Proskauer

newsletter

September 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.

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

The September § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.0%, which is the same as the August rate and an increase from July'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 1.66%, which is up from the August rate of 1.63% and the July rate of 1.22%. 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 August 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 in September are 0.25% for loans with a term of 3 years or less, 1.66% for loans with a term of 9 years or less, and 3.28% 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 1.66%, the child will be able to keep any returns over 1.66%. These same rates are used in connection with sales to defective grantor trusts.

United States v. Windsor and Rev. Rul. 2013-17 and I.R.S. News Release IR-2013-72

On August 29, 2013, the Internal Revenue Service (the "Service") issued Revenue Ruling 2013-17 and I.R.S. News Release IR-2013-72 in response to the United States Supreme Court's (the "Supreme Court") decision in United States v. Windsor, 570 U.S. --- (2013), which determined that Sec. 3 of 1996's "Defense of Marriage Act" ("DOMA") was unconstitutional as a violation of the liberties guaranteed to same-sex married persons under the Fifth Amendment to the Constitution of the United States.

Rev. Rul. 2013-17

Rev. Rul. 2013-17 consists of two distinct conclusions. The first conclusion is that the Code must be read in a gender-neutral manner with respect to "marriage" and "spouse" so that that the Code provisions for "marriage" and "spouse" include same-sex spouses. In retrospect, this conclusion was probably already assumed by practitioners but clarifies existing law by applying Windsor to the Code. If it is unconstitutional under Windsor to classify marriages based on sexual preference, it is logical to presume that any terms under the Code that could be interpreted as relating to a sexual preference distinction with respect to marriage must be interpreted in a neutral way.

The second conclusion resolved a much-debated issue within the tax practitioner community in that a same-sex married couple's state of residency is irrelevant for purposes of Federal recognition of the marriage so long as the individuals are lawfully married in a domestic or foreign jurisdiction whose laws authorize same-sex marriage. Therefore, if a same-sex couple marries in New York and moves to Florida (which does not recognize same-sex marriage), the couple will be considered to be married for all purposes of the Code even if such marriage was the result of "forum shopping" for a jurisdiction that would marry the same-sex couple.

At the end of the ruling, the Service noted that for Federal tax purposes, the term "marriage" does not include registered domestic partnerships, civil unions, or other similar formal relationships recognized under state law that are not denominated as a marriage under that state's law, and the terms "spouse," "husband and wife," "husband," and "wife" do not include individuals who have entered into such a formal relationship.

I.R.S. News Release IR-2013-72

In Notice IR-2013-72, the Service provides guidance for same-sex married couples for amending prior returns, providing that such authority is voluntary and not mandatory, and that such ability only extends to currently "open" taxable years. With respect to the open tax years, the Service gives credence to the proposition that an unconstitutional determination renders a statute as inoperative as if it had never been passed and never existed so as to be void ab initio. Such a determination would allow a taxpayer to file amended returns for such prior years based on the law as it now exists as to such time period, i.e., as if the applicable statute were not then in existence. This is to be contrasted by the repeal of a statute without retroactive effect – in that instance, the statute was valid for such prior years so the ability to claim a refund in the absence of such statute should not be present.

However, what if the tax year is closed under the applicable statute of limitations? Should the unconstitutionality cause the year to be re-opened? The Service was silent on this position, which is, from the Service's perspective, the proper course of action. The law is likely on the side of the Service in that, courtesy of the ability to file for a protective claim for refund, the Code provides an adequate post-deprivation remedy and therefore the unconstitutionality of § 3 of DOMA is not sufficient to overcome the applicable statute of limitations. ("DOMA"), which defined marriage for purposes of federal law as a marriage between a man and a woman, is unconstitutional and that the concept of defining "marriage" is the domain of the States.

The Supreme Court's ruling provides same-sex spouses the same recognition and benefits under federal law as opposite-sex spouses. In the estate planning arena, such benefits include, but are not limited to: (1) filing joint income tax returns; (2) the unlimited marital deduction for gift and estate tax purposes; (3) splitting of inter-vivos gifts;

(4) electing portability of the deceased spouse's unused applicable exclusion amount; (5) naming a spouse as the beneficiary under a qualified retirement account and allowing the surviving spouse to "roll over" the account into his or her own account, thereby potentially extending the ultimate payout of the account; (6) simplifying the basis and contribution rules with respect to jointly owned property; (7) eliminating adverse tax consequences for the transfer of property pursuant to a marriage settlement agreement; and (8) granting certain social security, Medicare and Medicaid benefits.

However, a debate has ensued regarding whether these new benefits are available to same-sex spouses who married in a jurisdiction that recognizes same-sex marriage but reside in a jurisdiction that does not recognize same-sex marriage or available only to same-sex spouses who reside in a jurisdiction that recognizes same-sex marriage. Arguments have been made for each position, and estate planning practitioners will need guidance from the IRS and the Treasury to resolve the issue.

United States v. Tyler, --- F.3d --- (3rd Cir. 2013)

The Third Circuit Court of Appeals held that co-executors of a deceased taxpayer's estate are personally liable for the cash proceeds of the taxpayer's 1/2 interest in real property that the co-executors sold without applying the proceeds to the taxpayer's federal tax debt.

The IRS assessed the taxpayer in 2002 for income tax from prior years. The taxpayer and his wife owned their residence as tenants by the entireties, but in 2003, the taxpayer transferred his interest in the residence to his wife for $1, which severed the tenancy by the entireties. The IRS filed a notice of federal tax lien on the property in 2004. The taxpayer died in 2006 and his wife died shortly after. The *Tyler* court affirmed that the lien attached to the property when the taxpayer was assessed and remained with the property when it became part of the estate of the taxpayer's wife because the tenancy by the entireties was severed and because she did not pay "adequate and full consideration" for her interest under § 6323(h)(6). The court acknowledged that the lien would not have survived the taxpayer's death had the tenancy by the entireties not been severed.

The couple's son (the sole heir and a co-executor) sold the residence in 2008 and lost the proceeds investing in the stock market. The *Tyler* court affirmed that the co-executors were required under the federal insolvency statute, 31 U.S.C. § 3713, to pay the U.S. government "first when … the estate of a deceased debtor … is not enough to pay all the debts of the debtor." Therefore, the co-executors were personally liable for the cash proceeds from the sale of the deceased taxpayer's property that was encumbered by a federal tax lien.

CLAT Assets Not Includible in Settlor's Gross Estate – PLR201323007

The IRS privately ruled that the taxpayer's transfer to a charitable lead annuity trust ("CLAT") that will pay the annuity to a private foundation in which the taxpayer is a director was a completed gift for gift tax purposes, the gift qualifies for the gift tax charitable deduction and none of the CLAT's assets will be included in the taxpayer's gross estate.

The taxpayer created a CLAT of which he could not serve as the trustee. In addition, the beneficiary of the CLAT income interest was a private foundation established by the taxpayer and his wife (the “Foundation”) of which the taxpayer and his wife and children were directors. The Foundation’s bylaws provided that (1) a director who establishes a charitable trust of which the Foundation is a beneficiary is prohibited from involvement in and decisions of matters concerning the receipt, investment, grant or distribution of the funds received by the Foundation from such charitable trust and (2) any funds received from a charitable trust be segregated into a separate and dedicated account for such funds to clearly trace the funds into and out of the separate account.

The IRS ruled that the taxpayer’s transfer to the CLAT was a completed gift for gift tax purposes and qualifies for the gift tax charitable deduction even though the taxpayer is a Foundation director. This was allowed because the taxpayer is not permitted to vote on matters relating to disbursement or grants of funds received from the Trust and any funds received by the Foundation from the CLAT are segregated into a separate account. For similar reasons, the IRS ruled that the taxpayer retains no interest or reversion in the CLAT and, therefore, the CLAT’s assets will not be included in the taxpayer’s gross estate.

Graev v. Comm’r, 140 T.C. 17 (2013)

The Tax Court concluded that a married couple was not entitled to a charitable contribution for their gift of cash and a conservation easement to an architectural trust because the donation was improperly conditioned on whether the IRS would allow their claimed deduction.

A taxpayer gifted a facade conservation easement and cash to the National Architectural Trust (“NAT”). Prior to the contribution, the taxpayer expressed concern to NAT that, based on a recent IRS Notice, the IRS intended to crack down on improper charitable contribution deductions for transfers of easements on real property to charitable organizations. NAT replied that it was NAT’s standard policy “to refund a cash contribution to the extent the IRS disallowed the donor’s deduction for the related easement.” The taxpayer asked NAT to memorialize NAT’s assurance in a “side letter” separate from the easement application which stated that should the IRS disallow the deductions in their entirety, NAT would refund the taxpayer’s cash contribution and join with the taxpayer to remove the facade conservation easement from the property’s title. Furthermore, the recorded deed reserved NAT’s power to do so.

The IRS issued the taxpayer and his wife a notice of deficiency disallowing the cash and non-cash charitable deductions because the contributions were “made subject to subsequent event(s).” The tax court upheld the IRS’s findings and concluded (based on existing case law and the taxpayer’s awareness that the IRS was giving extra scrutiny to similar deductions) that at the date of the taxpayer’s contribution, the possibility that the IRS would disallow the deduction and that NAT would return the cash to the taxpayer and remove the easement was not “so remote as to be negligible.” The *Graev* court stated, “A substantial risk obviously arose from the IRS’s then-announced intention to scrutinize charitable contribution deductions for facade easement contributions, and that risk is evident from Mr. Graev’s insistence on NAT’s issuing the side letter.”

Belk v. Comm'r, T.C. Memo 2013-154 (2013)

The Tax Court denied a motion for reconsideration of its previous denial of an income tax deduction for a contribution of a conservation easement, where the donor and the charity agreed that the donor could substitute other assets for the contributed property, because the donor failed to donate an interest in real property that was subject to a use restriction granted in perpetuity.

In 1994, the taxpayers transferred their 410 acre farm to the taxpayers' LLC which developed the property as a residential community and golf course. In 2004, the LLC executed a conservation easement agreement with the Smoky Mountain National Land Trust (the "Land Trust") for the land where the golf course was located. The conservation easement provided that the taxpayers and the Land Trust could change the property that is subject to the easement.

Under § 170(h), to be a qualified conservation contribution, the contribution must be of a "qualified real property interest," which is defined as a "restriction (granted in perpetuity) on the use which may be made of the real property." The *Belk* court rejected the notion of a "floating easement" and found that "section 170(h)(2)(C) requires that taxpayers donate an interest in an 'identifiable, specific piece of real property.'" The *Belk* court determined that it was the intent of the parties to permit substitutions because the conservation easement agreement permitted substitutions, and, therefore, the taxpayers did not agree to restrict their use of the donated property in perpetuity.

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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