Proskauer

Wealth Management Update

June 2012

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

The June § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 1.2%. This is a decrease from last month's rate of 1.6%. 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 1.07%. That is down from last month's rate of 1.3%. 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 financial and real estate market that remains undervalued presents a potentially rewarding opportunity to fund GRATs in June with depressed assets that 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 0.23% for loans with a term of 3 years or less, 1.07% for loans with a term of 9 years or less, and 2.64% for loans with a term of longer than 9 years. Thus, for example, if a 9-year loan is made to a child who invests the funds and obtains a return in excess of 1.07%, the child will be able to keep any returns in excess of that interest rate.

2012 – with an estate and generation-skipping transfer tax exemption of $5,120,000, and low interest rates and asset values – continues to be ripe for sophisticated estate planning techniques.

***Estate of Rankin M. Smith*, 109 AFTR 2d 2012-987 (Court of Claims, 2/13/2012)**

In *Smith*, the United States Court of Federal Claims found that Internal Revenue Code ("IRC") §2704 is applicable when the decedent's death triggers a lapse in the preferential voting rights connected to his Class A shares in a privately held company and the decedent's family controlled that company both before and after his death. As a result, the full value of the class A shares, including the preferential voting rights, is includible in the decedent's estate.

The decedent and his family owned a major sports league franchise, through an S corporation, when he died in 1997. When the company originally was formed, it was a C corporation. It became an S corporation in 1986, and the shares were converted to Class A and Class B shares. After the conversion, the decedent owned all of the Class A shares, which gave him an 81.75% vote. The Class A shareholders' agreement provided that the Class A shares would lose their preferential voting rights if they were sold or redeemed, but Class A shareholders could gift or bequeath their shares with the voting rights intact.

In 1991, some of the family members sold their Class B shares. A new shareholders' agreement was executed that outlined the rights of both Class A and Class B shareholders. That agreement provided that the Class A shares would be converted into Class B shares upon the sale of the Class A shares or upon the death of a Class A shareholder. When the decedent died in 1997, his Class A shares converted to Class B shares. The decedent's family retained 88% of the company vote after his death, as opposed to the 97% it controlled before his death.

Those facts fit neatly within the provisions of IRC § 2704 and Treasury Regulation § 25.2704-1, which generally provide that if there is a lapse of voting rights in a corporation at the death of a shareholder and the family that owns the corporation controlled it both before and after the lapse, then the full value of the preferred stock is includible in the decedent's estate. Nonetheless, the estate reported on the decedent's estate tax return the lower value of the Class B shares that it held after his death. The IRS audited the return and the estate paid the additional assessed tax and subsequently sued for a refund.

The estate conceded that the family had voting control of the corporation, but argued that § 2704 did not apply because the family did not have the power to restore the lapse of voting power. The court found that there is nothing in the legislative history that lends credence to that statutory interpretation and rejected the argument.

Next, the estate argued that the lapse occurred in 1991, when the new shareholders' agreement was signed; thus the lapse was a 1991 gift. The court rejected that argument as well, noting that the decedent retained his preferred voting rights until his death when those rights actually did lapse.

The estate continued along its creative line of reasoning, arguing that: (1) the lapse of the restrictions on the shares occurred in 1986, before § 2704 was enacted, (2) a hypothetical buyer would not be willing to purchase the shares from a hypothetical seller at the full value of Class A shares and (3) § 2703 applied, not § 2704, because the 1991 sale of shares was an arm's-length business transaction, and that is what resulted in the lapsing of voting rights. The court addressed the erroneous reasoning of each argument and ultimately found that the facts in this case were indistinguishable from the plain language of § 2704.

***Taproot Administrative Services, Inc. v. Commissioner*, 109 AFTR 2d 2012-1446 (U.S. Ct. Appeals, 9th Circuit, 3/21/2012)**

The Ninth Circuit Court of Appeals upheld the United States Tax Court's finding that a Roth IRA is not an eligible S corporation shareholder.

In 2003, Taproot Administrative Services, Inc. ("Taproot"), which previously had elected S corporation status, issued all of its outstanding shares of stock to a custodial Roth IRA account held for the benefit of its founder, Paul Di Mundo. The IRS issued a notice of deficiency for that year and deemed it taxable as a C corporation.

IRC § 1361(b) limits the types of eligible S corporation shareholders to domestic individuals, estates, particular types of trusts and certain tax-exempt entities. Treasury Regulation § 1.1361-1(e)(1) provides that the person for whom shares are owned by a nominee, guardian, custodian or agent can be an eligible S corporation shareholder. IRC § 1361(c)(2)(A)(i) permits grantor trusts to be S corporation shareholders.

Taproot argued that a custodial Roth IRA is held for the benefit of its owner who is indistinguishable from the IRA; in part, because the IRA does not file a separate income tax return. Alternatively, Taproot argued that the Roth IRA is the equivalent of a grantor trust. In either case, Taproot urged the court to look through the IRA to the sole individual owner as the eligible S corporation shareholder. The Tax Court rejected Taproot's propositions, noting that none of the statutes, regulations, legislative history and other IRS guidance supported its theories.

On appeal, the focus of Taproot's argument was its contention that IRAs and Roth IRAs function merely as forms of individual investment accounts that are indistinguishable from their owners. The court, however, noted that other eligible entity shareholders such as grantor trusts and qualified subchapter S trusts ("QSSTs") are specifically authorized shareholders, whereas IRAs are not enumerated in any class of permissible S corporation shareholders. The court also rejected Taproot's attempt to equate custodial IRAs with the custodial relationships authorized under Treasury Regulation § 1.1361-1(e).

The Court determined that the key distinguishing consideration was who currently bears the tax on any S corporation income. QSST and grantor trust beneficiaries as well as disabled and minor individuals for whom custodianship and guardianship accounts are held are taxed currently on S corporation income. The IRA taxation rules, on the other hand, defer tax payments until IRA distributions are made. The court stated that the attempts to read into the applicable laws an extension of the S corporation attribution rules "founders on the shoals of logic and well-settled rules of regulatory interpretation."

***U.S. v. MacIntyre, et al.*, 109 AFTR 2d 2012-1553 (USDC S.D. TX, 3/28/2012)**

In *MacIntyre*, the District Court in the Southern District of Texas held that donee liability for unpaid gift taxes attributable to indirect gifts to a grantor retained income trust ("GRIT") is chargeable to the GRIT income beneficiary rather than the remaindermen.

Eleanor Stevens received shares of stock in Marshall Petroleum Inc. ("MPI") as part of her divorce settlement with J. Howard Marshall, II. Stevens had funded a GRIT with a portion of those shares and was receiving the GRIT income when Marshall sold some of his shares back to the company for less than fair market value. That sale resulted in an indirect gift of the increased value of MPI shares owned by the other shareholders. After Marshall's death, and pursuant to a stipulation of settlement between the IRS and Marshall's estate, it was agreed that the estate owed gift tax related to the indirect gift. When the Marshall estate did not pay all of the gift tax, the IRS brought suit against Stevens' estate (Stevens also had died by then) and the GRIT trustees to collect those taxes.

The court stated that the unpaid gift tax should have been paid from the GRIT once it became clear that the Marshall estate would not pay the tax. Since the GRIT thereafter had terminated, the question had become whether the tax liability lies with the income beneficiary or remainder beneficiary. The Stevens estate claimed that Stevens was not the donee because (1) the GRIT remainder beneficiaries are responsible for any gift taxes attributable to an enlargement of corpus and (2) pursuant to both the applicable Kansas law and the trust agreement, the trust income does not include a gift to corpus.

The court disagreed with both arguments. First, it noted that a remainder interest is an uncertain future interest, and that the trust corpus could be depleted before distribution to the remaindermen. In that case, the remaindermen would be unfairly burdened with tax on assets they never received. The income interest, the value of which is increased by the increase in the value of the corpus, is a present source of funds sufficient to pay the tax. Second, the court held that under the terms of the trust agreement, Stevens had the right to all of the GRIT income, which would necessarily be increased by any augmented trust corpus; thus, any increase in income-producing property can be equated with an increase in income. As a result, the court found Stevens to be the donee liable for the unpaid gift tax.

Internal Revenue Bulletin T.D. 9582, 4/30/2012

The IRS has issued final regulations under IRC § 642(c) with regard to the federal tax consequences of an ordering provision in a trust, a will, or a provision of local law for income payable to a charitable beneficiary. Under the final regulations, if an ordering provision does not have an economic effect independent of any income tax consequences, the provisions will be disregarded for federal income tax purposes and income will be deemed to have been paid pro rata out of all sources of income.

***Marshall Naify Revocable Trust v. U.S.*, 2-12-1 U.S.T.C. 60,639 (U.S. Ct. Appeals, 9th Circuit, 2/15/2012)**

The United States Tax Court, in a claim for a refund of estate taxes, ruled that an estate's IRC § 2053 deduction for a claim against the estate is limited to the actual amount paid, not the potential liability that could have been incurred.

The decedent implemented a plan to avoid the payment of California income taxes on $660,000,000 in capital gains by transferring the property to which the gain was attributable to a Delaware corporation. After the decedent's death, the personal representatives did not report the gain on his California income tax return, but they did report a $62,000,000 federal estate tax deduction as the estimated amount of California taxes he would owe. After the estate tax return was filed, California did audit the decedent's income tax return and a $26,000,000 settlement was reached. The IRS then adjusted the estate tax deduction for the claim to the amount of the settlement that was actually paid and the estate paid the additional estate tax that arose as a result of the adjustment. Thereafter, the estate filed a claim for refund. The basis of the estate's claim was its proposition that, at the time of the decedent's death, there was a 67% probability that the originally deducted $67,000,000 would be owed; therefore, the allowable deduction on the estate tax return should have been $47,000,000.

The court noted that in order to take an IRC § 2053 deduction, a potential claim against an estate must be ascertainable with reasonable certainty on the decedent's date of death. In this case, the claim remained uncertain on the decedent's death because California had not yet initiated an audit, let alone issued a deficiency notice, and the extent to which the decedent's tax-avoidance scheme would be deemed unsuccessful was unknown. In addition, the estate's own expert who had proposed the 67% probability argument reported that the claim was contingent and had a range of potential values between $0 and $62,000,000. Given those circumstances and the suggestion in Treasury Regulation § 20.2053–1(b)(3) that a post-death claim is dispositive of a claim's value, the court found that the deduction was limited to the actual amount that the estate paid.

Private Letter Ruling 201216045 (4/23/2012)

In this PLR, the IRS, for the first time, specifically blessed the use of graduated charitable lead annuity trust ("CLAT") payments over a CLAT term.

The decedent's revocable trust created a ten-year CLAT, the charitable beneficiary of which was a private foundation. The trust utilized a zeroed-out CLAT formula that read as follows: "Accounting from the beginning date, the annual annuity amount shall be an amount that will produce a present value under § 7520 of the Code for the non-charitable remainder interest equal to zero or as close to zero as possible without exceeding zero." Two items were missing from the formula: the annuity rate and the amount. The CLAT Trustees initiated a probate court construction proceeding and proposed an annuity percentage that would increase in successive years by 20%. The CLAT Trustees presented evidence to the probate court that the CLAT likely could not fully satisfy the annuity interest if it used a straight-line annuity. The probate court approved the graduated-rate annuity proposal.

The IRS ruled that the trust terms, as construed by the probate court, satisfied the provisions of IRC § 2055(e)(2) for a guaranteed annuity interest, and that the property passing to the CLAT would qualify for a charitable deduction under § 2055(a). The IRS also ruled that the probate court's construction proceeding order would be treated as a settlement of a will contest and, therefore, the annuity amount was certain at the time the CLAT was to be funded. The IRS further ruled that (1) the CLAT would be allowed an annual § 642(c) deduction for each year that the annuity amount is paid to the charitable foundation, and (2) the CLAT terms, as construed by the probate court, do not violate any of the charitable foundation rules, such as the prohibition against self-dealing, that appear under IRC § 507, § 4941, § 4942, § 4943, § 4944 and § 4945.

***Estate of Lois L. Lockett v. Commissioner*, U.S. Tax Court, CCH Dec. 59,039(M), T.C. Memo. 2012-123, T.C.M. (Apr. 25, 2012)**

The Tax Court found that the full value of assets that had been transferred to a family limited partnership ("FLP") is includible in the decedent's estate because, pursuant to local law and the partnership agreement, the partnership had dissolved once the decedent became the sole partner.

The decedent created a FLP and funded it with her own assets and assets owned by her revocable trust. The decedent's two sons were listed as general partners in the FLP agreement, but they had not contributed any assets to the FLP and their partnership interests in the agreement were listed as zero. The decedent also was named as the only partner on the FLP tax returns and 100 percent of the FLP income was allocated to her. If all that were not enough, most salient to this case is the fact that the decedent's revocable trust was terminated before her death and all of the trust assets, including the FLP interests it owned, were distributed to the decedent. When the estate tax return was filed, the FLP, not its underlying assets, was reported, and the estate applied a forty percent valuation discount to the FLP interest.

The Tax Court found no evidence to support the claim that anyone other than the decedent owned any FLP interest after the termination of her revocable trust. Under the applicable Arizona law and the FLP agreement, the FLP automatically terminated when the decedent became the sole owner. Therefore, the court determined that the full, undiscounted value of all of the underlying FLP assets are includible in the decedent's estate.

The court also needed to determine whether certain transfers from the partnership to the decedent's relatives were gifts or loans. Despite a lack of adherence to formalities related to the promissory notes that had been issued with respect to two of the three transactions, the estate was able to rebut the presumption that the loans were gifts, and appropriate adjustments were made to the amount due.

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