Proskauer

newsletter

December 2011

in this issue

A monthly report for wealth management professionals.

December Interest Rates for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split Interest Charitable Trusts 1

Revenue Procedure 2011-48 (October 14, 2011) 2

Publication 4895 (October 14, 2011) 2

Final Form 706 Is Released for 2011 Decedents 3

New Estate/Gift/GST Tax Exemption Amounts for 2012 3

Discount for Family Limited Partnership Fails 3

Estate Loan Interest Held Deductible 4

Decedent's Partnership Interest in a Partnership Holding New York Real Property Is Not Subject to New York Estate Tax 5

Private Letter Ruling 201143002 (October 28, 2011) 5

Edited by **Henry J. Leibowitz**
Contributor: **Amy I. Dunphy**

As part of our ongoing efforts to keep wealth management professionals informed of recent developments related to our practice area, we have summarized below some items we think would be of interest. Please let us know if you have any questions.

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

The December applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 1.6%, an increase of two-tenths of a percent from the November rate. 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 9 years duration (the mid-term rate, compounded annually) increased to 1.27% (as compared to the November rate of 1.20%). 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 presents a potentially rewarding opportunity to fund GRATs in December 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 increased slightly in December to 0.20% for loans with a term of 3 years or less, 1.27% for loans with a term of 9 years or less, and 2.80% for loans with a term 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 1.27%, the child will be able to keep any returns over that amount. These same rates are used in connection with sales to defective grantor trusts.

Revenue Procedure 2011-48 (October 14, 2011)

The IRS has issued guidance on the procedure for the filing and resolution of a Protective Claim for Refund of estate tax that is based on a deduction for a claim or expense under section 2053 of the Internal Revenue Code (Code). In 2009 the Service advised that the amount deductible under Section 2053 is limited to the amount *actually paid* in settlement or satisfaction of that claim or expense. Although the Service recognized that the amount to be paid for such claims or expenses may in many cases be unknown at the time the estate tax return is due, the procedure for filing "protective claims" was not clear until now.

The claim must be filed by the later of (a) three years from the date that the return was filed, or (b) two years from the date that the estate tax was paid. For decedents dying before January 1, 2012, the fiduciary must file a Form 843 on behalf of the decedent's estate. For decedents dying after December 31, 2011, the fiduciary may choose to file either the Form 843, or simply attach a new Schedule PC to the decedent's estate tax return for every protective claim. In each case, the notation "*Protective Claim for Refund under § 2053*" must be entered across the top of the form. The claim itself must be clearly identified, which requires a description of the claimant(s), the subject matter of the claim, extent or amount of the claim, the status of the claim, and the reasons and contingencies delaying the actual payment to be made in satisfaction of the claim or expense; vague or broad language will not be sufficient. An adequately identified claim will automatically include related and ancillary expenses.

Claims that are timely filed but procedurally defective may be cured anytime within the original filing period, or 45 days after the Service provides notice of receipt, provided that the fiduciary ensures that the Service has received the protective claim. If the Service does not send confirmation of the protective claim within 60 days of filing the Form 843, or within 180 days of filing the estate tax return with Form PC attached, the fiduciary must contact the Service at (866) 699-4083 or risks forfeiting the refund; a certified mail receipt or other evidence of delivery of the claim will not be sufficient.

The filing of a protective claim will not affect the normal review of the estate tax return. Once the claim is ripe for consideration by the Service, the fiduciary must again file the Form 843 or a supplemental estate tax return within the later of (a) 90 days after the date the claim or expense is paid, or (b) 90 days after the date on which the amount of the claim or expense becomes certain. The Service will limit its review to the sections actually affected by the claimed deduction. The marital and charitable deductions are not reduced until the claim is actually deducted.

Publication 4895 (October 14, 2011)

The IRS released Publication 4895, which provides guidance to assist executors and individuals on the carryover basis rules for property acquired from a decedent in 2010. For those electing out of the estate tax in 2010, the normal carryover basis rules under Section 1014 do not apply. Instead, Section 1022 applies to determine the recipient's basis in most (but not all) property acquired from the decedent. To make the Section 1022 election, the fiduciary must file a Form 8939. (Note that the Service made minor changes to the Form 8939 following its original release. Accordingly, Forms 8939 downloaded prior to October 25, 2011 do not reflect the most current version.) The

fiduciary must provide a Schedule A to Form 8939 (including a description of the property, the date the decedent acquired the property, the adjusted basis of the property on the date of the decedent's death, the fair market value of the property on such date, the amount of basis increase allocated to such property, and the amount, if any, of ordinary income that would result on the sale of the property) to each person who acquired property from the decedent, within 30 days after the date the fiduciary files Form 8939. The amount of basis increase is $3 million for property passing to the decedent's spouse via an outright transfer or QTIP, or $1.3 million ($60,000 for non-resident decedents) plus carryovers and unrealized losses, as described in Rev. Proc 2011-41 (discussed in detail in the November issue of Wealth Management Update).

Final Form 706 Is Released for 2011 Decedents

The IRS has released the final Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return for 2011 decedents, which incorporates the changes in estate and GST tax rates and exemptions due to the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, as well as indexing and other changes.

New Estate/Gift/GST Tax Exemption Amounts for 2012

IRS Revenue Procedure 2011-52 announced the new estate, gift, and GST tax exemption amounts as adjusted for inflation for 2012. For 2012 they will increase from $5,000,000 to $5,120,000.

Discount for Family Limited Partnership Fails

In *Estate of Paul H. Liljestrand v. Commissioner*, T.C. Memo 2011-259, No. 29397-08 (November 2, 2011), the Tax Court held that discounts for a Hawaiian family limited partnership failed and the total value of the partnership assets were included in the decedent's estate for estate tax purposes. Dr. Liljestrand owned real estate in Hawaii, California, Oregon, Arizona, and Florida in his revocable trust, which he contributed to a family limited partnership ("FLP"), along with virtually all of his other assets in 1997. Dr. Liljestrand received 99.98% of the limited partnership interests, and his son Robert was granted a 1-unit Class A limited partnership interest. Robert also managed Dr. Liljestrand's real estate interests. Dr. Liljestrand's other children received their interests in the FLP through a series of gifts. A reputable accounting firm valued the FLP at over $8 million. Inexplicably, the parties ignored the third party appraiser's valuation. Instead, the decision was made to value the 59 general partnership units at $59,000, the 310 Class A limited partnership units at $310,000, and the 5,546 Class B limited partnership units at $2,007,652. As a result, each gift to the children in 1998 was valued at $62,092, and each gift in 1999 was valued at $11,913. Although the gifts exceeded the annual exclusion each year, no gift tax returns were filed until 2005, which was after the death of the taxpayer. Moreover, no bank account for the FLP was opened until two years after it was formed, and the income and expenses of the underlying real estate were reported on Dr. Liljestrand's personal income tax returns. Because Dr. Liljestrand had contributed virtually all of his income-producing property to the FLP, the FLP paid most of his personal expenses and made disproportionate distributions to him.

After Dr. Liljestrand's death, the estate reported an estate value of $5.69 million, and paid estate tax of $2.37 million. The Service refused to recognize the FLP discounts and issued a deficiency of $2.57 million.

In determining whether a bona fide sale of the FLP assets had occurred for purposes of the "bona fide sale for full and adequate consideration" exception to IRC §2036(a)(1), the Tax Court considered whether there was a legitimate and significant non tax reason for creating the FLP. It rejected the estate's argument that the FLP had been created to allow for centralized management of the properties because Robert had managed all of the properties before they were transferred to the FLP. In addition, the court rejected the estate's argument that a transfer to the FLP was necessary to avoid a potential Hawaii partition action by the beneficiaries, because most of the property was located outside of Hawaii, and the beneficiaries would not have held the property as joint tenants or tenants in common, so a partition action was irrelevant. The court also noted that the FLP would not allow for any increased creditor protection beyond that provided by holding the properties in trust. The court also noted the presence of a significant number of "bad facts" indicating that the FLP was a sham: (1) there was no FLP bank account until the third year of the partnership's existence; (2) only one formal meeting was held; (3) Dr. Liljestrand did not retain sufficient assets outside of the FLP and the FLP assets were used to pay Dr. Liljestrand's personal expenses and those of his grandchildren; (4) the FLP funds were commingled with trust funds; (5) Dr. Liljestrand received disproportionate distributions from the FLP; (6) loans were made by the FLP to partners without promissory notes or evidence of repayment; and (7) none of the children who were contemplated as partners, other than Robert, were consulted in the formation of the partnership.

The court also found that there was less than adequate and full consideration for the partnership interests transferred because they were not in proportion to their value. Finally, the court also held that Dr. Liljestrand had retained an interest in the FLP assets under IRC §2036(a)(1) based on the foregoing facts, and in fact there was no discernible difference in his relationship with the assets following their transfer to the FLP than there had been while they were held in his revocable trust.

Estate Loan Interest Held Deductible

In *Estate of Vincent J. Duncan Sr. v. Commissioner*, T.C. Memo 2011-255, No. 7549-10 (October 31, 2011), the Tax Court upheld a Section 2053 deduction for interest on a loan taken to pay estate tax. The decedent had a revocable living trust (the "2001 Trust") and also a trust that his father had created for him (the "Walter Trust"). Both trusts held significant interests in oil and gas businesses in California, Colorado, Texas, and Montana. After the decedent's death, there was roughly $2 million in cash and a distribution of $3.2 million from the oil and gas interests. In order to pay estate taxes (estimated to be over $11 million), the 2001 Trust borrowed roughly $6.48 million from the Walter Trust, on a 15-year term at 6.7% interest per annum. Prepayment was expressly prohibited, and the rate of interest was higher than the long-term applicable Federal rate in effect at the time of 5.02%. The decedent's estate claimed a deduction of $10.6 million for the interest payable on the loan. Although the Service claimed that the estate did not require the loan to pay the taxes because the estate could have sold its oil and gas interests, and alleged that the loan was a sham because the Trustees and the beneficiaries of the Walter Trust and the 2001 Trust were the same, the court held that

the deduction for interest was permitted because there was a bona fide debt, and the loan was incurred actually and necessarily in the administration of the estate.

Decedent's Partnership Interest in a Partnership Holding New York Real Property Is Not Subject to New York Estate Tax

On October 12, 2011, the New York Department of Taxation and Finance issued an Advisory Opinion building upon its previous April 8, 2010 Advisory Opinion (TSB-A-11(1)M and TSB-A-10(1), respectively) regarding the conversion of real property interests into intangibles for New York estate tax purposes, in both cases ruling that a Florida decedent holding an interest in New York real property via an interest in a partnership (or an LLC) held by her revocable trust did not own an interest in the underlying real property for New York estate tax purposes.

The Advisory Opinions concluded that, because a multiple member LLC or partnership is considered to be separate from its owner under the Internal Revenue Code, an individual's interest therein similarly is removed from the underlying property held by the LLC or partnership. Accordingly, such interest constitutes an intangible interest, which, for New York estate tax purposes, has a situs outside of New York (i.e., in Florida), and is therefore not subject to New York estate tax, despite the fact that the real property is located there.

Private Letter Ruling 201143002 (October 28, 2011)

The IRS ruled that a taxpayer's proposed exercise of his power of appointment will not cause assets of split trusts, combined trusts or sprinkle trusts to be includible in his gross estate under Section 2041, or to be subject to the GST tax. A settlor created a trust for his son and his son's issue (at the time of the ruling this consisted of 7 children, and 23 grandchildren and great-grandchildren). The son's issue had a vested interest in the trust, but only had the right to receive income from the trust after the son's death, and the principal of the trust at certain ages. Pursuant to a series of court judgments, the trust was divided into 14 subtrusts, two of which benefited each of the son's children as remainder beneficiaries. The son thereafter sought to recombine certain shares of the subtrusts and alter the distribution dates of each, such that after the exercise of his power of appointment certain trusts would benefit each of the children as remainder beneficiaries via continuation in further trust, certain other trusts would distribute outright in specified amounts and to named individuals of the class of his issue, and certain other trusts would continue in a sprinkle trust to benefit the son's living issue. The Service found that this proposed exercise of the son's power of appointment will not cause inclusion of the trust assets in the son's gross estate for estate tax purposes because the beneficiaries of the exercise were limited to the class consisting of the son's issue, and the exercise would not trigger GST tax because it did not suspend or postpone the vesting of an interest in the trust property.

The Personal Planning Department at Proskauer is one of the largest private wealth management teams in the country and works with high net-worth individuals and families to design customized estate and wealth transfer plans, and with individuals and institutions to assist in the administration of trusts and estates.

If you have any questions regarding the matters discussed in this newsletter, please contact any of the lawyers listed below:

BOCA RATON

Elaine M. Bucher
561.995.4768 — ebucher@proskauer.com

Albert W. Gortz
561.995.4700 — agortz@proskauer.com

George D. Karibjanian
561.995.4780 — gkaribjanian@proskauer.com

David Pratt
561.995.4777 — dpratt@proskauer.com

LOS ANGELES

Mitchell M. Gaswirth
310.284.5693 — mgaswirth@proskauer.com

Andrew M. Katzenstein
310.284.4553 — akatzenstein@proskauer.com

NEW YORK

Henry J. Leibowitz
212.969.3602 — hleibowitz@proskauer.com

Lawrence J. Rothenberg
212.969.3615 — lrothenberg@proskauer.com

Lisa M. Stern
212.969.3968 — lstern@proskauer.com

Philip M. Susswein
212.969.3625 — psusswein@proskauer.com

Ivan Taback
212.969.3662 — itaback@proskauer.com

Jay D. Waxenberg
212.969.3606 — jwaxenberg@proskauer.com

This publication is a service to our clients and friends. It is designed only to give general information on the developments actually covered. It is not intended to be a comprehensive summary of recent developments in the law, treat exhaustively the subjects covered, provide legal advice, or render a legal opinion.

Beijing | Boca Raton | Boston | Chicago | Hong Kong | London | Los Angeles | New Orleans | New York | Newark | Paris
São Paulo | Washington, DC

www.proskauer.com

© 2011 PROSKAUER ROSE LLP. All Rights Reserved. Attorney Advertising.