Proskauer

Wealth Management Update

February 2023

February 2023 Interest Rates for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split Interest Charitable Trusts

The February 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 3.82%, down from 3.85% in January 2023.

The February 2023 Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 4.60%, resulting in no change from the 4.60% Section 7520 rate in January 2023.

The AFRs (based on annual compounding) used in connection with intra-family loans are 4.47% for loans with a term of 3 years or less, 3.82% for loans with a term between 3 and 9 years, and 3.86% 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 3.86%, the child will be able to keep any returns over 3.86%. These same rates are used in connection with sales to defective grantor trusts.

SECURE Act 2.0

On December 29, 2022, President Biden signed the Consolidated Appropriations Act of 2023, which includes the Setting Every Community Up for Retirement Enhancement (SECURE) Act 2.0.

The SECURE Act 2.0 expands upon the initial SECURE Act previously enacted on December 20, 2019. Discussed below are some of the changes the SECURE Act 2.0 implemented which allow for more efficient retirement savings and charitable donations.

The age for Required Mandatory Distributions (RMDs) is raised to 73 (previously 72) as of January 1, 2023, allowing for individuals to defer RMDs to allow for more tax-free growth. On January 1, 2033, the age shall increase again to 75. By increasing the age for RMDs, accounts will have more time for tax efficient growth.

As of January 1, 2023, a participant aged 50 or older can make an additional "catch up" contribution of $7,500, indexed for inflation, in 2023. Beginning January 1, 2025, participants aged 60 – 63 may make catch-up contributions equal to the greater of $10,000, indexed for inflation, or 150% of the regular catch-up limit. As of January 1, 2024, catch-up contributions for participants with compensation of more than $145,000 must be made on an after-tax basis such as to a Roth account. Further, an individual aged 50 or older can make an additional catch-up contribution to a Roth IRA up to $1,000. Now, beginning in 2024, that $1,000 will be indexed for inflation which represents the first increase to this figure in over fifteen years.

Qualified Charitable Distributions (QCDs) have also been made more effective. An individual who is 70.5 or older can now make QCDs up to $100,000, indexed for inflation, directly from an IRA to a qualified charity without recognizing any income on the donated amount and can count toward the individual's RMD. Moreover, Individuals who are 70.5 or older can make a one-time QCD of up to $50,000 from an IRA to a charitable gift annuity (CGA), charitable remainder unitrust (CRUT) or charitable remainder annuity trust (CRAT) that benefits the participant or their spouse.

Randle v. Farmers New World Life Insurance Company, 2022 Cal. App. LEXIS 918 (Ct. App. Nov. 7, 2022)

A California Appeals Court held a Divorce Settlement Agreement could inform policy ownership and beneficiary designations.

In 1992, Judy Randle and her then-husband Alan McConnell purchased a life insurance policy from Farmers New World Life insuring Alan's life. The policy had a face amount of $250,000 and named Judy as sole beneficiary.

In 2004, Judy and Alan divorced and entered into a settlement agreement which gave Judy a 25% beneficial interest of the Farmers policy. Alan was required to maintain the policy for Judy's benefit to the extent of her 25% beneficial interest and was free to name any beneficiaries as to his remaining 75% interest. Judy and Alan were responsible for paying premiums for their respective interests in the policy, if either party discontinued paying the premiums, he or she would forfeit his or her interest in the policy.

In 2006, Alan submitted a form to Farmers to request to add each of his three sons with Judy as 25% beneficiaries and included some pages of the divorce agreement. Farmers stamped Alan's request as "Update Only" and "Not Registered" because he did not include the complete divorce judgment. Alan never gave a certified copy of the entire divorce agreement to Farmers and no one told Judy that Alan had submitted the beneficiary change request to Farmers.

In 2008, Judy began paying all premiums on the policy because Alan stopped paying out-of-pocket premiums. Judy told the agent she would make the premium payments if she were maintained as the 100% beneficiary and was told that she was still the sole beneficiary and she did not need to become the listed owner because Farmers would notify Judy if the beneficiaries were changed.

In 2014, Alan died and Judy submitted a claim to Farmers for 100% of the policy benefits. Farmers then informed Judy there was a dispute over the proper policy beneficiary. Alan's son then provided a complete copy of the divorce agreement. Shortly afterward, Farmers paid the policy proceeds to Judy and her three sons from her marriage to Alan.

Judy filed a lawsuit against Farmers in California alleging the following: (1) she was a rightful owner of the life insurance policy; (2) Farmers knew she was a rightful owner; (3) she was the valid 100% beneficiary of the policy; and (4) Farmers neglected its duty to tell her they didn't consider her to be the 100% beneficiary.

The trial court held for Farmers and dismissed Judy's claim. On appeal, the Appeals Court used precedent which said policy ownership could be established by factors other than who was listed as the owner at the insurance company and that there was evidence from which a reasonable factfinder could infer Judy was the owner of the policy and that Farmers was on notice of that fact before it paid out the proceeds. Accordingly, the Appeals Court reversed the trial's court decision and sent the matter back for trial.

In re Estate of Wallace, unpublished per curiam Mich. App. opinion 357441

A Michigan Appellate court held a personal representative can be held liable to an estate's creditors for losses that result from breaches of fiduciary duties.

The Decedent held several LLC business interests he operated with his ex-wife. Upon his death, the residue of his estate would pour-over to a Trust under which his ex-wife was named the successor Trustee and Beneficiary. The Decedent's ex-wife was also appointed Personal Representative of the Decedent's estate. After several years, the ex-wife was removed by the probate court following a finding she failed to pay creditor claims as ordered by the court. The successor Personal Representative sued the ex-wife on behalf of the estate and the LLCs and alleged a breach of fiduciary duties. The ex-wife argued she should not be found liable for damages because the estate was essentially insolvent, she didn't owe the creditors or the LLCs any fiduciary duties, and she continued to operate the businesses the way the Decedent had.

A forensic review of the estate determined a loss of roughly $525,000 including a calculation for interest and penalties relating to income tax returns the ex-wife failed to file.

The appellate court upheld the damages assessed against the ex-wife except for the included penalties as an element of damages given they hadn't yet been imposed by the IRS. The appellate court reasoned although a Personal Representative does not owe fiduciary duties to creditors, if breaches of fiduciary duties cause a loss to the estate, the Personal Representative is liable to interested persons, including creditors, for the resulting losses.

Rogers v. Rogers, 47 Fla. L. Weekly d2466 (2d DCA 2022)

The Second District Court of Appeal of Florida reversed a trial court order dissolving a marriage.

In a divorce action, a Florida trial court determined a boat was a nonmarital asset belonging to Husband. The trial court reasoned the boat was a nonmarital asset because it was a gift from Husband's father, paid for with funds from Husband's father's trust. On appeal, Wife argued the boat was a marital asset because the funds used to purchase it were first deposited into a joint bank account held by Husband and Wife.

The Second District Court ruled that because the funds were placed into a joint bank account shared by Husband and Wife, the boat lost its character as separate property and became marital property. Accordingly, the Court remanded the action to the trial court to equitably divide the boat.

United States v. Shant Hovnanian et al., No. 3:18-cv-15099 (27 December 2022)

The US District Court for the District of New Jersey concluded two trusts are the taxpayer's nominees in his $16 million tax liability.

The IRS alleged Shant Hovnanian owes more than $16 million in federal tax liabilities that arose because he engaged in illegal tax shelters. At all relevant times, Shant's primary residence was located at a home in New Jersey. Shant's sister, Nina Hovnanian, is the sole Trustee of the VSHPHH Trust and the Pachava Trust which each own real property in New Jersey, including Shant's primary residence. In its efforts to collect the alleged $16 million in owed federal taxes, the government sought federal tax liens and foreclose on the two pieces of real property held by the VSHPHH Trust and the Pachava Trust. On January 16, 2018, the government filed a notice of federal tax lien in the County Clerk's office against Shant and listed both trusts as his nominees. On October 18, 2018, the Government filed an action to obtain an order it has valid federal tax liens against the two properties.

After the primary residence was built in 2008, Shant and his family moved onto the property and were responsible for paying the expenses of the property. Shant used a Morgan Stanley bank account in the name of the Pachava Trust to pay for the expenses of the property, but never paid any rent while living at the property. The property held by the VSHPHH Trust is a two-floor office complex located in New Jersey. The VSHPHH never filed income tax returns with the IRS and while the first floor contained tenants that paid rent, Shant did not pay rent for any usage of space at the property.

After several years of audits, the partnership Shant used in his tax shelter lost an action brought before the US Tax Court resulting in a balance due of just over $16 million.

The US District Court used the *Patras* test for a nominee relationship which generally looks at six factors:

1. Whether the nominee paid adequate consideration for the property;
2. Whether the property was placed in the nominee's name in anticipation of a suit or other liabilities while the taxpayer continued to control the property;
3. The relationship between the taxpayer and nominee;
4. The failure to record the conveyance;
5. Whether the property remained in the taxpayer's possession; and
6. The taxpayer's continued enjoyment of the benefits of the property.

The factors in the *Patras* test are not to be applied rigidly but to determine whether a party exercises active or substantial control over the property. If the taxpayer is the true owner of the property, the property is subject to the tax lien.

The US District Court held the Pachava Trust was a nominee because the transfer was made for minimal consideration from Shant's mother to the trust, the transfer happened after Shant lost a case before the US Tax Court, Shant had a close relationship with the trustee, and the property remained in Shant's possession as it was used as his primary residence. Similarly, the US District Court held the VSHPHH Trust was a nominee because Shant continued to exercise substantial control over the property, rent was paid into a personal bank account, Shant did not pay rent for any space he used and Shant paid expenses for the property out of his personal business account.

As a result, the US District Court held for the government and allowed it to foreclose upon on the properties held by the trusts.

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