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.

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

The October § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.4%. This is up from September's 2.0% rate. The 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 up from September's rate to 1.93%. 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 § 7520 rate with financial and real estate markets that remain undervalued presents a potentially rewarding opportunity to fund GRATs in October 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 0.32% for loans with a term of 3 years or less, 1.93% for loans with a term of 9 years or less and 3.50% 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 1.93%, the child will be able to keep any returns over 1.93%. These same rates are used in connection with sales to defective grantor trusts.

IRS Issues its 2013-2014 Priority Guidance

On Aug 9, 2013, Treasury released its 2013-2014 Priority Guidance Plan, which lists 234 issues that are a priority for Treasury to review or resolve in the upcoming year (July 2013 to July 2014). Eleven items are listed that relate to gifts, estates and trusts, two of which are recent additions.

The first recent addition relates to the validity of "QTIP" elections on returns that are filed for the sole reason of taking advantage of the portability election. QTIP elections are made on a decedent's estate tax return to qualify for the marital deduction any property bequeathed to a marital trust for the benefit of the surviving spouse. A portability election is made to carry over for use by the surviving spouse whatever portion of the decedent's estate tax exemption amount that the decedent did not use. This election is also made on an estate tax return.

If an estate is less than the estate tax exemption amount (currently, $5,250,000), it does not have to file an estate tax return. However, to elect portability, the estate would have to file an estate tax return. A QTIP election may be made on this estate tax return for various reasons, none of which is to reduce the estate tax liability to zero (because it already is zero). In Rev. Proc. 2001-38, the Service stated that it "will disregard a QTIP election and treat it as null and void if the election was not necessary to reduce the estate tax liability to zero. . . ." Does this mean the Service will disregard QTIP elections made by small estates that are already below the threshold amount? We think the Service will resolve this issue in favor of the taxpayers, because the authority to make a QTIP election is granted by statute, which overrides the holding of Rev. Proc. 2001-38.

The second addition relates to the allocation of a taxpayer's generation-skipping transfer ("GST") tax exemption to property subject to an "estate tax inclusion period" (also known as an "ETIP"). A taxpayer may not allocate generation-skipping transfer tax exemption to property during an ETIP, which is the period of time during which the property would be included in the taxpayer's estate if the taxpayer died. An example of an ETIP is the annuity period of a grantor retained annuity trust (a "GRAT"). A taxpayer may want a portion of the trust fund existing at the termination of the GRAT to be exempt from GST tax. It is currently unclear how one can allocate GST to a portion of the remaining balance of a GRAT. The Service plans on looking more closely at this issue in the coming year.

IRS Holds That Right to Receive Dividends on Life Insurance Policy Does Not Cause Estate Inclusion in CCA 201328030

In CCA 201328030, the Service held that the retention of the right to receive dividends on a life insurance policy will not cause inclusion of the life insurance policy in the decedent's estate.

A decedent and his former spouse divorced, and as part of the divorce settlement, the decedent was required to maintain life insurance on his life for the benefit of his former spouse. The decedent was entitled to the dividends paid from the policy.

Under § 2042 of the Internal Revenue Code, if an individual dies while retaining certain incidents of ownership over a life insurance policy, it will be included in that individual's estate. "Incidents of ownership" include, for example, the power to change the beneficiary of the policy, to surrender or cancel the policy, to assign the policy or to pledge the policy for a loan.

The Service determined in this CCA that the right to dividends was not an incident of ownership under § 2042 of the Internal Revenue Code. Therefore, the life insurance policy was not included in the decedent's estate.

Sale of Asset for Self-Cancelling Installment Note Gives Rise to Gift Tax Liability in CCA201330033

CCA 201330033 asked whether the transfer of stock to a grantor trust in exchange for self-cancelling installment notes constituted gifts by the transferor. A SCIN is a promissory note where the debt is extinguished if the transferor/maker dies during the term of the note.

In general, a transaction where property is exchanged for a note will not be treated as a gift if the value of the property transferred is substantially equal to the value of the note. Treas. Reg. § 25.2512-4 provides that the fair market value of a note is presumed to be the amount of its unpaid principal plus accrued interest. For a gift to exist, the value of the gift must exceed the value of the note or the note must be uncollectible or the property pledged or mortgaged as security is insufficient to satisfy the note.

In analyzing the open issues in this CCA, the Service reviewed a SCIN case from the Sixth Circuit, *Estate of Costanza v. Comm'r*. In *Costanza,* the court held that a SCIN signed by family members is presumed to be a gift unless there is an affirmative showing that there existed a real expectation of repayment and intent to collect the debt. In *Costanza*, the taxpayers showed that the transferor required a steady stream of income to retire and an unwillingness to simply gift the transferred assets. According to the court, these facts showed an intention to actually collect on the debt. In the CCA, however, the SCINs only provided for interest payments each year, which to the Service, indicated that a steady stream of income was not contemplated. Also, according to the Service, the decedent in the CCA had sufficient assets so he did not need to rely on the notes for his living expenses. Together, these facts showed that the notes lacked the indicia of genuine debt. The Service found there was no reasonable expectation that the debt would be repaid.

The Service further held that the value of the notes should be determined using a willing buyer/willing seller standard, which looks at the value an unrelated willing seller would accept for the note and the amount an unrelated willing buyer would pay for the note. The Service also stated that decedent's life expectancy should be taken into consideration, since the notes would be extinguished at the decedent's death. The difference between the notes' fair market value based on the willing buyer/willing seller standard and the fair market value of the property transferred constituted a taxable gift.

There were no estate tax consequences associated with the cancellation of the notes.

Prenuptial Agreement Deemed Unenforceable by Nassau County Supreme Court in *CS v LS*

On June 6, 2013, the Nassau County Supreme Court refused to enforce a prenuptial agreement between divorced spouses. In this case, "Husband" had a net worth of "several million" dollars with an income of over one million dollars in 2011. "Wife" was a part-time teacher's assistant making $5,000 per year.

Prior to their engagement, Wife said she was willing to sign any prenuptial agreement if it meant they can get married. Days before the wedding, Husband presented Wife with a prenuptial agreement that had been drafted without her knowledge. Husband hired a lawyer for Wife, whom she met for the first time on the day she was to sign the agreement.

The Wife’s attorney was a commercial litigator who had some matrimonial experience. He was told that the agreement was non negotiable, and he did not obtain any financial information from Wife.

The prenuptial agreement gave Wife no consideration in the event of divorce and only allowed her to keep gifts Husband had given to her. If enforced, Wife would have been left with no home, no assets, no bank account and no maintenance.

Not surprisingly, the court overturned this prenuptial agreement, which clearly violated standard protocol for preparing a prenuptial agreement. In its opinion, the court stated that “one can predict with confidence that if each spouse retains a lawyer of his or her own choosing, is provided with a proposed agreement with sufficient time to give due consideration to the serious consequences of the proposed terms, is given fair and adequate disclosure, and is presented with an agreement that does not scream inequity or will leave one party practically destitute, it will be upheld.”

Massachusetts Supreme Judicial Court Authorizes Trust Decanting in *Morse v. Kraft*

The Massachusetts Supreme Judicial Court ruled in *Morse v. Kraft* that the trustee of an irrevocable trust who had full discretion to distribute trust principal “for the benefit” of a beneficiary could transfer the assets to a new trust without the consent of the beneficiaries or the court, provided that the recipient trust had the same distribution standard and only administrative modifications.

As a result of this decision, Massachusetts now has common law that may be relied upon to decant assets to new trusts. Massachusetts clients may find this helpful because Massachusetts does not currently have a statutory authorization for decanting.

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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