Proskauer

Wealth Management Update

October 2020

Grantor Trusts, Intra-Family Loans and Split Interest Charitable Trusts

Important federal interest rates continue to hold relatively steady. The October Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 0.4%, which is unchanged from a month ago.

The October applicable federal rates ("AFRs") (based on annual compounding) used in connection with intra-family loans are 0.14% for loans with a term of 3 years or less, 0.38% for loans with a term between three and nine years, and 1.12% for loans with a term of longer than nine years.

Thus, for example, if a 9-year loan is made to a child, and the child can invest the funds and obtain a return in excess of 0.38%, the child will be able to keep any returns over 0.38%. These same rates are used in connection with sales to defective grantor trusts.

The AFRs for October 2019 were 1.69%, 1.51%, and 1.86%, respectively, which outlines a drop in rates during the last year.

Jon Dickinson et ux. v. Commissioner, T.C. Memo 2020-128 – Donations of Stock to Donor Advised Fund Were Not Taxable Redemptions

In *Dickinson*, the Tax Court concluded in the taxpayers' favor that the donations of stock to a donor advised fund were absolute gifts of appreciated property, and they were not taxable redemptions followed by donations of cash proceeds as the IRS contended.

Here, the Petitioner husband was the CFO and a shareholder of GCI, a privately-held company. During the years in question, the donation transactions occurred in essentially the same manner. First, by written consent, the GCI board of directors authorized transfer of the shares to a Fidelity donor advised fund ("Fidelity"). The written consents included an acknowledgement that it was Fidelity's policy requirement to "immediately liquidate the donated stock." The Petitioner husband then donated appreciated GCI stock to Fidelity. Following the donation, (a) GCI would send written confirmation to Fidelity that the company's books and records reflected Fidelity as the new owner of the shares, (b) the Petitioner husband signed letters of understanding indicating that the stock was "exclusively owned and controlled by Fidelity" and that Fidelity "maintains full discretion over all conditions of any subsequent sale" of the stock and that Fidelity "is not and will not be under any obligation to redeem, sell, or otherwise transfer" the stock, and (c) Fidelity sent out letters confirming that Fidelity has "exclusive legal control over the contributed asset." As the last step, shortly thereafter, Fidelity would redeem the GCI shares for cash.

The Tax Court stated that, per *Humacid Co. v. Commissioner*, T.C. 894, 913 (1964), the form of the transaction is respected if the donor (1) gives the property away absolutely and parts with title thereto and (2) does so before the property gives rise to income by way of a sale. With regard to the first prong, the Tax Court found that the GCI letters confirming ownership, Petitioner husband's letters of understanding and Fidelity's confirmation letters all supported and confirmed Petitioner husband's claim that he had given away all rights in the GCI shares. With regard to the second prong, the redemption occurred after the donation, and there was no guaranteed redemption that would have occurred regardless of the gift (i.e., assignment of income doctrine). Accordingly, the Tax Court respected the form of the transaction, highlighting the importance of following proper procedures.

Estate of Mary P. Bowles, et al. v. Commissioner, T.C. Memo 2020-71 (June 1, 2020) – Characterization of a Loan as a Gift

In *Bowles*, the Tax Court determined that loans that had been made by the decedent to her oldest son, Peter, during her lifetime (and that were documented as such), should be recharacterized as gifts at the time that she realized and acknowledged that Peter was unlikely to ever repay the loans.

The decedent made large gifts to Peter totaling over $1,000,000 between 1985 and 2007 to support him professionally. The decedent had been impressed by Peter's initial success in architecture and believed that he would be successful in this venture. Following a decline in Peter's professional success, in the decedent's 1989 revocable trust, she specifically excluded Peter from any inheritance (leaving her estate to her other children), which the Tax Court would later view as a tacit acknowledgment that the decedent was unlikely to recover the loan amounts from Peter. Then, in 1994 or 1995, the decedent signed an amendment to her revocable trust that no longer excluded Peter, but provided for equalization for all children after taking into account "loans" made by the decedent during her life. The decedent's attorney, while preparing the Amendment, also prepared a one-page Acknowledgement that was signed by Peter and stated that Peter "has received, directly or indirectly, loans from [the decedent]", that Peter "had neither the assets, nor the earning capacity, to repay all, or any part" of the loans, and that Peter agrees that "irrespective of the uncollectability or unenforceability of the said loans" the total principal plus interest would be taken into account in determining the equalized gifts under the decedent's amended revocable trust.

In filing the estate tax return, the estate did not give any value to the bad debts to Peter. When it reached the Tax Court, instead of debating the date of death value of the notes, the sole argument was whether a gift occurred during the decedent's lifetime that should be included in the "adjusted taxable gifts" in computing the decedent's estate tax liability. The estate said they were loans at all times, and the IRS argued that they should have been treated as gifts.

In addition to the traditional factors in determining whether an advance is a loan or a gift, in the case of a family loan, there is a principle that an actual expectation of repayment and an intent to enforce the debt are critical to sustaining the tax characterization of the transaction as a loan. *Estate of Van Anda v. Commissioner*, 12 T.C. 1158, 1162 (1949), *aff'd per curiam*, 192 F.2d 391 (2d Cir. 1951). Citing the foregoing, the Tax Court held that although the decedent likely initially expected repayment, it was clear by the time of her 1989 Trust in which she excluded Peter as a beneficiary, that she had realized that repayment was unlikely. Accordingly, the Tax Court held that the advances were loans through 1989 and gifts thereafter.

James C. Nelson et ux. v. Commissioner, T.C. Memo. 2020-81 – Transfer of Limited Partnership Interests by

Fixed Dollar or Percentage Interests

In *Nelson*, the Tax Court ruled that married taxpayers that had intended to make a standard formula transfer of fixed dollar amount had instead made a gift of a specific percentage interest. The result was a significant transfer tax underpayment.

In 2008, the taxpayers formed Longspar Partners, Ltd. (the "FLP") and the wife created a trust for the benefit of the husband and their descendants (the "Trust"). On December 31, 2008, the wife made a *gift* of limited partnership interests in the FLP to the Trust by a written instrument that transferred the following:

> a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008..., as determined by a qualified appraiser within ninety (90) days of the effective date of this Agreement.

A few days later, on January 2, 2009, the taxpayers made a *sale* of FLP interests to the Trust by a written instrument that transferred the following:

> a limited partner interest having a fair market value of TWENTY MILLION AND NO/100THS DOLLARS ($20,000,000.00) as of January 2, 2009..., as determined by a qualified appraiser within ninety (90) days of the effective date of this Agreement.

No further definition of the "fair market value" was provided in any of the transfer documents. Upon appraisal shortly thereafter, the appraiser determined that the following limited partnership interests had been transferred: a 6.14% gift on December 31, 2008 and a 58.65% sale on January 2, 2009, for a total of 64.79% transferred.

Upon audit, the IRS determined that the taxpayers had undervalued the FLP interests and that, as a result, the initial gift was underreported, and the sale was a partial sale and partial gift. The taxpayers argued that instead of a tax deficiency, it was actually a specific dollar amount (which would mean a smaller percentage of limited partnership interests) that was transferred due to the formula nature of the transfer instruments.

The Tax Court stated that per *Succession of McCord v. Commissioner*, 461 F.3d at 618, it looks "to the terms of the transfer instruments and not to the parties' later actions except to the extent that we conclude the terms are ambiguous and their actions reveal their understanding of those terms." The Tax Court, in looking at the language in the transfer instruments, found that the transferred amounts were ultimately determined by "an appraiser within a fixed period" and were not further qualified (such as "as determined for Federal estate tax purposes."). Per the Tax Court "while [the taxpayers] may have intended this, they did not write this." Accordingly, the initial appraiser's determination of transferred percentages (64.79%) held, and, since the Tax Court found that the FLP had a higher value than initially reported, the taxpayers were held to have underreported the transfers, as argued by the government.

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