Proskauer

newsletter

Wealth Management Update

November 2013

in this issue

A monthly report for wealth management professionals.

Edited by **Henry J. Leibowitz**
Contributor: **Brandon A.S. Ross**

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.

Federal Exclusion from Gift, Estate and Generation-Skipping Transfer Taxes Increases to $5,340,000 in 2014

In Revenue Ruling 2013-35, the IRS announced certain inflation adjustments to tax exemptions and deductions. The IRS increased the basic exclusion amount for 2014 to $5,340,000 from $5,250,000. Decedent estates in 2014 will pay no federal estate tax if their taxable estate is under $5,340,000 and they did not use any of this exemption during their lifetime. Additionally, the basic exclusion amount is the amount that an individual may use to make tax-free gifts during his or her lifetime. Any exemption amounts used during life reduce the exemption amount available at death. Furthermore, the basic exclusion amount also determines the amount that may pass free of generation-skipping transfer taxes, which therefore also increases to $5,340,000.

The amount of the annual exclusion for gifts to U.S. citizens remains at $14,000 for 2014. This means that an individual may gift up to $14,000, per beneficiary, next year without reducing such individual's basic exclusion amount or being subject to gift tax. However, if the recipient of the gift is a spouse who is a non-U.S. citizen, the U.S. citizen spouse may gift up to $145,000 (increased from $143,000 this year) to the non-citizen spouse next year without including the amount in his or her taxable gifts. Comparatively, a married U.S. citizen couple may make unlimited gifts to each other without being subject to gift tax.

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

The November § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.0%. This is down from October's 2.4% rate. 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 down from October's rate to 1.73%. 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 with financial and real estate markets that remain undervalued presents a potentially rewarding opportunity to fund GRATs in November with depressed assets you expect 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 0.27% for loans with a term of 3 years or less, 1.73% for loans with a term of 9 years or less, and 3.37% 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 1.73%, the child will be able to keep any returns over 1.73%. These same rates are used in connection with sales to defective grantor trusts.

The Tax Court Holds, in a Summary Judgment Ruling, that the Beneficiaries of Gifts Who Are Obligated to Pay Any Potential Estate Tax Liability Arising from the Gifts May Decrease the Value of the Gift by the Actuarial Value of that Obligation

In *Steinberg v. Commissioner*, 141 T.C. No. 8 (September 30, 2013), a mother (the “Parent”) gave cash and securities to her daughters (the “Beneficiaries”) in exchange for the daughters’ agreement to pay the gift tax liability from the gifts and any estate tax liability if the Parent died within three years of making the gifts.

Under § 2502(c) of the Internal Revenue Code (the “Code”), the donor of the gift is responsible for payment of gift tax. When the beneficiary of a gift agrees to pay the gift tax liability for that gift, the value of the gift is reduced by the amount of gift tax paid by the beneficiary. This type of gift is a “Net Gift.” A Net Gift is often a solution for a taxpayer who wants to make a gift, but does not want to be responsible for paying the tax on that gift.

Under § 2035(b) of the Code, the amount of any gift made within three years of a decedent’s death increases the amount of the decedent’s estate by the amount of the gifts within three years of the decedent’s death. When the beneficiary of a gift agrees to pay the gift tax for the gift and any estate tax liability for a gift made within three years of death, this type of gift is a “Net, Net Gift.” A Net, Net Gift allows the donor to not only avoid paying the gift taxes associated with a gift, but also any estate tax that may arise from the donor dying within three years of making the gift.

As it is well settled that the value of a Net Gift for gift tax purposes is the fair market value of the gift reduced by the gift taxes paid by the beneficiaries of the gift, the IRS conceded, in *Steinberg*, that the Parent may reduce the value of the gift by the amount of the gift tax paid by the Beneficiaries.

However, the IRS disputed the reduction of the value of the Parent’s gift for any potential estate tax liability paid by the Beneficiaries because (1) the Beneficiaries did not pay any estate tax related to the gift and (2) determining the value of the Beneficiaries’ assumption of the potential estate tax liability at the time of the Parent’s gift was impossible.

The Tax Court ruled that, even though the Beneficiaries did not have to pay any estate tax related to the gift because the Parent lived longer than three years after her gifts, at the time of the gifts there was a chance that the Parent would die within three years and the Beneficiaries would be liable for the payment of estate tax. Overturning its own decision in another case, *McCord v. Commissioner*, 210 T.C. 258 (2003), the Tax Court found that there may be an actuarial way to determine the potential value of having to pay the estate tax arising from a gift made within three years of a donor's death. If this potential estate tax liability can be determined, then the value of the Parent's gift should be reduced accordingly.

Thus, the Tax Court dismissed the summary judgment for the IRS, allowing the Parent to provide evidence as to how the value of the Beneficiaries' potential obligation to pay the estate tax liability should be determined.

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

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