Proskauer

newsletter

August 2014

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.

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

The August § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.2%, the same as the § 7520 rate for July. The August 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 1.89%, up 0.07% from July.

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 August. 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 0.36% for loans with a term of 3 years or less, 1.89% for loans with a term between 3 and 9 years, and 3.09% 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 1.89%, the child will be able to keep any returns over 1.82%. These same rates are used in connection with sales to defective grantor trusts.

Inherited IRAs are not exempt from creditors

In *Clark v. Ramekers*, 573 U.S. (June 12, 2014) the United States Supreme Court addressed the issue of whether funds held in an inherited IRA are exempt from bankruptcy creditors under 11 U.S.C. § 522(b)(3)(C), ultimately holding that such funds are not exempt because they do not constitute "retirement funds" within the meaning of § 522(b)(3)(C).

At issue in *Clark* was an inherited IRA owned by Heidi Heffron-Clark ("Heidi"). Heidi had inherited the IRA from her mother upon her mother's death. Several years after inheriting the IRA, Heidi filed for bankruptcy and claimed that the funds within the inherited IRA were exempt from the claims of her creditors under § 522(b)(3)(C).

Section 522(b)(3)(C) exempts from the claims of bankruptcy creditors "retirement funds" that are held in an account or fund that is exempt from taxation under IRC §§ 401, 403, 408, 408A, 414, 457 or 501(a). Accordingly, to qualify for the § 522(b)(3)(C) exemption, two requirements must be satisfied:

(1) The funds must be held in a qualifying tax-exempt account or fund and

(2) The funds must constitute "retirement funds."

Inherited IRAs are exempt from taxation under IRC § 408, therefore satisfying the first requirement of § 522(b)(3)(C). The only issue left for the Court to determine was whether the funds held in the inherited IRA constituted "retirement funds" with respect to Heidi. Because the term "retirement funds" is not defined in the bankruptcy statutes, the Court applied the ordinary meaning of the term. According to the Court, the ordinary meaning of "retirement funds" is "a sum of money set aside for the date an individual stops working." Applying this definition of "retirement funds" in reaching its conclusion that funds held in an inherited IRA do not constitute "retirement funds" for purposes of the § 522(b)(3)(C) exemption, the Court identified the following three legal characteristics of inherited IRAs which distinguish inherited IRAs from traditional or Roth IRAs:

(1) The holder of an inherited IRA is prohibited from making additional contributions to the inherited IRA;

(2) The holder of an inherited IRA is required to withdraw funds from an inherited IRA irrespective of the holder's age relative to retirement; and

(3) The holder of an inherited IRA may withdraw funds from the inherited IRA at any time and in any amount without the imposition of a penalty.

Based on these characteristics, the Court held that funds held in an inherited IRA are essentially a pool of funds available for the account holder's immediate and unrestricted consumption, rather than funds "objectively set aside for retirement." Accordingly, such funds are not "retirement funds" for purposes of § 522(b)(3)(C) and, therefore, are not exempt from the claims of bankruptcy creditors under § 522(b)(3)(C).

The IRS publishes final regulations on the deductibility of miscellaneous itemized deductions of trusts and estates

The IRS has released final regulations addressing the deductibility of miscellaneous itemized deductions of non-grantor trusts and estates, effective for taxable years beginning after December 31, 2014 (Treasury Regulation § 1.67-4). The final regulations largely adopt the 2011 proposed regulations.

IRC § 67(e) of the Code provides that miscellaneous itemized deductions of non-grantor trusts and estates are deductible only to the extent that the aggregate of such deductions for any particular year exceed 2% of such trust's or estate's adjusted gross income

("AGI") for such year. An exception to this general rule provides that miscellaneous itemized deductions of non-grantor trusts and estates will be fully deductible if the cost or expense "would not have been incurred if the property were not held in such estate or trust." Historically, disagreement existed between the courts and the IRS as to the meaning of this phrase. *See O'Neil v. Comm'r*, 994 F. 2d 302 (6th Cir. 1993); *Mellon Bank v. United States*, 265 F. 3d 1275 (Fed. Cir. 2001); *J.H. Scott v. United States*, 328 F. 3d 132 (4th Cir. 2003). This disagreement was resolved in 2008 with the U.S. Supreme Court's decision in *Knight v. Comm'r*, 552 U.S. 181 (2008).

In *Knight*, which addressed the application of IRC § 67(e) to investment advisory fees, the Supreme Court held that a miscellaneous itemized deduction of a non-grantor trust or estate will not be subject to the 2% floor only if it would be "uncommon or unusual" for an individual to incur such expense. Because it is not uncommon or unusual for individuals to incur investment advisory fees, the Supreme Court held that investment advisory fees are subject to the 2% floor, except to the extent that the fee constitutes a special, additional charge applicable only to fiduciary accounts or due to unusual investment objectives.

In 2011, in response to the *Knight* decision, the IRS issued proposed regulations addressing the deductibility of miscellaneous itemized deductions of non-grantor trusts and estates that closely tracked *Knight*. The final regulations do not depart significantly from the 2011 proposed regulations.

Under final regulations, which are published at Treas. Reg. § 1.67-4, a cost will be subject to the 2% floor if it:

(1) Is included in the definition of miscellaneous itemized deductions under IRC § 67(b);

(2) Is incurred by a non-grantor trust or an estate; and

(3) Commonly or customarily would be incurred by a hypothetical individual holding the same property.

Similar to the 2011 proposed regulations, the final regulations set forth numerous categories of expenses and addresses whether such expenses are subject to the 2% floor. The following is a brief summary of some of the expense categories addressed by the final regulations:

(1) <u>Litigation Expenses</u> – Costs incurred in defense of a claim against an estate, a decedent or a trust that is unrelated to the existence, validity or administration of the trust or estate is subject to the 2% floor.

(2) <u>Tax Preparation Fees</u> – Costs incurred in the preparation of estate and generation-skipping transfer tax returns, fiduciary income tax returns and the decedent's final income tax return are fully deductible. Costs incurred in the preparation of all other tax returns are subject to the 2% floor (this includes gift tax returns).

(3) <u>Appraisal Fees</u> – Costs incurred to determine the fair market value of property as of the date of death (or the alternate valuation date), for purposes of making distributions or as otherwise necessary to prepare the estate's or trust's tax return are fully deductible. Costs incurred to determine the fair market value of

property for any other purpose (e.g., to obtain insurance), are subject to the 2% floor.

(4) Investment Advisor Fees – Generally, investment advisor fees are subject to the 2% floor. However, certain incremental costs in excess of what an individual would pay are fully deductible. Such incremental costs include special, additional changes added solely because the investment advice is rendered to a trust or an estate rather than an individual or is attributable to unusual investment objectives.

(5) Bundled Fees – Generally, bundled fees (i.e., a single fee paid to a fiduciary for the performance of a variety of services) are required to be unbundled and allocated between expenses subject to the 2% floor and expenses not subject to the 2% floor. However, if the bundled fee is not computed on an hourly basis, only that portion of the fee attributable to investment advice is subject to the 2% floor. The regulations provide that any reasonable method may be used to make the necessary allocation.

The IRS announces changes to its offshore voluntary disclosure program

The IRS has announced changes to its offshore voluntary disclosure program ("OVDP"), including changes to its streamlined compliance procedures (IR-2014-73, June 18, 2014). The changes are anticipated to assist a larger population of taxpayers come into compliance with their U.S. tax obligations.

The most significant changes to the streamlined filing procedures include: (1) making the streamlined procedures available to a wider population of U.S. taxpayers residing outside of the U.S. and, for the first time, to U.S. taxpayers residing in the U.S.; (2) eliminating the requirement that the taxpayer have $1,500 or less of unpaid tax per year; (3) eliminating the required risk questionnaire; and (4) requiring the taxpayer to certify that previous failures to comply were due to non-wilful conduct.

The most significant change to the OVDP will be an increase of the offshore penalty percentage from 27.5% to 50% if, before the taxpayer's OVDP pre-clearance request is submitted, it becomes public that a financial institution where the taxpayer holds an account is under investigation by the IRS or Department of Justice.

New streamlined application procedure for charitable organizations to have their exempt status recognized by the IRS

On July 1, the IRS released Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, providing small 501(c)(3) organizations a significantly streamlined procedure (a three page application rather than the current twenty-six page application) for having their exempt status recognized by the IRS (Revenue Procedure 2014-40).

The new streamlined application is available only to 501(c)(3) organizations with assets of $250,000 or less and gross receipts of $50,000 or less. Form 1023-EZ includes a twenty-six question Eligibility Worksheet for the applying entity to complete to determine whether it qualifies to use the new streamlined application. The IRS anticipates the approximately seventy percent of 501(c)(3) organizations will qualify to use the new streamlined application.

Is a Madoff account taxable for estate tax purposes?

Estate of Kessel, is a case that arose out of the Bernie Madoff ("Madoff") Ponzi scheme (*Estate of Kessel v. Commissioner*, T.C. Memo 2014-97 (May 21, 2014)). Bernard Kessel ("Mr. Kessel") was the sole owner of Bernard Kessel, Inc. (the "Corporation"). The Corporation had a pension plan (the "Plan") of which Mr. Kessel was the sole participant. The Plan invested approximately $2.8 million in an account with Bernard L. Madoff Investment Securities, LLC (the "Madoff Account").

Mr. Kessel died in 2006, prior to Madoff's arrest and the subsequent collapse of the Ponzi scheme. Mr. Kessel's estate reported the Madoff Account as an asset of Mr. Kessel's estate, valued at approximately $4.8 million. The value of the Madoff Account was based on an appraisal of the assets purportedly held in the Madoff Account on the date of Mr. Kessel's death.

Following Madoff's arrest, the Plan attempted to recover the assets purportedly held in the Madoff Account the month prior to the arrest (a little over $3 million) from the Madoff Trustee. The Madoff Trustee rejected the Plan's request because the Plan was deemed to be a "net winner." That is, the Plan had actually withdrawn more money from the Madoff Account than the Plan had contributed to the Madoff Account. After the Plan's request to recover assets was rejected, Mr. Kessel's estate filed a supplemental estate tax return reporting the value of the Madoff Account as $0 and requesting an estate tax refund of $1.9 million, which was the estate tax attributable to the inclusion of the Madoff Account in Mr. Kessel's estate at $4.8 million.

The IRS rejected the estate's request for a refund and the estate subsequently filed a Tax Court petition. In response to the Tax Court petition, the IRS filed a motion for summary judgment on two issues, both of which the Tax Court denied. First, the IRS argued that the property to be valued for estate tax purposes was the Madoff Account itself, and not the assets purportedly held in the Madoff Account. Based on the facts before the Tax Court, the Tax Court determined that it could not say whether the Madoff Account constituted a property interest includible in Mr. Kessel's estate separate from, or exclusive of, any interest Mr. Kessel had in the assets purportedly held in the Madoff Account. Second, the IRS argued that a hypothetical willing buyer and willing seller of the Madoff Account would not reasonably know or foresee that Madoff was operating a Ponzi scheme at the time of Mr. Kessel's death and, as a result, the later occurring event (i.e., the collapse of the Ponzi scheme) should not be taken into consideration in determining the fair market value of the Madoff Account on the date of Mr. Kessel's death. The Tax Court held that whether a willing buyer and willing seller would have known of or foreseen the Ponzi scheme is a question of disputed fact that needs to be resolved at trial. Accordingly, the Tax Court denied the IRS's motion for summary judgment on both issues.

To discuss any aspects of these cases, regulations or rulings 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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