Proskauer

Wealth Management Update

February 2017

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

The February § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.6%, up 0.2% from January. The February 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 2.10%, up from 1.97% in January.

The relatively low § 7520 rate and AFR continue to present potentially rewarding opportunities to fund GRATs in February with depressed assets that are expected to perform better in the coming years.

The AFRs (based on annual compounding) used in connection with intra-family loans are 1.04% for loans with a term of 3 years or less, 2.10% for loans with a term between 3 and 9 years, and 2.81% 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 2.10%, the child will be able to keep any returns over 2.10%. These same rates are used in connection with sales to defective grantor trusts.

IRS Grants Retroactive Effect to a Court Reformation of Several GRATs (P.L.R. 201652002 (December 23, 2016))

The taxpayer retained an attorney to draft several GRATs. The first page of each trust provided "WHEREAS, the Grantor wishes to establish an irrevocable Grantor Retained Annuity Trust, the retained interest of which is intended to constitute a qualified interest within the meaning of Section 2702(b)(1) of the Internal Revenue Code." In drafting each trust agreement, however, the drafting attorney failed to include language prohibiting the trustee from issuing a note or other debt instrument in satisfaction of the annuity obligation, as required by Treas. Reg. § 25.2702-3(d)(6).

The taxpayer retained a new attorney who discovered the error and filed an action in court to seek reformation of the trusts pursuant to a state statute that allows a court to "modify" a trust in order to carry out the settlor's tax objectives. The court issued a ruling reforming the trusts to correct the apparent scrivener's error retroactive to the date each of the trusts were established.

The taxpayer then requested a ruling from the IRS that, as a result of the judicial reformation of the GRATs, the taxpayer's interest in each trust was a "qualified interest" under Treas. Reg. §§ 25.2702-2 and 25.2702-3. The IRS found that the result of the judicial reformation of the GRATs to correct the scrivener's error was that the taxpayer's interest in the trusts was a "qualified interest," effective as of the date each trust was created.

The IRS Revokes a Prior Private Letter Ruling Holding That A Delaware Incomplete Non-Grantor Gift Trust ("DING") Was a Non-Grantor Trust (P.L.R. 201642019 (October 14, 2016))

A Delaware incomplete non-grantor gift trust (referred to as a "DING") is an income and gift tax planning technique used for purposes of saving state income taxes and for asset protection planning. The trust is created in a state like Delaware that does not impose state income taxes on trusts and does not tax distributions made to out-of-state beneficiaries.

The trust is designed such that the settlor of the trust must give up enough control over the assets gifted to the trust so that the settlor is not considered the grantor (*i.e.*, owner) of the assets for federal income tax purposes, but the Settlor must also maintain enough control over the assets such that the gift is considered incomplete for gift tax purposes. This balance is usually struck by implementing a distribution committee who has discretion to make distributions to beneficiaries, including the settlor. The distribution committee typically consists of beneficiaries other than the settlor.

The IRS has recognized this type of trust in numerous private letter rulings. In PLR 201642019, however, the IRS focused on a specific provision of the trust under consideration as analyzed under Internal Revenue Code ("IRC") Section 673 and found that the trust did not qualify as a non-grantor trust.

Under the terms of the trust, distributions could be made to the trust beneficiaries (including the settlor) as determined by the distribution committee, who consisted of beneficiaries. The trust provided that if a member of the distribution committee ceased to serve, he or she would not be replaced. Finally, the most relevant provision of the trust provided that if the settlor's children ceased to serve on the distribution committee or if fewer than two members were serving, the trust would terminate and all of the trust assets would be distributed back to the settlor.

Notwithstanding the fact that the IRS had previously held that the trust under consideration qualified as a non-grantor trust, the Service revoked its prior ruling, finding that because the members of the distribution committee could resign, the grantor held a reversionary interest in the trust, thereby causing the trust to be considered a grantor trust under IRC Section 673. The IRS determined that this reversionary interest was calculated assuming the maximum exercise of discretion in the settlor's favor. As a result, the Service concluded that the revisionary interest under Section 673 constituted 100% of the trust income and principal of the trust.

While this letter ruling appears to be an outlier, planners should exclude provisions in DINGs similar to the resignation provision in the trust under consideration.

The IRS Provides Guidance on a New Method Available to Confirm the Closing of an Examination of an Estate Tax Return (Notice 2017-12)

Notice 2017-12 provides guidance on the methods available to confirm the closing of an examination of the estate tax return. Of interest, the notice announces that an account transcript issued by the IRS can now substitute for an estate tax closing letter.

Prior to June 1, 2015, the IRS issued an estate tax closing letter for almost every estate tax return filed, however, for estate tax returns filed after June 1, 2015, the IRS changed its policy, and now, will only issue an estate tax closing letter at the request of an estate, which request is to be made at least four months after the filing of the estate tax return.

Now, in addition to requesting an estate tax closing letter, the IRS has announced that an account transcript may substitute for an estate tax closing letter. An account transcript is a computer-generated report that provides the current account details. The information reported on an account transcript includes: (1) the return received date, (2) payment history, (3) refund history, (4) penalties assessed, (5) interest assessed, (6) the balance due with accruals, and (7) the date on which the examination was closed. It does so by including transaction codes together with descriptions of those codes. So, for example, a transcript that includes transaction code "421" and the explanation "closed examination of tax return" indicates that the IRS's examination of the estate tax return has been completed and that the examination is closed. The notice concludes that an account transcript showing a transaction code of "421" is the "functional equivalent of an estate tax closing letter."

As with estate tax closing letters, an account transcript will indicate the closing of an estate that will not be reopened except for circumstances described in Rev. Proc. 2005-32 (*i.e.*, fraud, for example), or for determination of the transfer tax liability of the second spouse to die who made a portability election. An account transcript may be requested by having an estate or authorized representative file Form 4506-T, Request for Transcript of Tax Return via mail or fax.

Eleventh Circuit Rules Claim For Unpaid Fiduciary Fees Is Not Superior to Government's Special Estate Tax Lien (*U.S. v. Spoor*, 838 F.3d 1197 (11th Cir. 2016)

The Eleventh Circuit ruled that a claim for unpaid fiduciary fees by a personal representative was not superior to the government's special estate tax lien under IRC Section 6324A as part of a Section 6166 election to defer payment of federal estate tax. At the time the lien was granted, the personal representative had only been paid for a portion of his fees, leaving $486,265 unpaid. During the lien period, the value of the property securing the lien fell below the amount due to the IRS. The personal representative asserted that his claim to fees was superior to the tax lien and, therefore, sought to use the lien property as a source of funds for his unpaid fees. The IRS disagreed.

The personal representative won at the district court level on a summary judgment motion. The lower court found that because the statute was silent as to the priority of administrative expenses, then based on a "first in time first in right" theory the personal representative's claim was superior. The IRS appealed and the Eleventh Circuit overturned the lower court's ruling. The Eleventh Circuit found that the IRS had priority because the personal representative's claim for fees was not a lien and, therefore, the "first in time first in right" common law theory could not be applied.

The court analyzed the statute giving rise to a Section 6166 lien. While the general estate tax lien under IRC Section 6324 allows administrative expenses to take priority over the government's lien, the lien granted in regard to Section 6166 elections is under Code Section 6324A and not the general estate tax lien statute. As such, there was no explicit exception for administrative expenses. Therefore, fiduciaries making a Section 6166 election should be advised to make a separate provision for fees outside of the lien property.

The Alaska Supreme Court Recognizes a Holographic Will That Contained No Terminal Signature (*In the Matter of the Estate of Alva Marie Baker*, 2016 WL 7488253 (Dec. 30, 2016))

The Alaska Supreme Court held that a holographic will that was not signed by the testatrix at the end of the document was properly admitted to probate. The will was written entirely in the testatrix's handwriting and left most assets to her daughter. The testatrix, Alva Marie Baker, did not sign the document at the end of the document; however, the first line of the will stated "[m]y name is Alva Marie Baker." The testatrix's daughter argued that Alva's handwritten name in the first sentence was a signature, but two grandchildren contested and argued that a signature at the end of the document was required.

Alaska's version of the Uniform Probate Code allows for probate of a holographic will so long as the signature and material portions of the document are in the testator's handwriting. The issue before the court, however, was whether a terminal signature was required. The Alaska Supreme Court ultimately followed the lead of California and other states, allowing the handwritten name in the body of the will to substitute for a terminal signature if the document showed testamentary intent and was otherwise complete. In this case, the court found those requirements were met.

New York Surrogate's Court Ordered An Attorney to Produce His Entire Computer in a Will Controversy Litigation (*In the Matter of the Estate of Nunz*, 2016 WL 4198874 (Aug. 9, 2016))

A New York Surrogate's Court recently entered an order requiring an attorney to produce his entire computer during discovery in a will controversy litigation. The court found that a "proper basis" existed for the drafting attorney's computer to be tested in order to help resolve matters of uncertainty concerning the execution of a decedent's will. Wholesale access to the electronic data contained on a computer is generally not permitted as it could expose confidential communications, personal information and matters not relevant to the litigation. While most states, including New York, have a long standing policy that computerized data is discoverable if relevant, many states, like Florida, for example, have drawn a hard line that such discovery requests must be limited and controlled. *See e.g.*, *Monopoly, Inc. v. Hasbro, Inc.*, 94 Civ. 2120 (S.D.N.Y. 1995); *Strasser v. Yalamanchi*, 669 So.2d 1142 (Fla. 4th DCA 1996).

Under the facts of this case, one month prior to his death the decedent had a last will and testament prepared by an attorney. The decedent left his entire estate to his surviving spouse and nothing to his six surviving children. Five of the six children contested the decedent's will. During discovery, the parties learned that the drafting attorney had destroyed materials relating to the drafting of the will. The children sought production of the computer in order to have a forensic expert reconstruct the lost files in order to support their position. After an evidentiary hearing, the Surrogate's Court ruled that the electronically stored information, which could be obtained by a forensic analysis, was discoverable and ordered the attorney to hand over his computer to be cloned.

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