Proskauer

newsletter

Wealth Management Update

December 2012

in this issue

A monthly report for wealth management professionals.

Edited by **Henry J. Leibowitz**
Contributor: **Bradley A. Dillon**

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.

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

The December § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 1.2%, which is a slight increase from last month’s rate of 1.0%. 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 0.95%, which is up slightly from last month’s 0.89% but still very 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 a financial and real estate market that remains undervalued presents a potentially rewarding opportunity to fund GRATs in December with depressed assets that 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 0.24% for loans with a term of 3 years or less, 0.95% for loans with a term of 9 years or less and 2.4% for loans with a term of longer than 9 years. Thus, for example, if a 9-year loan is made to a child who invests the funds and obtains a return in excess of 0.95%, the child will be able to keep any returns in excess of that interest rate.

December, possibly the final month with an estate and generation-skipping transfer tax exemption of $5,120,000, continues to be ripe for sophisticated planning techniques.

Estate of Thouron v. United States, E.D. Pa., No. 2:11-cs-04058 (11/08/2012)

The U.S. District Court for the District of Pennsylvania held that relying on the advice of a tax attorney was not reasonable cause for the late payment of estate taxes.

The decedent's estate sought a refund for a penalty imposed and collected by the IRS for late payment of an estate tax. The decedent died at the age of 99. The decedent appointed a friend as personal representative of the estate, who, upon the decedent's death, hired an attorney to provide legal services regarding tax compliance of the estate. The estate was required to file a Form 706 nine months after the decedent's death. The personal representative, relying on his attorney's advice, filed an Application for Extension of Time to file a Return and/or Pay U.S. Estate Taxes (Form 4768). Unfortunately, the estate requested only an extension of the time to file the return and failed to file a request for an extension of time to pay the estate tax.

The personal representative claimed that his attorney advised him that the form for an extension of time to pay the tax was not due until he actually filed the tax return. The attorney told him that since the bulk of the estate consisted of illiquid assets, the tax due would be deferred under section 6166. His attorney also said that even if they did not qualify under section 6166, there would be no penalty imposed. Six months after the initial nine-month deadline, the estate filed Form 706, and, on the same day and for the first time, submitted a Form 4768 for an extension of time to pay the estate tax. The IRS denied the estate's request for additional time to pay the tax as untimely and hit the estate with a late-payment penalty for failure to timely pay the tax in an amount of $999,000.

The District Court cited the Supreme Court ruling in *United States v. Boyle*, which held that a taxpayer's reliance on an agent does not constitute reasonable cause for a late filing of a return. The court continued to cite *Boyle* for the proposition that "it requires no special training or effort to ascertain a deadline and make sure that it is met," before noting that "[o]ne does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due."

This case represents the second court to strictly apply the ruling from *Boyle*.

Towbin v. Towbin, 36 Misc. 3d 1236(A) (N.Y. Sup., August 22, 2012)

A New York court ruled that a transfer to a grantor retained interest trust ("GRIT") was not a completed gift, since title on the underlying property was never formally transferred. Robert Towbin held all the shares of stock in a cooperative apartment and had executed a lease that entitled him to occupy the apartment as his personal residence. He then created a GRIT for the purposes of transferring ownership of the apartment to his daughter, naming himself and his daughter as trustees. Under the terms of the GRIT, Robert was entitled to exclusive use and occupancy of the apartment for a fixed term of 15 years. At the expiration of the term, he and his spouse would be required to either vacate the apartment or rent it from the trustee of the GRIT at fair market value.

In furtherance of the transfer, Robert and his daughter executed a stock power, assignment of the lease, and acceptance and assumption of the lease. Robert's attorney advised his daughter that title to the stock and Robert's interest in the lease had been transferred to the trust. Robert then filed state and federal gift tax returns and paid the taxes associated with the transfer.

Under the terms of the lease, Robert was required to notify the co-op of the transfer and seek approval of the assignment of the lease. The lease required that (1) the assignment must be delivered to the co-op board, (2) the assignee must agree to be bound by the terms of the lease and must enter into a new lease with the co-op and (3) the board of directors of the co-op must consent to the assignment. Robert did not follow any of these procedures.

Fifteen years later, Robert ceased to act as trustee and his son succeeded his daughter as trustee. His son claimed he was the rightful owner of the apartment and instituted an action to evict his father and also sought $12 million in damages.

The court noted that in order to make a valid inter vivos gift under NY law, there must be intent to make the transfer, delivery of the gift, and acceptance by the donee. The court noted that execution of the GRIT evidenced the requisite intent to make the gift and acceptance is presumed where, as in the present case, the gift is of value to the donee. Delivery became the disputed matter.

Robert defended the action by claiming that the original transfer was not a completed gift since he had not requested a transfer of records on the books of the co-op (even though he had treated it as a gift on his federal gift tax return fifteen years prior).

The court stated that with a gift of stock, delivery "must proceed to the point of no return, where the donor no longer retains an interest in the stock." The only way this point of no return is reached in the case of stock is a transfer of record on the stock books of the company. The court ruled in Robert's favor, stating that, since he had not complied with the terms of the lease and delivered the assignment to the co-op, the gift was incomplete for lack of delivery. The court left the federal tax compliance issues to the IRS.

Rev. Proc. 2012-14 (10/18/2012)

The IRS released the inflation adjustments affecting various sections of the Internal Revenue Code for 2013. The gift tax annual exclusion amount will increase to $14,000 starting January 1, 2013, up from $13,000 this year. This means that the maximum amounts withdrawable pursuant to a Crummey power in an insurance trust or other trust increases to $14,000. In addition, the first $143,000 of gifts to a spouse who is not a citizen of the United States are not included in the total amount of taxable gifts under sections 2503 and 2523 of the Code. This is up from $139,000 in 2012.

Estate of Bates v. Commissioner, T.C. Memo. 2012-314, November 7, 2012

The Tax Court ruled that the cost of settlement could not be deducted as an administrative expense on an estate tax return, because the claim was for a beneficiary's distributive share and not for a creditor's claim against the estate.

In 1998, the decedent, a resident of California, executed a will which provided that her granddaughter would serve as executor. It also provided that estate assets would be used to pay expenses and any remaining assets would fund a family trust. The family trust provided, among other things, that the decedent's granddaughter would serve as trustee and that the trust property would be distributed evenly among decedent's three grandchildren. It also provided for a bequest to the decedent's caretaker.

In 2005, after being diagnosed with Alzheimer's, the decedent executed a new will and amended and restated her trust. The new will and trust provided that her caretaker would serve as executor and trustee, that her grandson would receive all of her personal property, and that the trust's interest income would be distributed evenly between the caretaker and her one grandson.

At the decedent's death, the granddaughter submitted the first will and the caretaker submitted the second for probate. There was some dispute over whether the caretaker was a care custodian under the CA Probate Code and whether this invalidated the second will and trust. Ultimately, the parties settled all disputes. The second will and trust was invalidated and the caretaker received $757,000.

The estate then deducted, as administration expenses, the funds paid to the caretaker in the settlement. The IRS disallowed the deduction.

The Tax Court cited section 2053 in siding with the IRS. Section 2053 states that a claim against an estate is deductible if it is supported by adequate consideration and not attributable to the testator's intent. The IRS cited several cases where settlement payments to beneficiaries were not deductible. The estate tried to distinguish the cases on the basis that the settlements in those cases were all made to family members, whereas the decedent's caretaker was not a family member. The Tax Court rejected this argument and stated that the reasoning is equally applicable to cases involving nonfamily members. Since he was a beneficiary of the first will and trust, the caretaker's claim represented a beneficiary's claim to a distributive share of the estate, rather than a creditor's claim against the estate. The Tax Court held that the settlement was merely a resolution to the amount a particular beneficiary received.

Rush University Medical Center v. Sessions, 2012 IL 112906 (09/20/2012)

In *Rush*, an estate tried to enforce a self-settled spendthrift trust without a state statute protecting it. Roger Sessions settled a trust in the Cook Islands in 1994. The trust was to be governed by the law of the Cook Islands. He placed a 99% limited partnership interest in a Colorado limited partnership, as well as real property in Illinois into the trust. At his death, these assets totaled nearly $19 million. Sessions was both the settlor and the lifetime beneficiary of the trust. The trust was irrevocable and it authorized the trustees to make distributions to Sessions for his maintenance, support, education, comfort, well-being, pleasure, desire and happiness. The trust also named Sessions as the trust protector, giving him the absolute power to appoint or remove trustees and to veto any of their actions.

In 1995, Sessions made an irrevocable pledge to plaintiff of $1.5 million at his death for the construction of a new president's house on the university campus. In reliance on the pledge, plaintiff constructed the house. Sessions later was diagnosed with late-stage lung cancer. He blamed the plaintiff -- the hospital -- for not diagnosing the cancer sooner so that it could be treated. In an act of retaliation, he executed a new will revoking his prior pledge to the hospital.

After his death, plaintiff sued Sessions' estate for the $1.5 million pledge, but the estate was found to contain less than $100,000. Thereafter, the plaintiff amended its complaint and sued to reach the assets of the irrevocable self-settled spendthrift trust that Sessions had created. The Illinois Appellate Court ruled that the assets of the trust could not be used to satisfy the plaintiff's claim, but the Illinois Supreme Court reversed, ruling that the law in Illinois for over 140 years has been that if a settlor creates a trust for the settlor's own benefit and inserts a spendthrift clause, the clause is void as to the then-existing and future creditors, and creditors can reach the settlor's interest under the trust.

The estate tried to argue that the Fraudulent Transfers Act abrogated the common-law rule, because the common-law rule provides greater protection than the statute. It also argued that the statute applied to transfers made with the intent to defraud creditors, and that the transfer in Sessions' case was made years before he rescinded his pledge. The Illinois Supreme Court disagreed and held that the statute and the common law supplement one another. Both the common law rule and the state are for the general purpose of protecting creditors, but the common law rule focuses on the additional matter of an interest *retained* by the settlor of a specific kind of trust, and not simply the fraudulent transfer of an asset, as does the statute.

As a result, Illinois will not join the growing list of domestic asset protection states, such as Nevada and Delaware, unless the Illinois state legislature acts.

***Windsor v. United States*, 2d Cir. No. 12-2335-cv(L) (10/18/2012)**

The U.S. Court of Appeals for the Second Circuit held that Section 3 of the Defense of Marriage Act ("DOMA") is unconstitutional because it violates equal protection.

In June, the US District Court for the Southern District of NY granted summary judgment to Edith Windsor, and held that the $363,053 Windsor was required to pay as executor of her wife's estate was improperly assessed because of the definition of marriage the IRS uses, as required under DOMA, which defines a "marriage" as a relationship between a man and a woman.

The court rejected the defendant's argument that under *Baker v. Nelson*, a Supreme Court case from 1971, Congress can prohibit same-sex marriage without violating the equal protection clause. The court ruled that *Baker* did not apply, because it was about whether *a state* could restrict same-sex marriage, so the holding did not apply to the issue of whether the federal government can define marriage constitutionally.

The court then determined that homosexuals compose a quasi suspect class that is subject to heightened scrutiny. The court rejected claims that DOMA protects "unique federal interests" such as maintaining a uniform definition of marriage, saving government resources by limited beneficiaries of government marital benefits, preserving a traditional understanding of marriage, and encouraging responsible procreation. The court rejected some of these arguments by noting that the decision of whether same sex couples can marry is left to the states, so DOMA – a federal law – is ineffective for most of these purposes.

Windsor is currently in front of the Supreme Court for certiorari.

Internal Revenue Bulletin 2012-46 (11/13/2012)

The IRS said that it does not acquiesce in the Tax Court's March ruling in *Wandry v. Commissioner*, despite the recent withdrawal of the government's appeal. *Wandry* involved the first defined value formula gift clause to be upheld by a court without a charitable adjustment clause to provide that, if the IRS disputed the value of the assets transferred, any excess would go to charity. The IRS had appealed the Tax Court's ruling to the Tenth Circuit but withdrew the appeal on October 16th.

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

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

Beijing | Boca Raton | Boston | Chicago | Hong Kong | London | Los Angeles | New Orleans | New York | Newark | Paris
São Paulo | Washington, DC

www.proskauer.com