Proskauer

Wealth Management Update

June 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.

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

The June applicable federal rate ("AFR") for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.8%. 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 2.25%. These are increases from May's rates. While the rates have gone up, they are still very low and 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 markets continues to present a potentially rewarding opportunity to fund GRATs in June with depressed assets you expect 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 .75% for loans less than 3 years, 2.25% for loans less than 9 years and 3.88% for long-term loans. Thus, if a $1 million loan is made to a child and the child can invest the funds and obtain a 5% return, the child will be able to keep any returns over the mid-term AFR of 2.25%. These same rates are used in connection with sales to defective grantor trusts.

IRS Announces New Mortality Tables under Section 7520

Internal Revenue Code §7520 requires the Treasury Secretary to revise the mortality assumptions underlying the IRS tables at least once every 10 years. The tables were last updated on May 1, 1999 (Life Table 90CM). New tables have been issued, effective for transactions on or after May 1, 2009 (Table 2000CM). These tables are used to compute probabilities of survival from one age to another age, which in turn are used for the valuation of partial interests in property under §7520, such as annuities, interest for life or term of years, and remainder interests (such as QPRTs and CRTs).

In general, mortality has improved under the new tables. All else being equal, a longer assumed life expectancy means the value of a remainder interest will be lower. Consequently, the deduction a person gets for a contribution to a life-contingent CRT will be less under the new tables. In addition, QPRTs will be affected negatively, primarily because the value of the reversion will fall. Conversely, private annuities will be affected favorably, as a longer life expectancy means a lower annual private annuity payment.

For gift tax purposes, if the date of transfer is on or after May 1, 2009, but before July 1, 2009, the donor may choose to determine the value of the gift (and/or any charitable deduction) under the tables based on either Life Table 90CM or Table 2000CM. Similarly, for estate tax purposes, if a decedent dies on or after May 1, 2009, but before July 1, 2009, the value of any interest (and/or any applicable charitable deduction) may be determined in the discretion of the executor under the tables based on either Life Table 90CM or Table 2000CM.

IRS Issues Two Revenue Rulings on the Taxation of Life Settlements

The IRS has issued Revenue Rulings 2009-13 and 2009-14, detailing the income tax consequences to sellers and buyers of life insurance policies in the secondary market. Such sales are commonly known as “settlements.”

Revenue Ruling 2009-13 (taxing the transferor) addresses the surrender or sale of a life insurance policy to a person who lacks an insurable interest in the policy in the context of three hypothetical situations. In situation 1, the surrender of a cash value contract, the taxpayer’s gain is the difference between the amount realized in the surrender (i.e., cash surrender value) and the seller’s adjusted basis (i.e., premiums paid). Any such gain is taxed as ordinary income, not capital gains. In situation 2, the sale of a cash value policy, the recognized gain is the difference between the amount realized in the sale and the seller’s adjusted basis, where basis is determined by subtracting from the total premiums paid the cost of the insurance for the pre-sale period. Any recognized gain up to the policy’s cash surrender value will be taxed as ordinary income and any gain above that value will be taxed as capital gain. In situation 3, the sale of a term policy, the amount realized is the amount received on the sale and the adjusted basis is usually only the unexpired portion of the last premium paid (the difference between the premiums paid and the cost of the pre-sale insurance coverage). Any such gain will be taxed as capital gain.

Revenue Ruling 2009-14 (taxing the transferee) explains the income tax consequences to the life settlement company or individual who bought the insured's life insurance policy when the insured dies, or when the buyer resells the policy, again in the context of three hypothetical situations. In situation 1, when a policy is sold to a transferee for value, and the insured dies, the gain is determined by subtracting from the death benefit received the sum of amount paid for the policy and premiums paid after the purchase. The gain is taxed as ordinary income. In situation 2, when a term policy is bought by a transferee, upon a later sale to a third party, any gain will be taxed as long-term capital gain (assuming the requisite holding period). Further, when a cash value policy is bought by a transferee, upon a later sale to a third party, any gain up to the policy's cash surrender value will be taxed as ordinary income. In situation 3, when the purchaser of the policy is a foreign corporation, any gain on the receipt of the death benefits will be taxable as U.S. source income if the insured and the insurer are both U.S. persons.
Revenue Rulings are generally retroactive unless they provide otherwise. Revenue Ruling 2009-13 specifically states that the holdings with respect to Situations 2 and 3 will not be applied adversely to sales occurring before August 26, 2009. Since Revenue Ruling 2009-14 contains no similar representation, that ruling would appear to apply retroactively.

California and New York Tax Law Changes

The recently adopted California budget included significant tax law changes. The sales/use tax was increased by one cent. Because of the recent failure of the budget propositions in the special election on May 19th, this tax rate increase will expire on June 30, 2011. In addition, the personal income tax brackets were increased by .25% (with a potential increase of only .125% if the federal stimulus trigger is pulled). Due to the failure of the budget propositions, this provision will apply only for 2009 and 2010.

Under a provision of New York's 2009 budget bill, New York will tax the gain on sales by nonresidents of interests in certain entities owning real estate in New York, effective May 7, 2009. Under prior law, a nonresident was not taxed on the gain on a sale of an interest in a corporation, partnership or LLC, even if the entity's principal asset was real estate in the state. Under the new law, however, an interest in a partnership, LLC, S Corporation, or a C Corporation with 100 or fewer shareholders, is treated as real estate located in New York if 50% or more of the entity's assets consist of real estate located in New York. In addition, only those assets that the entity owned for at least 2 years before the sale are taken into account for this purpose.

New York Recognizes Same-Sex Spousal Inheritance Rights

The federal Defense of Marriage Act, which does not provide same-sex couples with any rights or benefits, overrides the U.S. constitutional requirement that each state provide full faith and credit to the laws of another state in the case of same-sex marriage. Thus, only couples living in a state which recognizes these relationships will benefit from laws providing benefits and inheritance rights.

In Matter of the Estate of H. Kenneth Ranftle, File No. 4585-2008 (N.Y.L.J., Feb. 3, 2009), New York became the first state to recognize a same-sex spouse's rights of inheritance under state law. The Court recognized the validity of a same-sex marriage between two New Yorkers conducted in Canada and confirmed that a person may provide for his or her same-sex spouse to inherit his or her estate as a spouse. In addition, the opinion further provided that the deceased spouse's family members would not have standing to object to the Will.

Holographic Will Denied Probate Due to Statutory Time Limit

In Estate of Earley, 2009 WL 109906 (Cal. App. 2 Dist., Apr 24, 2009), the California Court of Appeal held that the statutory time limit for petitioning for probate of a Will applies where a petition to probate a single Will is filed after a determination that the decedent died without having a Will, which also is known as having died intestate. In this case, the decedent died on May 8, 2007. On July 31, 2007, the Petitioner, first cousin of the decedent, filed a petition seeking letters of administration. On September 5, 2007, the Court appointed Petitioner as administrator and also determined that the decedent had died intestate. On October 22, 2007, the Petitioner discovered a holographic Will and Codicils. The Petitioner had the Will (and Codicils) authenticated by a handwriting expert. On February 19, 2009, the Petitioner filed a petition for probate of the Will (and Codicils). A third party, a first cousin once removed, objected on the basis that the Will was not timely probated and that she was entitled to a share of the intestate estate. Under California Probate Code §8226, a person who has notice of a petition for probate may only petition for probate of a separate Will within the later of: (a) 120 days after the issuance of the order admitting the first Will to probate or determining the decedent to be intestate, and (b) 60 days after the proponent of the Will first obtains knowledge of the Will. The Court did not find any exceptions to the statutory deadlines, and thus, because the Petitioner did not petition for probate of the Will within 120 days of the intestate determination, the Court did not allow the Will to be probated.

Will's Estate Tax Provision Not Applicable to Witness Beneficiary

In Re Estate of Wu, N.Y. Sup. Ct. No. 3081/2005 (Apr 27, 2009), a New York Supreme Court ruled, in a case of first impression, that a witness to a decedent's Will who was also the beneficiary of several life insurance policies is liable for his apportioned share of the federal and state taxes on the estate, despite a provision in the Will requiring that such taxes be paid out of the estate. The decedent's Will provided that all estate taxes payable by reason of the decedent's death, whether passing under the Will or otherwise, must be paid without recovery from anyone who receives any such item included in the computation of the tax. The executor noted that in the absence of the provision, or in intestacy, the beneficiary would be charged with the estate taxes attributable to the life insurance policies. The Court found that the tax clause amounted to a "beneficial disposition" and that the policy invalidating a bequest to a witness of a Will is equally applicable to a benefit conferred by a tax clause. Finally, the Court stated that the beneficiary's knowledge of the life insurance policies was irrelevant.

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