Proskauer

Wealth Management Update

July 2021

July 2021 Interest Rates for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split Interest Charitable Trusts AFRs

The July 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 1.00%, down from 1.02% in June and up from 0.45% in July of 2020.

The July Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 1.2%, which is equal to June's 7520 rate, but is significantly higher than the 7520 rate of 0.6% in July of 2020.

The AFRs (based on annual compounding) used in connection with intra-family loans are 0.12% for loans with a term of 3 years or less, 1.00% for loans with a term between 3 and 9 years, and 2.07% 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 2.07%, the child will be able to keep any returns over 2.07%. These same rates are used in connection with sales to defective grantor trusts.

President Biden's 2022 Budget/Biden Administration Revenue Proposals for 2022

In late May, the Biden Administration released Revenue Proposals for 2022.

Increasing Top Income Tax Bracket: One proposal is to raise the top income tax rate from 37% to 39.6%, which will be the top rate effective in 2026 absent any earlier legislation. If this proposal becomes law, the new 39.6% rate will be effective on January 1, 2022 and will apply to taxable income over $452,700 for an individual and $509,300 for married couples; both figures will be indexed for inflation. Currently, the highest income tax bracket applies to taxable income over $523,600 for an individual and $628,300 for a married couple.

Recognition of Capital Gains Upon Transfer: A second proposal, also effective January 1, 2022, would impose a capital gains tax on death, the making of a gift or the distribution from a trust. (Currently, a capital gains tax is only imposed on an appreciated asset once that asset is sold. Therefore, assets transferred in kind, whether during life, at death or from a trust, are not subject to a tax.) If this proposal becomes law, there will be an exclusion for all tangible personal property, other than collectibles. Furthermore, there will be a $250,000 per person exclusion for residences, which would be portable between spouses, and an additional general $1,000,000 exemption, which is also portable and will be indexed for inflation. Any property that is gifted during life that is subject to the exemption will get a carryover basis. Any property transferred at death that is subject to the exemption will receive a stepped up basis.

If an asset is held in trust and no distribution is made for ninety years, a capital gains tax will be imposed on that asset every ninety years, beginning in 2030.

Transfers to spouses and charities will be excluded from this capital gains tax. If assets are held in a split-interest charitable trust, the charity's share of such asset will be exempt from the tax.

In determining the value of the asset subject to the tax, no partial interest discounts will be applied; therefore, the tax will be based on the relevant percentage of the fair market value of the asset.

The tax will be deferred on family businesses until the business is sold or is no longer a family business. In addition, the tax imposed with respect to any assets other than marketable securities will be payable over a fifteen-year period.

Any capital gains paid at death would be deductible on the federal estate tax return.

Taxation of Carried Interest as Ordinary Income: A third proposal would tax carried interest as ordinary income and require recipients of carried interest to pay self-employment taxes on such income. This change would be effective on January 1, 2022.

Repeal of 1031 Exchanges: The proposal relating to 1031 exchanges would, effective January 1, 2022, permit a taxpayer to defer gain only up to $500,000 for a like-kind exchange.

Taxation of Long-Term Capital Gains as Ordinary Income: Another proposal involves the taxation of long-term capital gains as ordinary income (*i.e.*, at the current top rate of 37% or, if enacted, the increased rate of 39.6%). This would only affect taxable income in excess of $1,000,000. Unlike the other proposals discussed above, this proposal would be effective after the date of announcement, which suggests that it would be retroactive to April (when President Biden first discussed the proposal) or May (when the written proposals were released).

New Rule Against Perpetuities in Texas

Effective September 1, 2021, the rule against perpetuities in Texas will be extended to 300 years. The new legislation results from an argument that the current rule against perpetuities violates the Texas Constitution's principle that "perpetuities and monopolies are contrary to the genius of a free government and shall never be allowed."

The new perpetuities period will be automatically applicable to trusts established on or after September 1, 2021. Any trusts created between now and September 1st can elect to use the new perpetuities period by including a statement in the trust agreement that the trust interests are to vest according to Section 112.036 of the Texas Trust Code applicable on the date that the interest vests.

Nothing has been stated definitively, but it is thought to be unlikely that trusts currently in existence will be able to take advantage of the new perpetuities period through judicial reformation or otherwise.

Estate of Grossman v. Commissioner, T.C. Memo 2021-65 (May 27, 2021)

Semone Grossman was a Jewish resident of the State of New York. In 1955, he was married in New York to his first wife, Hilda. Approximately ten years later, Semone obtained a unilateral divorce in Mexico. Semone then married Katia in New Jersey, but, after about eight years, they decided to divorce. At the same time, Hilda, Semone's first wife, commenced a lawsuit seeking a declaratory judgment that the unilateral divorce in Mexico was invalid, and, therefore, that she and Semone were still married. Hilda prevailed, although the couple never reconciled.

About ten years later, Semone fell in love with Ziona and wished to marry her. He approached Hilda, and she cooperated in this divorce proceeding, in which Semone was granted a divorce in an orthodox rabbinical court. As a result of the religious divorce, also known as a get, and with the assistance of other religious documentation, Semone obtained a letter stating that he was free to marry Ziona.

Ziona and Semone went to Israel with the letter they obtained in New York, and a rabbi in Israel presided over their wedding ceremony. Shortly after their wedding date, Semone and Ziona returned to New York, raised a family together, and were a happy couple until his death in 2014. (They even socialized with Hilda once in a while.)

After Semone's death, his Will was admitted to probate, in which he left the majority of his $87,000,000 estate to Ziona. In fact, his Will specifically stated that any reference to his wife was to refer solely to Ziona Grossman. Semone's Executor claimed a marital deduction under Section 2056(a) of the Internal Revenue Code for the property passing to Ziona, after which the IRS issued a notice of deficiency disallowing the deduction, claiming that the marital deduction was not applicable, as Semone could not have been married to Ziona when he died because he was still married to Hilda.

The IRS argued that the Court should look to New York State law to determine the status of the divorce between Semone and Hilda, while the Estate argued that the Court should look to federal law to determine the marital status between Semone and Ziona at the time of his death. Nonetheless, the Estate claimed that it would also prevail under a State law argument, so the Court elected to analyze the facts of the case under New York law.

Under New York law, pursuant to the so-called "Place of Celebration Test", a marriage is valid if the marriage is valid in the place of celebration unless (i) the validation of the marriage would be offensive to the public sense of morality to a degree generally regarded with abhorrence, or (ii) if there is positive or affirmative law in New York nullifying the marriage. (Interestingly, effective as of 2016, there is a Treasury Regulation that formalizes the Place of Celebration Test for federal tax purposes, stating that a marriage is valid for federal tax purposes if it is valid in the place of celebration and if at least one U.S. state recognizes the marriage. The parties in this case could not rely on the Treasury Regulation since Semone died in 2014, prior to its adoption.)

Furthermore, pursuant to caselaw in New York, there is a presumption of validity of subsequent marriages for public policy reasons, especially if the person contesting the marriage is a stranger to the family. In order for the party contesting the marriage to overcome his or her burden, he or she must disprove every reasonable possibility that would validate the marriage.

The IRS argued that both exceptions to the Place of Celebration Test applied. With respect to the first exception, they claimed that Semone was a bigamist. Secondly, they pointed to a provision of the New York Constitution that states that a divorce cannot be granted without due judicial proceedings. The Service further argued that it could overcome the presumption of validity of the marriage between Semone and Ziona by simply pointing to the judgment that invalidated Semone's marriage to Katia and reinstated his marriage to Hilda.

The Court elected to focus on the validity of Semone's marriage to Ziona and not the validity of Semone's divorce from Hilda, setting forth in detail Israel's bifurcated legal system. In Israel, marriage and divorce are under the jurisdiction of religious courts, and the Court pointed out that Semone and Ziona would not have been granted their marriage certificate in Israel unless Semone proved that any prior marriage had been dissolved. As the Israel marriage certificate was indisputable proof that the divorce between Semone and Hilda was valid in Israel and the marriage between Semone and Ziona was valid in Israel (*i.e.*, the place of celebration), the Court found that the marriage was valid in New York under the Place of Celebration Test.

The Court then discussed the two exceptions to the Place of Celebration Test. They dismissed the argument of the IRS that Semone was a bigamist, for Semone was never attempting to be married to two people at once and did not consider himself married to Hilda when he married Ziona. The Court also dismissed the argument relying on the verbiage in the New York State Constitution because Israel considered Semone divorced when he married Ziona; whether New York considered Semone divorced based on the get he received in New York was irrelevant.

Finally, the Court addressed the presumption of validity of the marriage, pointing out that New York has never invalidated a marriage that was valid in the place of celebration and challenged by a non-family member. The Court also addressed Hilda's court proceeding, but instead emphasized that Hilda did not challenge the marriage between Semone and Ziona and not because she did not know how to challenge marriages. To be sure, Hilda held herself out as single on her tax returns and made no attempt to exercise her right of election after Semone's death.

The Court also emphasized that (i) the law in New York regarding the validity of marriages has been unchanged for over a century, and (ii) the new Treasury Regulation is in effect, so the Service's concern that recognizing marriages celebrated outside of the State of New York would open the floodgates for one spouse to nefariously obtain a divorce in a jurisdiction with less restrictions is unfounded. The Court made it clear that it was perfectly lawful for parties to go abroad to get married solely to evade stricter matrimonial laws in effect in the State of New York and to return to New York immediately after the wedding.

Based on the opinion's focus on marriage, as opposed to divorce, the Court unsurprisingly held that Semone was married to Ziona at the time of his death, and that the Estate was, therefore, entitled to a marital deduction with respect to all property passing to Ziona under Semone's Will. The Court emphasized that this holding was in line with the desire that the Tax Court not become a domestic relationship tribunal. However, the Court was quick to point out that its holding was to be construed narrowly and only in light of the facts surrounding the specific marriage between Semone and Ziona, including the place of celebration and duration thereof, as well as the lack of any challenge of the marriage by any party prior to Semone's death.

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