Proskauer

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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 2.0%, down 0.2% from September. The October 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 1.67%, down 0.1% from September.

The relatively low § 7520 rate and AFR continue to present potentially rewarding opportunities to fund GRATs in October with depressed assets that are expected 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 0.55% for loans with a term of 3 years or less, 1.67% for loans with a term between 3 and 9 years, and 2.64% 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 1.67%, the child will be able to keep any returns over 1.67%. These same rates are used in connection with sales to defective grantor trusts.

State of North Carolina May Not Tax a Nonresident Trustee on the Income of a Nongrantor Trust Based on the Existence of Resident Discretionary Beneficiaries (*Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, Docket No. 12 CVS (N.C. Super. Ct., April 23, 2015))

The Business Court Division of the Superior Court of Wake County, North Carolina ruled that North Carolina did not have the authority to tax a nonresident trustee on the ordinary income and capital gains of a nongrantor trust based on the existence of resident discretionary beneficiaries.

North Carolina's relevant statute on income tax of trusts provides that tax may be imposed on the income of a trust that is *for the benefit of a resident* of North Carolina. The irrevocable trust in issue had been created in New York in 1992 by a New York resident. It named a New York resident as Trustee and designated New York as the governing law. Pursuant to its terms, the trust was divided into shares for the settlor's then living children (one of whom was a North Carolina resident) in 2002. The terms of the trust provided that income and principal could be distributed to beneficiaries for their best interests.

During the period at issue in this case (2005-2008), the trust investments consisted of financial assets, which were held with a custodian in Massachusetts; tax returns and other trust records were kept in New York, and no distributions were made to North Carolina residents.

Between 2005 and 2008, North Carolina taxed the trust on income accumulated in the trust. A total of $1.3 million was paid during that time. The Trustee brought suit, seeking a refund of that amount and challenging the state's authority to impose income taxes on the trust. The Trustee challenged the constitutionality of the statute under both the Due Process Clause and Commerce Clause of the U.S. Constitution.

The court looked at the U.S. Supreme Court's ruling in *Quill v. North Dakota* (1992), which provided two requirements for a state to impose a tax: (1) It required some minimum connection between a state and the person, property or transaction it seeks to tax, and (2) that the income attributed to the state for tax purposes be rationally relevant to values connected with the taxing state. The court found that the trust did not have sufficient contacts with North Carolina. The beneficiaries themselves had no control over the trust and were only discretionary beneficiaries, so their presence in the state, by itself, was not enough.

The court also did a commerce clause analysis using the four prongs identified in *Complete Auto Transit v. Brady* (U.S. 1977). A tax will withstand scrutiny if it meets all four of the following prongs: (1) It is applied to an activity with a substantial nexus to the taxing state; (2) it is fairly apportioned so as to tax only the activities connected to the taxing state; (3) it does not discriminate against interstate commerce; and (4) it is fairly related to services provided by the state. Based on the factors reviewed during the due process analysis, the court found that it failed on the first and fourth prongs.

Several other states (including California, Michigan and Ohio) seek to tax trusts on a similar basis. It is likely that challenges to taxes in those states will include similar arguments.

Court Relied on Square Corners Doctrine to Determine That New Jersey's Collection of Tax on Income Attributable to Non-New Jersey Assets Was Improper (*Residuary Trust A U/W/O Fred E. Kassner v. Division of Taxation, Department of the Treasury, State of New Jersey* (2015 N.J. Tax Lexis 11 (N.J. Sup. Ct. App. Div. 2015), aff'g, 27 N.J. Tax Ct. 2013))

Fred Kassner, who was a New Jersey resident at his death, created a testamentary trust under his will. The Trustee of the trust lived in New York and all aspects of trust administration occurred outside of New Jersey. The trust had no New Jersey assets in 2006 (the year in question).

Because the trust was created by a New Jersey resident, it met the definition of a "resident trust" for New Jersey income tax purposes (see NJSA § 54A:1-2(o)(2)-(3)). For the year 2006, the Trustee filed a New Jersey income tax return and paid tax on S corporation income attributable to activity in the state, but not on other income allocated outside of New Jersey. The return was audited, and the New Jersey Division of Taxation argued that all undistributed income should be taxable because the trust held assets in New Jersey.

The New Jersey Tax Court reviewed the tax on due process grounds and determined that the trust was not taxable on interest income and income attributable to business activity conducted outside of New Jersey. Further, it ruled that the trust could not be deemed to own assets in New Jersey just because it was a shareholder in S corporations that owned New Jersey assets.

The Appellate Division affirmed the Tax Court's decision, but did not even review the constitutional arguments. Instead, it looked at the state's "square corners doctrine," which requires the government to deal with its citizens fairly and equitably. The Division of Taxation had published literature since 1999 that indicated that undistributed trust income would not be taxable if the trustee was not a New Jersey resident and the trust had no New Jersey assets. The Division of Taxation did not issue publications contrary to that stance until 2011, after the year at issue in this case. Thus the Appellate Division ruled that it could not seek to apply its new position retroactively.

The Appellate Division emphasized the importance of the square corners doctrine in the field of taxation, because "trusts, businesses, individuals and others must be able to reliably engage in tax planning and, to do so, must know what the laws are." The Appellate Division did not review the constitutional issues in this case, so it is not known how it would rule if this tax had been imposed after 2011, when the Division of Taxation changed its policy. However, the New Jersey Tax Court's decision, which was based on a constitutional analysis, indicates that similar constitutional challenges may be successful in the future.

The Net Income Limitation Provision in a NIMCRUT Must Be Ignored, So That for Purposes of Determining the Present Value of the Charitable Remainder Interest, It Is Assumed that the Noncharitable Beneficiary Will Always Receive the Annual Standard Unitrust Payment (*Estate of Schaefer v. Commissioner* (145 T.C. 4 (T.C. July 2015))

In *Estate of Schaefer v. Commissioner*, the Tax Court looked at IRC Section 664(e), which provides the valuation rules for charitable remainder trusts. The trusts at issue in this case were NIMCRUTs (Net Income with Makeup Charitable Remainder Trusts). The issue before the Tax Court was whether the net income limitation contained in a NIMCRUT should be considered for purposes of determining the present value of the charitable remainder interest for purposes of the 10% remainder interest requirement. The Tax Court held that the net income limitation provision must be ignored, so that it is assumed that the noncharitable beneficiary will always receive the standard unitrust payment.

Mr. Schaefer created two charitable remainder unitrusts (CRUTs) in 2006, of which he was the initial income beneficiary. After his death, one son became the income beneficiary of one trust and one son became the income beneficiary of the other. CRUT #1 provided for a payout equal to the lesser of the CRUT's annual income or 11% of the annual fair market value of the trust. CRUT #2 provided for a payout equal to the lesser of the CRUT's annual income or 10% of the annual fair market value of the trust. The Unitrust Period for each trust ended on the later of (1) the date preceding the date of death of the last income beneficiary or (2) 20 years after the trust was created. Each trust provided that if trust income exceeded the fixed percentage, then additional distributions of income were to be made to make up for previous years when income did not yield enough to satisfy a distribution of the fixed percentage amount (this is the "Net Income with Makeup" provision).

When Mr. Schaefer died in 2007, the estate did not claim a charitable contribution deduction for any portion of the trusts, but rather reduced the amounts reported on Schedule D (Transfers During Decedent's Life) by the amounts it determined to be charitable. The estate tax return was audited, and the IRS adjusted the valuation of the trusts and argued that the trusts did not meet the requirement that the value of the charitable remainder interest be at least 10% of the net fair market value of the property on the date of contribution.

The Tax Court determined that IRC 664(e) was ambiguous, but ultimately ruled that the IRS was correct, after reviewing the relevant legislative history associated with the statute and associated regulations. The legislative history indicated that, for purposes of determining the charitable contribution, the remainder interest is computed on the basis that an amount equal to the fixed percentage is to be distributed each year, even though there is a possibility that amount may be less.

The court held that where the trust payout is the lesser of the trust income or a fixed percentage, the parties must use an annual distribution amount equal to the fixed percentage stated in the trust instrument to determine whether the estate is eligible for the charitable contribution deduction. In this case, this caused the charitable remainder interest to be valued at less than 10%, so the trust failed to qualify as a charitable remainder trust under § 664 and no charitable deduction was available to the estate.

Because the valuation rules of 664(e) looks to the value as of the date of contribution, this case emphasizes how important it is to determine that a particular trust will meet the 10% remainder interest requirement before it is created and funded.

IRS Extends the Time to File Basis Statements Required by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 to February 29, 2016 (IRS Notice 2015-57)

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (commonly referred to as the "Highway Bill"), signed by President Obama on July 31, 2015, added new "consistent basis reporting" rules to the Internal Revenue Code requiring beneficiaries of estates to use the Federal estate tax value of assets received as their basis for income tax purposes. This law is effective with respect to all estates filing estate tax returns after July 31, 2015.

The new rules require that within 30 days of filing Form 706, the executors must provide each beneficiary with a statement showing the estate tax value of all property to be received by the beneficiary and file a copy of each statement with the IRS. IRS Notice 2015-57, released on August 21, 2015, extends the deadline for providing these statements until February 29, 2016. According to Notice 2015-57, the IRS plans to issue guidance regarding these statements.

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

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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