Proskauer

Wealth Management Update

November 2010

November Interest Rates Remain the Same for GRATs but Decline for Sales to Defective Grantor Trusts, and Intra-Family Loans

The November applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.0%, the same as it was for October. 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 1.59%. Remember that lower rates work best with GRATs, CLTs, sales to defective grantor trusts, private annuities, SCINs and intra-family loans. The combination of a low AFR and the bear market environment presents a potentially rewarding opportunity to fund GRATs in November with depressed assets that you expect to perform better in the coming years. However, legislation currently remains pending in Congress that would significantly curtail short-term and zeroed-out GRATs. Therefore, GRATs should be funded immediately in order to be grandfathered from the effective date of any new legislation that may be enacted.

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 .35% for loans with a term of 3 years or less, 1.59% for loans with a term of 9 years or less and 3.35% 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 1.59%, the child will be entitled to retain any returns over 1.59%. These same rates are used in connection with sales to defective grantor trusts.

Changes in Florida Homestead Laws

Under Florida law, a "homestead" enjoys certain protections. A homestead is, generally, the home and land on which an owner and his or her family reside. The Florida Constitution exempts homesteads from most liens and judgments, which protection inures to the surviving spouse or heirs of the owner.

The Constitution prohibits an owner from “devising” a homestead if the owner is survived by a spouse or minor child (unless the owner is not survived by any minor children and devises the homestead to his or her spouse). Florida probate rules define “devise” and mandate certain dispositions if a homestead is devised inconsistently with the Constitution. A devise is a testamentary disposition of the property. A homestead devised contrary to the Constitution is void. Under prior law, if a decedent was survived by a spouse and descendants, property which was devised improperly passed instead to the surviving spouse for life with a vested remainder in the living descendants.

The new rules allow a homestead owner to transfer the property during his or her lifetime, with certain conditions, and be free from the Constitutional restrictions. The primary condition is that the owner cannot retain the power to revoke the transfer or revest the interest in himself or herself. The owner may retain extensive rights and impose substantial limitations on the rights of the donees without violating this condition.

The owner may, for example, change the rights of beneficiaries within a certain class as long as the owner cannot exercise the right in favor of himself or herself, his or her creditors, or to discharge his or her legal obligations. The transferor may also retain a separate interest in the property such as a life estate, reversion, etc. Moreover, the donees may possess the property only upon a certain date or specified event, such as the transferor’s death. The interest may also be subject to divestment upon a certain date or specified event.

Another major change is that the surviving spouse may now choose to be a tenant in common with the decedent’s living issue instead of possessing a life estate. This may help surviving spouses because the law for tenancy in common is clearer for purposes of valuation, allocation of ownership expenses, and division of sale proceeds than that of life estates. It also allows the spouse to use partition procedures – which is not permitted with a life estate.

***Estate of Stewart v. Commissioner*, 2d Cir., No. 07-5370-ag (8/9/10) – Court finds Tax Court erred when it apportioned entire value of a Manhattan brownstone to a Decedent’s estate when Decedent transferred 49% of the property to her son a few years before her death**

In this case the higher court reversed a lower court’s inclusion of the entire value of a real property in the Decedent’s estate when the decedent had transferred a portion of the property to her son during her life.

Specifically, prior to her death the Decedent transferred a 49% interest in a Manhattan brownstone to her son who lived with her on 2 of the floors. The Decedent and her son continued living on 2 of the floors until the Decedent’s death and leased the other 3 floors to a tenant. All income and most expenses on the rental portion were paid to and borne by the Decedent for the rest of her life.

The son argued there was an agreement to reconcile the income and expenses of the brownstone to a property in East Hampton that was also co-owned by them. In prior years tenants in the East Hampton property would pay either the Decedent or her son, then they would split the money every few months. After the transfer of the 49% in the brownstone, the Decedent received all income from the tenant in the brownstone and paid most of the expenses, but the son received all rent from the East Hampton property and did not split the proceeds with the Decedent.

The tax court found there was an implied agreement of retained enjoyment and included the entire property in the Decedent’s estate under §2036.

The higher court vacated the lower court’s ruling. This court stated that “co-occupancy of residential premises by the donor and donee is highly probative of the absence of an implied agreement.” The Court also explained that two factors are particularly significant in determining whether there is an implied agreement for retained possession or enjoyment of a residential property: (i) continued exclusive possession by the donor and (ii) withholding possession from the donee.

The higher court found that the son enjoyed the benefits of the residential portion of the 49% and at least some of the benefits of the rental portion and remanded for a determination of how much of the rental portion the decedent retained. The benefits to the Decedent’s estate is a potential 42.5% discount for lack of control and marketability and the exclusion of $125,000 of appreciation from the estate.

***United States v. MacIntyre*, S.D. Tex., No. 10-2812, (*complaint filed* 8/6/10) – U.S. government sues estate and donees of J. Howard Marshall II for unpaid gift taxes**

The U.S. government is suing the estate and donees of J. Howard Marshall for a combined $85 million of unpaid gift and GST taxes. The Complaint alleges that between 1993 and 1995 Marshall made more than $109 million in gifts to his ex-wife, son, and various other individuals and trusts. The IRS had previously issued deficiency notices to Marshall's estate for gift and GST taxes, then later entered into stipulations about the amounts owed. Marshall's estate failed or refused to fully pay the debts claimed. Since the estate did not pay, the government claims that the donees of the gifts were automatically personally liable.

In addition to seeking personal liability from all donee trusts and individuals, the government is suing the executors of Marshall's estate, his ex-wife's estate and the trustees of Marshall's and his ex-wife's trusts for personal liability. The government argues that under federal law a personal representative that pays a debt of the decedent prior to paying a government claim is personally liable to the government. Moreover, the government avers that under the relevant state law – Texas – a personal representative must preserve sufficient assets to pay tax liabilities of the decedent in accordance with the priorities established under Texas law and if he or she fails to do so, it subjects the representative to personal liability. The government alleges that the executors and trustees distributed the estates and trusts without paying the government and therefore breached their duties to the government and are personally liable.

The government is also seeking a 10% litigation surcharge under the federal Debt Collection Procedures Act.

***Breakiron v. Guidonis*, 2010 WL 3191794 (D. Mass. 8/10/2010) – Court rescinds nonqualified disclaimer and denies gift tax liability**

In this case, a disclaimant's parents set up Qualified Personal Resident Trusts ("QPRTs") that passed to the disclaimant, Craig, and his sister after the QPRT terms expired. Craig wanted to transfer his interest in the QPRTs to his sister and consulted with an attorney on the gift tax implications. The attorney incorrectly advised Craig that he could make a qualified disclaimer as long as he completed it within 9 months of the expiration of the QPRTs' terms. However, the disclaimer actually had to be completed within 9 months from the creation of the QPRTs. Due to the error the disclaimer was unqualified and Craig owed $2.5 million of gift tax liability.

Craig tried to rescind the disclaimer under the applicable state law (Massachusetts) and named the IRS as a party to the suit. Massachusetts law allows a written instrument to be rescinded on the grounds of mistake when there is full, clear, and decisive proof of the mistake. Massachusetts case law also has specifically recognized that a disclaimer may be rescinded if it was executed because of a mistake which frustrated its purpose.

The Court found that since the IRS was named as a party to the case and because the disclaimers were rescindable under the applicable state law, the disclaimers should be rescinded and no gift tax imposed.

***Estate of Stick v. Commissioner*, T.C., No. 16383-08, T.C. Memo. 2010-192 (9/1/10) – Loan interest paid by Trust held nondeductible in decedent's estate because it was unnecessary**

After Decedent's death, his trust borrowed $1.5 million from Decedent's Foundation to pay his estate tax liabilities (aka a "Graegin" loan). The trust claimed deductions for the interest on the loan under IRC §2053.

The IRS would not allow the deductions because the estate had sufficient liquid assets to pay its estate tax liabilities and the Regulations only allow deductions of administrative expenses that are actually and necessarily incurred in the administration. The Court agreed that since there were sufficient liquid assets, it was not necessary to take out the loan and the interest was therefore nondeductible.

***Estate of La Caer v. Commissioner*, 135 T.C. No. 14 (9/7/2010) – Court limits amount that surviving spouse was entitled to claim for tax on prior transfers under §2013**

This case involves credits for tax on prior transfers under IRC §2013. The credit amount varies based on the number of years between the two taxpayers' deaths. In this case husband died first and his wife died three months later. Under §2013, if the taxpayers died within 2 years of each other, the credit amount is the lesser of two limits. The first limit is the amount of the federal estate tax attributable to the transferred property in the estate that has already been taxed. The second limit is the amount of the federal estate tax attributable to the transferred property in the estate that has not yet been taxed.

The husband's personal representatives purposely caused certain of the husband's assets to not qualify for the marital deduction and therefore be taxed in the husband's estate. The husband's estate paid approximately $200k federal estate tax and $25,000 in Nevada estate tax. The Nevada estate tax is a "pickup" or "sponge" tax in that Nevada imposes a tax in the amount of the maximum credit allowable against the federal estate tax for payment of state death taxes.

The wife's estate claimed a credit in the full amount of all death taxes paid by the husband's estate, without taking into account any limits under §2013. The estate argued that the only portion of the husband's estate that was subject to estate tax was the nonmarital portion and, therefore, the limitations on the tax credit were not triggered when the husband passed no other property subject to the estate tax. The estate argued further that since the Nevada tax was essentially a portion of the federal tax paid to the state, it should also be given a credit. The tax court rejected both arguments, stating that the limitations apply and the state tax was not entitled to a credit.

The wife's estate also filed an amended return in which it deducted the husband's estate tax payment as a debt of the wife. The tax court also denied this deduction because the wife's estate did not introduce any evidence showing that the taxes were actually paid with assets in the wife's estate.

Related Professionals

- **Andrew M. Katzenstein**
  Partner
- **Jay D. Waxenberg**
  Partner
- **Henry J. Leibowitz**
  Partner
- **David Pratt**
  Partner
- **Mitchell M. Gaswirth**
  Partner
- **Albert W. Gortz**