Wealth Management Update

November 2012

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

The November § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 1.0%, which is a reduction from last month's rate of 1.2%. 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 0.89%, which is down slightly from last month's rate of 0.93%. 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 November 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 0.22% for loans with a term of 3 years or less, 0.89% for loans with a term of 9 years or less and 2.40% 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 0.89%, the child will be able to keep any returns in excess of that interest rate.

The final two months of 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.

Keller v. United States, 5th Cir., No. 10-41311 (09/25/12)

In *Keller*, the Fifth Circuit Court of Appeals ruled that an estate was entitled to an estate tax refund for the discounted value of a family limited partnership ("FLP") that was created during the decedent's lifetime but not fully funded until after the decedent's death. The Fifth Circuit concluded that the FLP was "deemed" to be funded as of the decedent's date of death under applicable state law (Texas), where the "intent of an owner to make an asset partnership property will cause the asset to be the property of the partnership."

Following their daughter's divorce, the decedent and her husband created joint revocable trusts due to concerns about preserving their family's wealth and protecting that wealth from creditors. Following her husband's death, the decedent was advised that creating an FLP would provide additional protection for her family's assets. The decedent decided to create and fund an FLP with approximately $250 million of cash and bonds, but did not actually transfer the funds to the FLP during her lifetime. The decedent's advisors, working under the impression that the FLP had not been funded, advised the estate to sell $147.8 million of bonds to pay the federal estate tax due. A year later, the decedent's advisor attended a seminar and learned that under Texas law the FLP may have been considered to have been funded at the time of the decedent's death. As such, the estate proceeded to complete any formalities associated with creating and funding the FLP. Since the bonds were deemed to be FLP property, the advisors retroactively structured the sale and payment of estate tax as a loan from the FLP to the estate in exchange for a promissory note payable to the FLP effective as of the date of the loan.

In addition to the discount applicable to the FLP property owned by the estate, the Fifth Circuit found that the interest payable to the FLP under the promissory note from the estate was a properly deductible expense of the estate. This determination was made by distinguishing a holding by the Tax Court under similar facts in *Estate of Black v. Comm'r*, 133 T.C. 340 (2009). In this case, unlike in the *Black* case, the estate did not have to redeem FLP units to satisfy the loan because the estate had sufficient other illiquid assets to repay its debt to the FLP. As a result, the interest payable to the FLP was properly deductible by the estate.

Hastings v. PNC Bank NA, Md. **No. 109 (09/27/2012)**

The Maryland Court of Appeals holds for PNC in a suit by the beneficiaries of a testamentary trust created under the will of a Maryland resident where the beneficiaries claimed that PNC breached its fiduciary duty in requiring them to sign a release agreement arguably too favorable to PNC before distributing assets to them. The reason for the action was that PNC subsequently miscalculated the Maryland inheritance tax due.

The court held that under Maryland law, the inheritance tax is owed on the total amount of the remainder trust if the tax was not prepaid when the estate was administered and the trust funded. Such prepayment is an option under Maryland law. The court explained that under Maryland law, the state inheritance taxes could be prepaid on the remainder interest when the trust was funded but before the remainder vested, or the taxes could be deferred and paid at the time that the interest vested, at which time the tax is based upon the entire value of the vested interest. The personal representative of the estate elected not to prepay the tax; therefore, the tax became due when the interest became vested.

In addition, the divided court held that by sending the release agreement to beneficiaries, PNC did not breach its fiduciary duty to the beneficiaries.

PNC sent a release and indemnity agreement to each of the beneficiaries for execution prior to distributing the trust funds to them. The beneficiaries argued that the release agreement was too favorable to PNC and that PNC should not have required them to sign the release agreement. The court held that the release agreement was not required, but, nonetheless, PNC did not breach its duty of loyalty to the beneficiaries because the release agreement terms were not so broad or one-sided as to place PNC's interests ahead of those of the beneficiaries.

The dissenting judges stated that the court "condones PNC's self-initiated upgrade in protection, at the risk and the expense of the Beneficiaries," and that the court should not "condone the practice of a bank's asking beneficiaries to provide the bank insurance against the bank's own blunders."

The key to the majority's decision was that the release agreement provided greater protection than that offered under state law, which was narrowly held to be permissible under Maryland law.

Private Letter Ruling 201236022 (09/11/2012)

In this PLR, the Internal Revenue Service ("IRS") ruled that amounts paid to charities from the residue of the decedent's estate pursuant to a settlement agreement qualified for the charitable deduction for federal estate tax purposes because the charities had an enforceable right under state law to receive a portion of the residuary estate due to the undue influence by the drafting attorney (who was also a beneficiary).

The Decedent hired an attorney to prepare her will, which included the provision that the residue of the Decedent's estate was to be distributed as follows:

"If [Attorney] survives me, to [Attorney], pursuant to the following: I have expressed my wishes to [Attorney] to handle this, my inheritance. In his sole discretion, he shall disburse funds from the estate to [Charity], and to Organizations for the preservation and care of orphan animals. It is up to his sole discretion without question and without the necessity of external intervention to disburse randomly, as he sees fit, funds to the above organizations and any remainder is to be retained by him as he sees fit."

In addition, the Decedent conveyed her residence to the Attorney and herself as joint tenants with right of survivorship, and similarly tilted assets in a brokerage account.

Following the Decedent's death, the Attorney took possession of the residence and sold it, and took possession of the assets of the joint brokerage account. The Attorney distributed some funds to charity, and retained the remainder.

The State Attorney General, on behalf of the charitable beneficiaries under the will, filed objections to the will and requested that those portions of the will appointing the Attorney as executor and that provide for a bequest to the Attorney be stricken. Shortly thereafter, an individual filed a petition in the applicable county court seeking a return of the joint brokerage account and the proceeds of the sale of Decedent's home.

The Attorney, the Attorney General and the individual, in an attempt to avoid the expenses and uncertainties of continued litigation of the estate, agreed on a proposed settlement where a fixed dollar amount of the joint brokerage account and all proceeds of the sale of the residence were paid to the estate, and the residue of the Decedent's estate was divided into two parts, with one part passing to charity and the other passing to the Attorney.

The IRS cited four factors for determining if the amount passing to charity pursuant to the settlement agreement would qualify for the federal estate tax charitable deduction, as follows:

1. "The settlement agreement was negotiated, and is in settlement of a bona fide will contest;
2. The charities have an enforceable right to the residue of the Decedent's estate under State law, and the payments are in recognition of that right;
3. The payments do not exceed what the charities would have received if they had pursued their rights in litigation; and
4. The form of the payments passing to the charities under the settlement agreement resembles the form of the benefits that the charities could have received under the terms of the Decedent's will."

The IRS found that under State law, there was a strong argument that the Attorney exerted undue influence over the Decedent, and that if a court in the State agreed, it would rewrite the Decedent's will to remove provisions in favor of the Attorney, leaving the residue instead to charitable organizations. As the facts here fell within the four factors above, the IRS permitted a full deduction for the negotiated amounts passing to the charitable beneficiaries.

Garcia v. Andonie, Fla. **No. SC11-554 (10/4/2012)**

The Florida Supreme Court ruled that a Honduran couple's condominium in Miami-Dade County qualified for the Florida homestead property tax exemption because the couple's minor children were US citizens and permanent residents of the state. The Supreme Court relied upon the provision of the Florida Constitution, which "permits every owner of Florida real property to apply for and receive ad valorem tax relief where it is sufficiently demonstrated that the owner has maintained on that property the permanent residence of another legal or naturally dependent of the owner."

Here, the Supreme Court determined that the minor children residing in the condominium were legally and naturally dependent upon the owners, who were a Honduran couple lawfully residing in the United States under a temporary (E-2) visa, and, therefore, under Florida law, the owners were entitled to ad valorem tax relief of a $25,000 reduction in assessed taxable value of their condominium.

Scaggs v. Comm'r**, T.C. No. 16342-11, T.C. Memo 2012-258 (09/10/2012)**

The United States Tax Court upheld the denial of a taxpayer's petition for redetermination of deficiencies and accuracy-related penalties because the taxpayer did not use a designated private delivery service. The taxpayer submitted the petition via Federal Express "Express Saver Third Business Day" service, which resulted in receipt by the IRS after the applicable filing period and therefore was rejected. The IRS identifies certain private delivery services and the type of specific delivery method for each; "Express Saver Third Business Day" is not on this list. Had the taxpayer used a designated private delivery service, the date the petition was sent, rather than the date of delivery, would have been the deemed date of receipt by the IRS.

This case serves as a warning to taxpayers to use the proper delivery service when filing with the IRS.

In re: Grand Jury Subpoena, 5th Cir., No. 11-20750 (09/21/2012)

The Fifth Circuit Court of Appeals reversed the district court's denial of the government's motion to compel production of foreign bank account records required to be kept under Treasury Department regulations by the target of a grand jury investigation (the "witness"). The witness stated he would not comply with the subpoena, citing his Fifth Amendment privilege against self-incrimination. The Fifth Circuit stated that the Fifth Amendment did not protect the witness in this case, instead finding that the government's request fell within the "Required Records Doctrine," under which the government may require that certain records be kept and produced without the protection of the privilege against self-incrimination.

The witness was a target of a grand jury investigation to determine whether he used Swiss bank accounts held with UBS to evade his federal income taxes. His name and records were among the documents provided to the US government by UBS as a part of its deferred-prosecution agreement with the Justice Department.

The Required Records Doctrine applies where "first, the purposes of the United States' inquiry must be essentially regulatory; second, information is to be obtained by requiring the preservation of records of a kind which the regulated party has customarily kept; and third the records themselves must have assumed 'public aspects' which render them at least analogous to public documents."

The Fifth Circuit noted that where the record-keeping requirements apply almost exclusively for people engaged in illegal activity, the doctrine would not apply – for example, the government cannot require those engaged in illegal gambling or selling illegal substances to keep records of these acts. Here, however, the Fifth Circuit reasoned that there is nothing inherently illegal about having a foreign bank account and the purposes of the record-keeping regulation serve purposes other than criminal law enforcement. As such, the record-keeping requirement was "essentially regulatory" within the meaning of the doctrine.

Next, there was no argument that bank records are of the type customarily kept by the witness in this case. Finally, the court noted that although bank records are typically private, they are analogous to subpoenaed medical records, which have been found to posses sufficient "public aspects" to satisfy the Required Records Doctrine.

In summary, the record-keeping and production requirements of the U.S. Treasury Department with respect to foreign bank accounts have been held by the Fifth Circuit, along with the Ninth Circuit (*In re M.H., 648 F.3d 1067 (9th Cir. 2011)*) and the Seventh Circuit (*In re Special Feb. 2011-1 Grand Jury Subpoena Dated Sept. 12, 2011, No. 11-3799, 2012 WL 3644842 (7th Cir. Aug. 27, 2012)*), to fall outside the protection of the Fifth Amendment privilege against self-incrimination.

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