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newsletter

Wealth Management Update

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in this issue

A monthly report for wealth management professionals.

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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.

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

The October § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 3.4%, down slightly from 3.44% in September. The October 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 semiannually) is 2.81%, also down slightly from 2.84% in September.

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

The AFRs (based on semiannual compounding) used in connection with intra-family loans are 2.53% for loans with a term of 3 years or less, 2.81% for loans with a term between 3 and 9 years, and 2.97% for loans with a term of longer than 9 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 2.81%, the child will be able to keep any returns over 2.81%. These same rates are used in connection with sales to defective grantor trusts.

Ohio Court of Appeals Refused to Force Grantor Trust to Reimburse Grantor for Income Tax or to Convert to Non-Grantor Trust (*Millstein v. Millstein*), 2018-Ohio-2295

In a case decided in July, the Ohio Court of Appeals refused to make a grantor trust reimburse the Settlor for trust income tax for which he was liable under the grantor trust rules. Two decades after creating two irrevocable trusts for the benefit of his descendants, the Settlor requested reimbursement of over $6 million of income tax generated by these trusts.

The lower court had granted a motion to dismiss the Settlor's claim, primarily focusing on the lack of statutory authority under the Ohio Trust Code for the Settlor to bring the claim.

The Court of Appeals agreed with the reasoning of the lower court, but expanded their analysis to consider the Settlor's claim for equitable relief. In brief, the Court of Appeals found no basis for either the Settlor's reimbursement claim or for a unilateral change to the tax treatment of the trust alternatively proposed by the Settlor before dismissing the case.

The Court of Appeals further noted that even if it were to consider the Settlor's claim for equitable relief, it would deny it, on the ground that the Settlor voluntarily created these trusts under their respective terms.

To provide some more color, in the late 1980s, Norman Millstein created two irrevocable grantor trusts for the benefit of his descendants, naming himself as settlor, and his son, Kevan, as trustee of both trusts. It wasn't until 2010 that Norman requested that Kevan, as trustee, begin to reimburse him for the income taxes he was paying on both trusts. Instead, Kevan agreed to use the assets in another trust to make these payments. In 2013, Kevan informed Norman that this third trust no longer had liquid assets. At that point, one of the two principal trusts was converted to a non-grantor trust, while the other remained a grantor trust.

Unable to reach a compromise with regard to the second trust, and still seeking reimbursement for income taxes paid, Norman then brought suit in the Cuyahoga County Court in Ohio, alleging that he was owed over $5 million from the trusts to compensate him for taxes he had paid from 2013 through 2015, arguing that he was owed "equitable reimbursement of income taxes."

As indicated, the lower court dismissed his petition without an opinion, based on a lack of standing under the Ohio Trust Code, the Ohio version of the UTC. When the appeals court affirmed the lower court's decision, it explained that the Settlor's lack of standing was because, under the Ohio Trust Code, a petition to modify a trust to achieve the settlor's tax objectives may not be brought by the settlor alone, but requires the cooperation of the trustee and the beneficiaries. The court also noted that even if the trustee and beneficiaries had joined, no modification could retroactively change the terms of the trust, essentially nullifying his claim for reimbursement.

The court cited clear legislative intent behind the relevant provisions of the Ohio Trust Code which precluded Norman from unilaterally changing the tax treatment of a trust, and pointed out that it is well established that equity will be of no help where there is clear legislation and legislative intent on the matter.

Despite all of this, the court still entertained the hypothetical of what their decision might have been had they considered Norman's claim for equitable relief, still concluding that it would be denied, on the ground that Norman voluntarily created these trusts under their respective terms, and that neither the trustee nor any of the beneficiaries acted in any way so as to force these trusts to be grantor trusts. In the words of the court, "equity will not aid a volunteer."

Tax Court Appears to Agree with IRS's Position that Estate Tax Value of Rights under Intergenerational Split-dollar Life Insurance Agreements Is at Least Equal to the Cash Value of the Underlying Policies
Estate of Cahill v. Commissioner, T.C. Memo. 2018-84 (June 18, 2018)

In a matter involving a series of intergenerational split-dollar life insurance agreements, the Tax Court appeared to agree with the IRS's position that the estate tax value of the rights of a deceased insured in such agreements is at least equal to the cash value of the policy, as opposed to the present value of the right to be repaid under the split-dollar agreement.

In contrast, two years ago, in the *Estate of Morrissette v. Commissioner*, 146 T.C. 171 (2016), the Tax Court upheld the general income and gift tax treatment of these types of split-dollar arrangements under the economic benefit regime of the split-dollar regulations. As a result, *Morrissette* had been seen as an indication that these split-dollar arrangements could be used both to reduce the value of a decedent's estate and increase estate liquidity. However, the court in that case did not directly address the estate tax treatment of these arrangements.

In *Cahill*, like in *Morrissette*, there is no definitive ruling as of yet, but the court refused to grant a summary judgment to the decedent's estate on these issues. When this matter proceeds to trial, this ruling will likely influence the ultimate disposition on this issue.

The estate may try to present a nontax purpose for the arrangement and could argue that the transaction was completed for full and adequate consideration. However, the court already appears to disagree with that position. Given the court's application of Internal Revenue Code §§ 2036, 2038 and 2703 in this matter, practitioners should be extremely wary of entering into these arrangements where the purpose is solely aimed at estate tax benefits.

Going a little deeper, this case started out with somewhat bad facts. The decedent, Richard Cahill, died in 2011. In 2010, when he was 90 years old and unable to manage his affairs, his son and attorney-in-fact, Patrick, entered into three separate split-dollar agreements, as trustee of Richard's revocable trust (known as the "Survivor Trust").

These agreements were entered into with the "MB Trust," an irrevocable trust that Patrick, as Richard's attorney-in-fact, had settled for the benefit of himself and his descendants, naming his son William, as trustee. The purpose for these agreements was to fund three separate whole-life insurance policies on the lives of Patrick and his wife held under the MB Trust. Under the terms of each of these agreements, the Survivor Trust promised to pay the premiums on these policies (using a $10 million loan from Northern Trust to do so).

Each split-dollar agreement provided that, upon the death of the insured, the Survivor Trust would receive a portion of the death benefit equal to the greatest of (1) any remaining balance on the loan as relates to the relevant policy, (2) the total premiums paid by the Survivor Trust with respect to that policy or (3) the cash surrender value of the policy immediately before the insured's death. The MB Trust would retain any excess of the death benefit over the amount paid to the Survivor Trust.

In addition, each split-dollar agreement also provided that it could be terminated during the insured's life by written agreement between the trustees of the Survivor Trust and MB Trust. If any one of the split-dollar agreements were terminated during the insured's life, the MB Trust could opt to retain the policy. In that the case the MB Trust would be obligated to pay to the Survivor Trust the greater of (1) the total premiums that the Survivor Trust had paid on the policy or (2) the policy's cash surrender value. If the MB Trust did not opt to retain the policy, it would be required to transfer its interest in the policy to Northern Trust. In that case, the Survivor Trust would be entitled to any excess of the cash surrender value over the outstanding loan balance with respect to the policy.

As of Richard's date of death, the aggregate cash surrender value of the policies was $9,611,624. The estate tax return filed by Patrick as executor reported the total value of decedent's interests in the split-dollar agreements as $183,700. The IRS issued the estate a notice of deficiency adjusting the total value of decedent's rights in the split-dollar agreements from $183,700 to $9,611,624, the aggregate cash surrender value of the policies as of Richard's date of death.

The IRS cited §§ 2036(a)(2), 2038(a)(1), and 2703(a)(1) and (2) in making this adjustment, zeroing in specifically on the rights held by the Survivor Trust to terminate the agreements. The estate filed a motion for partial summary judgment alleging that §§ 2036, 2038 and 2703 do not apply and that Treas. Reg. § 1.61-22 instead does apply in valuing Richard's interests in these arrangements.

The estate's motion for summary judgment was denied for various reasons. First, the estate argued that §§ 2036(a)(2) and 2038(a)(1) did not apply because the Survivor Trust did not have the sole right to terminate the agreements, but, rather, was dependent upon the MB Trust also electing to terminate them. However, the court rejected these propositions, noting that the words "in conjunction with any person" in § 2036(a)(2), and "in conjunction with any other person" in § 2038(a)(1), clearly defeat this position. The court relied in part on the recent case, *Powell v. Commissioner*, in making its decision. *Powell* applied § 2036(a)(2) to a decedent's contribution to a partnership in return for a limited partnership interest because all of the partners could agree to terminate the partnership.

The estate also relied on the exceptions under § 2036(a) and § 2038(a)(1) of a "bona fide sale for an adequate and full consideration in money or money's worth" to contend that neither section applies because Richard's transfer of $10 million was part of a bona fide sale for adequate and full consideration. However, the court agreed with the IRS's response that Patrick essentially stood on both sides of the agreements and that the transactions were therefore not bona fide sales resulting from arm's-length transactions.

In arguing against the applicability of § 2703, the estate contended that the IRS was improperly treating the policies themselves as the decedent's "property," and that restrictions on being able to access the policy values should be ignored under § 2703. Instead, the estate argued that only the bundle of rights under the agreements should be considered the decedent's "property," and that any restrictions are merely inherent in that bundle of rights.

The IRS, however, responded that by "viewing the property interests owned by decedent in light of all relevant facts and circumstances, including the split dollar agreements," and that the "contractual rights to an amount at least equal to the cash surrender value …

were held by decedent through the split dollar agreements … and more restricted because the agreements also allowed the MB Trust to prevent the decedent's immediate access to that amount."

The court reasoned "that the parties agree that the relevant property interests for purposes of section 2703(a) are the rights held under the split dollar agreements," and that the "decedent did in fact own the termination rights," so the estate's position was ill founded. Therefore, the court proceeded with an analysis of whether § 2703(a) applied to those rights.

As such, the court rejected the estate's arguments that §§ 2703(a)(1) and (2) were not applicable, and that § 2703(a) does apply in the form of disregarding the MB Trust's ability to prevent an early termination of the agreement on the basis that (1) because "the split dollar agreements, and specifically the provisions that prevent decedent from immediately withdrawing his investment, are agreements to acquire or use property at a price less than fair market value," the MB Trust paid basically nothing and essentially received the right to the full death benefits under the policies, (2) the decedent's ability to use his termination rights was significantly limited under the split-dollar agreements, as provided for in §§ 2703(a)(2), and (3) the Survivor Trust's rights extended not just to the split-dollar agreements, but rather to the underlying insurance policy values.

Finally, the court rejected the argument that Treas. Reg. § 1.61-22 instead applies because this regulation applies to gift tax, not estate tax, differentiating this ruling from that in *Morrissette*.

Florida Introduces New Decanting Statute Expanding Powers to Decant
Florida Statutes Section 736.04117

Until recently, Florida's decanting statute (Fla. Stat. 736.04117) only allowed decants of trusts where the trustees had an absolute power to invade the principal of a trust. The statute has been updated to now allow trustees to decant pursuant to a power to distribute that is not an absolute power (i.e., pursuant to a power to distribute that is limited by an ascertainable standard), analogous to the power to decant trusts subject to an ascertainable standard under New York law.

For trustees that have absolute power to invade principal, the beneficiaries of the second trust may only include beneficiaries of the first trust and may not reduce any vested interests. Powers of appointment may be retained, omitted (unless current), or created. If a power of appointment is created, the class of permissible appointees may be different from any class identified in the first trust. Accordingly, a power could be created to add a permissible appointee.

For trustees that are limited to an ascertainable standard, the interests of each beneficiary of the first trust must, in the aggregate, be substantially similar to such beneficiary's interests in the second trust. Any powers of appointment must be retained from the first trust to the second trust and the class of permissible appointees must be the same. New powers of appointment may not be granted. Notwithstanding the foregoing, to the extent that the term of the second trust extends beyond the term of the first trust, the

second trust may grant absolute powers to invade principal and may create or expand powers of appointment.

Some additional notes: a trustee can now decant the principal of a trust to a supplemental needs trust if the beneficiary has a disability, without regard to whether the trustee has an absolute power to invade principal. Other than the changes to the interests of the disabled beneficiary, the interests of the beneficiaries in the second trust must be substantially similar to their interests in the first trust.

Other general provisions of the statute include the option to make the second trust a grantor trust, the requirement that the second trust not extend beyond the perpetuities period that applied to the first trust, restrictions on increases to trustee compensation, and reductions to fiduciary liability standards. Notice must be given to all qualified beneficiaries of the first trust, all trustees of the first trust, and any person who has the power to remove or replace the trustee doing the decant.

In the past, we've contemplated the use of New York decanting laws whenever we've had Florida trusts that were limited to ascertainable standards. Most often, this meant a change of situs and addition of a New York trustee, followed by a decant under New York's decanting statute. Given this statutory change, this should no longer be necessary.

South County Courthouse in Palm Beach County, Florida Now Requires Restricted Depositories to Be Opened in Connection with Administration of Estates

In another issue that primarily relates to Florida but which may impact clients from any office, there has been a recent change to estate administration rules here in Palm Beach County. Specifically, all estates administered in the South County Courthouse only (for now) are now required to have restricted depositories in lieu of a bond or other alternative.

The two other courthouses in Palm Beach County are not currently imposing this requirement, though they may very well follow suit. This is relevant because the 15th Circuit, which covers Palm Beach County, directs that cases brought by counsel local to Palm Beach County are assigned to courthouses based upon the firm's geographical location, and our main office's location dictates that these cases go to the South County Courthouse. However, we do have a satellite office whose address gives us access to North County Courthouse, which is not yet imposing this restriction.

Courts are sometimes willing to allow for a case to proceed in a different courthouse, but this is subject to the judge's discretion and can't be counted on in the face of an established rule. However, because we have an office in the geographical area that dictates assignment to the North County Courthouse, we may be able to use this address instead to avoid this requirement, at least for now.

This is not a popular change, but the judges have expressed an unwillingness to change their stance in this regard. It's worth noting though that restricted depositories have been the norm for some time for estates administered in other nearby counties, especially Miami-Dade County.

As such, all cash and related assets will be required to be deposited into a restricted account. In addition, all proceeds from sales of estate assets also must be deposited in such an account. Additionally, consent of the court will be required for each action involving the assets held in these accounts. This includes payments to creditors and routine expenses of administration.

Decedent's Section 457(b) Deferred Compensation Plan, which Was Initially Paid Out to His Estate, Was allowed to Be Rolled Over by Surviving Spouse PLR201821008

In PLR 201821008, the IRS ruled that a decedent's deferred compensation plan under § 457(b) which was initially distributed to his estate could be rolled over by his surviving spouse, who was also the executor and sole beneficiary of his estate.

Generally, the spousal rollover rules under § 402(c)(9) that apply to qualified plans also apply to distributions from § 457 plans, including the rules that govern whether a surviving spouse may roll over a distribution into his or her own plan. Importantly, the IRS reached similar conclusions where an IRA was unintentionally made payable to the decedent's estate rather than his surviving spouse (PLR 201212021), and where a § 401(k) plan was funneled to a surviving spouse through a marital trust, where the surviving spouse was the sole trustor, trustee with absolute discretion, and beneficiary of the trust (PLR 201523019).

Here, the decedent had participated in an eligible § 457 deferred compensation plan. He died before reaching age 70 ½ and had failed to designate a beneficiary. The plan proceeds were then distributed to his estate. The surviving spouse distributed the remaining amount, after taxes, to herself in an IRA within 60 days of the initial distribution.

In the PLR, the IRS concluded that because the surviving spouse was the sole beneficiary and executor of the estate, she could be treated as having received the distribution directly from the plan, making it eligible to be rolled into her IRA. In addition, she was not required to include the rolled-over amount in her gross income because the transfer was timely made.

Proposed Section 199A Regulations Include Anti-Abuse Rules under Section 643(f)

The IRS and the U.S. Department of the Treasury issued proposed regulations on the 20% pass-through deduction under § 199A. Of particular note, these regulations include anti-abuse rules under § 643(f) aimed at preventing taxpayers from establishing multiple non-grantor trusts or contributing additional capital to multiple existing non-grantor trusts in an attempt to avoid income tax liability, including abuse of § 199A.

Changes to H.R. Bill 6068 Removes National Registry of U.S. Entity Ownership

House of Representatives Bill 6068 originally was introduced on the House floor in November of 2017 as the Counter Terrorism and Illicit Finance Act ("CTIFA"). It was intended, in part, to establish a national registry of beneficial ownership of all U.S. legal entities, corporations and LLCs to be administered by the U.S. Treasury's Financial Crimes and Enforcement Network (FinCEN), which is known primarily for monitoring U.S. investment in foreign banks and entities.

However, representatives recently amended the bill by deleting all of its transparency requirements. Instead, the new version of the bill merely requires the U.S. Comptroller General to submit a report evaluating the effectiveness of the collection of beneficial ownership information under the Customer Due Diligence regulation, as well as the regulatory burden and cost imposed on financial institutions subject to it.

House Ways and Means Committee Releases Tax Bills, Including One to Make Tax Cuts and Jobs Act of 2018 Permanent

The House Ways and Means Committee has released three tax bills, including H.R. 6760, which would make many of the provisions of the Tax Cuts and Jobs Act of 2018 permanent. These provisions include:

(1) Estate and Gift Tax Exemption Amounts;

(2) Current Individual Ordinary Income Rates;

(3) Changes to Itemized Deductions, including increased limitation on charitable contributions, limitation on deductions for qualified residence interests, termination of deductions with a 2% of adjusted gross income floor and limitation on deductions for state and local taxes; and

(4) 20% cap on income earned through pass-through entities.

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.

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