for federal estate tax purposes.

Like-kind Exchange of Life Insurance Policies – PLR 201304003

The IRS privately ruled that the exchange by an irrevocable trust of a second-to-die life insurance policy for a new first-to-die policy would qualify as a like-kind exchange under Internal Revenue Code Section 1035 with no recognition of gain or loss.

A husband and wife established an irrevocable trust that purchased a second-to-die life insurance policy insuring the lives of both of them. Sometime thereafter, the husband died, leaving the wife as the sole insured on the second-to-die policy. At a later date, the second-to-die policy was transferred to a new irrevocable trust created by the wife. The trustee of the new trust subsequently exchanged the second-to-die policy for a new life insurance contract covering only the wife's life.

The IRS ruled that the exchange qualified for like-kind exchange treatment under Internal Revenue Code Section 1035 because the exchange did not involve a change of insured, which would have otherwise disqualified the transaction from nonrecognition treatment. The IRS reasoned that at the time of the exchange the wife remained the sole insured on the second-to-die policy following the death of her husband, and the wife was also the sole insured on the new first-to-die policy. Because both policies related to the same insured, the IRS held that the new trust did not have to recognize any gain or loss on the exchange of the policies. The key takeaway from this ruling is that the eligibility of an exchange for like-kind treatment under Internal Revenue Code Section 1035 is determined on the basis of facts that are available at the time of the exchange.

Late GST Exemption Allocation – PLR 201313003

The IRS exercised its discretion to allow a taxpayer to make a late allocation of GST exemption. Over a six-year period, the taxpayer made transfers to two irrevocable trusts he created for the benefit of his issue. The transfers occurred sometime prior to the enactment of the automatic allocation rules. The taxpayer engaged a law firm to prepare the gift tax returns reporting these transfers. Although the law firm timely filed the gift tax returns, it failed to allocate any GST exemption to the transfers. A second law firm later discovered this omission.

Currently, there are no Treasury Regulations in effect prescribing the circumstances and procedures under which extensions of time will be granted to make an allocation of GST exemption. In the absence of Treasury Regulations, Notice 2001-50 provides that taxpayers seeking an extension must do so under Treasury Regulations Section 301.9100-3, which requires that the taxpayer establish that he or she acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. Under the 9100 criteria, the IRS determined that the taxpayer reasonably relied on a qualified tax professional, and the interests of the government would not be prejudiced.

The IRS and the Treasury issued Proposed Treasury Regulations Section 26.2642-7 about four years ago to subject late GST exemption allocation elections to a more stringent set of criteria, which, among other things, would require affidavits from the taxpayer, the return preparer and any advisors to the underlying transaction describing the events that led to the failure to allocate GST exemption and the events that led to the discovery of the failure. Although the Proposed Treasury Regulations were never finalized, the project has resurfaced in the IRS's recent 2012-2013 Priority Guidance Plans. If these Proposed Treasury Regulations are finalized, they will replace the 9100 relief provisions for late allocations of GST exemption.

Villareale v. Commissioner, T.C. Memo 2013-74

The Tax Court determined the taxpayer was not entitled to a charitable contribution deduction for contributions she made to a public charity she created, where she failed to have the charity issue written acknowledgements of the contributions.

The taxpayer co-founded the charity, was responsible for its finances and had access to its checking accounts. During one year, she made several contributions of more than $250 each. The contributions were made by electronic transfer from her personal bank account to the charity's account. The transfers were reflected in both the taxpayer's and the charity's bank statements, but the charity did not provide any written acknowledgment of the contributions to the taxpayer.

The Tax Court denied the charitable contribution deduction for these contributions because the charity failed to provide the taxpayer with a contemporaneous written acknowledgment required by Internal Revenue Code Section 170(f)(8)(A). The written acknowledgment must not only describe the property contributed but also state whether any goods or services were provided in consideration for the donation. The taxpayer argued that it would be meaningless to write herself an acknowledgement and that the bank statements should suffice to substantiate her contributions. The Tax Court disagreed, finding that the statements do not qualify under Internal Revenue Code Section 170(f)(8)(A) because they do not state whether the taxpayer received any goods or services in exchange for her contributions.

This case highlights that taxpayers need to conform fully to the written acknowledgement requirements in order to benefit from the charitable contribution deduction. This is especially important for clients who have private foundations they created or administer who may not already be aware of these requirements.

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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