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 Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.0%, down 0.2% from November. 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 having a duration of 3-9 years (the mid-term rate, compounded annually) is 1.72%, down 0.18% from November.

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 December.

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 0.34% for loans with a term of 3 years or less, 1.72% for loans with a term between 3 and 9 years, and 2.74% 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 1.72%, the child will be able to keep any returns over 1.72%. These same rates are used in connection with sales to defective grantor trusts.

Federal Exclusion from Gift, Estate and Generation-Skipping Transfer Tax Increases to $5,430,000 in 2015. Rev. Proc. 2014-61 (October 30, 2014).

The IRS announced certain inflation adjustments to tax exemptions and deductions. The IRS increased the basic exclusion amount for 2015 to $5,430,000, up from $5,340,000 in 2014. Thus, a decedent who dies in 2015 will pay no federal estate tax if the decedent's taxable estate is under $5,430,000, provided that he or she did not use any of this exemption during his or her lifetime. Additionally, the basic exclusion amount is the amount that an individual may use to make tax-free gifts during his or her lifetime. Any exemption amounts used during life reduce the exemption amount available at death. Furthermore, the basic exclusion amount also determines the amount that may pass free of generation-skipping transfer taxes, which therefore also increases to $5,430,000.

The amount of the annual exclusion for gifts to U.S. citizens remains at $14,000 for 2015. This means that an individual may gift up to $14,000, per beneficiary, next year without reducing such individual's basic exclusion amount or being subject to gift tax. However, if the recipient of the gift is a spouse who is a non-U.S. citizen, the U.S. citizen spouse may gift up to $147,000 (up from $145,000 in 2014) to the non-citizen spouse in 2015 without including the amount in his or her taxable gifts. Comparatively, a married U.S. citizen couple may make unlimited gifts to each other without being subject to gift tax.

Florida court allowed decedent's written correspondence to amend terms of revocable trust. *Kritchman v. Wolk*, 39 Fla. L. Weekly D 2082 (Fla. 3d DCA 2014).

During her lifetime, the decedent had created a revocable trust. The trust specified that the trustees shall "pay such sums from trust principal as [the decedent] may direct at any time." The decedent had used the trust's assets to pay for the educational expenses of her cousin's grandson (the "grandson") for several years prior to her death. Moreover, shortly before her death, the decedent wrote a letter to the Trustees, directing them to pay for the educational expenses of the grandson's junior and senior years in college. The trust itself did not include any such bequest for the benefit of the grandson.

The decedent passed away during the grandson's fall semester of his junior year. The Trustees paid for the grandson's educational expenses for one additional semester of college, but then refused to pay for his last three semesters. The grandson subsequently filed a lawsuit against the Trustees, demanding payment of his educational expenses.

The Florida appellate court held that the Trustees were obligated to carry out the decedent's written instructions to pay the educational expenses of the grandson's last three semesters. In reaching this conclusion, the court seems to have focused on language in the trust specifically directing the trustees to pay such sums as the decedent may direct at any time.

However, the court seems to disregard the requirements of Section 736.0403(2)(b) of Florida's Statute, which provides that all testamentary directives in wills and trusts be in writing and witnessed. This is an unusual case in that the court effectively allowed the decedent's written correspondence to amend the terms of the trust even though it ran afoul of the procedural requirements of this statute.

Residence constituted Florida homestead property even though decedent did not reside on property; surviving spouse took life estate interest in residence subject to terms of marital settlement agreement with decedent's former spouse. *Friscia v. Friscia*, 39 Fla. L. Weekly D 1810 (Fla. 2d DCA 2014).

Friscia evolved from a petition to determine the homestead status of Florida real property. At the time of the decedent's death, the decedent and his former wife each owned a one-half undivided interest in their former Florida marital residence. Pursuant to the couple's marital settlement agreement ("MSA"), the former wife was granted exclusive use and possession of the residence until their youngest child graduated from high school, at which time the residence was to be sold and the proceeds divided equally between the former spouses.

The decedent subsequently died while his youngest child was still in high school. At the time of the decedent's death, his former wife was living in the residence with the two children of their marriage. The decedent's second wife was appointed the personal representative of his estate.

The decedent's oldest son filed a homestead petition to protect the residence from any creditor claims against the decedent's estate. Besides creditor protection, there are other consequences of granting the residence homestead status that are relevant. First, homestead real property is not an asset of a decedent's probate estate. Consequently, the second wife, as personal representative, would not have jurisdiction over the residence at issue here. Second, because the decedent did not devise the property, the second wife would take a life estate interest in any homestead real property, with a vested remainder in the decedent's lineal descendants.

The decedent's second wife objected to the homestead petition, presumably because she wanted the value of the residence included in the calculation of her elective share and to stake a claim to control over the former marital residence as an asset of the estate.

The Florida appellate court first found that the residence constituted homestead property, noting that the law does not require that the decedent actually reside on the property; it is sufficient that the decedent's sons, whom he still supported financially, continued to live on the property. The court also rejected the second wife's argument that the MSA operated as a waiver of the decedent's homestead rights.

As a result, the court concluded that as to decedent's one-half interest in the residence, the Florida homestead exemption provided the second wife a life estate interest with a vested remainder in the decedent's children as lineal descendants. However, even though the second wife received this life estate interest, she took that interest subject to the rights of use granted to the former wife under the MSA.

IRS held that reformation of trust to correct scrivener's errors triggered remainder interests in GRATs to be completed gifts, and trust's assets would not be included in settlor's gross estate. PLR 201442046 (October 17, 2014).

The settlor met with an attorney to discuss estate planning for his four children. In contemporaneous correspondence, the attorney informed the settlor that a "grantor retained annuity trust" ("GRAT") may be an effective means to minimize gift and estate taxes. The settlor agreed to the plan and created two GRATs. The assets remaining in the GRATs at the end of the GRAT term would pass to a Children's Trust. The Children's Trust, however, was drafted as a revocable trust.

The settlor subsequently retained an accountant to prepare the gift tax return reporting the transfers to the GRATs. After reviewing the trust documents, the accountant informed the settlor that the language making the Children's Trust revocable defeated the settlor's strategy to minimize transfer taxes. The settlor then retained another attorney to file a petition in state court requesting reformation of the Children's Trust to correct mistakes due to scrivener's errors. The state court approved the petition and ordered that the Children's Trust be deemed irrevocable *ab initio*, as if included in the original trust document.

The IRS acknowledged that under state law, a court may reform a trust instrument, even if unambiguous, to conform to the settlor's probable intention, as proven by clear and convincing evidence. Moreover, the court may provide that the modification have retroactive effect. The IRS concluded that the state court's order reforming the Children's Trust based on scrivener's error is consistent with state law. As a result, the IRS ruled that the transfers of the remainder interests in the GRATs were completed gifts and that the assets of the Children's Trust would not be included in the settlor's gross estate when he dies provided he survives the GRAT term.

Transfer of assets from a living trust created by debtor's mother to a spendthrift trust for debtor's benefit was a fraudulent conveyance. *In re Castellano*, 514 B.R. 555 (Bankr. N.D. Ill. 2014).

The debtor's mother created a living trust providing that upon her death, the assets of the trust would be divided equally among her four children, including the debtor. The living trust contained a spendthrift clause that authorized the Trustee to pay out of the spendthrift trust those amounts that the Trustee, in his or her absolute discretion, deems advisable for the education and support of the beneficiary during his or her lifetime.

Upon the death of the debtor's mother, the debtor became entitled to her one-fourth share of the living trust's assets. The debtor's nephew became the trustee of the living trust.

When the debtor was facing imminent financial trouble, the debtor's attorney sent a letter to the trustee stating that the debtor was insolvent and that the trustee should act in accordance with the spendthrift provisions of the living trust. After receiving that notification, the trustee opened a spendthrift trust account titled in the debtor's name and transferred the debtor's one-fourth share of the living trust's assets to that account. The debtor then executed a receipt, in which she acknowledged that she would receive no current distribution from her mother's living trust and that the spendthrift trust would receive her lifetime, beneficial interest.

In determining that there was a fraudulent conveyance, the court relied on Section 548(e)(1) of the Bankruptcy Code, which voids any transfer of assets made by a debtor into a "self-settled trust or similar device." Thus, there were two issues the court needed to resolve. First, did the debtor transfer an interest in property? Second, were those assets transferred into a self-settled trust or similar device?

On the first issue, the court concluded that there was an *indirect* transfer. Rather than accepting direct receipt of a one-fourth share of the living trust's assets and then transferring those assets into a self-settled trust, the court found that the debtor recruited the trustee to accomplish the equivalent result, schooling him in the insolvency letter in his obligation to act in accordance with the spendthrift provisions of the living trust. The trustee honored her wishes, and although the debtor's use of the assets was then conditional on the trustee's discretion, the court downplayed that discretion because the trustee was an interested party—*i.e.*, the debtor's nephew.

On the second issue, the court concluded that there was a transfer made by the debtor to a self-settled trust or similar device—essentially, a trust in which the debtor is to receive the benefits.

The spendthrift clause clearly provided that the trustee was authorized to make distributions to the debtor for her education and support as the trustee deemed advisable. The debtor, by her own admission, also acknowledged in the receipt that she received a lifetime, beneficial interest in the spendthrift trust. Finally, the court placed a lot of emphasis on the family ties between the debtor and trustee, finding that the trustee would not exercise independent, unfettered discretion in administering the spendthrift trust and that the debtor would have every opportunity to influence the trustee to distribute funds according to her own wishes. The court concluded that there was a fraudulent conveyance and that the bankruptcy trustee could recover the assets placed into the spendthrift trust.

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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