Wealth Management Update

May 2020

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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.

May 2020 Interest Rates for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split Interest Charitable Trusts AFRs

Important federal interest rates continued to drop significantly for May of 2020. The May 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 0.58%, down from 0.99% in April and from 2.37% in May of 2019.

The May Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 0.8%, down from 1.2% in April and from 2.8% in May of 2019.

The AFRs (based on annual compounding) used in connection with intra-family loans are 0.25% for loans with a term of three years or less, 0.58% for loans with a term between three and nine years, and 1.15% for loans with a term of longer than nine years.

Thus, for example, if a 10-year loan is made to a child, and the child can invest the funds and obtain a return in excess of 1.15%, the child will be able to keep any returns over 1.15%. These same rates are used in connection with sales to defective grantor trusts.

The AFRs for May 2019 were 2.39%, 2.37% and 2.74%, respectively.

PLRs 202013001, 202013002, 202013003, 202013004 and 202013005 (March 27, 2020)

A trust was created by a married couple for their son prior to September 25, 1985 and was therefore perpetually exempt from generation-skipping transfer ("GST") tax. Pursuant to the terms of the trust, upon the death of the son, separate continuing trusts would be created for his spouse and his descendants. Those continuing trusts would terminate 21 years after the death of the son.

The son died, and several of his descendants disclaimed their interests in the trust, such that the trust assets were instead held in separate trust for younger, more remote descendants.

As a result, the fiduciaries of the separate trusts wanted to amend the trusts to provide that, upon the termination of the trusts 21 years after the son's death, any share for a beneficiary under a certain age would be held in further trust until he or she reached that age.

Each such trust would grant the beneficiary a general power of appointment, and periodic principal distributions would be made outright to each beneficiary upon attaining specific ages. The proposed modification was permissible under state law, but the fiduciaries were concerned about losing the grandfathered status of the trusts.

Therefore, the parties requested separate private letter rulings to determine whether the proposed modification would affect the grandfathered status of the trusts. The IRS, in its analysis, set forth the rule provided in Treasury Regulation § 2601-1(b)(4)(D), which states that any judicial reformation of a trust or a nonjudicial reformation that is valid under state law will not cause a trust to lose its grandfathered status if such modification (i) does not shift a beneficial interest in the trust to a beneficiary occupying a lower generation by increasing the amount of a generation-skipping transfer or by creating a new generation-skipping transfer, and (ii) does not extend the time for vesting of any beneficial interest in the trust beyond the period provided in the original trust.

Each Ruling pointed out that the grant of a general power of appointment to the beneficiary of each proposed continuing trust resulted in such beneficiary becoming the transferor of the principal of such trust for GST purposes.

The IRS concluded that the proposed modification of the trusts, which, again, included the grant of a general power of appointment, would not shift a beneficial interest in the trust to a lower generation or extend the time for vesting of any beneficial interest in the trust.

Estate of Streightoff v. Commissioner, 2020 BL 11889 (5th Cir. March 31, 2020)

The United States Court of Appeals for the Fifth Circuit affirmed the decision of the Tax Court to impose an estate tax deficiency as the result of an undervaluation of an entity interest.

Less than three years before his death, Frank Streightoff formed a limited partnership (the "Partnership") and gifted small interests in the Partnership to his children, retaining an 89% interest for himself. Shortly thereafter, he assigned his 89% interest to his Revocable Trust via an Assignment Agreement in which his daughter, Elizabeth, signed (i) on behalf of the assignor, as agent under a Power of Attorney, (ii) on behalf of the assignee, as Trustee of the Revocable Trust, and (iii) on behalf of the Partnership, as the Managing Member of the General Partner of the Partnership.

According to the Partnership Agreement, a partner can transfer his or her interest to a trust for his or her benefit without consent. However, to become a substituted limited partner, as opposed to a mere unadmitted assignee, the General Partner must approve of the transfer, and the transferee must be bound by the Partnership Agreement. A substituted limited partner could vote and look at the Partnership's books and records. A vote of 75% of the Partnership's interests could remove the General Partner and terminate and reinstate the Partnership.

In order to prepare the Federal Estate Tax Return for the Estate, Elizabeth, Frank's Executor, obtained an appraisal of the Revocable Trust's interest in the Partnership, which applied discounts for lack of control and lack of marketability based on the Revocable Trust being an unadmitted assignee and not a substituted limited partner. The IRS imposed a deficiency for the undervaluation of the transferred interest.

The Estate sued and challenged the imposition of the deficiency on both procedural grounds (contesting the invalidity of the notice of deficiency because of its lack of specificity) and on substantive grounds (opposing the increased valuation of the Revocable Trust's interest in the Partnership).

While the Court quickly dismissed the Estate's procedural argument, it did a comprehensive analysis with respect to the substantive issue of characterizing the interest transferred and the value of such interest. The analysis of the interest transferred was pursuant to Texas property law. The Court employed a substance over form analysis to value the interest, an analysis commonly used in federal tax cases.

The Fifth Circuit held that the Revocable Trust was a substituted limited partner. Texas partnership law provides that a partnership agreement's characterization of different interests supersedes Texas law, provided that the partnership agreement is governed by Texas law. The Assignment Agreement assigned *all* of the rights of the assigned interest and appurtenances thereto to the Revocable Trust, the Revocable Trust agreed to abide by the terms of the Assignment Agreement, the transfer from Frank to a trust for his benefit was clearly a permissible transfer under the Assignment Agreement, and the Assignment Agreement was signed in various places by a representative of the General Partner, which indicated consent to admission.

The Fifth Circuit then invoked the substance over form analysis, which allows the Court to look beyond the formalities of an intra-family transaction to determine the essence of the property that is transferred. Based on this analysis, the Court further held that even if the Revocable Trust were an unadmitted assignee, there was no practical difference between an unadmitted assignee and a substituted limited partner because the Partnership never held votes (and, even so, the right to vote does not always yield a difference in value of an interest), and no partner ever requested to look at the books and records (but if the Revocable Trust did so request, the very Trustee of the Revocable Trust, Elizabeth, was in charge of the books and records and therefore had access to them). Therefore, there was essentially no difference between the 89% interest that Frank owned and the 89% interest that the Revocable Trust owned.

As a result, the Court disallowed a lack of control discount (and even suggested that a hypothetical purchaser would actually pay a premium for an interest that would allow the holder of such interest to terminate the entire Partnership) and reduced the lack of marketability discount to 18% since, despite there being no ready market for such intra-family entity interests, the underlying assets in the Partnership were liquid, profitable and able to be distributed at any time.

Estate of Moore v. Commissioner, T.C. Memo 2020-40 (April 7, 2020)

Howard Moore was a self-made wealthy farmer who made plans to sell his farm to his neighbor. After becoming terminally ill, however, he temporarily shifted his focus to setting up various trusts and establishing a family limited partnership (the “FLP”). His Revocable Trust and each of his children contributed capital to the formation of the FLP. Upon his death, an *inter vivos* irrevocable trust for his children, established concurrently with the Revocable Trust and the FLP (the “Irrevocable Trusts”), would receive a portion of his estate, after the payment of administrative expenses, and any amount above his remaining estate tax exemption would be distributed to a charitable lead trust that he established.

The agreement establishing the Irrevocable Trust provided that any asset of the Irrevocable Trust includable in Howard’s estate would pour over to the Revocable Trust, such that it would factor into the formula calculation that allowed the his estate to avoid paying estate taxes by providing that any value in excess of his federal estate tax exemption would be distributed to the tax-exempt charitable trust.

A few days after forming the FLP, Howard’s Revocable Trust contributed a portion of the farm to the FLP. He ended up finalizing the sale of the entire farm with his neighbor, but, after the sale, continued to live on the property and make all decisions regarding the management and operation of the farm. Several days after selling the farm, he sold his entire FLP interest to the Irrevocable Trust in exchange for a promissory note.

After he died and a Federal Estate Tax Return was filed, his estate received a Notice of Deficiency alleging that (i) the transfer of the partnership interest from the Revocable Trust to the FLP was not a bona fide sale for full and adequate consideration, (ii) the charitable deduction was impermissible and (c) a $475,000 deduction for attorney’s fees was impermissible. All of the deficiencies were upheld by the Tax Court.

The Tax Court held that the transfer of the FLP interest to the Revocable Trust, which included the transfer of an 80% interest in the farm, was not a bona fide sale for full and adequate consideration because there was no significant nontax reason for the creation of the FLP, and Howard was the only partner involved in the drafting of the partnership agreement and the management of the farm. Also, Howard, by living at the farm after both the transfer to the FLP and the sale to his neighbor, enjoyed possession of the transferred property. Howard’s co-mingling of FLP assets with those of his Revocable Trust was further proof for the Court that there was no practical difference, with respect to Howard, between the Revocable Trust holding assets and the FLP holding those same assets.

The Tax Court also disallowed the charitable deduction, pointing out that charitable deductions must be ascertainable at the time of death and cannot be dependent on the occurrence of a condition precedent, like an IRS audit, litigation or settlement. The deduction at issue was the FLP interest held by the Irrevocable Trust that was sold by the Revocable Trust and paid for with a note. Once the FLP interest, including the farm, was deemed includable in Howard’s estate for 2036 purposes, the Executors sought to transfer the FLP interest, pursuant to the terms of the Irrevocable Trust, to the Revocable Trust, so that the interest could qualify for a charitable deduction. The Court disallowed this because the asset that increased the value of the gross estate was the farm. The farm was not an asset of the Irrevocable Trust at his death, and therefore, by the very terms of the Irrevocable Trust, that asset could not pour over to the Revocable Trust.

Even if the Irrevocable Trust provided that any value or amount included in Howard's gross estate would be distributed to the Revocable Trust, the determination that such assets were includable in Howard's estate was not made as the time of Howard's death and was dependent on the occurrence of a condition precedent – that is, an estate tax audit. The Court clarified that a deduction is allowed if the amount of the deduction isn't precisely known at the decedent's death. They distinguished that from the facts here, in which it was unknown at Howard's death whether there would actually be a charitable gift.

Finally, the Court disallowed the deduction for legal fees, finding that the fees were not all incurred in the administration of Howard's estate, and the attorney did not have itemized invoices or a description of work performed. The Court pointed out that the $475,000 flat legal fee was not commensurate with an estate with no claims and no probate property; not all of the work performed was related to estate administration; and there was no actual proof that the attorney performed $475,000 worth of work.

The Private Client Services 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.

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