Wealth Management Update

December 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.

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

Certain federal interest rates increased slightly for December of 2020, while others remained the same. The December 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 0.48%, up from 0.39% in November and down from 1.69% in December of 2019.

The December Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 0.6%, which is up from 0.4% in November and down from 2.0% in December of 2019.

The AFRs (based on annual compounding) used in connection with intra-family loans are 0.15% for loans with a term of 3 years or less, 0.48% for loans with a term between 3 and 9 years, and 1.31% for loans with a term of longer than 9 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 1.31%, the child will be able to keep any returns over 1.31%. These same rates are used in connection with sales to defective grantor trusts.

Federal and State Elections Reshape Tax Policy

The November 3rd elections will have far-reaching implications for tax policy.

As was widely expected, Joe Biden won the presidential election. But Republicans outperformed expectations, picking up several seats in the House of Representatives and limiting their losses in the Senate. It will be difficult for a President Biden to push controversial tax legislation – for example, a reduction in the estate and gift tax exemption or a repeal of "stepped-up" income tax basis – through a closely divided Congress. Biden's leverage will depend, in part, on the outcome of the two Georgia Senate runoff elections set for January 5, 2021.

Meanwhile, voters in several states voted on tax-related ballot initiatives.

In California, voters rejected Proposition 15, which would have excluded commercial and industrial buildings from the restrictions imposed by Proposition 13 (1978). But California voters also approved Proposition 19 (discussed in more detail below), which will make it harder for individuals to pass their low property tax bases to their children or grandchildren.

In Arizona, voters approved Proposition 208, which will create a new 8% income tax bracket for individuals with taxable incomes of $250,000+ or joint filers with taxable incomes of $500,000+. Arizona's current top marginal income tax rate – 4.5% – is one of the lowest in the country. The new rates, which take effect in January, are not indexed for inflation.

In Illinois, voters rejected the "Illinois Fair Tax Amendment," which would have replaced Illinois's 4.95% flat income tax with a progressive system topping out at 7.95%.

Lucero v. Commissioner, T.C. Memo 2020-136 (Tax Court, Sept. 29, 2020)

Ronald Lucero owned a short-term rental property in Sonoma County, California. A property management company managed the property's day-to-day operations, though Mr. Lucero would drive to the property from his home in Sacramento six to eight times a year to perform maintenance and buy things for the property. Mr. Lucero and his family also stayed at the property for one week around Christmas each year. On his 2014 income tax return, Mr. Lucero reported $26,223 of income from the property and $41,854 of expenses, for a net loss of $17,631. On his 2015 income tax return, Mr. Lucero reported $26,710 of income from the property and $51,200 of expenses, for a net loss of $24,490. The IRS disallowed both losses.

The IRS advanced two theories for why the losses should be disallowed. First, the IRS argued that the property was a personal residence and therefore, pursuant to Section 280A, Mr. Lucero was barred from claiming losses in connection with it. The Tax Court disagreed, noting that a property is considered a personal residence for purposes of Section 280A if the taxpayer uses it as a personal residence for the greater of (a) 14 days and (b) 10% of the number of days that the taxpayer rents it out in a given year. The IRS could not establish that Mr. Lucero had used the property as a personal residence for more than about seven days a year.

Second, the IRS argued that the rental income was subject to Section 469's passive loss limitation, which limits a taxpayer's deductible losses from "passive activities" – that is, activities in which the taxpayer did not "materially participate". Passive losses may not exceed the taxpayer's passive income, though any excess loss may be carried over to the subsequent year. As a general rule, rental activities are considered passive, but if renters rent out a property for an average of seven or fewer days and the taxpayer materially participates in the operation of the rental, the rental activities are considered active. In this case, the property was being rented for an average of fewer than seven days at a time. So the case came down to whether Mr. Lucero was materially participating in the rental operations. Material participation requires that a taxpayer be involved in the activity on a regular, continuous, and substantial basis. After the litigation began, Mr. Lucero tried to reconstruct his activities at the property by creating a time log based on invoices and receipts. The Tax Court, which rejected the log as unreliable, found that Mr. Lucero had failed to produce evidence of material participation in the rental activities and therefore sided with the IRS.

Notice 2020-75

The Tax Cuts and Jobs Act ("TCJA") capped state and local tax ("SALT") deductions at $10,000 for individual taxpayers while allowing businesses to continue taking unlimited SALT deductions. After the TCJA was enacted, a number of states revised their income tax laws to make it possible for the owners of "pass-through" businesses – that is, businesses that pass their income tax liability through to their owners, such as partnerships and S corporations – to be taxed at the entity level and therefore circumvent the SALT cap for individual taxpayers. On November 2, the IRS effectively blessed these state efforts. In Notice 2020-75, the agency announced that it will issue regulations allowing eligible owners of pass-through entities to deduct the full amount of any business income taxes.

California's Proposition 19

Proposition 19 was passed in the November election. It makes a number of changes to California law that impact the ability of parents to transfer real property to children without that property being reassessed for property tax purposes. The law applies to transfers of real property after February 15, 2021.

Existing Law Pre-Prop 19

Before Prop 19 takes effect, parents were allowed to transfer real estate in two circumstances to children (including trusts for their benefit) without the transfer being deemed a "change in ownership" for property tax purposes. That means that the transfer could take effect with the transferee child keeping the transferee parent's property tax base. In English, that means property taxes would remain unchanged.

Those two circumstances were:

1. Any transfer of a principal residence to children (or trusts for their benefit) was completely exempt from property tax reassessment (the "Principal Residence Exception"). Children did not have to reside in the residence after the transfer for this exception to apply.
2. Any transfer of up to $1,000,000 of assessed value of other property to children (or trusts for their benefit) was also exempt from property tax reassessment (the "Other Property Exception").

The exceptions were only available for transfers of real property, not for interests in entities owning real property. For that reason, some parents kept properties outside of entities so that these exceptions would be available to them.

Prop 19 Changes

Proposition 19 eliminates the Other Property Exception in its entirety.

The Principal Residence Exception is limited in two ways:

1. Children must reside in the principal residence after the transfer in order to be eligible for the exception.
2. If the increase in value of the principal residence at the time of transfer is less than $1,000,000 more than its assessed value, so long as the children reside in the residence after the transfer there is no property tax reassessment. However, if the increase in value of the principal residence at the time of the transfer is greater than $1,000,000 more than the assessed value, the property is reassessed at its fair value minus $1,000,000 (so long as the children reside there after the transfer). (The $1,000,000 amount is adjusted by inflation according to the statute each year.)

If you would like to make a transfer that takes advantage of the existing rules before Proposition 19 takes effect, you should do so before February 16, 2021.

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:

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