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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.

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

The November Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.2%, unchanged from October. The November 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 having a duration of 3-9 years (the mid-term rate, compounded annually) is 1.9%, up 0.05% from October.

Lower rates work best with GRATs, CLTs, sales to defective grantor trusts, private annuities, SCINs and intra-family loans. The low AFR presents a potentially rewarding opportunity to fund GRATs and sell assets to intentionally defective grantor trusts in November.

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 0.39% for loans with a term of 3 years or less, 1.9% for loans with a term between 3 and 9 years, and 2.91% 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 1.9%, the child will be able to keep any returns over 1.9%. These same rates are used in connection with sales to defective grantor trusts.

Significant fractional ownership interest discount permitted for artwork partially owned by estate. *Estate of Elkins v. Commissioner*, 5th Cir., No. 13-60472, 2014 BL 255704, September 15, 2014.

For purposes of computing the estate tax, the Fifth Circuit held that discounts ranging from 51.69% to 79.74% were appropriate for determining the value of an estate's undivided fractional interest in each of 64 pieces of art. The decedent and his wife owned the 64 pieces of art as community property. Part of the wife's 50% share was transferred by means of a Grantor Retained Income Trust and a disclaimer at the predeceased wife's death to their three children. As a result, at the decedent's death, the artworks were owned fractionally by the decedent and his three children. The estate contended that a 44.75% discount was appropriate and supported its valuation by calling several art valuation experts to the stand. The commissioner took the position that no discount should be applied but failed to adduce any expert in support of this argument. The Tax Court held that a "nominal" 10% discount was appropriate. On appeal, the Fifth Circuit held that there was no viable factual basis for the Tax Court's 10% holding. On the contrary, the estate's experts were "uncontradicted, unimpeached, and eminently credible." Therefore, a refund of $14,359,508.21, plus statutory interest, was due to the estate.

This case may represent a significant victory for taxpayers because, historically, the IRS has taken the position that fractional interest discounts were inapplicable (or at least severely limited) in the context of gifted or devised artwork. The IRS has maintained that, unlike land or business interests, the value of artwork is in the ability to use it as an aesthetic or decorative ornament. Therefore, it is argued, dividing the ownership of a piece of art should not result in a discount if the use of the artwork remains essentially unchanged (e.g., if it continues to hang on the wall in the home of the donor). However, it is unclear whether the reach of the Elkins decision will be limited due to the IRS' uncharacteristic reliance on conclusory arguments rather than on expert opinions and other evidence. In addition, it is unclear whether the reasoning in Elkins will be adopted by jurisdictions outside the Fifth Circuit.

Testimony of New York attorney who supervised execution was sufficient to admit a Will to probate where witnesses invoked their Fifth Amendment right and refused to testify. *Matter of Buchting*, 111 A.D.3d 1114, (NY App. Div. 3d Dep't October 7, 2013).

A decedent's surviving spouse sought to probate the decedent's Will in a New York probate proceeding. The two execution witnesses to the Will refused to testify, invoking their 5th Amendment rights against self-incrimination. However, the attorney-draftsman who oversaw the execution ceremony testified before the Court. The decedent's children from a prior marriage objected to admission of the Will on the grounds of lack of due execution, lack of testamentary capacity and undue influence. The Surrogate's Court of Greene County admitted the Will to probate, finding that there was *prima facie* evidence of due execution. The Appellate Division, Third Department, found that although there was sufficient unrebutted evidence of due execution, the Will should not have been admitted, pending development of the testamentary capacity and undue influence issues.

The Court began its analysis by reciting the rule that to establish due execution, the proponent of the Will must produce the attesting witnesses unless an exception applies. Invocation of the 5th amendment is “akin to a failure to recall,” and thus, the Will could be admitted under the Surrogate’s Court Procedure Act (“SCPA”) Section 1405(3), which provides ***“Where an attesting witness has forgotten the occurrence or testifies against the execution of the Will and at least 1 other attesting witness has been examined, the will may be admitted to probate upon the testimony of the other witness or witnesses and such other facts as would be sufficient to prove the Will.”***

In this case, the objectants to the Will argued that because there was no attesting witness who remembered the execution (both had invoked the 5th Amendment), the exception was inapplicable. The Court responded that no witness need actually remember the execution, as long as all relevant testimony is elicited. The witnesses were, in essence treated as having testified for this purpose because the Court could not draw a negative inference resulting from the invocation of the 5th amendment.

The next issue was whether there was sufficient *prima facie* evidence of due execution without having a witness who actually recalled the execution. In New York, a presumption of due execution arises where the attorney-draftsman supervises the execution. The objectants argued that because there were certain minor irregularities in the documents, the attorney-draftsmen was not a credible witness. However, because there was insufficient evidence to rebut the presumption, the Surrogate’s Court properly found that the Will was duly executed.

Lastly, the Court held that, in any event, the Will should not have been admitted to probate without a determination of the facts concerning undue influence and testamentary capacity. The matter was remitted to the Surrogate’s Court for further proceedings on these issues, and the Surrogate’s Court’s analysis of SCPA 1405(3) was upheld.

Guidance on reformed New York state estate tax rules issued by New York State Department of Taxation and Finance. NYS Estate Tax Guidance TSB-M-14(6)M

New York State estate tax guidance was issued on August 25, 2014. Although it does not contain any real surprises, it serves to confirm our understanding of the altered New York State estate tax regime. Also, the TSB may provide some oblique guidance concerning the rate structure. Section 952 of the NYS Tax law, as amended, contains a rate structure with a top rate of 16%, which phases in at $10,100,000. The lead-in language before the rate structure is clear that the statute only applies “in the case of decedents dying on or after April 1, 2014 and before April 1, 2015.” It is unclear whether the legislature intends to further amend the rate structure or keep it as, and that leaves an open question for anyone subject to the New York estate tax after April 1, 2015. The TSB sets out a copy of the rate structure, but does not address the time limitation in the statute, which may telegraph that the Department of Taxation’s position is that the current rate structure is intended to be permanent.

The TSB does not discuss tax issues other than the estate tax. Included below for the benefit of the reader is a broader overview of the New York State Budget Bill provisions dealing with transfer and other taxes relevant to estate planners, effective for decedents dying after April 1, 2014.

a. Estate Tax.

(1) *Calculation.* The New York estate tax is no longer a decoupled pickup tax. It is now calculated by determining the New York gross estate and subtracting certain deductions (which vary depending on whether or not the decedent was a New York resident) and applying the graduated tax rates set forth in Section 952(b) of the NYS Tax law, with the highest tax rate of 16% being imposed when the New York taxable estate exceeds $10.1 million. The tax rates are effective "in the case of decedents dying on or after April 1, 2014 and before April 1, 2015." The rate structure beyond April 1, 2015 is as yet unknown.

The New York State exemption amount, known as the Basic Exclusion Amount, set forth in Section 952(c) of the New York State Tax Law, is as follows:

Death on or After:	and Before:	Basic Exclusion Amount:
April 1, 2014	April 1, 2015	$2,062,500
April 1, 2015	April 1, 2016	$3,125,000
April 1, 2016	April 1, 2017	$4,187,500
April 1, 2017	January 1, 2019	$5,250,000

After January 1, 2019, the Basic Exclusion Amount will be equal to the federal exclusion amount and will be indexed annually to mirror the federal exclusion going forward.

The exclusion available at the state level quickly diminishes if the taxable estate exceeds the basic exclusion amount. If the taxable estate is more than 105% of the basic exclusion amount, the estate will receive no state exclusion, which produces a "cliff" effect. The federal concept of portability has not been incorporated in the New York estate tax regime. Accordingly, it remains necessary to ensure that both husband and wife have sufficient includible assets to ensure that both exclusion amounts will be utilized regardless of death order. It is expected that credit shelter trust/marital trust planning will continue to be an important component in many estate plans.

(2) *Includible Gifts.* Gifts made within three years of a decedent's death may be added back to the New York gross estate, thus potentially being subject to New York estate tax at the maximum rate of 16%. However, the add-back does not include gifts made before April 1, 2014 and on or after January 1, 2019.

(3) *Alternate Valuation.* The New York State gross estate is the same as the federal gross estate, whether or not federal alternate valuation is elected. The estate may elect to use the alternate valuation for determining the value of the New York gross estate even if no IRS Form 706 is required to be filed at the federal level. However, similar to the rule under federal law, alternate valuation will only be allowed if it decreases the value of the New York gross estate and the amount of tax imposed reduced by any credits allowed. The election must be made no

later than the due date of the return (including extensions) or at any time thereafter as may be allowed by the commissioner. Once the election is made, it is irrevocable.

(4) *Q Terminable Interest Property Elections.* If no IRS Form 706 is required to be filed, an executor may nonetheless make a state level QTIP election. QTIP elections are irrevocable.

(5) *Federal Elections.* All federal elections, including QTIP elections, are binding on the New York estate tax return.

b. <u>Generation-Skipping Transfer Tax.</u> The New York GST tax regime has been repealed. Accordingly, multigenerational intervivos gift planning may be an attractive option following the expiration of the 3 year add-back rule on January 1, 2019.

c. <u>Gift Tax.</u> Despite initial proposals, there is still no gift tax in New York. (However, see the note above concerning estate tax add-back provision.)

d. <u>Income Tax.</u>

(1) *Tax on Distributions of Accumulated Income.* New York State now imposes an income tax on accumulated income that is distributed to a New York State beneficiary. To avoid double taxation, New York provides an offsetting credit for tax paid to other states.

(2) *Tax on Incomplete Gift Non-Grantor Trusts.* Foreign Incomplete Non-Grantor Trusts (often described as "Delaware Incomplete Non-Grantor Trusts", "DING" or using similar acronyms in other states) will be treated as grantor trusts even though they are non-grantor trusts for federal income tax purposes. As a result, New York State grantors will be subject to tax on income earned by any incomplete gift non-grantor trusts settled by them. This provision effectively precludes the use of such trusts to avoid paying New York State income tax.

2014-2015 Internal Revenue Service Priority Guidance Plan

On August 26, 2014, the IRS released its priority guidance plan listing 10 issues in the area of "gifts, estates and trusts" it has flagged for guidance. Among the highlights are: (1) Issuance of a Revenue Procedure under §2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability; (2) Final regulations under §§2010 and 2505 regarding portability of the deceased spousal unused exclusion (proposed and temporary regulations were published on June 18, 2012); (3) Final regulations under §2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period (proposed regulations were published on November 18, 2011); (4) Regulations under §2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP; (5) Final regulations under §2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption (proposed regulations were published on April 17, 2008).

"Uniform Fiduciary Access to Digital Assets Act" or "UFADAA" (the "Act") finalized and released by National Conference of Commissioners on Uniform Laws.

In July of 2014, the National Conference of Commissioners on Uniform Laws finalized the Act in draft form. The Act generally gives fiduciaries (including executors, trustees, attorneys-in-fact and conservators) broad access to digital assets. The Act generally puts the executor, trustee or attorney-in-fact in the shoes of the decedent, principal or settlor (respectively) with respect to all digital assets. The fiduciary can contact account administrators and assume the accounts with a new password in a fiduciary capacity. The Act defines a fiduciary as an authorized user to allow access to all digital devices without committing any crime under Federal law and clarifies that disclosure of all emails should be allowed, to the extent permitted under the Electronic Communications Privacy Act. Custodians are granted immunity if they comply in good faith with the Act.

The Act provides for several exceptions. First, it applies only to accounts with an account holder who entered into a TOS agreement. It is not applicable to private email through an employer (emails generally belong to the employer and not the decedent, per employment policies). This may create a trap for business owners who use their email accounts. If business succession is not to sympathetic beneficiaries, they may refuse to divulge emails.

Secondly, general provisions in a TOS agreement restricting fiduciary access are deemed unenforceable as a matter of public policy unless the account-holder agreed "by an affirmative separate act" to the fiduciary limitation. Similarly, a choice of law provision to a non-UFADAA jurisdiction is unenforceable. These rules are somewhat unhelpful because nobody reads click-wrap; it seems likely that all TOS boiler-plate agreements will simply incorporate a separate check box for this provision.

States have begun to adopt the UFADAA. On August 12, 2014, Delaware adopted its own version, the Fiduciary Access to Digital Assets and Digital Accounts Act.

To discuss any aspects of these developments or associated tax implications, please contact one of the lawyers in the Personal Planning Department at Proskauer Rose LLP.

Value of assets transferred by part sale/part gift to an annuity trust was included in estate of Settlor under Section 2036 of the Internal Revenue Code ("Section 2036"). *Estate of Trombetta, T.C. Memo*. 2013-234 (October 21, 2013).

The decedent Helen Trombetta and her husband Joseph owned several rental properties. Helen managed the operation of the properties, including upkeep responsibilities and collecting rent and Joseph managed the financial aspects. The case concerned particularly a 27 unit apartment building known as Black Walnut Square and a 79 unit apartment building known as Tierra Plaza, which were purchased by Helen and Joseph and made subject to significant debt. Helen and Joseph were personally liable on the mortgages for these properties. Thereafter, Helen and Joseph were divorced. Pursuant to the divorce judgment, Helen received several rental properties, including Black Walnut Square and Tierra Plaza. The judgment further provided that Helen would hold Joseph harmless for the mortgages on those properties, which remained significant. Helen depended on the income generated by Black Walnut Square and Tierra Plaza for her living expenses. Helen engaged attorneys to plan her estate. They developed, what the Court called, “a comprehensive and integrated estate plan,” which included a will, a living trust, an annuity trust and a personal residence trust. Helen also formed Helen Properties Limited Partnership to hold all her income-producing properties with the exception of Black Walnut Square and Tierra Plaza.

Helen was the grantor and sole beneficiary of the annuity trust. Helen and her three children were co-Trustees. With respect to trustee actions, Helen had 50% of the voting rights and the three children split the remaining 50%. The term of the trust was 180 months, subject to Helen’s ability to unilaterally reduce the term. The trust was to pay $75,000 per year, with an annual 4% increase. The trust was prohibited from making distributions to Helen after the 180 month initial term. The three children who were acting as co-Trustees provided guarantees for the annuity trust payments. The trust provided that if the income earned in the trust exceeded the annuity payments, the Trustees had discretion to distribute the excess to Helen or accumulate the cash within the trust. At the later of the end of the annuity term or Helen’s death, the trust property was to pass to Helen’s descendants. The trust agreement recited that it was supposed to be a qualified interest under Section 2702(b)(1), and prohibited additional contributions after the initial funding of the trust. Helen transferred Black Walnut Square and Tierra Plaza into the annuity trust. At the time of the transfer, both properties were still highly leveraged. The annuity trust began to make the mortgage payments for the properties, though it never actually assumed the mortgages. The value of Helen’s retained interest in the annuity trust was about $500,000 less than the value of Black Walnut Square and Tierra Plaza, so she reported a part sale and part gift on her gift tax return.

Helen began receiving annuity trust payments pursuant to the terms of the trust agreement. After a time, she decided that she needed less cash and began to receive less, with the understanding that the unpaid amounts would be deferred and eventually paid to Helen or her estate, with accumulated interest. The annuity trust began to keep account of how much it owed Helen for back payments. Helen later decided she needed more cash and began to take payments in excess of the annuity amounts due to her, which began to cause the account held on credit for her to diminish. Eventually, the trust made up the balance and payments were again lowered, causing the trust to once again accrue a balance due to Helen.

In an effort to lower the mortgage payments on Tierra Plaza, Helen executed deeds of trust in her individual capacity to refinance the property. Helen was still personally liable on the mortgage and the annuity trust continued to make the mortgage payments. At Helen’s direction, the annuity trust also entered into a lease agreement with an option to purchase with her daughter (one of the Trustees) and her son-in-law with respect to Black Walnut Square and Tierra Plaza. The rental payments generated cash sufficient to make the annuity payments to Helen. Eventually, the annuity trust paid off the mortgage securing Black Walnut Square. Helen then caused the annuity trust to issue a note to Helen Properties, whereby the partnership would lend the annuity trust a substantial amount of cash, secured by Black Walnut Square and Tierra Plaza.

Shortly after that, Helen was diagnosed with cancer and, because she did not believe she would outlive the annuity trust term, she exercised her right under the agreement to shorten the term to 156 months. Helen died in 2006, at which time the annuity trust owed her over $100,000 in back annuity payments, which it made to the estate, with interest. Following the filing of the estate’s 706, the Service sought to include the full value of all property contributed to the annuity trust on the theory that Helen had retained an impermissible right under Section 2036 to the possession or enjoyment of Black Walnut Square and Tierra Plaza.

The Court first looked at whether the value transferred to the annuity trust was includible under Section 2036 and found that the trust assets were includible. The Court noted that assets will be includible under Section 2036 if three prongs are satisfied: (1) the decedent made an inter vivos transfer of property, (2) the transfer was not a bona fide sale for adequate and full consideration; and (3) the decedent retained an interest or right that was not relinquished before death. Helen's estate first argued that the bona fide sale exception should apply. In first looking at the bona fide sale exception, the Court recited the rule that the transaction must have been for full and adequate consideration and there must have been an arm's length transaction. Neither prong was met in this case. The Court held there was no full and adequate consideration because the trust was funded by part sale and part gift. There was no bona fide sale because there were no meaningful negotiations with the trustees. The transfer of the properties to the annuity trust was part of a "canned" estate plan. Helen was a trustee and sole beneficiary and stood on both sides of the transaction. In response, Helen's estate argued that there were legitimate non-tax reasons to engage in the transaction, but the Court held this was unavailing because that standard applies in family limited partnership cases and is inapplicable to transfers to an annuity trust. Moreover, the evidence suggested that the transaction was entirely tax driven. The annuity trust was part of her larger estate plan to reduce taxes.

Helen's estate next argued that Helen had not retained any interest in the subject properties, and therefore, Section 2036 should not apply. In responding, the Court recited the rule that the decedent must have "absolutely, unequivocally, irrevocably and without possible reservations parted with all of her title, possession, and enjoyment of the transferred assets." An implied understanding to use the property in favor of the decedent constitutes a retained power and the estate tax regulations relating to Section 2036(a)(2) provide that it is immaterial whether such a power is exercisable alone or in conjunction with an adverse party. Helen's retention of managerial power as a Trustee was not a per se Section 2036 violation, so the Court went on to analyze all the facts and circumstances. There were several "bad facts": (1) There was testimony that the co-Trustees generally acted on Helen's recommendation, suggesting an implied understanding; (2) Helen took the lead role in negotiating the refinancing on Tierra Plaza and had executed the pertinent documents; (3) Helen retained sole signatory authority over Black Walnut Square and Tierra Plaza, as evidenced by her ability to lease the properties to her daughter and son-in-law; (4) Helen could act with one other Trustee to make discretionary distributions of excess income to herself; (5) The annuity trust paid the mortgages on which Helen was liable, thereby discharging her obligation. As a result, the Court ruled that Helen retained de facto control of the properties and Section 2036 should apply.

Helen's estate next argued that if Section 2036 did apply, only the annuity payments due to Helen should have been includible in the estate. The estate's theory was that the transaction was a sale in exchange for an annuity rather than a transfer with a retained interest, and therefore, the annuity payments were essentially severable from the corpus of the trust. The Court disagreed because the transfer was more akin to a transfer with a retained interest than a sale in exchange for an annuity. This was suggested by the facts that Helen controlled Black Walnut Square and Tierra Plaza after the transfer and that she intended the annuity payments to be made from their income stream alone. No payments were ever made from principal, which suggests that the payments were merely a conduit to pass the income to Helen. Recall that the Trustees offered personal guarantees, which was done to shore up the sale aspect of the transaction, in accordance with a case called *Fidelity-Philadelphia Trust Company v. Smith*. The Court differentiated Fidelity-Philadelphia and held that the personal guarantees were meaningless here because the parties knew the trust was well funded and would never produce less income than necessary to meet the annuity obligations. The duties created under the guarantees were never actually utilized. The Court also held that because the transferred assets were the sole source of funding for the annuity payments, personal guarantees were ineffective. In addition, Helen could (and in fact did) vary the annuity payment terms based on her cash needs and could (and in fact did) unilaterally change the annuity period, which made the transaction look more like a gift with a retained interest.

Finally, the estate argued that because California law restricts the ability of an interested trustee to make distributions to health, education, maintenance and support, Helen did not retain an interest. The Court found this argument unconvincing because Helen still had some authority to distribute, and that was enough to trigger Section 2036.

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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