Proskauer

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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.

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

The January § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.2%, which is a 0.2% increase from last month. The December 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 having a duration of 3-9 years (the mid-term rate, compounded annually) is 1.75%, which is a 0.10% increase from the December rate.

The relatively low § 7520 rate and AFR continue to present potentially rewarding opportunities to fund GRATs in January with depressed assets that are expected 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 0.25% for loans with a term of 3 years or less, 1.75% for loans with a term between 3 and 9 years, and 3.49% 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 1.75%, the child will be able to keep any returns over 1.75%. These same rates are used in connection with sales to defective grantor trusts.

Tax Court Refused To Admit Appraisal into Evidence when Taxpayer Failed To Qualify the Appraiser as an Expert Witness

In *Tanenblatt v. Commissioner*, the Tax Court made clear that it would not allow a taxpayer to circumvent the Federal Rules of Evidence or the Court's own rules of procedure by compelling the IRS to "stipulate" that an appraisal attached to a petition was submitted into evidence.

Diane Tanenblatt died in February 2007 owning a minority interest in a limited liability company, whose principal asset was real estate in midtown Manhattan. The decedent's executors filed an estate tax return that reported the fair market value of the minority interest as $1.788 million, based on an appraisal that applied consecutive discounts of 20% for lack of control and 35% for lack of marketability, resulting in a combined discount of 48%.

On audit, the IRS applied consecutive discounts of 10% and 20% for lack of control and lack of marketability, resulting in a combined discount of 28% and claimed that the fair market value of the interest was $2,475,882, increasing the taxable estate by $687,882 and resulting in an estate tax deficiency of $309,547.

The decedent's executor filed a petition in Tax Court and attached a new appraisal, which valued the minority interest at $1,037,796. Based on the new appraisal, the executor claimed a deficiency of zero and an overpayment of estate tax entitling the estate to the refund.

At trial, the IRS called its own expert witness. The IRS's expert accepted the net asset value of the LLC provided in the taxpayer's original appraisal. However, he applied consecutive discounts of 10% for lack of control and 26% for lack of marketability (33.4% combined) and concluded that the fair market value of the interest was $2,303,000.

The Tax Court's opinion focused on the procedural defects in the Petitioner's attempts to enter the appraisal into evidence. Before trial, the Petitioner moved to compel the Service to "stipulate" that the new appraisal was submitted into evidence. This was an attempt to avoid the regular procedure by which the taxpayer must serve a copy of the written appraisal report on the IRS at least 30 days before trial, call the appraiser to testify as an expert witness, and have the witness identify the report before it can be received into evidence. Failure to follow the procedure resulted in the appraisal being deemed an unadmitted allegation in a complaint, which cannot be relied upon as evidence.

The Petitioner filed no response to the Service's motion to exclude the appraisal. When asked whether the Petitioner was relying on his own motions with respect to stipulating the appraisal into evidence, counsel candidly responded: "Probably, Your Honor, because right now my client's in a fee dispute with the appraiser, so right now I cannot get the appraiser to come in and testify."

Besides failing to properly admit the new appraisal into evidence, the executor never sought to enter into evidence the original appraisal filed with the estate tax return.

Despite being unable to rely upon the estate's appraisal report as evidence, the Court addressed Petitioner's argument that the estate's interest was an "assignee interest" rather than a member interest. The Court found that the value of an asset received by an estate must be based on what the decedent owned at death, not the nature of the interest transferred to the estate. The Court accepted the IRS expert's classification of the interest as a membership interest.

As a result of the Petitioner's failure to provide expert testimony which could serve as a basis for finding that greater discounts were in order, the Court accepted the discounts applied by the IRS expert witness and the resulting value of $2,303,000.

Although the issue was not raised at trial, at least one commentator has noted that the IRS may have valid objections to any claim by Tanenblatt's estate that expenses associated with obtaining the second appraisal are properly deductible as litigation expenses under Section 2053. While in most instances such fees would be properly deductible, in this case no appraisal was admitted into evidence at trial.

Income Tax Is Payable on Proceeds from Surrender of a Life Insurance Policy Used To Repay a Loan against the Policy

In a recent income tax case, the Tax Court affirmed the principal that the proceeds received from surrender of an insurance policy in excess of the policyholder's investment in the policy are taxable as income. This is the case even if almost all of the proceeds were used to repay a loan against the policy.

The taxpayers in *Brach v. Commissioner* were the owners of an insurance policy that allowed the policyholder to borrow up to the entire cash value of the policy. When the taxpayers became unable to pay the premiums or make loan repayments, they had to cancel the policy. The termination resulted in a gross distribution of about $65,903, which, after repayment of the loan, was reduced to $3,786. Taxable income on the distribution, however, was over $33,125 (the difference between the cash value and the taxpayers' investment of $32,778 in the policy). The taxpayers' failure to report the income resulted in a deficiency of $6,949 and an accuracy-related penalty of $1,390.

The Court rejected the position taken by the taxpayers that the surrender of the policy gave rise to "cancellation of indebtedness income" which, in light of the fact that the taxpayers were insolvent, was not includible in gross income by virtue of Section 108(a)(1)(B)(7) of the Internal Revenue Code.

Instead, the Court cited Section 72, which provides that an amount received in connection with a life insurance contract which is not received as an annuity generally constitutes gross income to the extent that the amount received exceeds the investment in the insurance contract. In this case, surrendering the policy entailed repayment of the loan. In contrast to repayment, "discharge of indebtedness" occurs when "the debtor is no longer legally required to satisfy his debt either in part or in full." Therefore, the taxpayers' debt obligation was satisfied rather than discharged.

Despite the clear rejection of the taxpayers' reporting, the Court found that imposition of a 20% penalty for underpayment was not appropriate. The taxpayers were relatively inexperienced in tax matters. They sought advice from a qualified professional, provided their adviser with all relevant information, and reasonably believed the adviser was competent to prepare their return. They had no reason to question the professional advice they received. Therefore, the underpayment fell within the exception under Section 6664(c)(1) which provides that an underpayment is not subject to penalty if the taxpayer establishes that there was reasonable cause for the underpayment and the taxpayer acted in good faith.

This case is illustrative of the Tax Court's willingness to consider all the facts, including a taxpayer's level of sophistication when deciding whether there was good faith reliance on expert advice. It is not clear that the Court would have held the same way had the taxpayers been better versed in tax matters or had they failed to disclose important information to their tax adviser.

New York Considers Raising Estate Tax Exemption, Reinstating Gift Tax, Eliminating GST Tax and Closing the Resident Trust Loophole

On November 14, 2013, the New York State Tax Reform and Fairness Commission presented its final report to the Governor containing various recommendation for reforms that would make New York's tax system "simpler and fairer and to help reduce the tax burden faced by New Yorkers and businesses." Among the various proposals was a wholesale reform of New York's estate tax system.

Current New York law allows for an estate tax exemption of $1 million, which is based on the federal estate tax law as it existed on July 22, 1998. The exemption amount is equal to the maximum state death tax credit at the time. New York has not had a gift tax since 2000, and New York's generation-skipping transfer tax is applicable only to taxable distributions and taxable terminations occurring at the same time as, and as a result of, the death of an individual.

The Commission's report recommends increasing the estate tax exemption amount to $3 million, which would result in almost three-quarters of estates being exempt from the tax. In addition, the proposal would simplify the tax by no longer linking it to the federal estate tax as of a particular date.

On December 10, 2013, the New York State Tax Relief Commission (separate body working in cooperation with the Tax Reform and Fairness Commission) recommended raising the estate exemption amount to $5.25 million, indexed for inflation, and lowering the tax rate to 10%. This would exempt nearly 90% of all estates from tax.

Both Commissions cited concerns that if reforms are not enacted, middle-class households will be subject to estate tax because of the increasing value of assets, such as real estate, and the current low threshold. In addition, a higher estate tax threshold would protect family farms and small businesses and reduce incentives for wealthy New Yorkers to move to other states in order to avoid paying estate tax.

In addition to recommending a higher estate tax exemption, the Tax Reform and Fairness Commission recommended two options for reinstating a state-level gift tax. The first and preferred option would subject gifts above a certain threshold to gift tax at rates consistent with the state estate tax. A second option would be to require estates to add back the value of gifts above a certain threshold in calculating estate tax. Either option would prevent taxpayers from reducing or avoiding estate tax by making lifetime gifts. Reinstating a gift tax is projected to generate approximately $150 million in annual revenues.

In an effort to curb the loss of income tax revenue resulting from Delaware Incomplete Gift Trusts, the Tax Reform and Fairness Commission also recommended "decoupling" from federal treatment of such trusts and treating them as grantor trusts for New York income tax purposes.

In contrast to these other proposals that would reinstate gift tax and impose additional fiduciary income tax on trusts, the Tax Reform and Fairness Commission recommended repealing the state-level generation-skipping transfer ("GST") tax. Less than 50 GST tax returns are filed per year in New York. The Commission's report notes that the tax generates less than $500,000 per year in revenue, and eliminating it would help to streamline New York State tax law.

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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