Proskauer

Wealth Management Update

February 2010

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

The February applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 3.4%. The rate for use with a sale to a defective grantor trust, SCIN or intra-family loan, with a note of a 9-year duration (the mid-term rate, compounded annually), is 2.82%. These are slight increases from January's rates. 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 AFR and a decline in the financial markets continues to present a potentially rewarding opportunity to fund GRATs in February 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 .72% for loans less than 3 years, 2.82% for loans less than 9 years and 4.44% for long-term loans. Thus, if a $1 million loan is made to a child and the child can invest the funds and obtain a 5% return, the child will be able to keep any returns over the mid-term AFR of 2.82%. These same rates are used in connection with sales to defective grantor trusts.

Tax Court Finds Transfers of FLP Interests Do Not Qualify for the Gift Tax Annual Exclusion Because Gifts Were Not of Present Interests – *Price v. Commissioner*, TC Memo 2010-2

This Tax Court decision provides guidance on the availability of the annual exclusion from gift tax under Section 2503(b) for gifts of interests in family limited partnerships. It is an important case for anyone who plans to engage in this kind of gifting, and it calls for a careful review of the provisions of the partnership or LLC agreement.

In 1976, Walter Price started a company, Diesel Power Equipment Company ("DPEC"), which distributed and serviced heavy equipment. Some time later, Mr. Price made the decision to sell the business. In 1997, he formed Price Investments Limited Partnership as a limited partnership and contributed to it the stock in DPEC and three parcels of commercial real estate. When it was formed, the partnership was owned 1% by its general partner, Price Management Corp., 49.5% by the Walter Price Revocable Trust and 49.5% by Mr. Price's wife's revocable trust. Price Management Corp. was owned by Mr. and Mrs. Price's revocable trusts.

In 1998, the partnership sold the DPEC stock and invested the proceeds in marketable securities. Over the next several years, each of Mr. and Mrs. Price gifted interests in the partnership to their children such that by 2002 the children's cumulative interest in the partnership was 99%. Gift tax returns were filed properly for each year, reporting zero gift tax because of the use of annual exclusion and unified credit amounts. Valuation reports were attached to the gift tax returns indicating substantial discounts for lack of control and marketability (which the IRS stipulated were reported correctly).

The IRS issued the Prices deficiency notices disallowing the use of the gift tax annual exclusion under Section 2503(b) with respect to the transferred partnership interests on the ground that the gifts were of "future interests in property." The Prices argued that their gifts were of present interests because (i) the donees could freely transfer the interests to one another or to the general partner and (ii) each donee had immediate rights to partnership income and could freely assign income rights to third persons. Relying on *Hackl*, the IRS argued that the transferred partnership interests were future interests because the partnership agreement effectively barred transfers to third parties and did not require income distributions to the limited partners.

The Tax Court agreed with the IRS and applied the methodology of *Hackl* in concluding that the Prices failed to show that their gifts conferred upon the donees the immediate use, possession or enjoyment of either (i) the transferred property or (ii) the income therefrom.

In its analysis of the "transferred property" prong, the court focused on the terms of the partnership agreement. Specifically, the court notes that the donees have no unilateral right to withdraw their capital accounts; that their rights to transfer and assign partnership interests are restricted; and that a transferee is a mere assignee rather than a substitute limited partner. The Tax Court, citing *Hackl*, states that transfers subject to the contingency of approval cannot support a present interest characterization.

In its analysis of whether the gifts of the partnership interests afforded the donees the immediate use, possession or enjoyment of "the income therefrom," the court held that (1) the partnership would have needed to generate income at or near the time of the gifts; (2) some portion of that income would have to have flowed steadily to the donees; and (3) the portion of income flowing to the donees had to be readily ascertainable. The Court found that the partnership's income did not flow steadily to the donees since there were no distributions in certain years. Furthermore, the court found problematic the fact that neither the partnership nor the general partner had any obligation to distribute profits, and distributions were secondary to the primary purpose of the partnership in achieving a reasonable, compounded rate of return on a long-term basis.

Tax Court Holds that Gift Tax Paid with Respect to Decedent's Deemed Gifts of Remainder Interests in QTIP Property Are Includible in her Gross Estate under Section 2035(b) - *Estate of Morgens v. Commissioner*, 133 T.C. 17 (2009)

Anne Morgens and her husband established a revocable inter vivos trust in a community-property state. After Mr. Morgens' death, the portion of the trust representing his one-half of the community property was allocated to a residual trust for Mrs. Morgens, for which a QTIP election was made. During Mrs. Morgens' lifetime, the residual QTIP trust was divided into two trusts, and Mrs. Morgens made gifts of her qualifying income interests to both trusts, which, in turn, triggered deemed transfers of the remainder interests under Section 2519. The Trustees of the QTIP trusts paid the gift taxes on these deemed transfers.

Mrs. Morgens died within three years of the transfers. Her Executor did not include the amounts of gift tax paid by the Trustees of the QTIP trusts on her estate tax return on the theory that those amounts were not gift tax paid by Mrs. Morgens within three years of her death. The IRS audited the return and determined an estate tax deficiency of approximately $4.6 million.

The IRS argued that the gift tax amounts were includible in Mrs. Morgens' gross estate under Section 2035(b) because Mrs. Morgens was personally liable for the gift tax as the deemed donor of the QTIP, even though she would have a right of recovery from the Trustees who paid it under Section 2207A(b). The Estate argued that applying Section 2035(b) to the gift tax paid by the Trustees would result in an increased estate tax burden contrary to the legislative intent of the QTIP regime. More specifically, the Estate contended that because the ultimate responsibility for paying the gift tax on the Section 2519 deemed transfers lies with the Trustees of the QTIP trusts, Section 2035(b) does not apply.

The Tax Court agreed that Congress intended that, as between QTIP recipients and the surviving spouse, it is the QTIP recipient who should bear the ultimate financial burden for the transfer taxes. However, the Court does not believe that, by allocating the financial burden for gift tax to the recipients of the QTIP Congress shifted to them liability for the gift tax. Section 2207A(b) does not provide that the donees of the QTIP are liable for the applicable gift tax – rather, it refers to the surviving spouse's right to recover from the donees the gift tax paid. The gift tax liability remains with the donor, and, because the QTIP regime treats the surviving spouse as the deemed donor of the QTIP, the gift tax liability attributable to a Section 2519 deemed transfer remains with the surviving spouse.

Over the Estate's objections, the court found that for purposes of Section 2035(b) the deemed transfer of the QTIP is in this case similar to a net gift. The Tax Court previously held in *Estate of Sachs v. Commissioner* that the phrase "gift tax paid by the decedent or his estate" in Section 2035(c) included gift tax attributable to net gifts made by a decedent during the three-year period before his death, even though the donees of the net gift are contractually obligated to pay the gift tax.

The court also noted that if, as a result of a lifetime disposition of the qualifying income interest, the inclusion of the QTIP uses up some or all of the surviving spouse's unified credit, the surviving spouse may not recover the credit amount from the remaindermen. The court states that Congress' refusal to restore the surviving spouse's unified credit undercuts the Estate's argument that Congress intended to hold the donees liable for the gift tax on gifts of QTIP interests under Section 2519.

The court holds that an exception from Section 2035(b) for gift tax paid on QTIP transfers would encourage transfers of QTIP property in contemplation of the surviving spouse's death, which is inconsistent with the goal of Section 2035(b). Without a clear legislative mandate to except gift tax liability of the surviving spouse on Section 2519 transfers from the application of Section 2035(b), the court would not infer such an exception.

Tax Court Holds Loan from FLP to Surviving Spouse's Estate Not "Necessarily Incurred" and Interest thereon Not a Deductible Administration Expense; Transfer to FLP Escapes Estate Inclusion under Consideration Exception – *Estate of Black v. Commissioner*, 113 T.C. 15 (2009)

In this case, the Tax Court objected to a *Graegin*-type loan arrangement between related entities. It is an important decision to review if you are considering such a loan. This case also considered whether certain transfers of FLP interests are includible in a decedent's estate.

Estate of Black involves the estates of Samuel and Irene Black. Samuel Black owned a large amount of stock in Erie Indemnity Company. In 1993, at the age of 91, Mr. Black, his son and two trusts for Mr. Black's grandchildren contributed their Erie stock to an FLP in exchange for partnership interests proportionate to the fair market value of the Erie stock each contributed. The transaction was initiated to implement Mr. Black's buy-and-hold philosophy with respect to the family's Erie stock, and concerns about his son's marriage and the possibility that his grandsons would sell the stock when their trusts terminated. At the time the FLP was formed, Mr. Black was in good health and retained approximately $4 million in assets outside the FLP.

Mr. and Mrs. Black died within five months of each other, with Mr. Black dying first. There was a liquidity shortfall to pay estate taxes, so the Executor (who was their son) approached several banks about a loan but he did not like the terms, and the banks did not want FLP interests as collateral. The Executor also approached the Erie Company about a loan, but was turned down. Ultimately, the Blacks' son, as general partner of the FLP, undertook a secondary offering of approximately one-third of the FLP's Erie stock. The FLP and Mrs. Black's estate worked out a loan whereby the FLP would lend the estate approximately $71 million to pay, among other things, estate taxes, a charitable legacy and certain expenses in connection with the secondary offering. The interest was payable in a lump sum on a date more than four years from the date of the loan, and the estate had no right to prepay interest or principal, being patterned on the loan approved in the *Graegin* case.

The Executor computed the interest on the loan to be $20,296,274 and deducted that amount on Mrs. Black's estate tax return, in full, as an administration expense of her estate. The IRS assessed large estate tax deficiencies in both estates, denying the deductibility of the interest paid, and arguing for the inclusion in Mr. Black's estate, under Section 2036, of the Erie stock Mr. Black transferred to the FLP.

The taxpayer won on the 2036 issue, with the Tax Court finding that there was a substantial non-tax reason for forming the FLP and that Mr. Black's transfer of the stock to the FLP in exchange for the partnership interest was a bona fide sale for adequate and full consideration in money or money's worth. With respect to the deductibility of the loan interest, the estate argued that the loan was bona fide and similar to the loan blessed by the Tax Court in the *Graegin* case. The Tax Court ruled for the IRS, holding that the loan was not "necessarily incurred" (and thus not a deductible administration expense) since the FLP could have distributed Erie company stock in redemption of the estate's partnership interest in an amount that could have covered the estate tax, charitable legacy and other expenses. The Tax Court also was troubled by the fact that the Blacks' son effectively stood on both sides of the loan transaction, as general partner of the FLP and as Executor of Mrs. Black's estate.

Disclaimer Allowed for Pre-1977 Trust Interest within Nine Months of Disclaiming Beneficiary Reaching Majority as "within a Reasonable Time" under Law Applicable Prior to Section 2518 - PLR 200953010 (Dec. 31, 2009)

This PLR involves a requested ruling on the gift tax consequences of a taxpayer's proposed disclaimer of a contingent remainder interest in an irrevocable trust created prior to January 1, 1977.

The taxpayer is a great-grandchild of the Grantor. The Trustees may make principal and income distributions to or for the benefit of the Grantor's child and the descendants of that child in the event of illness, accident, other misfortune or any emergency, or if, in the Trustee's judgment, distributions are necessary for the beneficiaries' comfortable maintenance, support or education. The taxpayer previously had received discretionary distributions from the Trust. The Trust terminates 20 years after the death of the survivor of the Grantor's descendants living on the date the Trust was funded, and on termination, the remaining principal is distributed to the descendants of the Grantor's child who have no living ancestor who is a descendant of such child, per stirpes.

The taxpayer proposes to disclaim her right to receive any distribution from the Trust upon its termination, though she will retain her right to receive discretionary distributions during the Trust term. The disclaimer will be executed by the taxpayer within nine months after attaining majority.

Whereas Section 2518 and the related Treasury Regulations govern disclaimers of interests in property created by transfers made after December 31, 1976, Treasury Regulation Section 25.2511-1(c)(2) provides that, in the case of transfers made before January 1, 1977, a refusal to accept ownership does not constitute the making of a gift if the refusal: (1) is unequivocal; (2) is effective under local law; (3) is made before the disclaimant has accepted the property; and (4) is made within a reasonable time after knowledge of the existence of the transfer creating the interest to be disclaimed.

In the case of a disclaimer of an interest in trust, in general, the transfer occurs when the trust is established rather than when the interest actually vests in the disclaimant, if the transferor has not reserved any power over the trust. However, the time limitation for making the disclaimer does not begin to run until the disclaimant has attained the age of majority and is no longer under a legal disability to disclaim. In this case, the Service concluded that the proposed disclaimer, occurring nine months after the taxpayer reached majority, would be considered to satisfy the "within a reasonable time" standard of Treasury Regulation Section 25.2511-1(c)(2).

Tax Court Holds Deficiency Notice Invalid where IRS Sends Notice to Address on Estate Tax Return, despite Having Notice of Executor's New Address – *Estate of Rule v. Commissioner, TC Memo 2009-309*

This case addresses the issue of whether the IRS mailed an estate tax deficiency notice to the estate's last known address if the IRS mailed the notice to the address shown on the estate tax return, despite having notice that there was a new address for the executor. The deficiency notice was returned by the postal service marked "Attempted Not Known." The IRS did not issue another deficiency notice after the original one was returned because the deadline for issuing a deficiency notice to the estate had passed.

The Tax Court held that the IRS knew at the time the deficiency notice was issued that the estate's address had changed, and that the IRS therefore failed to use reasonable care and diligence in mailing the notice to the estate's last known address. The deficiency notice was held to be invalid, and, accordingly, the estate's motion to dismiss for lack of jurisdiction was granted.

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