Proskauer

newsletter

Wealth Management Update

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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.

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

The July applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.4%. This is down from the June rate of 2.8%. 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 slightly, to 2.00%. 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 July with depressed assets you expect to perform better in the coming years. However, the Obama Administration, in its 2012 fiscal budget, has proposed to significantly curtail short-term and zeroed-out GRATs. Therefore, GRATs should be funded as soon as possible in order to be grandfathered from the effective date of any law 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 0.37% for loans with a term of 3 years or less, 2.00% for loans with a term of 9 years or less and 3.86% 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 2.00%, the child will be able to keep any returns over 2.00%. These same rates are used in connection with sales to defective grantor trusts.

Malpractice claim against an estate was too uncertain to be deductible as of date of death and thus, the deduction would be based only on the amount actually paid by the estate – *Estate of Gertrude H. Saunders, et al. v. Comm'r*, 136 T.C. No. 18 (4/28/2011)

In *Saunders*, a malpractice claim for $90,000,000 was filed against the decedent's predeceased husband's estate, alleging a breach of fiduciary duty by the decedent's husband. The Plaintiff in the malpractice claim accused the decedent's husband, who was an attorney, of having revealed client confidential information to the IRS. On the decedent's estate tax return, a deduction for $30,000,000 was claimed based on an appraisal of the value of the malpractice claim. During the jury trial, the jury found that the breach of duty by the decedent's husband was not a legal cause of injury to the Plaintiff. Although the Plaintiff appealed this verdict, the claim was ultimately settled for $250,000.

The Tax Court noted that Treasury Regulation § 20.2053-1(b)(3) (as in effect at the decedent's death in 2004) provided that a claim against an estate was deductible if the value of the claim was "ascertainable with reasonable certainty, and will be paid." In determining whether the value of the claim was "ascertainable with reasonable certainty," the Tax Court did not consider the actual settlement amount paid. The Tax Court, however, determined that the value of the claim was not "ascertainable with reasonable certainty" because there were at least four appraisals of the value of the claim and these appraisals varied in amount by almost $11,000,000 (i.e., the values reported were $30,000,000, $25,000,000, $19,300,000 and $22,500,000). Additionally, the Tax Court noted that none of the appraisals indicated that the claim would actually be paid. Accordingly, only the amount actually paid (i.e., $250,000) was deductible by the decedent's estate.

Estate not entitled to discount the value of three marital trusts for claims by ESOP members against the marital trusts' assets – *Estate of Foster v. Comm'r,* T.C. Memo 2011-95 (4/28/2011)

In *Foster,* the Tax Court considered the following: (1) whether an estate was entitled to discount the value of assets in three marital trusts due to the potential for litigation; and (2) whether assets in the marital trusts could be discounted for lack of control over and lack of marketability of the marital trusts' assets. In this case, the beneficiaries of an Employee Stock Ownership Plan ("ESOP") filed suit against the decedent's predeceased husband and the corporate trustee, as co-Trustees of the ESOP. The beneficiaries of the ESOP alleged that the co-Trustees breached their fiduciary duty in connection with the ESOP. The beneficiaries also sought restitution against the decedent and another corporate trustee, as co-Trustees of the three marital trusts which were created at the death of the decedent's husband, and requested the imposition of a constructive trust over the marital trusts' assets. To limit the liability of the co-Trustees of the marital trusts, the corporate trustee froze the decedent's right to withdraw principal from one of the marital trusts. The ESOP beneficiaries lost in district court and did not seek a stay of judgment. The decedent's estate tax return included the value of the marital trusts after applying a discount for the hazard of litigation and a discount for the lack of control over and the lack of marketability of the assets in the marital trusts resulting from the asset freeze imposed by the corporate trustee.

The Tax Court did not allow a discount for the hazard of litigation because the ESOP beneficiaries did not seek a stay of judgment against the assets in the marital trusts. The Tax Court distinguished cases in which a discount was allowed because in such cases the rights of a purchaser of the assets could have subsequently been impaired by litigation. In this case, because a stay of judgment was not sought, the constructive trust was not imposed on the marital trusts' assets at the time of the decedent's death. Consequently, a willing buyer would not have insisted on a discount on the marital trusts' assets because the ESOP lawsuit would not have affected the buyer's rights to such assets.

The Tax Court similarly did not allow a discount for lack of control over or lack of marketability of the marital trusts' assets because two of the three marital trusts were not subject to the asset freeze and the asset freeze on the third marital trust applied only to the decedent's ability to withdraw principal from the trust rather than on the right to sell the assets in the trust. Accordingly, the Tax Court held that a discount was not appropriate because a hypothetical buyer would be unaffected by the asset freeze.

Sale of assets for fair market value between a marital trust and a nonmarital trust to settle a dispute between beneficiaries and trustees of the trusts was neither a taxable gift nor a transfer of an income interest in a QTIP – Priv. Ltr. Rul. 201119003 (May 15, 2011)

In this private letter ruling, the issue was whether the transfer of assets for fair market value between a marital trust and a nonmarital trust resulted in a taxable gift or a disposition of an income interest in qualified terminable interest property ("QTIP"). Upon the decedent's death, the decedent's Family Trust became irrevocable and was divided into the Marital Trust and the Exempt Trust. The decedent was survived by a spouse from a second marriage ("Spouse 2") and two children, grandchildren and great-grandchildren from his first marriage (the children are referred to herein as "Child 1" and "Child 2"). The Marital Trust, Child 1, Child 2 and a trust for the benefit of Child 1 each owned interests in various entities. At the time of decedent's death, Child 1 was the manager, managing-member or general partner of eight of these entities. Child 1 and Child 2 filed a petition for an accounting of the Family Trust and the Trustees of the Marital Trust filed a petition to establish the ownership interest of the Marital Trust in certain entities and to enforce Child 1's resignation as manager. The parties ultimately entered into a settlement agreement during a court ordered mediation. The agreement required the Marital Trust to purchase at fair market value ("FMV") the interests of Child 1 and Child 2 in certain entities and for Child 1 and Child 2 to purchase at FMV the interests of the Marital Trust in other entities. To the extent there was any difference in the aggregate FMV of the Marital Trust purchases and the Child 1 and Child 2 purchases, an equalizing payment would be made. The FMV of the interests would be determined by 2 commercial appraisers.

Under IRC Section 2512(b), the amount by which the value of property exceeds the amount received as consideration is deemed to be a gift. Accordingly, when property is transferred for adequate and full consideration in money or money's worth no gift occurs. The IRS ruled that the transactions between the Marital Trust and Child 1 and Child 2 to resolve discord between the decedent's surviving spouse and her stepchildren were the result of a bona fide adversarial proceeding and arms-length negotiations such that the

FMV exchange would be made for adequate and full consideration in money or money's worth and not subject to gift tax.

Under IRC Section 2519(a), a disposition of all or part of a qualifying income interest for life in QTIP property results in a deemed transfer of the value of the residuary interest in such property which is subject to gift tax. The ruling request asked whether the transfers pursuant to the agreement would result in a disposition of a qualifying income interest under IRC Section 2519. The IRS held that after the transfers, Spouse 2 would continue to possess a qualifying income interest for life in the assets of the Marital Trust, and, therefore, the transfers pursuant to the agreement would not result in a disposition of a qualifying income interest.

IRS issues an inconsistent ruling on whether a grantor trust can hold an IRA - Priv. Ltr. Rul. 201117042 (April 29, 2011)

In 2006, the IRS issued Private Letter Ruling 200620025 in which the IRS approved of the transfer of an Inherited IRA to a special needs trust ("SNT") that was a grantor trust for income tax purposes. The 2006 ruling indicated that one of four surviving sons of the decedent was disabled and the four sons were named as IRA beneficiaries. A state court established a SNT for the disabled son and the guardian and trustee of the SNT intended to transfer the disabled son's share of the Inherited IRA to an Inherited IRA benefiting the SNT and its beneficiaries. One of the issues was whether the transfer of the Inherited IRA from the disabled son to the SNT was a transfer that required the recognition of income by the disabled son under IRC Section 691(a)(2). By applying the grantor trust rules, the disabled son was treated as the owner of the assets held by the SNT. Consequently, the IRS held that the transfer of the Inherited IRA to the SNT was not a sale or disposition of the Inherited IRA for federal income tax purposes.

Conversely, on April 29, 2011, in Private Letter Ruling 201117042, the IRS noted that a financial institution correctly stated that an IRA (not an inherited IRA) cannot be set up and maintained in the name of a grantor trust. In this ruling request, pursuant to a court order, a SNT was established for an individual that was determined to be disabled. The court specified an amount that was to be transferred to the SNT, which was a grantor trust. The amount ordered to be transferred to the SNT corresponded to the balance in the individual's IRA. The IRA custodian refused to process the paperwork to transfer the IRA from the individual to the SNT stating that the IRA could not be maintained in the name of the SNT. As a result, the entire IRA was deemed to have been distributed to the individual and the proceeds deposited into a non-IRA account owned by the SNT even though the individual intended to continue his IRA. The ruling request was submitted to obtain a waiver of the 60-day IRA rollover requirement, so that the IRA could be restored to an IRA held in the individual's name and not in the trust. Prior to ruling on the waiver of the 60-day requirement, the IRS briefly stated that the custodian correctly noted that an IRA cannot be set up and maintained in the name of a grantor trust.

Nevada Governor signed into law S.B. 221 with an effective date of October 1, 2011, which makes Nevada's asset protection trust laws even stronger – S.B. 221, 76th Sess., Reg. Sess. (Nev. 2011)

On June 4, 2011, Nevada Governor Brian Sandoval signed into law S.B. 221 with an effective date of October 1, 2011. The legislation is intended to improve and update Nevada's laws to make the state an ideal jurisdiction for the establishment of trusts. Chapter 166 of the Nevada Revised Statutes was previously amended to allow for self-settled asset protection trusts, which are irrevocable trusts that are exempt from claims of the settlor's creditor provided that the transfer to the trust is not proven to be fraudulent during the 2-year period following the transfer. S.B. 221 further updates Chapter 166 to clarify and expand existing law.

Beginning on October 1, 2011, the following trusts will qualify as self-settled asset protection trusts, making the settlor's interest in such trusts exempt from the claims of creditors:

- A Charitable Remainder Trust that provides for annual payments to the Settlor;
- A trust that distributes retirement benefits (whether as income or in the amount of the Required Minimum Distribution);
- A Grantor Retained Annuity Trust; and
- A Qualified Personal Residence Trust.

Additionally, the settlor of a self-settled asset protection trust may use real or personal property owned by the trust without limiting the scope of the protection provided by such trust.

The law makes clear that no action of any kind may be brought at law or in equity against the trustee of an asset protection trust if at the date the action is brought an action by the creditor would be barred by Section 166.170 of the Nevada Revised Statutes. This clarification is intended to dispose of any arguments that Nevada's fraudulent transfer laws, which include a 4-year statute of limitations, negates the more favorable 2-year statute of limitation rule provided for self-settled asset protection trusts. The legislation makes clear that if an individual is a creditor at the time the transfer to the asset protection trust occurs, then such individual must bring an action by the longer of (i) two years from the date of the transfer to the trust or (ii) six months from when the person discovers or reasonably should have discovered the transfer.

The law also allows for the transfer of a trust from a foreign jurisdiction to Nevada without re-starting the statute of limitation period (i.e., the date of the original transfer to the trust is treated as the date the property was actually transferred to the trust rather than the date the trust situs was moved to Nevada). For this rule to apply, the transfer must be from a state where the asset protection laws are substantially similar to Nevada's.

Pursuant to the revisions to Section 166.170, a creditor may not bring an action with respect to a transfer of property to an asset protection trust unless the creditor can prove by clear and convincing evidence that the transfer either (1) was a fraudulent transfer or (2) violates a legal obligation owed to the creditor under a contract or a valid court order that is legally enforceable by that creditor. The determination of whether a transfer is

fraudulent does not affect a separate transfer to the trust. Consequently, if a transfer is determined to be fraudulent, it will not taint the exemption of the entire trust.

Also notable, the law provides that if assets are appointed into a second trust pursuant to Section 163.556 of the Nevada Revised Statutes (i.e., if the trust is decanted), the assets in the second trust are deemed to have been transferred to such trust as of the time they were transferred to the original trust. Therefore, decanting an irrevocable trust to a new trust will not re-start the statute of limitations.

Florida Governor signed into law H.B. 253, which amended Florida Statute § 608.433 to explicitly provide that a charging order is the "sole and exclusive remedy" against LLC membership interests – H.B. 253, 2011 Leg., (Fla. 2011)

On May 31, 2011, Florida Governor Rick Scott signed into law H.B. 253, which amended Florida Statutes § 608.433 to explicitly provide that a charging order is the "sole and exclusive remedy" against limited liability company ("LLC") membership interests. The law, however, further provides that a charging order is not the sole and exclusive remedy in the context of a single-member LLC if the judgment creditor establishes to the satisfaction of a court that distributions under a charging order will not satisfy the judgment within a reasonable time. In such case, a court may order a foreclosure sale of a debtor's single-member LLC interest.

This legislation was adopted to clarify the decision in *Shaun Olmstead, et. al. v. Federal Trade Commission*, 44 So. 3d 76 (Fla. 2010), in which the Court held that charging orders are not the exclusive remedy to enforce a judgment against the sole member of a single-member Florida LLC. The law clarifies that the decision in *Olmstead* does not apply in the context of a multimember Florida LLC.

Florida Third District Court of Appeals withdrew its opinion in *Habeeb v. Linder* that a husband and wife can waive homestead rights merely by signing a joint warranty deed - *Habeeb v. Linder*, 3D10-1532 (Fla. 3d DCA 2011)

On February 9, 2011, the Florida Third District Court of Appeals held that a husband and wife waived their post-death homestead rights merely by signing a joint warranty deed transferring the homestead property to the wife. On May 17, 2011, the Court, released a sue sponte Order withdrawing its decision in *Habeeb*. Although the withdrawal of this decision now leaves the door open for future litigation, the *Habeeb* decision may not be relied on as precedent.

Florida Governor signed into law H.B. 469, which amends Florida Statutes § 222.21(c) to provide that inherited IRAs are protected from claims of creditors of a debtor beneficiary – H.B. 469, 2011 Leg. (Fla. 2011)

On May 31, 2011, Florida Governor Rick Scott signed H.B. 469 into law. The law amends Florida Statutes § 222.21(c) to clarify the Legislature's intent that inherited IRAs are exempt from claims of creditors of the owner, beneficiary or participant of the inherited IRA. The law is remedial in nature and has retroactive application to all inherited IRA accounts without regard to the date an account was created. Additionally, the law should protect inherited IRAs in both state court and bankruptcy court.

Florida Governor signed into law C.S./H.B. 325, which establishes that there is no fiduciary exception to the attorney-client privilege – C.S./H.B. 325, 2011 Leg. (Fla. 2011)

On June 21, 2011, Florida Governor Rick Scott signed C.S./H.B. 325 into law. The law confirms that there is no fiduciary exception to the attorney-client privilege and that only the person or entity acting as a fiduciary is considered a client of the lawyer. The law provides that a client acts as a fiduciary when serving as a personal representative, a trustee, an administrator ad litem, a curator, a guardian or guardian ad litem, a conservator, or an attorney-in-fact. Accordingly, the law requires a personal representative in a probate proceeding to include in the Notice of Administration a statement that the fiduciary lawyer-client privilege applies with respect to the personal representative and any attorney employed by the personal representative. Additionally, the law requires that the trustee include in the initial notice to qualified beneficiaries a statement that the fiduciary lawyer-client privilege applies with respect to the trustee and any attorney employed by the trustee.

Effective October 1, 2011, a surviving spouse's share of a decedent's intestate estate will be increased from the first $60,000 of the intestate estate plus one-half of the remaining estate to the entire intestate estate when all of the decedent's descendants are also descendants of the surviving spouse and the surviving spouse does not have any other descendants. If there are one or more surviving descendants of the decedent who are not lineal descendants of the surviving spouse, the intestate share for the surviving spouse is one-half of the decedent's intestate estate. Similarly, if there are one or more surviving descendants of the decedent, all of whom are also descendants of the surviving spouse, and the surviving spouse also has one or more descendants who are not descendants of the decedent, the intestate share for the surviving spouse is one-half of the decedent's intestate estate.

Effective July 1, 2011, a court may reform a will, even if unambiguous, to conform the terms of the will to the testator's intent if it is proven by clear and convincing evidence that both the accomplishment of the testator's intent and the terms of the will were affected by a mistake. In determining the testator's intent, the court may consider extrinsic evidence even if it contradicts the plain meaning of the will. Additionally, a court may modify a will, with or without retroactive effect, to achieve the testator's tax objectives provided that such modification is not contrary to the testator's probable intent. The law provides that in proceedings to reform a will for mistake or to modify a will to

achieve the testator's tax objective, a court is authorized to award taxable costs, including attorney's fees and guardian ad litem fees.

Further, the law authorizes challenges to the revocation of a will or trust on the grounds of fraud, duress, mistake or undue influence after the death of the testator or settlor. Finally, in judicial proceedings regarding trusts, the law provides that Florida Rule of Civil Procedure 1.525 applies for purposes of determining when and under what circumstances a trustee or beneficiary of a trust or attorney must file a motion for attorney's fees and costs, with specifically listed exceptions.

Except as otherwise indicated above, these provisions are effective as of June 21, 2011, and apply to all proceedings pending before such date and all cases commenced on or after the effective date.

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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