Proskauer

newsletter

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in this issue

A monthly report for wealth management professionals.

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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.

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

The August applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.6%, the lowest rate so far this year. 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) is also down, to 2.18%. 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 August with depressed assets you expect to perform better in the coming years. However, legislation is currently 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 should also continue to consider "refinancing" existing intra-family loans. The AFRs (based on annual compounding) used in connection with intra-family loans are .53% for loans with a term of 3 years or less, 2.18% for loans with a term of 9 years or less and 3.79% for loans with a term of 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 2.18%, the child will be able to keep any returns over 2.18%. These same rates are used in connection with sales to defective grantor trusts.

Privity No Longer an Absolute Defense in New York

As we previously reported in a special edition of *Wealth Management Update*, the New York Court of Appeals recently issued a decision in *Estate of Schneider v. Finmann,* 2010 N.Y. Slip Op. 05281 (N.Y. June 17, 2010), a case involving the applicability of New York's strict privity defense in an estate planning malpractice claim. In what is sure to cause every estate planning attorney and personal representative to take note, the Court of Appeals held that a personal representative may maintain a legal malpractice claim for estate losses resulting from negligent estate planning representation.

By way of background, in New York, a third party, without privity, generally cannot maintain a claim against an attorney in professional negligence. This strict privity rule has been applied to estate planning malpractice lawsuits, effectively protecting estate planning attorneys from suits commenced by personal representatives or beneficiaries. However, this rule also left a decedent's estate with no recourse against a negligent estate planning attorney. Recognizing this, the Court of Appeals has carved out an exception to the privity rule.

In *Estate of Schneider*, the decedent retained the services of an attorney for estate planning advice. Thereafter, the decedent transferred ownership of a $1 million life insurance policy to himself, individually, from a family limited partnership he controlled. When the decedent died, the insurance proceeds were, predictably, subject to estate tax. The decedent's estate commenced a malpractice action, alleging that the estate planning attorney negligently advised the decedent to transfer (or failed to advise the decedent not to transfer) the policy, which resulted in increased estate tax. The trial court granted the attorney's motion to dismiss the estate's complaint for failure to state a cause of action. The Appellate Division affirmed, holding that, in the absence of privity, the estate may not maintain an action for legal malpractice.

The Court of Appeals then reversed the decision, finding that privity does exist between a personal representative and the estate planning attorney. In siding with other jurisdictions that have a relaxed privity rule, the Court noted that "the estate essentially 'stands in the shoes' of the decedent" and, therefore, "has the capacity to maintain the malpractice claim on the estate's behalf." This decision, however, does not completely strike down the privity defense; the Court noted in its decision that strict privity remains a bar against estate planning malpractice claims brought by beneficiaries or other third-party individuals (absent fraud or other special circumstances).

In short, a personal representative is no longer prevented from raising a negligent estate planning claim against the attorney who caused harm to the estate. As a result, a personal representative may now need to review the estate planning advice given to the decedent during his or her lifetime to determine whether any such claim exists and should be pursued.

Florida Supreme Court Limits Charging Order Protection of Florida LLCs

The Florida Supreme Court has issued its opinion in the case of *Olmstead v. Fed. Trade Comm'n*, No. SC08-1009 (Fla. June 24, 2010), holding that a court may order an owner of a single-member Florida Limited Liability Company ("LLC") to surrender its ownership interest in the LLC to satisfy an outstanding judgment. The Court's holding clarifies that charging orders are not the exclusive remedy to enforce a judgment against the member of a single-member Florida LLC. Additionally, the holding creates uncertainty regarding the benefits provided by multimember LLCs formed in Florida and jeopardizes the level of asset protection provided by such LLCs.

This opinion is of note even to non-Floridians, since it acts as a reminder that LLCs, which were originally conceived to limit the liability of business owners, may not be the best option for clients looking for a personal asset protection strategy.

Prior to this ruling, it was not clear under the Florida Limited Liability Company Act (the "LLC Act") whether a charging order was the exclusive remedy available for judgment creditors with respect to a single-member Florida LLC. A "charging order" is a legal remedy that provides judgment holders with the limited right to receive distributions (if any) made by an LLC to its members, but which does not allow a judgment holder to seize the debtor's entire ownership interest. In *Olmstead*, the Court held that a charging order is not the exclusive remedy available to creditors, and that therefore an individual's ownership interest in a single-member Florida LLC (i.e., the right to receive distributions and to manage the LLC) may be subject to levy and sale to a third-party to pay the judgment.

The Court's analysis focused on the charging order provision of the LLC Act, which provides that a court may charge a member's LLC membership interest for payment of a creditor's judgment lien. The question decided by the Court was whether the charging order provision provides the exclusive remedy with respect to a judgment debtor's ownership interest in a single-member Florida LLC. The Court concluded that the charging order is a "non-exclusive remedy" because there is no express language in the statute providing that it is the exclusive remedy to satisfy a judgment lien, unlike the Florida Revised Uniform Partnership Act ("Partnership Act") and the Florida Revised Uniform Limited Partnership Act ("LP Act"), both of which specifically state that charging orders are "exclusive remedies" for enforcement of judgment liens.

In addition to subjecting single-member Florida LLC interests to actual levy and sale, this case appears to threaten the degree of protection provided by "multimember" Florida LLCs, since the provisions of the charging order statute apply to single-member as well as multimember Florida LLCs. As a result, the *Olmstead* decision threatens multimember Florida LLCs in two ways: first, owners of LLC membership interests may find their holdings subject to levy and sale to satisfy a judgment lien (rather than merely being subjected to a charging order to pay over LLC distributions), and second, other members of the LLC may find that a judgment creditor of one of the members has quite unexpectedly become the newest (and likely unwanted) member of the LLC, with the right to fully participate in its management and operation.

Mid-Year Replacement of Trustees May Render a New York Resident Trust Immediately Non-Taxable by New York State

Under New York law, a New York resident trust (such as any testamentary trust created by a decedent who was domiciled in New York at his or her death) is not taxable in New York as long as three conditions are satisfied: (1) none of the Trustees are domiciled in New York, (2) all of the assets of the trust are located outside of New York and (3) the trust has no New York sources of income.

Until recently, it was uncertain whether a mid-year change in the taxable status of a New York resident trust (such as by replacing all Trustees domiciled in New York with Trustees domiciled elsewhere) would take effect immediately, or whether the entire taxable year would be "tainted" by that portion of the year in which the trust was taxable in New York; just as one dollar of New York source income renders the entire income of the trust taxable in New York, the fear was that a single day as a taxable trust rendered the trust taxable in New York for the entire year.

Happily, in June the New York Department of Taxation and Finance issued Advisory Opinion No. TSB-A-10(4)I (June 8, 2010), which clarifies that a New York resident trust is non-taxable by New York immediately upon satisfying the three conditions listed at the beginning of this article. As such, in the year of the change in taxable status, New York will only tax income accrued prior to the trust's becoming non-taxable by New York State.

However, even if a resident trust is non-taxable in New York for the entirety of the tax year (and thus no New York tax is due), another recent publication of the New York Department of Taxation and Finance, Memorandum TSB-M-10(5)I (July 23, 2010), clarifies that the trust must still file a New York State fiduciary income tax return if the trust is required to file a federal income tax return. The New York return must include with it Form IT-205-C, *New York State Resident Trust Nontaxable Certification*, wherein the Trustees affirm that the trust is not taxable by New York State.

IRS Requires California Domestic Partners to Split Community Income Between Themselves on Their Individual Federal Income Tax Returns

Since 1999, California has allowed same-sex couples to register as domestic partners and receive many of the legal privileges granted to married couples. However, the California Domestic Partner Rights and Responsibilities Act of 2003 (the "Domestic Partner Act"), instructed registered domestic partners to use the same filing status on their state income tax returns as they had used on their federal returns. Since federal law prohibits same-sex partners from filing as "married" on their individual federal income tax returns, domestic partners thus could not file as "married" on their individual California state tax returns (note that the Defense of Marriage Act prevents same-sex couples from filing *joint* federal returns).

This meant that domestic partners were at a tax disadvantage, since they could not allocate their community income equally between themselves, which might have decreased their total tax due by lowering the applicable tax bracket of the higher-earning partner.

In 2006, the Chief Counsel of the IRS issued an Advice concluding that since it was not the "inveterate policy" of California to treat domestic partnership like marriage (since domestic partners did not have the same community property rights as a married couple), domestic partners could not apportion their community income equally between themselves.

Shortly thereafter, California amended the Domestic Partner Act so as to no longer prohibit domestic partners from filing as "married" on their individual returns. As a result, on May 8th the Chief Counsel issued Advice Number 201021050, which concludes that since California now treats domestic partners equivalent to married couples for community property purposes, domestic partners must now divide their community income between themselves on their individual tax returns. Domestic partners may, but are not required, to amend their 2007 through 2009 returns to comply with this ruling.

New Florida Statute Affirms that Inter Vivos QTIPS are Not Self-Settled Trusts

The Florida legislature has amended § 736.0505 of the Florida Trust Code, effective July 1st, to explicitly state that an inter vivos qualified terminal interest property ("QTIP") trust will not be considered a self-settled trust, even if the trust agreement provides that assets are to be held in further trust for the benefit of the Settlor if he or she survives his or her spouse.

An inter vivos QTIP trust is often used to allow a richer spouse to pass assets to the poorer spouse so that each spouse can take maximum advantage of their respective estate tax exclusion amount. As long as the transfer is not fraudulent, the inter vivos QTIP trust's assets are not reachable by the Settlor's spouse's creditors. Such trusts are particularly useful in second marriages, since they allow the Settlor to designate his or her children from a previous marriage as the ultimate beneficiaries of the trust's assets.

Often, inter vivos QTIP trusts provide that, in the event the Settlor survives his or her spouse, the trust's assets are to be held in further trust for the benefit of the Settlor. Such an arrangement allows the Settlor to have his or her cake and eat it too, since assets equal to the estate tax exclusion amount pass estate tax-free at the spouse's death, but remain available for the Settlor's support during his or her lifetime.

Prior to this change in law, the possibility existed that Florida (like several other states) would treat such an inter vivos QTIP trust as a self-settled trust, thereby placing its assets within reach of the Settlor's creditors. This, in turn, raised the possibility that the trust would be included in the Settlor's estate by virtue of the creditors' constructive power of appointment.

By confirming that an inter vivos QTIP trust will not be considered self-settled in these circumstances, and that the assets of the trust will only be includable in the estate of the Settlor's spouse, the legislature has sanctioned the use of a valuable mechanism for "equalizing" assets between spouses for purposes of the estate tax exclusion amount.

Florida Legislature Grants Courts the Broad Power to Construe Wills and Trusts in the Absence of a Federal Estate Tax

The Florida legislature has amended § 733.1051 of the Florida Probate Code and § 736.04114 of the Florida Trust Code to grant Florida courts broad authority to determine and effect the Testator/Settlor's probable intent in employing a formula bequest, in the event such bequest does not function correctly due to the lack of a federal estate or generation-skipping transfer ("GST") tax in 2010.

The statutes allow the court to consider "the terms and purposes" of the document, the "facts and circumstances" surrounding its creation and the Testator/Settlor's probable intent. In the course of this analysis, the court is allowed to consider evidence relevant to intent, “even though the evidence contradicts an apparent plain meaning of the trust instrument.”

The legislatures of other states, such as Virginia and Utah, have handled the unexpected (if not unforeseen) elimination of the federal estate tax in 2010 by construing formula bequests as if the 2009 federal tax laws were still in effect. For instance, if the Will of a decedent dying in 2010 creates a credit shelter trust, these states would direct that the trust be funded with the remaining portion of the Testator’s ersatz $3.5 million exclusion amount (i.e., the exclusion amount in effect in 2009).

The Florida statutes, by comparison, give the court greater flexibility to fashion a construction that takes into account both the tax law as it stands in 2010 and the tax law as the Testator expected it to be. For instance, in accordance with the statute, the court, rather than being locked into using a $3.5 million exemption amount, could choose to fund the credit shelter trust with $1.3 million of general property subject to the aggregate basis increase under § 1022(b) of the Code, and then place $3 million of spousal property subject to the aggregate basis increase under § 1022(c) of the Code into a separate marital trust for the surviving spouse.

The Florida statutes do not apply if the Will or trust explicitly provides for the possibility that no federal estate or GST tax is in effect.

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.

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