Proskauer

Wealth Management Update

May 2015

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 1.8%, which is a slight decrease from April's rate of 2.0% and remains the same as March's rate of 1.8%. 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 1.53%, which is down slightly from the April rate of 1.70% and up slightly from March's rate of 1.47%. 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 May 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 are 0.43% for loans with a term of 3 years or less, 1.53% for loans with a term of 9 years or less, and 2.30% 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 1.53%, the child will be able to keep any returns over 1.53%. These same rates are used in connection with sales to defective grantor trusts.

Case to Watch – Use of Art Owned by a Controlled Corporation

Allbritton v. U.S., **S.D. Tex., 4:15-cv-00275**

On January 30, 2015, a complaint was filed in the U.S. District Court for the Southern District of Texas alleging that the IRS erroneously determined, that in 2005, a deemed distribution was made from a corporation to its controlling shareholder of art that was owned by the corporation and used by the shareholder. In this case, the art was owned by a Delaware corporation and the corporation was owned by the taxpayer, his family and trusts for the benefit of his family. The art was kept in various residential properties owned by the corporation which were used by the taxpayer. The IRS assessed tax against the taxpayer for having enjoyed the artwork without paying the corporation for such use. The taxpayer argued that as a joint owner of a 5% interest in the art, the taxpayer was entitled to possession of the jointly-owned art. The taxpayer also argued that they paid rent to the corporation for the use of the residential properties and furnishings therein (including the art). The IRS's answer to the complaint is due on May 20, 2015. In assessing tax against the taxpayer, the IRS took the position that the taxpayer treated the $140,000,000 art collection owned by the corporation as his own, and thus, the IRS treated the art as having been constructively distributed to the controlling shareholder (i.e., the taxpayer) in 2005. Additionally, because of the constructive distribution of the art, the IRS is also treating the corporation's payment of insurance premiums on the art as constructive distributions to the controlling shareholder in 2005. Alternatively, the IRS is arguing that, if there was not a constructive distribution of the art, there was instead a constructive distribution of the fair market value rent for the art totaling $64,000,000. We will continue to keep an eye on this case and provide an update once the case is decided.

Trust Provision Requiring Disputes to be Settled by an Arbitration Panel Does Not Affect Crummey Rights

***Mikel v. Commissioner*, T.C. Memo 2015-64 (April 6, 2015)**

The Court held that withdrawal rights for 60 individual beneficiaries were present interests in property even though a trust provision required any dispute over interpretation of the trust be submitted to an Orthodox Jewish arbitration panel. In 2007, husband and wife made a gift to a family trust of $1,600,000. After being notified by the IRS, the taxpayers filed a late gift tax return in 2011 reporting the gift in 2007 and indicating annual exclusion gifts of $720,000 each contending that there were $12,000 crummey gifts made to each of 60 present interest beneficiaries. After the application of the taxpayer's gift tax exemptions, no gift tax was due. The IRS assessed a tax deficiency of approximately $270,000 and a late-filing addition to tax of $67,000 claiming that the beneficiaries lacked legally enforceable rights to withdraw funds from the trust and disallowing the application of their annual exclusions. The trust language provided each beneficiary with a right to withdraw from property transferred to the trust an amount equal to the taxpayer's annual exclusion. The trust also included a provision indicating that any dispute arising over the proper interpretation of the trust must be submitted to arbitration before a panel consisting of three persons of the Orthodox Jewish faith – referred to as a beth din. Finally, the trust included an in terrorem provision relating to challenges to the trustees exercise of discretion to make distributions from the trust.

The IRS claimed that, a taxpayer's annual exclusion, could only be used if it related to a "present interest in property". A "present interest in property" is defined by the Treasury Regulations as "an unrestricted right to the immediate use, possession or enjoyment of property or the income from property." The IRS contended that the beneficiaries did not receive a "present interest in property" because their rights of withdrawal were not "legally enforceable" since the beneficiary could not "go before a state court to enforce their right." Using a hypothetical, the IRS stated that if the trustees refused, without legal basis, to honor the withdrawal rights, the beneficiary would be required to submit the dispute to a beth din, and, if the beth din, without legal basis, sustained the trustees refusal to honor the demand, the beneficiary could seek redress in a New York court but would be reluctant to do so because of the in terrorem clause in the trust. Accordingly, the IRS contended that, practically speaking, the beneficiaries' withdrawal rights were illusory and not a present interest in property because any attempt to seek legal enforcement of that right would result in adverse consequences to the holder.

The Court noted two flaws in the IRS arguments and held that the withdrawal rights were present interests in property to which the annual exclusion applied. The first flaw noted by the Court was that the beneficiary did not need to go to court to enforce their withdrawal rights. Rather, if the Trustees breached their duties by refusing a withdrawal demand, the beneficiary could seek justice from a beth din which was directed to enforce the provisions of the trust. The second flaw noted by the court was that the in terrorem provision applied only to challenges made to a trustees decision to make discretionary distributions of trust property and, thus, the court found that the beneficiaries should not be dissuaded by the in terrorem provisions.

LLC Interest Owned by a FL Resident is Subject to FL Jurisdiction

***Wells Fargo Bank v. Barber*, 2015 WL 470589 (MD Fla., Feb. 4, 2015)**

The Court held that, unlike a physical stock certificate, an interest in an LLC is personal property and, if held by a debtor in Florida, a creditor may either foreclose such LLC interest or obtain a charging order against such LLC interest. In this case, Wells Fargo had a deficiency judgment against an individual and a non-party for approximately $62,000,000. Wells Fargo sought to foreclose on the individual's membership interest in the LLC or, alternatively, sought a charging order against such interest. A charging order is a lien on the membership interest that can never be foreclosed and allows the creditor to receive distributions from the LLC that the member would have received until the judgment is paid. With a charging order, the creditor does not control the LLC or control whether distributions are made from the LLC. If a membership interest is foreclosed, the interest is sold in a foreclosure sale and the purchaser (usually the creditor) replaces the member for all purposes. In a foreclosure, the member loses all interests and rights in the LLC and the purchaser (i.e., the creditor) gets distribution rights in perpetuity rather than only until the judgment is paid.

In this case, there were two issues: (1) a jurisdiction issue and (2) a conflict of law issue. First, the individual claimed that the Florida court lacked jurisdiction to foreclose or to enter a charging order on the LLC because the LLC was created under the laws of Nevis (a small island in the Caribbean) and, thus, was beyond the jurisdiction of the court.

The individual was relying on another recent Florida case, *Sargeant v. Al-Saleh,* 137 So. 3d 432 (Fla. Dist. Ct. App. 2014), in which the court held that the Florida court lacked jurisdiction over corporate stock because the stock was located where the stock certificates were located which was outside of Florida. Wells Fargo claimed that the *Sargeant* case was not applicable here because the interests in that case were corporate interests which are different than interests in an LLC. The Court agreed with Wells Fargo and stated that "a membership interest in a limited liability company is intangible personal property, which 'accompanies the person of the owner'". Therefore, because the individual in this case resided in Florida, the membership interest in the LLC was located in Florida and was subject to the jurisdiction of the Florida courts.

The second issue was a conflict of law issue. The Court noted that a creditor's remedy under the Florida LLC Act included both a charging order and a foreclosure action against a single member LLC while the law of Nevis granted creditors only the right to a charging order. Accordingly, the Court had to decide which law applied to this case. The Court found that, when faced with a conflict of law question in a Federal Court diversity jurisdiction case, the Court must apply the forum state's choice of law rules. Accordingly, since the issue in this case involved property, the Court found that Florida's choice of law rules require the Court to apply the law of the situs of the property. Therefore, as the Court had already determined that the individual's membership interest was located in Florida, Florida law applied. In applying Florida law, the Court held that Wells Fargo was entitled to either foreclose the interest or obtain a charging order.

Of lesser import was the Court's discussion of whether various transfers made by the individual were fraudulent transfers. The Court set aside the transfers if they were made with "actual intent to hinder, delay or defaud." In determining whether there were fraudulent transfers, the court focused on a list of badges of fraud. In this case, the individual was insolvent at the time of the transfers, the individual transferred all of her assets to the LLC of which she was the sole member, the individual retained possession and control of the funds and the list goes on.

Various Estate/Gift Tax Revisions Based on the New York 2015-2016 Budget

New York A.3009-B/S.2009-B (2015)

The New York 2015-2016 Budget included various changes to New York's estate and gift tax laws.

Estate Tax Exemption:

The New York estate tax exemption amount was increased as of April 1, 2015 to $3,125,000 and will increase again on April 1, 2016. Due to a drafting error in the original legislation, the estate tax rates were said to only apply until March 31, 2015. This error was corrected in the budget legislation so that the estate tax rates now apply to all decedents.

Charitable Gift Add-Back:

Last year's budget increased the New York gross estate of a New York resident decedent by the amount of any taxable gifts made within three years of death if the decedent was both a New York resident at the time of the gift and at the time of death. This gift add-back provision did not apply to gifts made on or after January 1, 2019. This provision has been revised so that the gift add-back provision does not apply to estates of decedents dying on or after January 1, 2019.

Based on last year's budget, if a New York resident gifted out-of-state property within three years of death, the value of the real property would be added back to such individual's gross estate. But, if that same individual died with the same out-of-state property, it would not be included in the individual's New York gross estate. On August 25, 2014, the New York Department of Taxation and Finance issued a Technical Memorandum, TSB-M-14(6)M, indicating that gifts made by New York residents of out-of-state real or tangible property are not added back to such resident's gross estate.

The 2015-2016 Budget expressly includes this clarification in the legislation such that real and tangible out-of-state property is excluded from the gift add-back provision for a New York resident.

Estate Tax of Non-Resident:

Currently, intangible personal property of a non-resident of New York is not included in computing the non-resident's New York taxable estate. The budget legislation clarified that deductions relating to such intangible property are disallowed in computing the New York estate tax liability.

A change that was made last year but which is worth noting again is that there will be no New York estate tax imposed on a non-resident if the value of such individual's New York situs property does not exceed the applicable New York estate tax exemption amount (currently $3,125,000) in the year of such individual's death.

List of NO Change Items:

There has been no change to the estate tax cliff. Estates that exceed 105% of the basic exclusion amount do not get the benefit of the New York estate tax exclusion amount (until April 1, 2016 this would be estates in excess of $3,281,250).

There is still no portability for New York purposes. Although the Assembly bill included a portability proposal, this was not part of the adopted budget.

There is still no separate QTIP election when a Federal estate tax return is filed solely for portability purposes. Under current law, an executor may make a separate New York QTIP election only if a Federal estate tax return is not required to be filed. If a Federal estate tax return is filed, a Federal QTIP election must be made in order for a QTIP trust to qualify for the New York marital deduction. If a Federal return is filed and a Federal QTIP election is not made, a QTIP election may not be made for New York purposes.

There has been no change to the estate tax maximum rate. The maximum rate remains at 16%.

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