Proskauer

Wealth Management Update

August 2011

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

The August applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.2%. This is down from the July rate of 2.4%. The rate for use with a sale to a defective grantor trust, self-cancelling installment note ("SCIN") or intra-family loan with a note of a 9-year duration (the mid-term rate, compounded annually) is also down slightly, to 1.89%. 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 and real estate markets continues to present a potentially rewarding opportunity to fund GRATs in August with depressed assets you expect to perform better in the coming years. However, the Obama Administration, in its 2012 fiscal budget, has proposed to curtail significantly short-term and zeroed-out GRATs. We anticipate that this may become an even hotter topic in light of the recent budget and debt ceiling debates in Washington. Therefore, GRATs should be funded as soon as possible in order to be grandfathered from the effective date of any law 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 0.32% for loans with a term of 3 years or less, 1.89% for loans with a term of 9 years or less and 3.86% for loans with a term of longer than 9 years.

Thus, for example, if a nine-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 1.89%. These same rates are used in connection with sales to defective grantor trusts.

Tax Court upholds use of "defined value clause" on transfer of closely held stock to family trusts and charitable foundation – *Hendrix v. Commissioner,* T.C. Memo 2011-133 (June 15, 2011)

In *Hendrix v. Commissioner*, the taxpayer scored yet another victory in a growing line of cases finding favorably for the use of defined value clauses. *Hendrix* involved the transfer of stock in a closely held corporation to two trusts for the donors' family and to a charitable foundation. The transfer included a so-called "defined value clause" which stated that the donors were transferring a specified number of shares in the company, and that the trusts were to receive $10.5 million and $4.2 million worth of stock, respectively, and any stock over such amount was to pass to a charitable foundation. The terms of the transfer permitted the trusts and the charitable foundation to determine the fair market value of the stock and divide it accordingly among them. Subsequently, the trusts obtained an appraisal valuing the stock, which the charitable foundation further reviewed through its independent appraiser. Approximately five months after the initial transfer, the trusts and the charitable foundation divided the transferred stock based on the appraisal. The IRS challenged the transaction on the basis that the defined value clause was void as against public policy and not reached at arm's length.

As to the public policy argument, the IRS argued that based on the 1944 case of *Procter v. Commissioner*, 142 F.2d 824 (4th Cir.), the use of the clause violated public policy on the grounds that it discouraged the collection of tax by defeating the gift, that it required the court to pass on a moot case, and that a final judgment would be self-defeating. The Tax Court reviewed a recent line of cases upholding the use of defined value clauses. It reasoned, consistent with the recent cases, that where a defined value clause, such as the one in *Hendrix*, does not rely on a condition subsequent to defeat a gift, it is not susceptible to the same public policy concerns as advanced in *Procter*. To the contrary, where the residual beneficiary of the transfer is a charity, public policy actually favors the transfer.

As to the arm's length argument, the Tax Court applied a relatively low standard to determine that the parties had negotiated fairly and at arm's length. Notwithstanding the relationship between the donors and the trust beneficiaries, the Tax Court found that the economic and business risk assumed by the trusts placed the family members at odds with the donors and the charitable foundation. Additionally, the charitable foundation demonstrated arm's length negotiation in its dealings with the donors and the trusts by retaining independent counsel, being actively involved in negotiating the terms of the agreement, and being bound by its fiduciary duty to advance its charitable purpose.

Tax Court applies 25 percent lack of marketability discount to valuation of interest in limited partnership holding timber property, but finds that lack of control discount is already implicit in valuation methodology applied to property – *Estate of Giustina v. Commissioner,* T.C. Memo 2011-141 (June 22, 2011)

At issue in *Giustina* was the valuation of a minority interest in a limited partnership that owned approximately 48,000 acres of timber property. The Tax Court heard testimony from the estate's appraiser and the IRS's appraiser. Both appraisers relied on customary valuation approaches in valuing the limited partnership interest. Namely, each weighed the valuations under an income capitalization approach, a net asset value approach, and a guideline company approach. The appraisers, however, produced significantly different valuations for the limited partnership interest based on the weight that each accorded to the various valuation approaches.

The Tax Court held that the valuation of the limited partnership interest should be based 75 percent on the income capitalization approach and 25 percent on the net asset valuation approach, which resulted in a value between the two appraisals. Interestingly, the Tax Court weighed the income capitalization approach much more heavily than either of the appraisers, and it completely disregarded the guideline company approach. Additionally, the Tax Court determined based on the testimony of each of the appraisers, a 25 percent lack of marketability discount should be applied with respect to the valuation under the income capitalization approach. However, the Tax Court declined to apply a lack of marketability discount with respect to valuation under the net asset valuation approach and further declined to permit a lack of control discount altogether. In a seemingly novel holding, the Tax Court determined that these discounts were already implicit in the valuation approaches themselves. Given this holding and the substantial sums at stake, we may very well see the case appealed to the Ninth Circuit.

Tax Court finds that life insurance proceeds were estate tax includible on account of decedent's retained incidents of ownership, that annuities were estate tax includible, and that estate was liable for failure to file timely penalty – *Estate of Coaxum v. Commissioner,* T.C. Memo 2011-135 (June 16, 2011)

In *Coaxum v. Commissioner*, the Tax Court found that the decedent retained incidents of ownership in six life insurance policies, rendering their values includible in the gross estate, that the value of the annuities owned by the decedent was includible in the gross estate, and that the estate was liable for a failure to file timely penalty.

On the decedent's estate tax return, filed almost two and a half years following the decedent's death, the estate reported six life insurance policies as includible in the decedent's gross estate. Additionally, though the return reported several annuities, it listed their value at zero. Subsequently, the estate argued that the life insurance policies, over which the decedent had retained the power to change the beneficiary, were not includible in the gross estate. The IRS issued its notice of deficiency and assessed a failure to file timely penalty.

In a short opinion, the Tax Court found against the estate on all counts. As to the life insurance, the Tax Court found that the Treasury Regulations expressly provide that the power to change the beneficiary of an insurance policy constitutes an incident of ownership, and the proceeds of the policies were accordingly estate tax includible. With respect to the annuities, the estate apparently tried to argue that because some or all of the annuities would be treated as income in respect of a decedent (IRD) and accordingly deductible for purposes of the estate tax, that the annuities could be included at a zero value. The Tax Court dismissed this argument, passing only on the includibility of the annuity in the gross estate. Finally, the Tax Court found the estate liable for the failure to file timely penalty, as the failure to file timely was not due to reasonable cause or willful neglect.

Tax Court finds taxpayers who employed Roth IRA conversion tax shelter were liable for excise tax and penalties – *Paschall v. Commissioner,* 137 T.C. No. 2 (July 5, 2011); *Swanson v. Commissioner*, T.C. Memo 2011-156 (July 5, 2011)

In the companion cases of *Paschall v. Commissioner* and *Swanson v. Commissioner*, the Tax Court found that taxpayers who employed a Roth IRA conversion tax shelter were liable for excise taxes on account of excess contributions to the Roth IRAs and were also liable for failure to file penalties.

The taxpayers had relied on a strategy promoted by a senior-level professional at a prominent accounting firm. The strategy was promoted as a product, where the taxpayers paid a lump sum for the advice and implementation of the tax strategy. Under the strategy, the taxpayers each formed two S corporations. The taxpayers then used their traditional IRAs to purchase all of the stock in one of their respective S corporations, resulting in a large quantity of cash in the first of the S corporations. Concurrently, the taxpayers each funded a new Roth IRA with $2000, and used that sum to acquire all of the stock in the second S corporations. The first S corporations then transferred all of their cash to the second S corporations, and shortly thereafter, the first S corporations were "merged" into the second S corporations underlying the Roth IRAs. Each of the taxpayers took the position that this alchemy converted their traditional IRAs into Roth IRAs, without triggering any tax. However, they did not properly report the transactions to the IRS. In 2004, the accounting firm informed that taxpayers that their names were being turned over the IRS as having engaged in a potentially "listed transaction." Subsequently, notices of deficiency were issued characterizing the transactions as excess contributions to the Roth IRAs, thereby resulting in an excise tax and a failure to file penalty.

In citing basic tax principles of substance over form, the Tax Court rebuffed the taxpayers' positions that the transaction did not result in an excess contribution to the Roth IRAs. Additionally, the Tax Court held against the taxpayers on the issue of penalties. The Tax Court found that notwithstanding the taxpayers' reliance on the tax professionals, the taxpayers were still bound to exercise "ordinary business care and prudence." Because the taxpayers did not conduct due diligence in response to the conflict of interest between the tax professionals as promoters and as advisers, the Tax Court found the taxpayers had not exercised ordinary business care and prudence. Accordingly, the Tax Court upheld the imposition of the excise tax and the failure to file penalties.

SEC finalizes definition of "family office" for purposes of registration exemption – *SEC Rule 202(a)(11)(G)-1* (June 22, 2011)

The SEC released on June 22, 2011 its final Rule 202(a)(11)(G)-1 exempting "family offices" from registration under the Investment Advisers Act of 1940. In order to qualify for the exemption, a family office adviser must: (1) only advise "family clients" with respect to securities; (2) be wholly-owned by "family clients" and exclusively controlled by "family members;" and (3) not hold itself out to the public as an investment adviser. Key to the application of the exemption is the scope of the definition of the term "family clients," which includes family members, former family members, certain key employees, charities funded by family clients, revocable trusts of family clients, irrevocable trusts where family clients are the only current beneficiaries, estates of family members and key employees, and entities wholly owned by family members.

For more information, see Proskauer client alert, "SEC Releases Final Rule Exempting Family Offices," June 29, 2011.

Nevada passes restrictive "charging order" legislation to increase asset protection afforded by business entities – *Nevada* SB 405 (June 16, 2011)

Nevada Senate Bill 405, which was signed into law by the Governor on June 16, provides that a "charging order" is the exclusive remedy of a judgment creditor against interests in Nevada limited liability companies, limited partnerships and corporations. A charging order is an order entered by a court in favor of a judgment creditor that permits the creditor to attach to distributions made to the debtor from the business entity. The Nevada legislation expressly applies to single member entities, thus avoiding problems that have arisen in other states, most recently in Florida. The legislation also provides that no other "equitable remedies" are available. This means that doctrines such as reverse veil piercing, alter ego, constructive trust and resulting trust would generally not be available against the owner of an interest in a Nevada business entities. A statutory exception is made, however, for the application of the alter ego doctrine to a Nevada corporation. The strengthening of Nevada's asset protection law in this regard may make Nevada a leading choice for formation of business entities in the months and years to come.

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