Proskauer

Wealth Management Update

August 2012

August Interest Rates

The August applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs, and GRATs is 1.0%. 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) has declined, to 0.88%. Remember that lower rates work best with GRATs, CLTs, sales to defective grantor trusts, private annuities, SCINs and intra-family loans. The low AFR presents great estate planning opportunities to move assets to lower generations with little cost.

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 0.25% for loans with a term of 3 years or less, 0.88% for loans with a term of 9 years or less and 2.23% 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 0.88%, the child will be entitled to retain any returns over 0.88%. These same rates are used in connection with sales to defective grantor trusts.

Portability Regs

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRUIRJCA") allowed portability of the applicable exclusion amount ($5,120,000 in 2012) between spouses. The portability sunsets at the end of the 2012, so currently it only applies to decedents dying in 2011 and 2012. The IRS recently issued Regulations to provide guidance. The following are highlights of the Regulations:

1. Definition of Applicable Exclusion Amount – The applicable exclusion amount is now defined to equal the sum of the basic exclusion amount and the deceased spouse unused exclusion ("DSUE").
2. Definition of DSUE – The DSUE is defined as the lesser of (A) the basic exclusion amount of the deceased spouse or (B) the decedent's applicable exclusion

amount, less the amount with respect to which the tentative tax is determined on the estate of such deceased spouse. The regulations clarified that an original reference in (B) to the "basic exclusion amount" actually meant to refer to "applicable exclusion amount."

3. Electing Portability – The surviving spouse may only use the DSUE if the estate of the deceased spouse elects portability and computes the DSUE. The election is made by timely filing an estate tax return. Until the form is revised, the return will be deemed to include a DSUE computation. To opt out the executor may either make an affirmative statement or not file a return (if not otherwise required to do so).
4. Extension for Decedent's Dying in Early 2011 – The IRS granted an extension to file for estates of a decedent dying in the first half of 2011 who were not otherwise obligated to file the return. These estates must file the return within 15 months of death.
5. Relief for Small Estates – If an estate is not otherwise obligated to file the estate tax return, it does not have to report the value of certain property qualifying for the marital or charitable deduction. It need only report enough information to establish an asset's eligibility for a deduction. Instead, the 706 Instructions will provide value ranges and the personal representative must select the appropriate range based on a good faith estimate.
6. Who May Make the Election – Only an executor may make the election. If there is no executor, any person in actual or constructive possession of property may elect portability.
7. Gifts Which Incurred Tax Excluded for Purposes of Determining DSUE – Any gifts upon which the deceased spouse paid tax are excluded in the DSUE calculation.
8. Ordering Rule – When a surviving spouse makes a gift, the DSUE of the last deceased spouse will be considered to apply before the surviving spouse's own basic exclusion amount.
9. Statute of Limitations – The IRS may examine an old estate tax return at any time for purposes of calculating the DSUE.

***U.S. v. Johnson*, Case No. 2:11-CV-00087, U.S. District Court (May 23, 2012)**

Court holds representatives personally liable for estate tax despite having an indemnity agreement

Decedent was survived by four children, two of whom were the personal representatives of her estate. The fiduciaries elected to defer a portion of the estate taxes under IRC Section 6166. Soon after, they distributed her assets to the beneficiaries, who each agreed in writing to bear responsibility for unpaid estate taxes.

A few years later the relevant corporation went bankrupt. The next year the estate defaulted on unpaid estate taxes. The IRS then attempted to collect the taxes both from the personal representatives and all beneficiaries.

The Court concluded that the beneficiaries were not liable because Code Section 6324(a)(2), which imputes personal liability to the Decedent's transferees, did not apply to the beneficiaries because they did not receive the assets immediately upon death. They were only entitled to assets after certain gifts were made and all taxes were paid. The Court concluded that the immediate transferees were the Trustees of the family trust which received the assets under the decendent's Will.

The Court also held the personal representatives personally liable under the claims statute for distributing assets before estate taxes were paid. The contribution agreement did not change this conclusion because this was treated as a contract between the personal representatives and the beneficiaries, which agreement did not affect the IRS.

New Net Investment Tax Will Afflict Almost All Non-Grantor Trusts

Starting in 2013, all non-grantor trusts and estates with income of over $11,200 (indexed for inflation) (note the Wall Street Journal recently stated that $12,000 is the threshold) will be subject to a new net investment tax of 3.8%. Until recently, investors were waiting to see how the Supreme Court would rule on the new health care plan. Now that the plan has been upheld, the tax is sure to come into effect. The IRS has not yet issued guidance.

***Wimmer v. Commissioner*, T.C. Memo 2012-157 (June 4, 2012) Gifts of Limited Partnership interests qualified as present interests for annual exclusion**

Three cases prior to *Wimmer* denied annual exclusions for gifts of limited partnership interests. The *Wimmer* Court found that the gifts qualified because the donees received income distributions.

The partnership was funded with publicly traded and dividend paying stock. In the first three years the partnership made distributions to the limited partners to pay their income tax. After that, the partnership distributed all dividends. Also, limited partners had access to capital account withdrawals.

The Court stated that in order for the gifts to convey a present interest, they must convey a substantial economic benefit by allowing use, possession, or enjoyment of (1) property or (2) of income. The Court found that because the limited partnership agreement contained many restrictions on transfer, the beneficiaries did not have a present right to use the property.

The Court then considered whether the beneficiaries had a right to income. There is a three-part test: (1) if the partnership would generate income, (2) if some portion of the income would flow steadily to the donees, and (3) if that portion of income could be readily ascertained. This test was satisfied. The partnership was expected to generate income because it consisted of publicly traded stock. It was expected that some portion of income would flow steadily because the general partners owed fiduciary duties to the limited partners. One donee was a trust with no other assets, so the partnership was required to make income distributions to provide this trust with funds to pay its taxes. Since the partnership agreement required pro-rata distributions, all other limited partners would also receive income. Last, the income could be readily ascertained based on the stocks' histories.

***Windsor v. U.S.*, Case 1:10-cv-08435-BSJ-JCF (June 6, 2012, Southern Disctrict of NY) DOMA does not withstand rational basis test**

In this big victory for the taxpayer, the Court granted summary judgment against the U.S. finding that the Defense of Marriage Act ("DOMA") had no rational basis. The taxpayer was the surviving spouse in a same sex couple. The couple had been legally married in Canada. Decedent's entire estate passed to her spouse, but, because of DOMA, the estate was not entitled to a marital deduction and owed about $360,000.

The taxpayer argued that homosexuals should be treated as a "suspect class," thereby subjecting DOMA to higher constitutional scrutiny. However, the Court declined to determine whether they should be a suspect class because it concluded, under summary judgment, that DOMA fails even under the lowest level of scrutiny – rational basis. Specifically, the Court found that DOMA does not promote its stated goals (such as promoting marriage, protecting family structures, etc.).

President's Budget Proposal Attempts to Curb Use of Intentionally Defective Grantor Trusts

For the first time a President's budget has included a proposal to deter use of Intentionally Defective Grantor Trusts ("IDGT"). Specifically, President Obama's 2013 budget proposal would require any grantor trust to be included in the grantor's estate or to pay gift taxes if assets are distributed before the grantor's death or the grantor ceases to be treated as an owner. Even if the budget does not pass with this provision, it is significant that the government is, for the first time, taking notice of this popular estate planning technique.

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