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.

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

The December § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.0%, which is unchanged from last month. The December 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 1.65%, which is a decrease from the November rate. 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 with financial and real estate markets that remain undervalued 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 are 0.25% for loans with a term of 3 years or less, 1.65% for loans with a term of 9 years or less, and 3.32% 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 1.65%, the child will be able to keep any returns over 1.65%. These same rates are used in connection with sales to defective grantor trusts.

Delaware Supreme Court Offers Guidance on When Delaware Law Applies to a Trust Originally Subject to Another State's Law

In a series of three opinions, all relating to trusts created for the benefit of members of the Peierls Family, the Delaware Supreme Court has offered clarification as to when Delaware law applies to a trust that previously was administered in another state.

http://courts.delaware.gov/opinions/download.aspx?ID=195780

http://courts.delaware.gov/opinions/download.aspx?ID=195790

http://courts.delaware.gov/opinions/download.aspx?ID=195800

Several of the trusts at issue included provisions directing that the validity and effect of the trusts was to be determined by the laws of either New York or New Jersey (depending on the particular trust). The trusts allowed for the appointment of successor Trustees without any geographic restriction (i.e., the successor Trustee could be domiciled in any state). None of the Trustees of the trusts were domiciled in Delaware.

The beneficiaries petitioned the Delaware Court of Chancery to: (1) allow the current Trustees of each trust to resign; (2) appoint a Delaware trust company as sole Trustee; (3) reform each trust to allow a sole Trustee to act; and (4) reform each trust by converting them into "directed trusts," with a Trust Protector and an Investment Advisor.

The Delaware Court of Chancery has the power to reform a trust under Court of Chancery Rules 100 through 103, which it adopted effective May 1, 2012. However, those rules only apply to trusts to which Delaware law applies. Since the Peierls trusts did not yet have a Delaware Trustee, the Court of Chancery concluded that Delaware law did not apply to the trusts, and thus it did not have the jurisdiction to make the requested reformations. The Delaware Supreme Court affirmed.

The Delaware Supreme Court concluded that the law governing a trust is the law designated in the trust agreement (even if designated indirectly, as long as the Settlor "manifested an intention" that a particular state's law should govern). In the absence of such a provision, the law that governs is that of the state to which the administration of the trust is most substantially related.

However, even if the trust agreement designates a particular state law to govern, there is no presumption that the Settlor thereby intended that the governing law could not change in the future. So, if the trust agreement allows for the appointment of successor Trustees without any geographic restriction, the Settlor is consenting thereby to the possibility of a different law someday governing the trust (since the administration of the trust will be deemed to take place in the state in which the Trustee is domiciled). Accordingly, the appointment of a Delaware Trustee can be sufficient to change the trust's governing law to that of Delaware, even if the trust agreement expressly provides that it is to be governed by the law of another state.

The Delaware Supreme Court concluded that the Peierls trusts were not yet governed by Delaware law, since no Delaware trustee had yet been appointed (since the Peierls family had asked for the appointment of a Delaware Trustee and the reformation of each trust in the same petition). Therefore, the Court of Chancery had no authority to modify the trusts. However, the Delaware Supreme Court noted that, for some of the Peierls trusts, no prior judicial approval was necessary for a Trustee to resign and for a successor Trustee to be appointed. So, if the Peierls family appointed a Delaware Trustee on their own, they could then submit a new petition to the Court of Chancery, which would then have the jurisdiction to make the requested modifications.

However, with respect to any testamentary trusts, and to certain inter vivos trusts over which another state already had exercised oversight, the petitioners would need the consent of the other state's courts in order to transfer the situs of the trust to Delaware.

As a result of the *Peierls* opinion, Delaware law may apply to any trust that has a Delaware Trustee, even if the trust agreement expressly provides that the trust was to be governed by another state's law. In order to prevent any such switch in governing law, the trust agreement would need to direct that either (1) the original governing law should continue to apply even if the situs of the administration of the trust is changed, or (2) that successor Trustees must be domiciled within the state whose law initially governs the trust.

Liability of a Trust Protector at Issue in *McLean v. Ponder*

The Missouri Court of Appeals recently issued an opinion involving the liability of a Trust Protector for not exercising his powers to remove and replace the Trustees of a supplemental needs trust.

In the trust at issue in *Robert T. McLean Irrevocable Trust v. Ponder,* 2013 WL 5761058, the Trust Protector, Ponder, was granted the power to (1) remove Trustees, (2) appoint successor Trustees and Trust Protectors, and (3) resign as Trust Protector.

The terms of the trust provided that the Trust Protector was to act in a "fiduciary capacity" and was not to be liable for any actions taken "in good faith." There was no indemnification provision, but the Trust Protector had no power or duty to supervise the Trustees.

From 1999 through Ponder's resignation in 2002, the assets of the trust were substantially depleted by the Trustees. The beneficiary's mother, who was appointed a successor Trustee in 2002, brought suit against Ponder, claiming he had acted in bad faith as Trust Protector by failing to monitor the Trustees and by not replacing the Trustees when notified of their alleged misuse of trust funds. The trial court granted Ponder's motion for a directed verdict, which the beneficiary's mother appealed to the Missouri Court of Appeals.

The Court of Appeals concluded that the complaint failed to state a valid claim of action, since the plaintiff provided insufficient evidence of the cause of the reduction in the trust corpus. A decrease in trust assets, by itself, is insufficient grounds for a complaint, absent an attendant assertion of a verifiable harm (such as evidence that trust distributions were impermissible under the terms of the trust agreement, or that distributions were made in violation of the Trustees' fiduciary duty).

The Court of Appeals also noted that the greatest decrease in the corpus of the trust occurred *before* Ponder was informed by the beneficiary and his attorney that they believed the Trustees were inappropriately spending trust funds. Accordingly, the court concluded that Ponder could not be held accountable for any damage which occurred before that date of which he was unaware.

Because the directed verdict was necessitated by the deficiencies of the plaintiff's assertions, the court did not engage in any detailed analysis of the liability or role of Trust Protectors under Missouri law. However, the case is a reminder of the perils of serving as a trust fiduciary in any capacity. Because the trust had no indemnification provision and no provision requiring the trust to pay for the defense of the fiduciaries, Ponder likely had to pay for his defense out of his own pocket. Since it is common practice to impose a fiduciary duty on a Trust Protector (albeit a limited one), it is crucial to provide such a provision if the Settlor intends for the Trust Protector to be as protected as possible from future claims.

Nassau Surrogate's Court Issues Opinion on Decanting under New York EPTL 10-6.6

With *In Re Kroll*, 971 N.Y.S.2d 863, the Nassau Surrogate Court has issued what may be the first opinion dealing with the amended decanting statute under New York Estates, Powers and Trusts Law ("EPTL") § 10-6.6.

At issue was a trust for a grandchild created in 1992, apparently in accordance with § 2503(c) of the Internal Revenue Code. The trust provided that, while the beneficiary was under age 21, distributions of income and principal could be made to him at the discretion of the Trustees. At age 21, the beneficiary had the power to withdraw the entirety of the trust principal. Thereafter, the beneficiary was entitled to receive the income from any principal that he did not withdraw. One half of any remaining principal would be distributed outright to the beneficiary upon his attaining age 30, with the entirety of the principal being distributed outright at age 35.

The trust was created when the beneficiary was still an infant. However, by the time the beneficiary approached his twenty-first birthday, he suffered from several disabilities and was the recipient of Medicaid and SSI benefits.

The Trustees determined that the trust assets should be "decanted" under EPTL § 10-6.6 into a new supplemental needs trust, which would eliminate the beneficiary's right to withdraw principal, to receive mandatory income payments or to receive the principal outright at ages 25 and 30. Because § 10-6.6(n) prohibits decanting to eliminate a beneficiary's current right to income (or to withdraw the trust's assets), it was necessary for the Trustees to decant the trust's assets before the beneficiary attained age 21 (since until then he had no current, mandatory right to trust income or principal).

Under EPTL § 10-6.6, a decant is generally only effective thirty days after notice has been given to all interested parties. However, the *Kroll* Trustees were nonetheless able to decant the trust six days before the beneficiary's twenty-first birthday, since the interested parties consented to an immediate effective date as permitted by EPTL § 10-6.6(j) (since the beneficiary was under a legal disability, his father consented on his behalf).

The New York Attorney General objected on behalf of the New York Department of State (i.e., the agency with oversight over the Medicaid benefits that the beneficiary would continue to receive as a result of the decant).

The court upheld the appointment of assets from the old to the new trust, noting that since the decanting exercise took effect prior to the beneficiary's twenty-first birthday, the beneficiary at no point actually held a mandatory right to receive or withdraw income or principal, and thus the supplemental needs trust to which the trust assets were appointed would not be considered a self-settled trust (and thus the new trust did not need to require that, at the beneficiary's death, the trust remainder be used to repay New York for any funds it expended for the beneficiary's medical expenses).

The *Kroll* opinion is a welcome affirmation of the power of § 10-6.6 to provide flexibility where time and circumstances have rendered the terms of an irrevocable trust undesirable. However, it is possible that the cost of that flexibility in this case is an increased tax burden.

Under the Code, a donor's annual gift tax exclusion amount generally is not applicable to gifts to a trust. Two exceptions to this rule are trusts where a beneficiary has the power to withdraw a portion of contributions made to the trust ("Crummey trusts"), and trusts that, along with certain other required provisions, provide that the beneficiary may withdraw the entirety of the trust's assets upon attaining age 21 ("§ 2503(c) trusts").

If the trust at issue in *Kroll* was originally a § 2503(c) trust, it ceased to be so once the Trustees effectively eliminated the beneficiary's power to withdraw principal at age 21. As such, it is likely that the IRS would argue that the gifts by which the trust was funded originally by the beneficiary's grandfather were thereby no longer sheltered by the grandfather's annual gift tax exclusion amounts. If the grandfather had used up the entirety of his lifetime gift tax exemption before making his contributions to the trust, then this loss of § 2503(c) status means that each gift the grandfather made to the trust gave rise to a gift tax.

However, this may have been a result the Trustees were willing to live with, particularly if the grandfather at all times had sufficient lifetime gift tax exemption remaining to make the gifts and did not need to rely on his annual gift tax exclusion amounts with respect to the beneficiary.

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:

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