

Wealth Management Update

September 2015

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

The September § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.2%, which is the same as last month. The September 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 1.77%, which is a 0.05% decrease from the August rate.

The relatively low § 7520 rate and AFR continue to present potentially rewarding opportunities to fund GRATs in September 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 0.54% for loans with a term of 3 years or less, 1.77% 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 1.77%, the child will be able to keep any returns over 1.77%. These same rates are used in connection with sales to defective grantor trusts.

Disregarded Entities Owned by Nonresidents Will Be Disregarded for New York Estate Tax Purposes

In Advisory Opinion TSB-A-15(1)(M) (May 29, 2015), the New York State Department of Taxation and Finance confirmed that it would disregard a single-member LLC owning a condominium in New York if the LLC were a disregarded entity for Federal income tax purposes. New York imposes estate tax on New York situs property owned by nonresidents, which includes real property and tangible personal property located in New York. New York does not impose estate tax on intangible property owned by nonresidents. Intangible property generally includes membership interests in an LLC. In this case, however, the Department made clear that it would treat the decedent's interest in a single-member LLC that owned a condominium as real property for estate tax purposes.

The Department's ruling relied on the fact that the single-member LLC is a disregarded entity for income tax purposes. If the taxpayer would elect for the LLC to be taxed as a corporation, the LLC interests would be intangible property of a nonresident and, therefore, not subject to New York estate tax. The Department issued a similar ruling in Advisory Opinion TSB-A-08(1)M (October 24, 2008), in which it concluded that an interest in a single-member LLC electing to be treated as a corporation under the check-the-box rules, as well as an interest in an S Corporation, would be treated as intangible property. The 2008 Advisory Opinion goes further in reminding the taxpayer that the S Corporation still would have to pass the "business purpose" test to be recognized; *i.e.*, the entity would have to serve a purpose related to a business activity.

While the recent ruling confirms a position already established by the New York State Department of Taxation and Finance, it also serves as a reminder to practitioners regarding the complexity involved in planning for nonresidents who own property in New York. Advisors must consider both the income tax and estate tax consequences of transferring property into certain types of entities, as well as nontax advantages such as privacy, protection from liability and eliminating the need for ancillary probate in New York.

New York City's New Reporting Requirements for Partnerships and LLCs Acquiring Real Estate

As of May 18, 2015, partnerships and multimember LLCs that acquire real estate in New York City are required to disclose the name and tax ID number of each general partner or LLC member to the NYC Department of Finance. The stated purposes of the new rules are to improve tax reporting and assessment, as well as to make it more difficult for criminals to hide purchases through shell companies.

When real estate in New York City changes hands, the City requires both the grantor and the grantee (*i.e.*, the seller and the buyer) of any interest in real property to file a joint Real Property Transfer Tax Return (Form NYC-RPT). For all boroughs except Staten Island, Form NYC-RPT can be filed online through the Automated City Register Information System ("ACRIS"). The ACRIS database contains property records from all five boroughs (including Staten Island) from 1966 to present and can be accessed and searched by the general public via a Web site maintained by the City.

Effective May 18, 2015, Form NYC-RPT was revised to include two new grantor-grantee types – "Single Member LLC" and "Multiple Member LLC." Grantors and grantees who are partnerships or multiple-member LLCs must provide the name and tax ID number of each general partner or member. The Department of Finance claims that the information will be kept confidential and used for tax administration purposes only.

While it is still possible to acquire New York City real estate through entities that are not fully transparent, the new rules may affect ownership structures used by individuals and their families who are hesitant to disclose certain personal information on Form NYC-RPT.

District Court Dismisses Policyholders' Lawsuit against Carrier Engaged in "Shadow Insurance" Transactions

In *Ross v. AXA Equitable Life Insurance Co.*, No. 14-CV-2904 (SDNY, July 21, 2015), the District Court for the Southern District of New York denied a motion for class certification and dismissed a claim brought by two New York residents alleging that their life insurance carrier engaged in "shadow insurance" transactions to make the company appear financially stronger. The court found that the plaintiffs were unable to show actual injury resulting from the disclosures provided by their insurance carrier.

State regulators require insurance companies to maintain a certain level of assets that can be used to satisfy claims made by policyholders. In order to mitigate risk and reduce assets required to be held, many insurers engage in "reinsurance" transactions by which a primary insurer pays a premium to a secondary insurer in exchange for assuming risk associated with policies written by the primary insurer. If a reinsurance transaction meets certain requirements, state regulators will allow a primary insurer to claim "reserve credits" and hold fewer assets in reserve. Some primary insurers will purchase reinsurance from affiliated "captive" insurance companies based in jurisdictions with less strict regulatory requirements. In some instances, the reinsurance will be guaranteed by the parent company of the primary insurer. These "parental guarantees" may allow companies to obtain reserve credits without transferring risk to unaffiliated third parties.

The plaintiffs in *Ross* alleged that their carrier failed to disclose adequately guarantees and indemnifications received through affiliates. These inadequate disclosures induced them to purchase life insurance from a carrier with fewer reserves and less-sound financial backing than other carriers who may not have engaged in shadow transactions.

The court found that the plaintiffs were unable to show that they actually suffered as a result of the disclosures made by the primary insurers. The plaintiffs did not claim that they relied on or were influenced by the carrier's financial disclosures or that they would not have purchased their policies had the shadow transactions been disclosed. The possibility that harm could occur if, as a result of shadow transactions, the carrier became unable to pay the plaintiffs' claims was too speculative to warrant payment of damages.

The ruling serves as a reminder that those who buy life insurance (and their fiduciaries and advisors) should review carefully disclosures regarding the insurance carrier's financial health.

Consistent Basis Reporting under New Internal Revenue Code Sections 1014(f) and 6035

On July 31, 2015, the president signed the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (commonly referred to as the "Highway Bill") , which added two provisions to the Internal Revenue Code aimed at requiring the beneficiaries of estates to use the Federal estate tax value of assets received as their basis for income tax purposes. The new "consistent basis reporting" rules were originally 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. On August 21, 2015, the IRS released Notice 2015-57, which extends the deadline for providing these statements until February 29, 2016.

The new Section 1014(f) to the code, states the general rule that a beneficiary's basis in the property received from a decedent must be consistent with the "final value" of the property for estate tax purposes. The final value can mean the value reported on the estate tax return, the value as finally determined on audit (either by court or by the IRS) or, if there has been no final determination, the value shown on a statement provided by the executor under new Section 6035(a). A taxpayer who commits "inconsistent estate basis reporting" (i.e., who incorrectly reports basis as being higher than the final value) is subject to a 20% penalty on any resulting underpayment of tax under new Section 6662(b)(8) and 6662(k). This specific penalty will not apply to assets that did not increase estate tax liability, such as assets that qualified for the charitable or marital estate tax deduction or assets received from an estate not required to file Form 706.

The new Section 6035(a) requires that, within 30 days of filing an estate tax return (or 30 days of the due date in the case of a late return) the executor of any estate required to file Form 706 must send a statement to each beneficiary stating the value of the assets that beneficiary will receive. Copies of the statements must be filed with the IRS. Failure to file a statement (which is considered an "information return") with the IRS could result in a \$250 penalty under Section 6721. If any values are later adjusted, supplemental statements need to be sent with 30 days after the adjustment is made.

The new requirements present a host of practical issues for executors and their advisors. Notice 2015-57 notes that the IRS expects to issue additional guidance to assist with compliance. Presumably, the guidance will include instructions for preparing and filing the required notices to beneficiaries and perhaps even contain model forms. A more serious issue for executors will be determining which assets pass to which beneficiaries within 30 days of filing Form 706. Administration of complex estates can take several years, and decisions regarding which assets to use to fund various legacies and bequests often require careful consideration. If the new law effectively requires that all those decision be made within 16 months of death, executors will have their work cut out for them.

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