Wealth Management Update

July 2020

Edited by Henry J. Leibowitz
Contributor: Allison M. Heimann

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.

July 2020 Interest Rates for GRATs, Sales to Defective Grantor Trusts, Intrafamily Loans and Split-Interest Charitable Trusts

The July Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 0.6%, which is identical to the June rate. The July applicable federal rate ("AFR") for use with a sale to a defective grantor trust, self-cancelling installment note ("SCIN") or intrafamily loan with a note having a duration of three to nine years (the mid-term rate, compounded annually) is 0.45%, up slightly from 0.43% in June.

The low Section 7520 rate and AFRs continue to present potentially rewarding opportunities to fund GRATs in July with depressed assets that are expected to perform better in the coming years.

The AFRs (based on annual compounding) used in connection with intrafamily loans are 0.18% for loans with a term of three years or less, 0.45% for loans with a term between three and nine years and 1.17% for loans with a term of longer than nine years. With the short and mid-term rates remaining exceptionally low (although the latter is slightly up since June), clients who have the liquidity to repay loans within three years will likely prefer the short-term rate for their estate planning transactions, and clients seeking a broader time horizon will likely prefer to use the mid-term rate.

Precious Metals Now Deemed Tangible Personal Property in Florida

Effective July 1, 2020, there is a new law in Florida (Section 731.1065 of the Florida Probate Code) that treats "precious metals in any tangible form, such as bullion or coins, kept and acquired for their historical, artistic, collectable, or investment value apart from their normal use as legal tender for payment, [as] tangible personal property." Accordingly, unless such items are specifically addressed in a client's Will or Revocable Trust, regardless of the value of such items, the precious metals would pass to the beneficiary of the client's tangible personal property (which generally is disposed of outright) rather than to the beneficiary or beneficiaries of the client's residuary estate (which is generally held in a trust that should (1) be protected from creditors, (2) be treated as separate property if the beneficiary divorces, and (3) stay in the bloodline for multiple generations, and be excluded from transfer tax at every generation to the extent GST exemption has been allocated).

Individuals who own precious metals are encouraged to review their estate planning documents to ensure that either (1) such items are expressly addressed and directed to be distributed in a specific manner or (2) they are comfortable with such items being distributed by default to the beneficiary or beneficiaries of the tangible personal property. Individuals should be reminded that such items will not pass as part of their residuary estate.

The Tax Court reiterates and applies the factors for determining whether intrafamily loans are, in fact, loans in *Estate of Bolles v. Commissioner*, T.C. Memo 2020-71 (2020)

Estate of Bolles v. Commissioner concerns the treatment of loans made by the decedent, Mary Bolles, to her son Peter, who failed to repay the loans following the failure of his business, despite the passage of many years.

Mary Bolles had five children whom she had always intended to treat equally for estate planning purposes, making equal "advances" to each child that were recorded as loans and forgiven to the extent of the annual exclusion amount each year. However, Mary's son Peter was treated differently in several respects, likely in an attempt to support Peter's failing architecture firm which he had taken over from his father.

Peter, as president of his architecture firm, had entered into an agreement with the Bolles Trust, a family trust of which Mary and her children were beneficiaries. Pursuant to that agreement, Bolles Trust property was used as security for $600,000 in loans to Peter's architecture firm, and the firm owed the Bolles Trust $159,828 in back rent. Peter defaulted on both payments and the Bolles Trust was held liable for $600,000 in bank loans.Mary, despite being aware of the above-referenced transactions with the Bolles Trust, made transfers to Peter from 1985 through 2007 (having an aggregate value of $1,063,333) that she did not make to her other children. Per the advice of counsel, Mary treated her transfers as loans. In large part, these transfers were used to support Peter's architecture practice, which he had taken over from his father. Despite showing early promise, Peter's practice experienced a slow and steady decline and ultimately failed.

In 1989, Mary signed a revocable trust specifically excluding Peter from receiving any distributions from her estate. In 1996, Mary signed a First Amendment thereto in which Peter was included, but each of her children's equal share of her estate would be reduced by the value of any loans outstanding at her death, plus interest. Mary's lawyer had Peter sign an Acknowledgment in which he admitted that he owed Mary $771,628 that he could not repay, and acknowledged that such sum would be taken into account in the formula to reduce his share under the first amendment to Mary's revocable trust.

When Mary died, the IRS assessed a deficiency in estate tax, arguing that her "loans" to Peter had been undervalued in her estate tax return and their value, plus interest, should be included in her estate. By the time this matter came to trial, that claim was conceded, and the IRS instead argued instead that the aggregate transfers to Peter should be treated as gifts and incorporated into the calculation of Mary's estate tax liability as adjusted taxable gifts.

The Court applied the "traditional" factors from *Miller v. Commissioner* to determine whether the transfers were loans or gifts. The *Miller* factors indicating the presence of a loan are: (1) there was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was security or collateral, (4) there was a fixed maturity date, (5) a demand for repayment was made, (6) actual repayment was made, (7) the transferee had the ability to repay, (8) records maintained by the transferor and/or the transferee reflect the transaction as a loan, and (9) the manner in which the transaction was reported for Federal tax purposes is consistent with a loan.

However, the Tax Court emphasized that in the family loan context, "expectation of repayment" and "intent to enforce" are critical to sustaining characterization as a loan. Here, the Court found that Mary could not have expected Peter to repay the loans once it was clear that his architecture business had failed. Thus, the Court held that the transfers were loans through 1989, but were transformed into advances on Peter's inheritance (*i.e.*, gifts) when Mary accepted they would not be repaid, as evinced by (a) her 1989 exclusion of Peter from receiving a share of her residue, and later (b) the signing of Peter's acknowledgment that the loans he was unable to repay would be deducted from his share of Mary's residue.

In *Goodrich, et al. v. USA*, 125 AFTR 2d 2020-1276 (DC LA, 3/17/2020), the U.S. District Court for the Western District of Louisiana sends a reminder that state substantive law can sometimes determine federal tax consequences

Goodrich, et al. v. USA concerns a federal levy for unpaid income taxes that was improperly imposed on property passing to the taxpayer's heirs and beneficiaries.

Henry and Tonia Goodrich owned community property during their joint lives. At Tonia's death, Tonia left her share of certain community property to her children (also Henry's children), subject to a usufruct for Henry (a Louisiana structure similar to a life estate). Thus, during his life, Henry owned this property one-half outright and one-half as usufructary. This included certain personal property, certain mineral rights, and certain stocks and options. During his life, Henry sold the stock and exercised the options, but did not sell the personal property or mineral rights.

Henry failed to pay income taxes for several years, and died with a significant debt to the IRS. To collect, the IRS issued levies to (a) certain mineral operators, who were required to

pay mineral revenue directly to the IRS in respect of mineral rights that were subject to the one-half usufruct, and (b) J.P. Morgan, seizing Henry's estate ("succession") account. The succession account had contained the proceeds of sale, following Henry's death, of personal property subject to the usufruct. It also contained (y) mineral revenues that had been paid directly to Henry's estate prior to the levy on the mineral operators, and (z) cash that had been generated by the sale, during Henry's life, of the stock and options subject to the one-half usufruct. Henry's children sued for wrongful levy for their one-half share as post-usufruct owners of all the levied property upon Henry's death.

According to the Louisiana law of usufruct, with respect to "nonconsumables" (*e.g.*, land, furniture), the children became the direct owners of such property as soon as Henry died and the usufruct expired. Thus, with respect to the usufruct items that had been nonconsumables at Henry's death (personal property, mineral rights), the Court found the IRS levies were wrongful, and one half of the proceeds of the post-death sale of the personal property, as well as one half of the post-death mineral revenues, should be returned to the children. The Court also held that the children did not have to produce robust "tracking" evidence to distinguish the proceeds of their property from other cash held by Henry's estate.

By contrast, when Henry sold usufruct stocks and exercised options during his life, previously nonconsumable property (stocks and options) were converted into consumable property (cash proceeds) subject to the usufruct. Under Louisiana law, with respect to any consumables (cash) subject to the usufruct at Henry's death, the children became unsecured creditors of Henry's estate. Accordingly, with respect to the cash proceeds of the stocks and options sold during Henry's life, the children did not become direct owners at Henry's death—instead, they joined the line of estate creditors behind the IRS. Thus, the levies on the proceeds of stocks formerly owned by Henry (and sold prior to his death) were not wrongful, and the funds did not have to be returned to the children.

This case is a strong reminder that the underlying substantive property law governing a particular transaction (in this case, the relatively unique law of the Louisiana usufruct) can determine the federal tax consequences of a transaction or dispute.

California Bill A.B. 2936 may indicate increased scrutiny, or even regulation, of donor-advised funds

California bill A.B. 2936 passed the California State Assembly on June 10, 2020, and is currently in the Senate for further debate. A.B. 2936 would classify donor-advised funds as their own category of nonprofit organization in California, giving the attorney general the authority to issue new regulations that apply to them.

It is not clear what kind of regulations the Attorney General might impose under this bill—the bill itself does not impose any regulations or scrutiny, leaving the decision entirely to the Attorney General. Assemblywoman Buffy Wicks, who introduced the bill, commented that California loses $340 million in tax revenue to charitable contributions each year, so the state should learn more about the operation of donor advised funds, a major category of recipient.

The fact that A.B. 2936 remains actively on the agenda in the midst of the COVID-19 crisis (having moved up to the Senate in mid-June) may indicate that increased oversight of donor advised funds is a priority for California. The bill's effect on the ongoing appeal of donor advised funds is as yet unclear.

COVID-19 Update

By way of a brief update, the following considerations may be relevant to clients engaging in estate planning during COVID-19:

- A New York Executive Order (EO 202.38) has extended remote witnessing and notarization through July 6, 2020.
- The Massachusetts Department of Revenue issued a notice titled "Important COVID-19 Coronavirus Response Update from DOR" (most recently updated on June 26, 2020), in which it stated that, while some tax filing and payment deadlines were extended, "[d]ue dates for estate tax returns and payments have not changed."
- Clients sheltering in jurisdictions that are not their typical tax residencies should take note of the potential effect on their income and death tax liability. While some countries have issued guidelines regarding COVID sheltering (including Australia, Singapore, the U.K. and the United States), these might not be ironclad, sufficiently broad or even completely clear. Each country (and U.S. state) has its own tax residency criteria. Clients are encouraged to consult counsel if they are sheltering in a jurisdiction that is not their typical tax residency.

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.

If you have any questions regarding the matters discussed in this newsletter, please contact any of the lawyers listed below:

BOCA RATON

Albert W. Gortz
+1.561.995.4700 — agortz@proskauer.com

David Pratt
+1.561.995.4777 — dpratt@proskauer.com

Lindsay A. Rehns
+1.561.995.4707 — lrehns@proskauer.com

LOS ANGELES

Mitchell M. Gaswirth
+1.310.284.5693 — mgaswirth@proskauer.com

Andrew M. Katzenstein
+1.310.284.4553 — akatzenstein@proskauer.com

NEW YORK

Nathaniel W. Birdsall
+1.212.969.3616 — nbirdsall@proskauer.com

Stephanie E. Heilborn
+1.212.969.3679 — sheilborn@proskauer.com

Henry J. Leibowitz
+1.212.969.3602 — hleibowitz@proskauer.com

Vanessa L. Maczko
+1.212.969.3408 — vmaczko@proskauer.com

Jay D. Waxenberg
+1.212.969.3606 — jwaxenberg@proskauer.com