Proskauer

Wealth Management Update

August 2009

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.

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

The August applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs remains at 3.4%, the same as last month. The rate for use with a sale to a defective grantor trust, SCIN or intra-family loan, with a note of a 9-year duration (the mid-term rate, compounded annually), is up very slightly at 2.8%. Remember that lower rates work best with GRATs, CLATs, sales to defective grantor trusts, private annuities, SCINs and intra-family loans. The combination of a still low AFR and a decline in the financial and real estate markets presents a potentially rewarding opportunity to fund GRATs in August with depressed assets you expect to perform better in the coming years.

Clients should also continue to consider "refinancing" existing intra-family loans. The AFRs (based on annual compounding) used in connection with intra-family loans are .83% for loans less than 3 years, 2.8% for loans less than 9 years and 4.26% for long-term loans. Thus, for example, if a nine-year loan is made to a child and the child can invest the funds and obtain a return in excess of 2.8%, the child will be able to keep any returns over 2.8%. These same rates are used in connection with sales to defective grantor trusts.

Connecticut Governor Signs Act Reforming Probate Court System but Rejects Estate Tax Increases

On June 12, Connecticut Governor M. Jodi Rell signed legislation reforming the state's sprawling probate court system. Public Act No. 09-114 shrinks the number of probate courts from 117 to between 44 and 50, with the final number to be proposed by a Probate Redistricting Commission. Each probate court will serve a population base of at least forty thousand people and will be open 40 hours a week. Accounting and distribution of Court fees will be handled by a centralized Probate Court Administration Fund, which will disperse funds to the courts based on workload and population. In addition, the Act requires that all new probate judges be attorneys, although current judges without law degrees may maintain their positions.

The major impetus for the legislation appears to be financial, since the probate court system was projected to run a deficit of $5 million by 2011. The consolidation and centralization measures in the legislation are expected to save the state approximately $9 to $10 million each year from 2012 onwards.

On July 1, Governor Rell vetoed Senate Bill 1801, a state budget bill designed to remedy Connecticut's $1.5 billion budget deficit. One of the bill's provisions would have increased the income tax rate for estates and trusts from 5% to 7.5% and imposed a 30% surcharge on the state estate tax for decedents dying between 2009 and 2011 (Connecticut's current state estate tax exemption amount is $2 million). The 30% surcharge would have resulted in a revenue gain of roughly $50 million dollars a year for the three years it was to be in effect.

No Privity Between New York Widow and Attorneys Who Drafted Husband's Will

In *Leff v. Fulbright & Jaworski*, LLP, 2009 NY Slip Op. 31445(U) (Sup Ct., New York County 2009), the New York County Supreme Court ruled that there was no privity between a widow and the attorneys who drafted her husband's Will, and thus the widow could not bring a claim against the attorneys for malpractice.

In drafting the Will, the defendant attorneys failed to consider the decedent's separation agreement with his first wife, in which he agreed to leave half of his estate to his son. The widow claimed that, due to this error, she did not receive $9 million of her husband's $90 million estate.

New York continues to follow the traditional rule that an attorney is liable for malpractice only to his or her client. Unlike other states, New York has not loosened or abandoned privity requirements in regards to malpractice suits over Will drafting errors. Neither a surviving spouse nor an executor is in privity with a decedent's drafting attorney solely by virtue of their relationship to the decedent. Since the decedent—the client with privity to the attorney—is dead, the privity rule prevents affected third parties from bringing malpractice claims in the context of Will and trust drafting.

In *Leff*, the widow attempted to bypass a strict privity interpretation by claiming that because the attorneys had also drafted her Will and had represented her in other matters, she was in at least "near privity" with them. However, the Court determined that the husband and wife had not engaged the attorneys as part of a *joint* estate plan. As such, there was neither actual nor "near" privity, despite the widow's subjective belief that she had an attorney-client relationship with the attorneys in regards to her husband's estate plan.

Separate Judgments Are Not a Joint Debt Under Florida Tenancy By the Entirety Law

In *In re Davis*, 2009 WL 1080019 (Bankr. M.D. Fla. 2009), a U.S. Bankruptcy Court ruled that a creditor with separate judgments against a husband and a wife was not thereby a joint creditor of the couple, and thus could not reach property held by them as tenants by the entirety.

In response to a judgment the creditor obtained against him, the husband, on his wedding day, moved millions of dollars into a bank account held by him and his wife as tenants by the entirety. The couple then used the funds to purchase a $2 million St. Petersburg home, also as tenants by the entirety.

The creditor, undaunted, successfully argued to the Tampa District Court that the transfer of funds into the bank account had violated the Florida Uniform Fraudulent Transfer Act and obtained a judgment against the wife. The creditor then forced the husband into bankruptcy and attempted to attach the home.

The Court determined that when a debtor has made a fraudulent transfer within 10 years of filing for bankruptcy, federal bankruptcy law can, in certain situations, trump the Florida homestead exemption. However, the Court concluded that federal law does not trump Florida tenancy by the entirety law, which only allows property to be attached by a joint creditor. Although the creditor in *Davis* had separate judgments against both the husband and the wife, these separate debts could not be combined to render him a "joint creditor" under Florida law, and thus he could not attach the home.

The creditor's mistake was in pursuing the fraudulent transfer action only against the wife, rather than against the husband as well (which could have resulted in a joint judgment against the couple). By instead relying on his previous judgment against the husband, the creditor recovered nothing under the bankruptcy plan approved by the Court.

Indiana Court Examines the Duty of Care Required of Trustees of Irrevocable Life Insurance Trusts

In *In re Stuart Cochran Irrevocable Trust*, 901 N.E.2d 1128 (Ind. Ct. App. 2009), the Indiana Court of Appeals examined the duties owed to beneficiaries by a trustee of an irrevocable life insurance trust ("ILIT") under the Indiana version of the Uniform Prudent Investor Act ("UPIA").

The defendant bank was the trustee of an ILIT that owned an $8 million variable universal policy on the Settlor's life. The policy, invested in mutual funds, lost much of its value when the stock market tumbled after 9/11. The Trustee, at the urging of the Settlor's insurance agent, therefore surrendered the policy (paying surrender charges of over $100,000) and purchased a new $2.7 million replacement policy.

Shortly thereafter, the Settlor unexpectedly died at the age of 53. The beneficiaries, upset at receiving $2.7 million rather than $8 million, sued the bank for breach of fiduciary duty, arguing that the bank had impermissibly delegated its duties to the Settlor's personal insurance agent by heeding his request to surrender the policy.

The Court concluded that there was no improper delegation, because the bank had hired an independent consultant to analyze the $8 million policy and did not blindly follow the advice of the Settlor's insurance agent. Although the consultant had not originated the idea to surrender the policy, he ultimately supported the transaction. Further, the bank had met its duty to consider other options, as it had considered one other alternative besides the new policy that was ultimately purchased. In addition, because hindsight is immaterial under the UPIA when determining the prudence of a Trustee's decision , the Court held that the unanticipated death of the Settlor, as well as the subsequent rebound of the stock market, were immaterial.

The Court also disregarded accusations that the bank had failed to give proper notice to the beneficiaries. The bank sent notices only to the non-custodial parent of the minor beneficiaries and then failed to send documents directly to beneficiaries when they turned 18 (although documents were made available at the bank itself). The court noted that the bank's efforts to keep the beneficiaries informed, though minimal, at least established the bank's good faith, and that, in any case, lack of information to the beneficiaries was not a proximate cause of any damage caused by the surrender of the policy.

Abusive Conversion of Nongrantor Trust to Grantor Trust Is Nonetheless Not a Taxable Transfer

In IRS Chief Counsel Advisory Opinion 200923024 (June 5, 2009), the Chief Counsel concluded that, although susceptible to abuse, the transformation of nongrantor trust into a grantor trust was nonetheless not a taxable transfer.

At issue was a family whose members formed a partnership and funded it with stock each owned in a corporation. Each family member then (1) formed a separate irrevocable nongrantor trust for the benefit of his or her issue and (2) sold their respective partnership interest to his or her trust in exchange for an annuity substantially equal to the value of the partnership interest.

The partnership then made an election under IRC §754 to step up the partnership's basis in the corporation to fair market value. The partnership then sold all of the shares of the corporation during its initial public offering.

Next, the Trustee of the family trusts was terminated by an outside advisor, in accordance with the trusts' terms. This converted the nongrantor trusts to grantor trusts, since the successor Trustee was an employee of a corporation over which the family exercised voting control and thus a related or subordinate party under IRC §672(c).

Through these transactions, the family effectively avoided recognizing income on annuity payments received after the trusts were converted from nongrantor to grantor trusts, thereby also avoiding recognizing gain from the sale of the appreciated stock.

The Chief Counsel acknowledged the transaction was abusive, but declined to rectify the abuse by concluding that the conversion of a nongrantor trust to a grantor trust results in taxable income in such situations. The Chief Counsel noted that no prior guidance dealing with such transaction suggested that they would result in taxable income to the transferee, and that such taxation would adversely impact non-abusive conversions, such as when a Grantor borrows trust corpus under IRC §675(3).

The Chief Counsel also rejected the argument that the partnership's step-up in basis should be negated by regarding the annuity swap as an indirect borrowing by the Settlors. The Chief Counsel noted that it was unlikely any borrower would put up collateral equal to the full amount being borrowed. Despite rejecting these efforts to tax the family, the Chief Counsel did suggest that the IRS should work to come up with further arguments to challenge the non-taxability of transactions of this nature.

New York County Surrogate's Court Considers Fiduciary Ineligibility Due to Inability to Read and Write English

In *In re Toribio*, 2009 WL 1515448 (Sur. Ct., New York County 2009), the New York County Surrogate's Court curtailed the application of SCPA §707(2), which grants the Court discretion to "declare ineligible to act as fiduciary a person unable to read and write the English language."

In Toribio, a father, who was only literate in Spanish, sought to become successor administrator of his 3-year-old daughter's estate so he could pursue a wrongful death action stemming from her death in a fire attributed to arson.

Justice Kristin Booth Glen used the father's petition as an opportunity to examine SCPA §707(2), which she concluded had been used on occasion to falsely equate English literacy with intelligence and as a means of blocking the disabled (such as the blind) from becoming administrators.

Justice Glen concluded that denying fiduciary status based on a lack of English was unacceptable in today's pluralistic society, noting that 26% of the population of New York is foreign-born, that children in New York public schools speak nearly 170 languages at home and that the Office of Court Administration now employs 300 staff interpreters speaking 30 languages.

Justice Glen held that an otherwise competent non-English speaker should only be denied Letters of Administration in the unlikely event that there is no accommodation that can be reasonably provided to address any deficiency caused by a lack of language competence. Thus, if a petitioner can communicate satisfactorily with his or her attorney and thereby execute fiduciary responsibilities, there is no reason to make a lack of English proficiency, by itself, an obstacle to appointment as a fiduciary.

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