Wealth Management Update

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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.

Supreme Court Ruling in *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 588 U.S. [TBD] and its Relevance to Income Taxation of Accumulated Income in California Trusts

The Supreme Court ruled unanimously on June 21, 2019, that a trust beneficiary's residence in a State, standing alone, is not sufficient for that State to impose income tax on that trust. While this case is important for residents of North Carolina and for a small number of other States that rely on state residency of beneficiaries without regard to whether the beneficiary is certain to receive trust assets to impose taxation, it will likely have no immediate impact on California trust taxation because California currently imposes its tax only if the relevant trust beneficiary is "non-contingent."

Facts and Holding

The relevant trust was created by a New York settlor and had a New York resident trustee. The trustee had "absolute discretion" to distribute trust assets to the beneficiaries "in such amounts and proportions" as the trustee might "from time to time" decide. The trust distributed outright to the settlor's children when they attained age 40. The trust was subject to New York law and its assets were custodied in Massachusetts. It had no real property in North Carolina and there were no direct investments in it. One beneficiary (a child of the Settlor) and her children moved to North Carolina in 1997. At issue was North Carolina's right to tax undistributed trust income from 2005 to 2008.

North Carolina taxes any trust income that "is for the benefit of" a state resident. But to satisfy the Due Process Clause of the U.S. Constitution, there must be "minimum contacts" between the State and the person, property or transaction it seeks to tax. In determining that beneficiary residence did not establish "minimum contacts," the Court "focused on the extent of the in-state beneficiary's right to control, possess, enjoy or receive trust assets." The only connection this trust had with North Carolina was a beneficiary's residence. The Court held: "…the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain ever to receive it." Because the Court found that: (a) the beneficiaries did not receive any income from the trust in the years at issue; (b) the beneficiaries had no right to demand trust income or otherwise control, possess or enjoy the trust assets in the years at issue; (c) the trustees, not the beneficiaries, had the right to make trust investments; and (d) the beneficiaries were prohibited from assigning to another person any right they might have to the trust property, there were not sufficient minimum contacts to satisfy the Due Process Clause requirements.

Relevance to California

California law provides for taxation of trust income if (a) there is a California trustee, or (b) the trust has non-contingent beneficiaries resident in California. The Court stated specifically that its decision "does not address state laws that consider the in-state residency of a beneficiary as one of a combination of factors, that turn on the residency of the settlor, or that rely on the residency of noncontingent beneficiaries."

The key takeaways follow: First, this case is only relevant to non-grantor trusts. If a trust is a grantor trust, the trust income flows through to the grantor's tax return and is taxed in the State of his or her residency. Second, it only applies to undistributed trust income. Distributed income generally is taxed by the recipients' State of residence. Third, California can always tax California source income (as well as income distributed to a resident beneficiary). Fourth, if a trustee is resident in the State that qualifies as sufficient minimum contacts to allow taxation. Fifth, we know now that if the only nexus for taxation is residence of a contingent beneficiary in the State that is not enough. Sixth, California does not impose state income tax on accumulated trust income if the rights of California beneficiaries are "contingent" only (North Carolina's statute is much broader than California's and it sought to tax trusts which had *only* contingent beneficiaries). Thus, this ruling will likely have no immediate impact on California taxation of trusts.

Future Questions

In a concurring opinion, three Justices joining the majority indicated that residency of the beneficiary should never be a determining factor as to whether a State can tax undistributed trust income. In their view, even if the beneficiaries are non-contingent, a State still could not tax undistributed income until it was actually distributed. It remains to be seen if there are any future challenges to similar state laws. If the views of the concurring trio are adopted by a future majority, California would not be able to tax undistributed trust income based on even non-contingent beneficiary residency.

July 2019 Interest Rates for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split Interest Charitable Trusts

Important federal interest rates continue dropped for July 2019. 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 2.08%, down from 2.38% in June.

The July Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.6%, down from 2.8% in June.

The AFRs (based on annual compounding) used in connection with intra-family loans are 2.13% for loans with a term of 3 years or less, 2.08% for loans with a term between 3 and 9 years, and 2.50% for loans with a term of longer than 9 years. With the mid-term rate now *less than* the short-term rate, clients will likely prefer the mid-term rate in their estate planning transactions.

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 2.08%, the child will be able to keep any returns over 2.08%. These same rates are used in connection with sales to defective grantor trusts.

The AFRs for July 2018 were 2.38%, 2.87%, and 3.06%, respectively. Thus, rates have not risen as was rumored in late 2018.

Blau et al. v. Commissioner of Internal Revenue, No. 17-1266 (May 24, 2019)

The U.S. Circuit Court of Appeals for the District of Columbia Circuit has ruled that a taxpayer's failure to report its basis in donated assets means failure to "substantially comply" with the reporting requirements for charitable contributions. For the taxpayer at issue, this meant the total rejection of its claim for a charitable deduction and the assessment of heavy penalties.

On February 7, 2002, RS Hawthorne, LLC ("Hawthorne") purchased a web-hosting facility in Hawthorne, California (the "Property") for $42,350,000. Hawthorne was wholly owned by RS Hawthorne Holdings, LLC ("Holdings"), which, in turn, was wholly owned by Red Sea Tech I, Inc. ("Red Sea"). The Property was leased to AT&T for 15.5 years, ending in May 2016. AT&T also held options to renew the lease up to three times, for five years at a time. Hawthorne financed the purchase with a loan. In connection with the loan, the bank had the Property appraised. The value was $47,000,000 as of August 16, 2001.

Also on February 7, 2002, Red Sea divided its member interest in Holdings into (a) a term of years interest lasting until December 31, 2020 and (b) a remainder interest. Red Sea then sold the remainder interest to RJS Realty Corporation ("RJS") for $1,610,000.

In March 2002, RERI Holdings I, LLC ("RERI") purchased the remainder interest from RJS for $2,950,000.

In August 2003, a donor and member of RERI, pledged a $4,000,000 gift to the University of Michigan (the "University"), later increasing it to $5,000,000. RERI then assigned the remainder interest to the University pursuant to an agreement that provided that the University "shall hold the Remainder Estate for a minimum of two years, after which the University shall sell the Remainder Estate in a manner and to a buyer of its choosing."

In December 2005, the University sold the remainder interest to HRK Real Estate Holdings, LLC for $1,940,000, although it had the property appraised at $6,500,000 earlier in 2005. The sale proceeds were credited to Ross's pledge.

RERI claimed a charitable contribution deduction on its 2003 federal income tax return in the amount of $32,935,000 for the remainder interest donation. This valuation came from an appraisal performed in September 2003 by Greenwich Realty Advisors. RERI attached the appraisal to its return and completed Form 8283 for Non-Cash Charitable Contributions; however, RERI left blank the space for "Donor's cost or adjusted basis." RERI also did not provide an explanation for the omission.

In March 2008, the IRS audited RERI's 2003 return and issued a Notice of Final Partnership Administrative Adjustment to RERI. It disallowed $29,000,000 of the charitable deduction, based upon its finding that the remainder interest was worth only $3,900,000. The IRS also imposed a 20% penalty for a substantial valuation misstatement.

In April 2008, RERI filed a petition in the Tax Court challenging the FPAA. In its answer, the IRS revised its determinations, asserting RERI was entitled to no deduction for a charitable contribution on the ground that the transaction giving rise to the deduction was "a sham for tax purposes or lacks economic substance." It argued in the alternative that the deduction should be limited to $1,940,000, the amount the University had realized from the sale of the SMI. Finally, the IRS claimed the valuation misstatement was "gross" rather than merely "substantial," triggering a penalty equal to 40% of the tax underpayment.

After a four-day trial, the Tax Court ruled in favor of the IRS, holding that (a) RERI was not entitled to any charitable contribution because it failed to substantiate the value of the donated property, (b) the gross misstatement penalty of 40% was appropriate, and (c) RERI did not qualify for a reasonable-cause exception to accuracy related penalties.

On appeal, the U.S. Court of Appeals for the District of Columbia Circuit affirmed the Tax Court decision. The D.C. Circuit held that "RERI failed substantially to comply [with the requirements under Treas. Reg. § 1.170A-13] because it did not disclose its basis in the donated property."

RERI argued that its basis in the remainder interest was not necessary to evaluate its charitable contribution because the deductible amount was the fair market value of the donated property. The D.C. Circuit stated, to the contrary, that:

RERI fails to recognize that the purpose of the substantiation requirements is not merely to collect the information necessary to compute the value of donated property. The requirements have the broader purposes of assisting the IRS in detecting and deterring inflated valuations. Because the cost or other basis in property typically corresponds with its FMV at the time the taxpayer acquired it, an unusually large difference between the claimed deduction and the basis alerts the IRS to a potential over-valuation, particularly if the acquisition date, which must also be reported, is not much earlier than the date of the donation.

Given the disparity between the amount RERI paid for the remainder interest ($3M) and the charitable contribution deduction claimed ($33M), the basis was particularly important to alert the IRS as to an overvaluation. The D.C. Circuit, therefore, affirmed the Tax Court's decision to disallow the charitable contribution deduction attributable to the remainder interest.

The D.C. Circuit also upheld the IRS's assessment of penalties and rejected RERI's claim for the reasonable-cause exception to accuracy-related penalties.

An Update Regarding Connecticut's Uniform Trust Code

Connecticut is on the verge of enacting its version of the Uniform Trust Code. On June 5, 2019, the Connecticut Senate passed HB 7104 (36 to 0), entitled "An Act Concerning Adoption of the Connecticut Uniform Trust Code" (the "Act"). The Act passed in the Connecticut House of Representatives (133 to 0) on May 20, 2019. Governor Ned Lamont signed the Act in to law on June 26, 2019.

The Act is generally effective January 1, 2020, though it applies to trusts created before, on, or after that date. Some notable additions to Connecticut's trust laws would be provisions allowing for the creation of "directed trusts" (Sections 81-98), self-settled asset protection trusts (Sections 99-108), and an 800-year wait-and-see period for Connecticut's rule against perpetuities. Notably missing from the Connecticut UTC is a provision for trust decanting.

Indiana Allows for Domestic Asset Protection Trusts

On May 5, 2019, Indiana enacted SB 265, which provides for the creation of "legacy trusts"—Indiana's term for domestic asset protection trusts. In general, SB 265 provides for a two-year statute of limitations on claims against qualifying transfers to legacy trusts.

The states allowing for the creation of domestic asset protection trusts now include Alaska, Connecticut (Pending, HB 7104), Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.

PLRs 201919002 and 201919003 – IRC Section 2042

Settlor created an irrevocable trust (the "Trust") for his child ("Child 1") and Child 1's descendants. Child 1 was appointed trustee of the Trust. Child 1, as Trustee, had discretion to distribute net income and principal to Child and Child's descendants under a HEMS standard. Child 1 held a limited testamentary power of appointment over the remaining Trust assets, exercisable in favor of Child 1's descendants.

Section 2042(2) of the Internal Revenue Code states that the gross estate includes the value of all property "[t]o the extent of the amount receivable by all other beneficiaries [other than the decedent's executor] as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person."

The Trust agreement provided that the "Settlor does not intend that the Trustee have any power over trust property that, if held by the Trustee in a fiduciary capacity, would result in inclusion of trust assets in the estate of the Trustee for federal estate tax purposes." The Trust agreement further provided that "a Special Co-Trustee shall be appointed if a trust governed under this agreement owns or otherwise possesses any incidents of ownership over any life insurance policies on the life of the primary Trustee within the meaning of § 2042."

Child 1, as Trustee, proposed to purchase a life insurance policy on the joint lives of Child 1 and Child 1's Spouse. This would have created a risk that the value of the policy would be included in Child 1's federal gross estate, absent further action, because, as Trustee, Child 1 would hold all ownership powers in the policy.

Child 1 petitioned a state court to modify the terms of the Trust (1) to remove Child 1's power of appointment over any life insurance policy on Child 1's life or the proceeds of any such policy, (2) to add an Insurance Trustee who alone will have all powers of the Trustee with respect to any policy insuring Child 1's life, and (3) to require that premium payments on policies insuring Child 1's life be made from the Trust's principal. The court approved the modification.

The Settlor's other child ("Child 2") was appointed as the initial Insurance Trustee. Child 1 retained the power to appoint, remove, and replace Insurance Trustees, other than a related or subordinate person within the meaning of IRC Section 672(c).

Child 1, as Trustee, sought a ruling that a policy insuring Child 1's life and owned by the Trust, as modified, would not be included in Child 1's federal gross estate. Child 1 stipulated that Child 1 had not, and would not, make contributions to the Trust. The IRS ruled that any policy insuring Child 1's life that is owned by the Trust would not be included in Child 1's federal gross estate. The IRS stated that its ruling assumes that "Child 1 is not serving as Insurance Trustee at the time of Child 1's death" and that the Trust is not modified such that "Child 1 regains fiduciary powers over life insurance on Child 1's life."

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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