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newsletter

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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.

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

The May § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.4%, up 0.2% from April. The May 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 1.93%, up 0.12% from April.

Lower rates work best with GRATs, CLTs, sales to defective grantor trusts, private annuities, SCINs and intra-family loans. The low AFR presents a potentially rewarding opportunity to fund GRATs in March. Current legislative proposals would significantly curtail short-term and zeroed-out GRATs. Therefore, GRATs should be funded immediately in order to be grandfathered from the effective date of any new legislation that may be enacted.

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 0.33% for loans with a term of 3 years or less, 1.93.% for loans with a term between 3 and 9 years, and 3.27% 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 1.93%, the child will be able to keep any returns over 1.93%. These same rates are used in connection with sales to defective grantor trusts.

United States v. Shriner (113 AFTR2d 2014-616 (March 12, 2014)) – District Court for the District of Maryland Rules that Administrators of an Estate Were Personally Liable for Decedent's Unpaid Income Taxes, Where Administrators Distributed the Assets of the Estate While Debt was Outstanding

The District Court for the District of Maryland granted the government's motion for summary judgment and ruled that the administrators of an estate were personally liable for the decedent's unpaid income taxes because the administrators distributed the assets of the estate and rendered it insolvent while there was a debt outstanding.

The decedent failed to file income tax returns for 1997 and the period of 2000 through 2003. When decedent died, the administrators filed income tax returns on behalf of the decedent, and the Service assessed tax liabilities of $27,908 against the Estate. The administrators also filed a Form 2848 (power of attorney) authorizing the Service to send all notices to the law firm handling the estate administration. The Service sent numerous notices regarding the outstanding liabilities to the law firm.

The administrators (who were also beneficiaries) distributed the Estate and left the Estate without sufficient assets to pay the income tax liabilities. The administrators denied that they had actual or constructive knowledge of the debts, but the Court ruled that this denial was insufficient to establish a genuine issue of material fact to defeat the motion for summary judgment. The court discussed Section 3713 of Title 31 of the United States Code, which provides that a representative of a person or an estate will be liable for unpaid claims to the government if (i) they distributed assets out of the estate, (ii) the distribution rendered the estate insolvent, and (iii) the distribution took place after they knew, or should have known, about the government's claim.

In summary, the administrators of an estate can be personally liable for a decedent's debts to the government if they distribute assets out of an estate, rendering the estate insolvent, when they know or should know that there is an outstanding claim against the estate.

Estate of Foster v. Commissioner (2014-1 U.S.T.C. 60,675 (C.A. 9, March 26, 2014) – Ninth Circuit Upheld Tax Court's Determination that Litigation was not "Ascertainable with Reasonable Certainty" at the Time of Decedent's Death and so "Hazard of Litigation" Valuation Discount Did Not Apply

At the time of her death, the decedent was the defendant in several lawsuits in her capacity as trustee of three marital trusts established under her husband's estate. The executors of the decedent's estate had the marital trusts appraised, and the appraisal included a 29% discount attributable to the hazards of litigation presented by the lawsuits against decedent in her capacity as trustee. The Service denied the "hazards of litigation" discount. Subsequent to the decedent's death, the suits were settled.

The Tax Court upheld the Service's denial of the "hazards of litigation" discount because the litigation was not "ascertainable with reasonable certainty" at the time of the decedent's death. In preparation for the trial at the Tax Court level, the executors obtained a second appraisal, which determined only a 12.9% to 17.2% discount (the difference between the two appraisals was approximately $8.1 million). The Tax Court used this discrepancy as proof there was a lack of reasonable certainty with respect to the litigation.

This is an interesting case in light of Estate of Saunders v. Commissioner (U.S. 9th Circuit, No. 12-70323 (March 12, 2014)), where the Ninth Circuit considered valuation discounts for litigation pending at the time of decedent's death. The Court noted that unlike the taxpayers' experts in *Saunders*, the experts in *Foster* could not reasonably opine that the amounts they suggested would ever actually be paid by the Estate. In fact, one of the lawsuits against the decedent had been decided in her favor before her death (the experts had noted in their appraisal that an appeal was pending with respect to that particular litigation).

It is important to note that in both *Saunders* and *Foster*, the Court applied the Section 2053 regulations prior to the 2009 changes. Prior to 2009, in order to deduct the estimated amount of a claim against the estate, the estate had to show that the amount of the claim was ascertainable with reasonable certainty and the estimated amount is deductible only if the amount will be paid. Under new Treas. Reg. § 20.2053-4(d)(1), generally no estate tax deduction can be taken for claims against the estate while the claim is merely potential or unmatured. If a claim later matures, it can be deducted in connection with a timely refund claim. In order to preserve the estate's right to claim a refund for claims that mature and become deductible after the expiration of the period for filing a refund claim, the estate should file a protective claim for refund.

Frank Aragona Trust v. Commissioner (T.C., No. 15392-11, 142 T.C. No. 9 March 27, 2014) – Tax Court Holds that a Trust can Qualify for the "Real Estate Professional Exception" of Section 469(c)(7)

The Tax Court recently handed down its decision in Frank Aragona Trust v. Commissioner, ruling that a trust can qualify for the real estate professional exception of Section 469(c)(7). By taking into account the actions of the trustees, a trust can be considered to be materially participating in real estate activities. This means that losses from real estate activities can be treated as nonpassive and therefore deductible in determining the trust's taxable income. This decision is especially relevant to trusts that own business as it affects the application of the passive activity loss rules in Section 469 and whether income from those activities is subject to the new 3.8% net investment income Medicare surtax under Section 1411.

The Frank Aragona Trust (the "Trust") was a Michigan trust that owned several pieces of real property and was also involved in the business aspects of developing and maintaining the property. The Trust had six trustees, three of whom were also employees of Holiday Enterprises, LLC (the "LLC"). The LLC was owned 100% by the Trust. The LLC also employed other professionals.

The Trust had losses in 2005 and 2006 from its real estate activities and deducted those losses(on the basis that they resulted from nonpassive activities) on its income tax returns. In issuing a notice of deficiency for those tax years, the Service determined that the real estate activities were passive under Section 469 and therefore any related losses were not deductible.

In general, real estate rental activity is considered passive regardless of whether the taxpayer materially participates in the real estate business. However, there is an exception for "real estate professionals" under Section 469(c)(7). Before the Tax Court, the Trustees argued that the Trust was a "real estate professional" as defined in Section 469(c)(7) so that the losses were considered to be from nonpassive activities and therefore deductible. To qualify for the real estate professional exception, a taxpayer must pass two tests. First, more than one-half of the personal services performed in a taxable year must be performed in real property trades or businesses in which the taxpayer materially participates. Second, the taxpayer must perform more than 750 hours or services during the taxable year in real property trades or businesses in which the taxpayer materially participates. The Service argued that the regulations to Section 469(c)(7) define "personal services" as "work performed by an *individual* in connection with a trade or business [emphasis added]." Because the trust was not an individual, it could not perform personal services and therefore did not fall under the Section 469(c)(7) exception.

The Tax Court rejected the Service's argument that the trust could not be considered an individual under Section 469(c)(7) and the associated regulations. Further, the Court found that the Trustees' participation in the real estate activities met the material participation requirements of Section 469(c)(7) because they were regular, continuous and substantial. The Court determined that the participation of the Trustees should be considered in determining whether the taxpayer (the Trust) materially participated in the real estate activities. The Service argued that the activities of the Trustee should only apply if they are performed in their capacity as Trustees (as opposed to employees of the LLC). Here, the Court looked to Michigan law, under which trustees are required to administer trusts solely for the benefit of the trust beneficiaries. The Court explained that the Trustees could not simply stop acting as Trustees because they were also employees of the LLC, so that their activities in other capacities could be considered in whether the Trust was a material participant in the real estate activities.

In summary, a trust may be able to qualify for the real estate professional exception of Section 469(c)(7). If the trust qualifies for the exception, losses from the associated real estate activities may be deductible on the trust's income tax return. This distinction has increased importance with the application of the new 3.8% net investment income Medicare surtax under Section 1411.

Estate of Elwood Olsen v. Commissioner (T.C. Memo. 2014-58 (April 2, 2014)) – Husband's Failure to Properly Fund Trusts After Wife's Death Caused Gross Inclusion of the Entire Balance of Wife's Revocable Trust in his Gross Estate

In 1994, husband and wife created revocable trusts identical to one another. The trusts provided that upon the first spouse's death, a credit shelter trust (the "Family Trust"), a GST exempt QTIP trust and a GST non-exempt QTIP trust (the two QTIP trusts, the "Marital Trusts") would be created. The Marital Trusts provided that income was to be paid to the surviving spouse on an annual basis. The Family Trust also provided an inter vivos power of appointment for the surviving spouse to appoint property to any one or more of their descendants and charitable organizations.

The wife died in 1998 with a gross estate large enough that all three trusts were to be created and funded. The husband never segregated the trust assets into the three trusts. During the husband's lifetime, he made three significant withdrawals from the trust. He withdrew about $250,000 and then about $830,000 which he used to make a charitable contribution to a university. He also withdrew about $400,000 which he deposited into one of his accounts.

When the husband died, his Personal Representative could find no record of funding the three trusts, so he deemed all of the distributions to have come from the Marital Trusts. These distributions would have exhausted the assets of the Marital Trusts so that only the Family Trust, which did not have to be included in the husband's gross estate, was left.

The Service argued that the amounts later contributed to the university could only have come from the Family Trust because that was the trust with an inter vivos limited power of appointment in favor of charities and that the contributions were made directly from the wife's trusts to the university (rather than being distributed to the husband first). The amount that the husband withdrew from the trust account and then deposited into his own account was deemed to have come from the Marital Trusts.

In summary, it is important to segregate assets and fund trusts correctly at the appropriate time. While it can be attractive to leave assets in one trust account for ease of administration, the trusts must be funded correctly to achieve estate tax planning objectives.

Peck v. Peck (Case no. 2D13-113. Fla. 2d DCA Feb. 26, 2014) – Florida District Court of Appeal Upholds Trial Court's Determination that, Under Common Law, an Irrevocable Trust Can be Terminated with Consent of Settlor and All Beneficiaries, Even if Termination Contradicted Intent of Party Who Funded the Trust

The Florida Second District Court of Appeal recently held that the trial court acted properly when it determined that, if the settlor and all beneficiaries of an irrevocable trust consented, the trust could be terminated even if the termination would be in conflict with the intentions of the party who funded the trust.

As background, Bernard Peck ("Bernard") executed a Last Will and Testament that left assets to a marital trust for the benefit of his wife. Upon the death of the wife, the remaining assets in the marital trust were to be distributed to self-settled irrevocable trusts for his children, Constance Peck ("Constance") and Daniel Peck ("Daniel"). Bernard funded Constance's trust (the "CLP Trust") with gifts he had made to her over a period of years under the Florida Uniform Transfers to Minors Act. The CLP Trust was created in 1992. Constance was the settlor of the CLP Trust and was co-trustee with Bernard. Daniel was named as the successor trustee of the CLP Trust.

The CLP Trust provided that the income was to be paid to Constance during her life. In addition, Constance had a testamentary power of appointment in favor of her descendants. The CLP Trust contained a provision that it was “irrevocable and shall not be subject to amendment, and no portion of the Trust Estate may be withdrawn from the operation of this Trust except in accordance with the terms herein before set forth.” Constance also had the right to receive five thousand dollars per year from the principal of the CLP Trust until the age of fifty. That amount increased to ten thousand dollars until age fifty-five, and then fifteen thousand dollars from the age of fifty-five until her death.

Bernard died in 2009. His wife predeceased him and at his death, the CLP Trust received the assets set aside for Constance. Upon Bernard’s death, Daniel became the co-trustee of the CLP Trust with Constance.

In 2012, Constance filed a petition to terminate the CLP Trust. Her children agreed to the termination, but Daniel, as co-trustee, argued that Constance would squander the assets and objected. Daniel also argued that under section 736.04113 of the Florida Statutes, termination would be improper because the purposes of the trust had not been fulfilled. The trial court terminated the CLP Trust and noted that section 736.04113 provides that “the provisions of this section are in addition to, and not in derogation of, rights under the common law to modify, amend, terminate or revoke trusts” and so the court still had the authority to terminate the trust. The Florida Second District Court of Appeal discussed Preston v. City National Bank of Miami (294 So. 2d 11 (Fla. 3d DCA 1974)), which notes that Florida common law requires the trial court to allow modification or termination of a trust if the settlor and all beneficiaries consent, even if the trust is irrevocable and even if the purposes of the trust have not been accomplished.

In affirming the trial court’s decision to terminate the CLP Trust, the Florida Second District Court of Appeal noted that Bernard was the one who drafted the CLP Trust and that he knew it would receive the assets passing from his estate. The Court noted that Bernard could have been the settlor of the trust that would receive assets for Constance’s benefit, but he did not do that. He should have known that she could modify or terminate the trust with the consent of the beneficiaries, even if it defeated Bernard’s intentions. The Court emphasized that this termination was authorized by Florida common law and that Florida common law was not limited by the application of section 736.04113 of the Florida Statutes.

To discuss any aspects of these cases or associated tax implications, please contact one of the lawyers in the Personal Planning Department at Proskauer Rose LLP.

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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