Proskauer

Wealth Management Update

November 2015

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

The November § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.0%, the same as October. The November 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 1.59%, down from 1.67% in October.

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

The AFRs (based on annual compounding) used in connection with intra-family loans are 0.49% for loans with a term of 3 years or less, 1.59% for loans with a term between 3 and 9 years, and 2.79% 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 1.59%, the child will be able to keep any returns over 1.59%. These same rates are used in connection with sales to defective grantor trusts.

2016 Annual Gift Exclusion

For 2016, the first $14,000 of gifts a taxpayer makes to any particular individual are not subject to gift tax. This "annual gift exclusion" amount is unchanged from 2015.

2016 Gift and Estate Tax Exemption Amount

For 2016, each taxpayer's unified gift and estate tax exemption amount is $5,450,000, a $20,000 increase from last year's exemption amount of $5,430,000.

This amount represents the maximum aggregate amount that a taxpayer may gift during his or her lifetime or bequeath at his or her death without the imposition of any federal gift or estate taxes.

Tax Court Upholds Valuation Discount on "Net Net Gift" (*Steinberg v. Commissioner*, 145 T.C. No. 7 (September 16, 2015))

Plaintiff, Jean Steinberg, was the beneficiary of a marital trust created under the Will of her deceased husband. The trust was a "QTIP" trust (short for "Qualified Terminable interest Property"), meaning the assets used to fund the trust were not subject to federal estate tax at the death of Ms. Steinberg's husband, but will be subject to federal estate tax at her death. Under the terms of the QTIP, at her death the remaining trust assets were to be distributed to Ms. Steinberg's four daughters.

In 2007, when the assets in the marital trust had a value of approximately $123 million, Ms. Steinberg entered into a written agreement with her daughters, whereby she agreed to terminate the trust and distribute approximately $109 million of trust principal outright to her daughters. Even though these distributions were subject to federal gift tax, they had the potential to minimize the family's total transfer taxes since (a) New York would impose a state estate tax on the trust's assets at Ms. Steinberg's death but does not impose a gift tax on lifetime transfers and (b) the cash used to pay the gift tax is removed from Ms. Steinberg's estate and will not be subject to estate tax at her death.

In exchange for the early termination of the trust, Ms. Steinberg's daughters agreed to use the funds they received, in part, to pay Ms. Steinberg's $32 million federal gift tax liability with respect to the transfers.

In addition, they agreed to pay any estate taxes at Ms. Steinberg's death attributable to the gift tax payable on the current transfers. Estate tax could be due, since Section 2035(b) of the Code provides that any gift tax paid by a decedent within three years before her death is included in the donor's estate (although the property actually gifted is not). In Ms. Steinberg's case, if she survived for at least three years after the date of the gift, no estate taxes would be imposed at all with respect to the transfers to her daughters. However, if she died within that three-year period her estate would owe approximately $17 million of additional estate tax (i.e., the $32 million in gift tax previously paid, multiplied by a maximum aggregated federal and state estate tax rate of 53.8%, assuming Ms. Steinberg were to have died in 2008).

Because the daughters took the transferred assets subject to these two obligations, the gifts are referred to as a "net net gifts," and the reportable value of the gifts must be reduced accordingly.

Ms. Steinberg filed a 2007 federal gift tax return reporting aggregate gifts to her daughters of approximately $71.5 million, representing (1) the $109 million of assets actually transferred, (2) reduced by $32 million of gift tax paid by daughters, then (3) further reduced by $5.8 million, representing a professional appraiser's determination of the value of the daughters' Section 2035(b) payment obligation (in other words, the value to Ms. Steinberg of her daughters' promise to pay any estate tax attributable to the transfers if Ms. Steinberg died within three years).

The IRS challenged the reduction of the gift value attributable to the 2503(b) obligation, rejecting the technical methodology used by Ms. Steinberg's appraiser. However, the IRS did not engage its own appraiser or present an alternative appraisal to the court.

The court rejected the arguments of the IRS, concluding that the obligations taken on by the daughters in exchange for the gift should be valued just as the obligations would be in the context of an arm's-length transaction between a hypothetical willing buyer and willing seller, noting the lengthy negotiations involved in formulating the agreement between Ms. Steinberg and her daughters, and that each side was represented by separate counsel.

This case confirms that a valuation discount should apply where a donee assumes the potential liability of estate tax under 2503(b), provided that the donor and the donee enter into a bona fide negotiation as to the terms under which the gift will be made, and that a professional appraiser is engaged to value the donee's obligation. Anyone considering making a substantial lifetime gift that will give rise to gift tax should thus consider the advantages of structuring the transfer as a "net net gift."

IRS Memorandum Illustrates Importance of Adequately Describing and Valuing Reportable Gifts (Legal Advice Issued by Field Attorneys 201522001F (March 13, 2015))

Under Section 6501 of the Code, if a taxpayer files a gift tax return that adequately describes a gift and the manner in which it was valued, the IRS will generally only have a three-year statute of limitations period within which to challenge the reported value of the gift.

In a legal memorandum in September, an IRS attorney analyzed whether certain gifts reported by a taxpayer on a gift tax return had met the adequate disclosure requirements under Section 6501, as part of a determination of whether the IRS could challenge the value of the gifts after the three-year limitations period had passed.

Taxpayer gave his daughter minority interests in two partnerships that held farmland. Taxpayer apparently had the farmland professionally appraised, and also may have obtained some sort of appraisal of the partnerships, for purposes of determining the reportable value of the gifted interests.

However, neither the farmland appraisal nor any partnership appraisals were attached to the gift tax return reporting the gifts. Instead, a one-paragraph statement was attached to the return, which stated that the farmland had been independently appraised by a certified appraiser and that a valuation discount was being applied for lack of marketability and because only minority partnership interests were being transferred. The percentage discount was presented as an aggregate number, with no indication of what portion thereof was attributable to the lack of marketability and what portion was attributable to a minority interest.

Both partnerships were referred to on the return by abbreviated names, rather than their full legal names, and the names also omitted any sort of designation indicating what type of entity was involved (i.e., "L.P." or "L.L.P."). The return showed the correct nine-digit federal tax identification number ("EIN") for one partnership, but for the other partnership provided only eight of the nine digits of the EIN.

The IRS memorandum first analyzes whether the return provided an adequate description of the transferred interests. For the partnership for which a complete EIN was provided, the IRS attorney concluded that the gifted interest likely was adequately described, since the IRS could use the EIN to search its database for the correct legal name of the partnership. However, the IRS had no means of identifying the other partnership, for which taxpayer had provided neither the correct name nor the correct EIN.

The memorandum then tackles the issue of whether the return as filed provided a sufficiently detailed description of the methods used to determine the reportable fair market value of the gifted partnership interests. Here the return clearly fails with respect to both partnerships, since only a conclusory statement of value was provided, without any explanation of the method used to determine the value of the farmland or any explanation of how the valuation discounts were calculated (or any breakdown of what the specific discount percentages were for the different discount types). The memorandum concludes that since there was no adequate description of the valuation method for either partnership, the filing of the gift tax return did not commence the statute of limitations period.

The memorandum is a reminder of the importance of providing detailed descriptions of any gifted interests on a gift tax return. If there is no readily available market value for the gifted interest, a professional appraisal generally *must* be attached to the return. If the appraisal relies on a separate appraisal of an underlying asset (for instance, the farmland held in the taxpayer's partnerships), that underlying appraisal also must be attached. The correct names, addresses and taxpayer identification numbers of all donees must be reported in detail, along with a description of the donee's relationship to the donor. Failing these disclosure requirements in any particular opens the door for the IRS to argue that no statute of limitation applies to the reported gifts.

Massachusetts Appeals Court Includes Irrevocable Trust for Husband in Division of Assets in Divorce (*Pfannenstiehl v. Pfannenstiehl*, Nos. 13-P-906, 13-P-686 & 13-P-1385 (Mass. App. Ct. Aug. 27, 2015))

In most states, including New York, the general rule is that when dividing property between divorcing spouses, any irrevocable trusts for the benefit of a spouse (unless created by the spouse for his or her own benefit) are excluded from consideration. However, in some jurisdictions, such as Massachusetts, courts can take these trusts into account when determining how marital assets should be divided.

In *Pfannenstiehl*, the Massachusetts Appeals Court upheld the Probate and Family Court's determination that a portion of an irrevocable trust of which the husband was a beneficiary should be included in the marital estate. The trust was a "sprinkle" trust created by the husband's father for the benefit of all of the father's descendants. The Trustees were empowered to distribute income and principal to any descendant (even to the exclusion of the other beneficiaries) as they deemed advisable to provide for his or her comfortable support, health, maintenance, welfare and education. The Trustees had been using this power to make monthly distributions to the husband (and his siblings), although the distributions to the husband immediately stopped once an action for divorce was filed.

Because the trust was subject to an "ascertainable," rather than a fully discretionary, distribution standard, the Probate and Family Court concluded that the husband had a present enforceable right to distributions from the trust. Because the husband could take the Trustees to court to compel distributions for his health, maintenance and support, the value of the husband's interest in the trust could be quantified in terms of a dollar amount (and thus factored into the division of marital assets). The history of monthly distributions to the husband also helped to quantify what amounts would be necessary for his support.

If the trust had instead been fully discretionary (i.e., if the Trustees had been empowered to make distributions to any beneficiary for any reason), likely the trust would not have been included in the marital estate, since the husband's interest in the trust would be impossible to value.

At the time of divorce, the total value of the trust was approximately $25 million and the trust had eleven permissible beneficiaries, consisting of the Settlor's children and grandchildren. The Probate and Family Court determined, therefore, that the husband held a one-eleventh interest in the trust, and that the wife was entitled to half of that amount. The court did not have the authority to compel the Trustees to make distributions to the husband. However, it did issue an order directing the husband to make twenty-four monthly payments to wife of approximately $50,000 each, putting the burden on the husband to come up with the necessary funds.

The husband requested, by letter, that the Trustees make distributions to him so he could make the court-ordered monthly payments. The Trustees refused, likely concluding that the Settlor's intent was for trust assets to benefit his descendants, not the former spouses of his descendants. The lower court then found the husband in contempt for his failure to make the monthly payments (concluding that, taking the trust into account, he had sufficient assets to make the payments) and sentenced him to sixty days in jail.

On appeal, the Massachusetts Appeals Court upheld the lower court's determination that the trust's ascertainable distribution standard meant the husband's interest in the trust could be quantified, and thus that interest could be included in the marital estate. However, the court set aside the contempt judgment, noting that the husband had written the Trustees requesting a distribution, and that it had not been proved by clear and convincing evidence that he had made no attempts to secure funds for his wife and had thus violated a court order.

Although irrevocable trusts provide a great measure of protection against a beneficiary's divorcing spouse, *Pfannenstiehl* illustrates that there are still circumstances (and states) where a trust alone does not provide complete protection. For this reason, a prenuptial agreement (wherein each party waives his or her right over assets held in trust for the benefit of the other) is the best mechanism for determining that trust assets will not be a factor in the division of marital property.

To discuss any aspects of these cases or associated tax implications, please contact one of the lawyers in the Private Client Services Department at Proskauer.

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