

Wealth Management Update

May 2017

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

The May § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.4%, down 0.2% from April. The May 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 2.04%, down from 2.12% in April.

The relatively low § 7520 rate and AFR continue to present potentially rewarding opportunities to fund GRATs in May 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 1.15% for loans with a term of 3 years or less, 2.04% for loans with a term between 3 and 9 years, and 2.75% 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 2.04%, the child will be able to keep any returns over 2.04%. These same rates are used in connection with sales to defective grantor trusts.

Highest Court in Washington State Forces Estate To Include Federal Gift Taxes Paid by Decedent within 3 Years of Death for State Estate Tax Purposes

The Supreme Court of Washington, in a 5-4 decision, struck down a challenge to state estate taxes levied on \$5.5 million in federal gift taxes paid by media mogul (and one-time owner of the Seattle SuperSonics) Barry Ackerly within 3 years of death. The estate, which included the gift taxes on its federal estate tax return, argued for exclusion on the grounds that the state estate law definition of "transfers" (limited to transfers "of the Washington taxable estate") was narrower than the federal definition under the IRC. This argument was rejected as contrary to the Washington legislature's intent to "mirror" the federal rules; the majority decision noted that the relevant inquiry was whether the taxable estate as a whole, rather than its constituent parts, transferred upon death. The dissent asserted that no transfer occurred upon death with regard to the gift taxes paid during the decedent's life, so the only justification for inclusion would be if the gifts themselves were deemed testamentary transfers.

The IRS Privately Rules on Tax Effects of Trust Funded Pursuant to Divorce (P.L.R.s 201707007 and 201707008)

The IRS ruled on the tax effects of a divorcing husband's contribution of company shares to a trust created pursuant to a property settlement agreement. The divorcing wife was entitled to net trust income and principal subject to trustee discretion or under a limited annual withdrawal right, but the trustee was prohibited from distributing or selling the company shares. She lacked any powers of appointment, and the remaining principal at her death was to revert to her ex-husband or his estate.

The IRS ruled that:

1. Neither party would recognize gain or loss on the share contribution (deemed considered made for full and adequate consideration) or be treated as a donor;
2. IRC 2702(a) won't apply to determine whether the transfer of the term interest in the trust is a gift or for purposes of determining the transfer's value;
3. The fair market value of trust principal on the divorcing husband's death, reduced by the value of the divorcing wife's outstanding term interest, is includible in his gross estate; and
4. The divorcing wife's estate will only include the value of any unexercised withdrawal rights.

The IRS Privately Rules that Declaratory Judgment Resolving Trust Ambiguities Does Not Cause Adverse Transfer Tax Consequences (P.L.R.s 201707003, 201707004 and 201707005)

The IRS ruled that no adverse tax consequences, including loss of grandfathered GST exemption, would flow from a declaratory judgment proposed by the trustee to resolve ambiguities in the beneficial interests of a trust previously modified by settlement agreement. The original trust, settled before October 21, 1942 for the primary benefit of the settlors' son, was the subject of litigation surrounding improper withholding of trust income by the trustee. After the settlement (which the IRS previously ruled did not jeopardize the grandfathered exemption from generation-skipping transfer tax of the split trusts), the son disclaimed his general power of appointment and the granddaughter thereafter disclaimed an interest contingent on the son's release of his general power of appointment.

These disclaimers, when read alongside the trust instrument and the settlement agreement, made the beneficiary class after the son's death ambiguous. Because the declaratory judgment resolved a bona fide issue regarding proper interpretation of dispositive provisions, applied the applicable law of the highest court of the state and did not vary the beneficial interests of the beneficiaries, there were no negative generation-skipping tax or gift tax consequences from the declaratory judgment. Further, because the original trust was created before October 21, 1942, disclaimer by the son of his general power of appointment did not qualify as a taxable exercise. Finally, the granddaughter's disclaimer was deemed a qualified disclaimer because the "9-month window" began on the date of the son's disclaimer.

U.S. Tax Court Rejects Art Valuation Due to Appraiser's Conflict of Interest in *Estate of Kollsman v. Commissioner* (T.C. Memo. 2017-40, T.C., No. 26077-09, February 22, 2017)

The U.S. Tax Court found that the estate of a New York taxpayer had undervalued two paintings it inherited by \$1,770,000. The presiding judge ruled that the estate's expert was unreliable due to significant conflicts of interest. The paintings were first valued by Sotheby's "based on firsthand inspection" at \$500,000 and \$100,000, respectively. The \$500,000 painting was eventually consigned to Sotheby's and listed at \$2,400,000. The estate used the \$500,000 and \$100,000 valuations on the federal estate tax return. The IRS issued a deficiency notice, alleging values of \$2.1 million and \$500,000, respectively.

The IRS successfully argued that the Sotheby's valuation expert had direct financial incentive to curry favor with the executor by "lowballing" the values and also provided no comparables to support his valuations. The court ruled that the paintings would be valued at \$1,995,000 and \$375,000.

U.S. Court of Federal Claims Denies Foreign Gambler Income Tax Refund for U.S. Gambling Winnings in *McManus v. United States* (2017 BL 66227, Fed. Cl., No. 1:15-cv-00946, March 3, 2017)

The U.S. Court of Federal Claims rejected a creative treaty-based claim for refund on U.S. income taxes paid on \$17.4 million in U.S.-sourced gambling winnings earned over three days. The taxpayer, an Irish citizen living in Switzerland, sought a refund under the U.S.-Ireland treaty by arguing that his payment of Ireland's "domicile levy" made him an income tax resident of Ireland under the treaty. Ireland does not tax gambling winnings and the U.S.-Ireland treaty states that income types not described by the treaty, such as gambling winnings, are taxable only in the taxpayer's country of residence. Unfortunately for the taxpayer, the IRS obtained advice from Ireland's Office of the Revenue Commissions that the domicile levy was not an income tax covered by the treaty and that the taxpayer had not been subject to Irish income tax since 1995.

Taxpayer's Dog Plays Significant Role in New York's Division of Tax Appeals Domicile Ruling in Favor of Taxpayer in *In re Blatt*, N.Y. Tax App. Trib., N. 826504, February 2, 2017

New York's Division of Tax Appeals determined that the Chairman of Match.com changed his domicile from New York to Texas in no small part because he moved his dog. The taxpayer moved to New York in 1992 and unobjectionably remained a New York resident until 2009, when he accepted the CEO position at the Dallas-based Match.com (a subsidiary of his former New York-based employer, InterActiveCorp ("IAC")). After that point, the taxpayer listed his New York apartment for sale and began renting a one-bedroom apartment and a car in Dallas. He also executed an amended employment agreement that listed his principal place of employment as Dallas. He then joined a Dallas gym, began obtaining his prescriptions and medical care in Dallas, obtained a Texas driver's license and voter registration, moved his dog, and finally changed his address with the U.S. Postal Service and his various banks and credit card companies. In 2010, the taxpayer completed the sale of his New York apartment, but shortly thereafter accepted a position as successor to Barry Diller as CEO of IAC, which ultimately required him to move back to New York City in mid-2011. During the taxpayer's "Dallas years," he still owned a car and a boat in New York and spent his summers predominantly in the Hamptons. However, the court found that taxpayer's move of his dog, a "near and dear item," constituted his "ultimate change in domicile to Dallas." Finding that the taxpayer proved a change in domicile by clear and convincing evidence, the assessment for tax years 2009 and 2010 was expunged.

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