Proskauer

newsletter

Wealth Management Update

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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 2.2%, the same rate as August. The September 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 1.86%, down 0.03% from August.

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 September.

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, 1.86% for loans with a term between 3 and 9 years, and 2.97% 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 1.86%, the child will be able to keep any returns over 1.86%. These same rates are used in connection with sales to defective grantor trusts.

Tax Court ruled that the IRS overvalued a decedent’s interest in a closely held business because it failed to discount the interest to reflect the value of the personal goodwill of the decedent’s son. *Estate of Franklin Z. Adell v. Commissioner*, T.C. Memo. 2014-155, 2014 WL 3819046 (Aug. 4, 2014).

At his death, the decedent’s revocable trust was the sole shareholder of a C corporation (the “Corporation”) that derived nearly all of its income from a not-for-profit corporation that the decedent and his son, Kevin, formed. The Corporation and the not-for-profit corporation entered into a Services Agreement, which governed the relationship between the entities and imposed certain restrictions on the entities. Kevin, through his education, business acumen, and connections, was primarily responsible for the success of the Corporation. Kevin never signed a non-compete agreement with the Corporation. On the estate tax return, the estate reported the value of the Corporation at $9.3 million. The estate filed two amended estate tax returns. In the first and second amended estate tax returns, the Corporation was valued at $9.3 million and $0, respectively.

After reviewing the estate tax returns, the IRS issued a notice of deficiency in which it valued the Corporation at $92.2 million. The estate filed an action to redetermine the deficiency.

During trial, the estate introduced expert testimony and reports that valued the Corporation at $4.3 million. The experts represented that the estate’s original valuation of $9.3 million was too high because it failed to account for the restrictions contained in the Services Agreement.

During trial, the IRS introduced expert testimony and reports that valued the Corporation at $26.3 million.

After considering the evidence, the court had to determine the Corporation’s fair market value. For estate tax purposes, fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither under any compulsion to buy or sell and both having knowledge of relevant facts.

After considering the evidence submitted by both the estate and the IRS, the court disregarded the expert opinions presented at trial and ruled that the Corporation’s fair market value was $9.3 million, the original value reported by the estate. The court disregarded the IRS’s expert testimony for two reasons. First, the court determined that a willing buyer would not pay $26.3 million for the Corporation because this price did not reflect a discount for the value of Kevin’s “personal goodwill,” his education, business acumen, and relationships which led to the Corporation’s success. A willing buyer would recognize that Kevin did not sign a non-compete and he could leave the Corporation at any time, which would substantially decrease the value of the Corporation. Accordingly, because Kevin could leave at any time and form a competing company, the court ruled that the IRS’s valuation was flawed because it included Kevin’s personal goodwill as an asset of the Corporation. Second, the court ruled that, if a willing buyer wanted to retain Kevin’s services, a willing buyer would have to pay Kevin a salary that exceeded the market rates. If Kevin’s salary, which the court determined was “unreasonable,” was decreased, Kevin would leave the Corporation and form a competing business because he did not sign a non-compete.

The District Court for the Central District of California ruled that a protective election to pay assessed taxes in installments does not toll the applicable statute of limitations. *United States v. Baileys*, Case No: 8:13-CV-966-JLS.

In this case, the estate filed an estate tax return reporting over $5 million of taxes due. The IRS assessed the amount reported on the return against the estate on September 20, 1999.

On the return, the estate filed for a “protective election,” which preserved the estate’s ability to pay the assessed taxes in installments if (1) the estate was later determined to qualify for installment payments and (2) the estate filed a final election.

The estate never filed a final election.

On June 25, 2013, the United States filed this case in an attempt to collect the assessment against the estate. The estate filed a motion for partial summary judgment in which it argued that the United States is barred from collecting the assessment because the statute of limitations passed. There is a ten-year statute of limitations on the collection of estate taxes. The United States argued that the filing of the protective election tolled the applicable statute of limitations.

After considering the parties’ arguments, the District Court for the Central District of California ruled that the protective election did not extend the time for payment of the estate tax. The court granted partial summary judgment in favor of the estate and denied the United States’ claim to collect the assessment.

The IRS privately ruled that a beneficiary’s testamentary power of appointment over trust property was not a general power of appointment. Private Letter Ruling 201427008 (July 3, 2014).

A grandfather established a trust for the benefit of his grandson. Upon the grandson’s death, the grandson has the right to appoint the property to his father’s descendants. The appointment provision did not expressly provide that the grandson could not appoint property to himself, his estate, his creditors, or the creditors of his estate.

If the grandson has the right at his death to appoint property to himself, his estate, his creditors, or the creditors of his estate, he would have a “general power of appointment” over the trust and the principal of the trust would be subject to estate tax at the grandson’s death.

The grandfather intended to create a trust for his grandson that would not be subject to tax at the grandson’s death. Accordingly, the trustee filed a Complaint for Declaratory Judgment in which the trustee moved the court to construe the ambiguous provision to provide that the testamentary power was not a “general power of appointment.”

After hearing testimony regarding the grandfather’s intentions regarding the establishment of the trust, the state court issued a declaration construing the testamentary power as a “limited power of appointment”; therefore, the grandson could not appoint the property to himself, his estate, his creditors, or the creditors of his estate.

A state court’s interpretation of a trust provision is not necessarily binding on a federal court or agency, including the IRS, so the trustee requested a private letter ruling confirming the state court’s interpretation of the appointment provision.

The IRS ruled that the state court order was binding on a federal court or agency because the state court order, which relied upon the grandfather's intention that the trust not be subject to estate tax at the grandson's death, was consistent with applicable state law as it would be applied by the highest court of the state. Accordingly, the IRS ruled that the testamentary power granted to the grandson was not a "general power of appointment" and would not subject the property to estate tax at the grandson's death.

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

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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