Proskauer

Wealth Management Update

April 2012

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

The April § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 1.4%. This is the same as the January, February and March rates. 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 a 9-year duration (the mid-term rate, compounded annually) is 1.15% (up slightly from the March rate of 1.08%). 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 a decline in the financial and real estate markets presents a potentially rewarding opportunity to fund GRATs in April 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 0.25% for loans with a term of 3 years or less, 1.15% for loans with a term of 9 years or less and 2.72% 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 1.15%, the child will be able to keep any returns over 1.15%. These same rates are used in connection with sales to defective grantor trusts.

Estate of Stone v. Comm'r, T.C. Memo 2012-48 (2/22/2012)

In *Stone*, a recent Tax Court case, the Court determined that the transfer of undeveloped woodlands to a family limited partnership (an "FLP") was a bona fide sale, since the record established that the FLP was created for legitimate non-tax reasons. As a result, since the taxpayer had gifted during her lifetime her 49% limited partnership interest in the FLP to other family members, the woodlands were only includable in her estate for federal estate tax purposes to the extent of the 1% general partnership interest she retained as of her death.

The land at issue was 740 acres of woodlands in Tennessee, which includes a lake created by a dam constructed by the local water utility. However, the resulting lakefront property is of limited value for sale as home sites, since the water level of the lake falls considerably each summer when the utility draws water to supply drinking water for the local community.

Under § 2036 of the Code, property gifted by a decedent will be included in his or her gross estate when three conditions are met: (1) the decedent transferred the property during his or her lifetime, (2) the transfer was not a bona fide sale for adequate and full consideration and (3) the decedent retained certain interests or rights in the property which he or she had not relinquished prior to his or her death.

At issue in *Stone* was the second prong of this three-part test. The IRS argued that the only purpose of the partnership was to simplify the gifting process (i.e., so that deeds would not have to be executed each time a portion of the woodlands was gifted to a particular family member), and that this was not a sufficient nontax motive to support the conclusion that the transfer was a bona fide sale.

The court concluded, however, that the FLP was created for two additional purposes as well, namely (1) to create a family asset that could eventually be developed and sold by the family in the event that the utility someday ceases drawing water from the lake and (2) to protect the property from division (and attendant loss of value) as a result of partition actions, which family members would be able to bring if they were granted outright interest in the woodlands rather than non-controlling interests in the FLP. The existence of these nontax purposes meant that the transfer to the FLP failed the second prong of § 2036, and thus the property would not be included in the decedent’s gross estate.

The IRS then argued the family members had not respected the formalities of the FLP, since the decedent and her husband had paid all FLP taxes out of their personal funds and because there was inadequate documentation relating to the initial gifts and to certain quitclaims of interests in the FLP made by the divorcing spouses of various family members.

The court agreed that certain formalities had not been respected, but concluded that the FLP was not illusory because the woodlands were formally transferred to the FLP, there was no commingling of funds between the FLP and its partners and no distributions were ever made from the FLP. In addition, the court noted that the gifts of FLP interests to the decedent's family had not involved any valuation discounts (such as for lack of marketability or lack of control).

It is difficult to extract useful lessons from cases involving FLPs, since each case is so fact-specific. This is particularly true in *Stone* due to the (uncommon) absence of valuation discounts. At a minimum, *Stone* highlights the importance of formulating and documenting the non-tax purposes of the FLP upon its creation and ensuring that all partnership formalities are respected.

Chief Counsel Advice Memorandum 201208026 (9/28/2011)

In a recently released Memorandum, the IRS Office of Chief Counsel concludes that contributions made by Settlors to a discretionary trust for their descendants were taxable gifts, since (1) the Settlors had not retained any rights that would make the gifts incomplete and (2) the withdrawal powers granted to the beneficiaries were unenforceable in state court and thus illusory.

Under the trust agreement, the Settlors retained testamentary limited powers of appointment, presumably with the intent that these retained powers would render contributions to the trust incomplete under Treas. Reg. § 25.2511-2(b), and thus not subject to immediate gift taxation. The Settlors then commenced funding the trust each year with interests in a family entity (the nature of which is not specified in the Memorandum) in amounts equal to the couple's annual gift tax exemption amounts with respect to the trust beneficiaries.

The Memorandum, however, concludes that, under established case law, a testamentary power of appointment relates only to the remainder of the trust and not to the interest held for the benefit of the current beneficiaries. As a result, each gift to the trust has to be thought of as consisting of two parts, a current interest (which is complete for gift tax purposes) and a remainder interest (which is incomplete for gift tax purposes).

In this case, the value of the gift of the current interest is equal to the entire fair market value of the transferred property, for two reasons: (1) since the Trustee of the trust has the power to terminate the trust at any time by distributing all of the principal to one or more of the current beneficiaries, the present value of any remainder interest is negligible and (2) because the incomplete gifts of the remainder interests are not "qualified interests" under the special valuation rules of § 2702, the value of the retained interest is treated as zero.

As a result of this analysis, practitioners wishing to ensure that a gift is incomplete should not rely on a retained testamentary power and should make certain that the grantor is also given an applicable lifetime power, such as a lifetime limited power of appointment or a power to veto trust distributions.

The Memorandum goes on to discuss the withdrawal rights granted to the beneficiaries, which were designed to ensure that gifts to the trust were free of gift taxation to the extent of the Settlors' annual gift tax exemption amounts with respect to the beneficiaries. The trust agreement designates relevant state law as the law of the trust, but requires that all disputes relating to the trust to be resolved in an "Other Forum" (likely a reference to mandatory binding arbitration). In addition, the trust agreement provides that any beneficiary who participates in any civil proceeding to enforce the trust will have his or her beneficial interest terminated.

The Memorandum concludes that the beneficiaries have no means of enforcing their withdrawal rights under state law, since the Other Forum is not bound by state law and no beneficiary would be willing to petition the state court for relief at the risk of terminating his or her beneficial interest in the trust. Because these withdrawal rights are therefore deemed unenforceable, the Settlors were not allowed to use their annual gift tax exemption amounts to shield any portion of their contributions to the trust.

General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (February 2012)

Each year, the U.S. Department of the Treasury issues a report setting forth the revenue proposals of the current presidential administration. This report, known as the "Greenbook," often proposes sweeping changes to the Internal Revenue Code. Although the Greenbook provides a valuable insight into the intentions and positions of the administration, many of its proposals are aspirational and have little chance of passage.

The Greenbook for the 2013 fiscal year, released in February, contains several proposals relating to gift and estate taxation, most notably its recommendations as to how these taxes should work in 2013. In 2012, each individual is entitled to a unified gift and estate tax exemption of $5,120,000, meaning that he or she may give, in the aggregate, assets up to that amount free of transfer taxes, whether during life (as gifts) or at death (as bequests). Any transfers in excess of that amount will be subject to gift or estate tax at a 35% rate.

Absent Congressional action, the current gift and estate tax regime will "sunset" at the end of 2012 and revert to the exemption and rates in effect in 2001, namely a $1 million estate and gift tax exclusion, with transfers above that amount taxed at a maximum rate of 55%.

The Greenbook proposes to take a middle ground between the 2001 and 2012 rates by making permanent the tax regime in effect in 2009, when the gift tax exemption was $1 million, the estate tax exemption was $3.5 million and the maximum gift and estate tax rate was 45%. These new rates would apply only for transfers made after December 31, 2012. In addition, the Greenbook would make permanent a taxpayer’s ability (also scheduled to otherwise sunset at the end of 2012) to utilize any estate tax exemption left unused by a deceased spouse (known as "portability").

The Greenbook also seeks to place restrictions on the use of certain estate planning techniques commonly used by wealthy individuals to transfer assets to their descendants during their lifetimes. For instance, GRATs would be subject to a minimum term of ten years and would be required to have a remainder interest greater than zero. The imposition of a ten-year minimum term may increase the chances that a given GRAT will be unsuccessful, since a GRAT fails entirely if the Settlor dies during the GRAT term (the likelihood of which increases along with the GRAT term). In addition, a GRAT with a longer term may be less successful than a succession of short-term rolling GRATs in taking maximum advantage of market fluctuations. For instance, if trust assets appreciate wildly for five years and then suffer an equivalent decrease in value in the next five years, two successive five-year GRATs will collectively outperform a single ten-year GRAT.

The Greenbook also proposes to include in the gross estate of a grantor any trust he or she is considered to be the owner of for income tax purposes (i.e., any "grantor trusts"). At present, by proving a grantor certain retained powers in a trust agreement, estate planners can structure a trust such that (1) all trust income is payable by the grantor but (2) trust assets are not included in the grantor's estate at death. This disparate treatment (and the fact that sales, loans and other transactions between a grantor and a grantor trust do not constitute recognition events for income tax purposes) gives rise to several sophisticated estate planning techniques that allow a grantor to leverage his or her gifts to pass more assets to his or her descendants free of gift tax, such as by selling assets to an intentionally defective grantor trust in exchange for a promissory note.

Although the proposed inclusion of grantor trust assets in the grantor's estate will not apply to certain widely used trusts (such as GRATs and qualified personal residence trusts), the scope of the proposed change is still breathtaking. Numerous trusts that estate planners create on a daily basis, and that do not appear to be the intended targets of the proposal, would be negatively impacted, including insurance trusts and inter vivos marital trusts. Given the dramatic nature and breadth of this proposal, it is unlikely that it will be put into effect.

In 2012, each individual has a lifetime generation-skipping transfer tax (the "GST" tax) exemption of $5,120,000, meaning that a married couple could together create a $10,240,000 trust for descendants that will never be subject to future transfer taxation. If the trust is created in a jurisdiction with no rule against perpetuities, the trust can, theoretically, continue indefinitely and provide transfer tax-free distributions to successive generations of descendants. The Greenbook proposes to curtail the effectiveness of such trusts by requiring that no trust shall be allowed to have its assets exempt from GST tax for longer than ninety years.

Finally, the Greenbook proposes to limit the use of discounts when valuing transfers of interests in family-controlled entities between family members. For these transfers, certain restrictions imposed on the transferred interest, which otherwise might give rise to a valuation discount (such as for lack of control or lack of marketability), will be disregarded if, after the transfer, the restriction will lapse or can be removed by the transferor or his or her family. This proposal (which was also included in the Greenbook for the 2012 fiscal year) is intended to minimize the use of family limited partnership and other entities to obtain valuation discounts that decrease the amount of gift or estate tax the government collects.

IRS Notice 2012-21 (3/5/2012)

In order for a surviving spouse to retain use of a deceased spouse's unused estate tax exemption, he or she must make a portability election on a timely filed federal estate tax return for the deceased spouse, even if no federal return needs to be filed because the decedent's assets were below his or her remaining federal estate tax exemption amount.

Because taxpayers may have been unaware of this filing requirement, in Notice 2012-21 the IRS has granted a six-month extension for the filing of a federal estate tax return for a decedent who died in the first six months of 2011. This extension only applies if the decedent's gross estate was $5 million or less and if there is a surviving spouse.

To take advantage of the extension, the decedent's estate must submit a Form 4768 (i.e., a request for an extension of time to file a return) within fifteen months of the date of the decedent's death. The form should reference Notice 2012-21 and may be submitted simultaneously with the estate tax return.

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