Proskauer

newsletter

Wealth Management Update

June 2013

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.

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

The June § 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% but remains the same as May's rate of 1.2%. 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 midterm rate, compounded annually) is 0.95%, which is down slightly from the April rate of 1.09% and May's rate of 1.00%. 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 June 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 0.18% for loans with a term of 3 years or less, 0.95% for loans with a term of 9 years or less, and 2.47% 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 0.95%, the child will be able to keep any returns over 0.95%. These same rates are used in connection with sales to defective grantor trusts.

Estate of Liftin v. U.S., 111 AFTR-2d 2013-1426 (Ct. Fed. Cl.)

The Court of Federal Claims held that an estate was not entitled to a refund of a late-filing penalty because the estate lacked reasonable cause for waiting to file the estate tax return. In this case, the decedent was survived by a spouse who was a United States resident and a citizen of Bolivia at the time of the decedent's death. The executor's attorney advised that the estate should wait to file the estate tax return until the surviving spouse became a United States citizen so that the estate would be entitled to a marital deduction for the bequests passing to the decedent's spouse. The surviving spouse also filed claims against the estate arising out of her rights under a prenuptial agreement. Based on the attorney's advice, the executor requested a six-month extension of the time to file the estate tax return and made an estimated tax payment which the executor believed to be sufficient to satisfy the taxes due even if the estate were unable to claim the marital deduction.

At the time the extension period ended and the estate tax return was due, the surviving spouse was in the process of applying for citizenship. The attorney again advised the executor to file the return late to claim the marital deduction, indicating that the late filing would not trigger a penalty as long as the return was filed within a reasonable time after the spouse became a citizen <u>and</u> the ancillary matters (i.e., the spouse's claims against the estate) were settled. Approximately fourteen months after the extended due date for the estate tax return, the spouse became a United States citizen, and nine months after that date the surviving spouse and the estate entered into an agreement settling the ancillary matters. The court determined that the attorney's advice to the estate constituted reasonable cause for the estate to delay its filing until after the surviving spouse became a United States citizen. Nonetheless, the court found that the attorney's advice did not constitute reasonable cause to delay filing until all of the ancillary matters were concluded because such advice was not an interpretation of substantive tax law. As a result, the estate's additional nine-month delay subjected it to the maximum late-filing penalty.

Knappe v. U.S., 111 AFTR-2d 2013-1531 (9th Cir.)

The executor relied on the advice of his accountant that the time period for both extending the time to file an estate tax return as well as the time to pay the tax was twelve months from the due date, disregarding the specific date on the extension form that the deadline for filing was six months. Generally, an executor who fails to file a timely estate tax return is subject to a late filing penalty unless it is shown that such failure is due to reasonable cause and not due to willful neglect. To establish reasonable cause a taxpayer must prove that he "exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time." The executor in this case argued that, by relying on his expert accountant's advice about the effect of the extension on the deadline for filing the return, he had exercised ordinary business care and prudence. The 9th Circuit Court of Appeals held that such reliance was misplaced and was not sufficient "reasonable cause" necessary to abate the late-filing penalties because it was nonsubstantive advice (i.e., not advice about substantive tax law).

Estate of Koons v. Commissioner, T.C. Memo 2013-94

The Tax Court adopted the IRS's valuation of a revocable trust's interest in a business with mostly liquid assets, finding that the taxpayer's valuation overstated the marketability discount appropriate for the large size of the interest and the business's liquidity. The Tax Court also held that the estate was not entitled to deduct the projected interest expense on a "*Graegin* loan," finding it was unnecessary to borrow the funds to pay estate tax.

In this case, prior to the decedent's death, he sold his soft drink company and created a limited liability company (an "LLC") with the proceeds. At the time of the decedent's death, his revocable trust owned a 46.94% voting interest in the LLC. Prior to his death, however, the LLC offered to redeem the interests in the LLC owned by the decedent's children. A few weeks after the decedent's death, the redemption was completed, leaving the decedent's revocable trust owning a 70.42% interest in the LLC. Several months later, the LLC loaned the decedent's revocable trust $10,750,000 under a term promissory note at a 9.5% annual interest rate with principal and interest due in fourteen equal installments starting in 2024. The terms of the loan prohibited prepayment and the proceeds were to be used by the revocable trust to make a payment towards the estate and gift tax liabilities of the estate (i.e., a *Graegin* loan). At the end of the loan, the total interest payments paid to the LLC would be $71,419,497. Furthermore, at the time of the loan, the revocable trust's primary asset was the LLC, which had over $200 million dollars of liquid assets and two operating companies.

On the estate tax return, the revocable trust's interest in the LLC was reported at a value of $117 million and the estate claimed a deduction for the $71,419,497 interest expense. The Tax Court determined that the estate could not deduct the projected interest expense on the LLC loan because it was an unnecessary expense. As the revocable trust had a 70.42% interest in the LLC, the court found that the trust could force a pro rata distribution to the members, which made it unnecessary for the trust to borrow from the LLC.

Regarding the fair market value of the LLC interest reported on the return, the court analyzed the marketability discounts proposed by each party – the estate expert determined a 31.7% discount should apply, whereas the IRS's expert contended that a 7.5% discount was appropriate. The Tax Court agreed with the 7.5% discount presented by the IRS's expert because (1) such expert took into account the redemption of the interests that had begun before the decedent's death and (2) the revocable trust could force a distribution of the LLC assets due to its 70.42% ownership.

U.S. v. Blake, E.D.N.Y, No. 12-CV-02577

The U.S. District Court for the Eastern District of New York abstained from jurisdiction in a claim by the government to collect estate taxes because the ultimate resolution depended on the application of state law in a quiet title action pending in state court. In July 1991, the IRS made a tax assessment against an estate for estate tax due plus penalties and interest. In August 1995, an installment agreement was executed by the estate because the estate had no liquid assets to provide for payment of the liability. Under the agreement, the estate agreed to pay the estate tax liability by making monthly payments. In June 2005, the executrix of the estate died and the estate defaulted on the installment payments. Accordingly, the IRS issued a notice requiring immediate payment of the outstanding balance due, demanding payment within 30 days of the date of the letter and indicating that the IRS had filed appropriate Notices of Federal Tax Liens to protect the government's interest.

The wrinkle here is that, although the two properties that were subject to the liens are owned presently by the estate in fee simple, the executrix, in her individual capacity, had already commenced an action against the government in the Supreme Court of the State of New York alleging that any claims to, or liens against, the properties that the government may make are invalid and of no force and effect because the government and the IRS were time-barred from asserting said claims or liens. The executrix, in her individual capacity, was seeking to quiet title to the premises, indicating that she was the lawful owner.

Accordingly, in light of: (1) the fact that the parties' dispute involved property over which the state court had assumed jurisdiction; (2) the duplicative nature of the two proceedings; (3) the likelihood of piecemeal litigation and the waste of federal judicial resources if both actions were to proceed; (4) the government's failure to remove the quiet title action to federal court; (5) the fact that the quiet title action was commenced more than two years prior to the assessment action and has been litigated actively; and (6) the need to apply state law to ultimately determine the outcome of the government's claim, the court exercised its discretion to abstain from jurisdiction and dismissed the action without prejudice.

Schwab v. Commissioner, 111 AFTR-2d 2013-667 (April 24, 2013)

The Court of Appeals for the 9th Circuit held that the "amount actually distributed" when taxpayers received ownership of life insurance policies was "the fair market value of what was actually distributed," and that surrender charges associated with a variable universal life insurance policy may be considered as part of the general inquiry into a policy's fair market value.

Two individuals (i.e., a married couple) were both employees and sole shareholders of a corporation. On the advice of their accountant, they purchased variable life insurance through the corporation and the policies were held by a third-party company as part of a nonqualified employee benefit plan. Both policies were subject to surrender charges (i.e., the fee incurred if the policies lapsed or were terminated prior to a contractually specified date). Due to poor performance of the employee benefit plan, the plan administrator terminated the plan and distributed the policies to the respective insured. On the distribution of the policies, there was a taxable event which required inclusion in the couple's gross income of the value of the policies. Believing that they were only required to pay taxes on the net cash surrender values of their policies (which were negative at the time of distribution), the couple did not report any taxable income. The IRS disagreed and issued a deficiency notice indicating that the full stated policy values must be treated as income.

The couple petitioned the Tax Court, arguing that they actually received nothing of value and, thus, should not pay taxes on the distribution. The IRS asserted that the surrender charges may never be considered in determining the value of the policies and that the couple actually received the full stated policy value of their respective policies. The Tax Court came down in the middle finding that the court could consider surrender charges but only as part of a more general inquiry into the policy's fair market value. In this case, the Tax Court considered the surrender charges in determining the value of the policies actually received and found that the only taxable value of the policies at the time of distribution was the unused premium (i.e., the coverage attributable to the single premium that the corporation had paid on each policy some three years earlier).

TAM 201317010 (April 26, 2013)

In this TAM, Trust A and Trust B owned interests in Company X. B was a Trustee of both Trust A and Trust B. A was a shareholder in Company X and a special trustee of Trust A and Trust B. Company X owned Company Y as a subsidiary and A was also the president of Company Y. Regarding Company X and Company Y stock owned by the Trusts, A, as the special trustee, controlled all decisions regarding the sale or retention of such stock and all voting of such stock. A indicated that he was unable to differentiate his time spent as president of Company Y, as special trustee of Trust A and Trust B, and as a shareholder of Company X. B, as Trustee of Trust A and Trust B, was not involved in the operations of the activities of either Company X or Company Y.

The TAM indicates that based on the above facts, the Trusts did not materially participate in the activities of Company X or Company Y for purposes of § 469(h). Under § 469(h)(1), material participation is defined as an activity which the taxpayer participates in on a regular, continuous and substantial basis. There are no Treasury regulations indicating how this applies to estates and trusts but the legislative history for § 469 indicates that "an estate or trust is treated as materially participating in an activity . . . if an executor or fiduciary, in his capacity as such, is so participating." Accordingly, A's time spent as special trustee voting the stock of Company X and Company Y or considering the sales of such stock would count for purposes of determining the Trusts' material participation, but such time did not rise to the level of being "regular, continuous and substantial." Therefore, the TAM concludes that Trust A and Trust B did not materially participate in the activities of Company X or Company Y.

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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