Proskauer

Wealth Management Update

September 2017

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

The September § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.4%, the same as in August. The September 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 1.93%, down slightly from 1.94% in August.

The relatively low § 7520 rate and AFRs continue to present potentially rewarding opportunities to fund GRATs in September 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 1.29% for loans with a term of 3 years or less, 1.93% for loans with a term between 3 and 9 years, and 2.58% 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 1.93%, the child will be able to keep any returns over 1.93%. These same rates are used in connection with sales to defective grantor trusts.

IRS rules that only one of two tests must be met to avoid sacrificing GST-exempt status in a decanting in PLR 201718014 (May 5, 2017)

In Rev. Proc. 2017-3 (January 3, 2017), the IRS declared it would not rule on whether a trustee decanting from an irrevocable GST-exempt trust to another irrevocable trust would result in a change of beneficial interests that sacrifices GST-exempt status or constitutes a taxable termination or taxable distribution under Section 2612. However, on March 17, 2017 the IRS published PLR 201711002, which stated that such a decanting did not sacrifice GST-exempt status. The IRS ruled similarly on May 5, 2017 in PLR 201718014, but in this ruling it provided additional guidance.

The grantor executed a trust agreement before September 25, 1985 that created four irrevocable trusts for each of the grantor's four children. The grantor's daughter and a bank were named as trustees and only the bank, as the disinterested trustee, had authority to make distributions. At some date after the grantor's death the bank decided to resign as trustee and so the trustees decided to decant the assets into a new trust that would have amended trustee resignation, removal and appointment provisions. The new trust also would authorize appointment of a trust protector who would have the power to modify or amend the terms of the trust to achieve more favorable tax status or take advantage of other new laws, though the trust protector would not be able to modify the trust in a way that would shift any beneficial interests in the assets. Aside from those changes, the new trust would be largely identical to the prior trust: it would have the same beneficiaries and distributive provisions, the same perpetuities period and the same restriction that only a disinterested trustee could make distributions.

The ruling states that to avoid sacrificing GST-exempt status when trustees decant a grandfathered GST trust into a new trust, the decanting must satisfy one of two tests. The Modification Test is found in Treas. Reg. § 26.2601-1(b)(4)(i)(D) and requires that (1) the decanting not shift a beneficial interest to a beneficiary occupying a lower generation than the person who holds that interest under the original trust; and (2) the decanting not extend the time for vesting of any beneficial interest in the trust beyond the period provided in the original trust. The Discretion Test, found in Treas. Reg. § 26.2601-1(b)(4)(i)(A), requires that (1) at the time the trust became irrevocable, distributions to a new trust were authorized either by the terms of the instrument itself or by local statutory or common law; (2) neither beneficiary consent nor court approval for decanting is required; and (3) the new trust not suspend or delay the vesting in an interest in the trust beyond the perpetuities period.

The IRS found that the decanting met the Modification Test because the only modifications were administrative in nature and did not shift beneficial interest to a lower generation, but that it did not meet the Discretion Test because the state statutory law permitting decanting was not in effect when the trust was executed and the trust instrument itself did not authorize a decanting.

Treasury issues guidance on estate tax lien and holding sales proceeds in escrow in SBSE-05-0417-0011 (April 5, 2017)

In June 2016 the Specialty Collection, Offers, Liens and Advisory Office took over the investigation and management of requests for discharge of the estate tax lien and began requiring that all net proceeds from sales of decedents' houses be held in an escrow account before discharge. On April 5, 2017, the Treasury issued guidance in SBSE-05-0417-0011 to employees in the Office, informing them that there are circumstances in which an estate may be entitled to discharge of the estate tax lien without escrow.

Section 6324 provides that a federal estate tax lien comes into existence on the day someone dies, attaching to all assets of the decedent's gross estate that are reported on a Form 706. The purpose of the estate tax lien discharge is not to evidence payment or satisfaction of the estate tax, but rather to permit the transfer of property free from the lien in case it is necessary to clear title during an estate sale. As a general matter, the IRS always has discretion to determine whether sales proceeds should be held in escrow. If the proceeds are in escrow, a discharge of the lien may be issued. The difficulty is that it can take months or years to receive a closing letter evidencing discharge of the lien, which may hamper efforts to conjure up estate liquidity. To combat this, estate attorneys sometimes draft informal affidavits attesting that all estate debts have been paid and agreeing to indemnify against failure to pay the full estate tax that is due. Buyers often deem this sufficient to clear title on the sale. However, title companies and managing agents of co-op boards sometimes refuse to accept these affidavits and instead require receipt of either estate closing letters or formal discharges of the estate tax lien.

The Treasury's guidance highlights that the primary focus in determining whether to grant the discharge is whether the government's interest is adequately secured. There is only one circumstance in which there can be no discharge of the lien without escrow: if the estimated estate tax liability is greater than the net sales proceeds, and the full estate tax has not been paid, the proceeds must be held in an escrow account. There are several circumstances, however, in which an estate may be entitled to discharge of the lien without escrow: (1) where no estate tax will be due; (2) where the estate tax return has been filed and the reported tax has been paid; (3) where the estate has paid the full estimated tax liability at the nine-month due date and filed for the automatic six-month extension to file the return; (4) where the IRS has determined an adequate amount has been paid in partial satisfaction of the tax due; and (5) where (i) the fair market value of the property is worth at least twice as much as the estimated tax liability and (ii) other

liens on the property have priority over the estate tax lien.

From this guidance it is possible to glean a few rules of thumb. If the estate pays all sales proceeds over to the IRS before the estate tax payment is due, and the proceeds or other assets cover the amount of the estate tax, no escrow agent will be needed. If the decedent's house is sold before the estate tax payment is due, but the estate tax liability is higher than the sale price, the estate has two options. It could either pay over all the sales proceeds in hopes that the IRS will consider it partial satisfaction of the liability and grant discharge of the lien, or it could pay an agent to hold the proceeds in escrow (generally, title companies only charge around $100 to act as escrow agent). If the house will be sold between the nine-month payment date and the fifteen-month return filing date, or if the fair market value of the house is higher than the estimated estate tax liability, the estate could file for a Section 6161 extension of time to pay the estate tax. This is a strong option when the house is one of the major assets of the estate so liquidity for paying an estimated tax is impossible otherwise, and the house will be sold within twenty-one months of the decedent's date of death when the 6161 extension will expire. If the house will be sold after the twenty-one month extension date, the sale proceeds will likely have to be held in escrow until an estate administration closing letter is issued.

In the wake of President Trump's Executive Order, proposed Section 2704 Regulations are unlikely to become final in Notice 2017-38 (July 8, 2017)

On April 21, 2017 President Trump issued an Executive Order instructing the Treasury to reform unduly burdensome regulations. In response, on July 8, 2017 the IRS and Treasury issued Notice 2017-38, which identifies several regulations that meet the President's criteria. Among those are the proposed Section 2704 regulations that would make it more difficult to obtain valuation discounts on lifetime transfers of minority or nonvoting interests in a closely held enterprise.

Section 2704 provides that certain noncommercial restrictions on the ability to dispose of or liquidate family-controlled entities should be disregarded in determining the fair market value of an interest in that entity. The proposed Section 2704 regulations would create an additional category of restrictions that also would be disregarded, which commentators have felt would eliminate or restrict common discounts like minority discounts and discounts for lack of marketability, thereby resulting in increased valuations and transfer tax liability.

IRS upholds adequate disclosure requirement for gift tax returns in Chief Counsel Memorandum 20172801F (July 14, 2017)

In Chief Counsel Memorandum 20172801F, the IRS reiterated that under Section 6501(c)(9) the statute of limitations will not begin to toll on a gift tax return that lacks adequate disclosure. Under Treasury Regulation § 301.6501(c)-1(f)(2), a gift is adequately disclosed if the return includes (i) a description of the transferred property; (ii) any consideration received by the transferor; (iii) the identity of and relationship between the transferor and transferee; and (iv) a detailed description of the method used to determine the fair market value of the gift.

Under the facts as stated, a taxpayer made gifts in Years 1 through 6 and failed to file Forms 709. The taxpayer made gifts in Year 7 and did file a Form 709, but failed to describe the property transferred or provide a description of the valuation method. The IRS concluded that in Years 1 through 7 the taxpayer failed to disclose adequately the gifts made and so the gift tax could be assessed at any time, without regard to the limitations period. Note that, under Rev. Proc. 2000-34, a donor can commence the statute of limitations by filing returns for years where returns lacked adequate disclosure by filing complete and accurate Forms 709.

Tax Court holds taxpayer did not make a completed gift of the donated property and thus denies the charitable deduction in *Fakiris v. Commissioner*, T.C. Memo 2017-126 (June 28, 2017)

In *Fakiris v. Commissioner*, the Tax Court denied a taxpayer's charitable deduction because the taxpayer retained the power to alter the beneficial enjoyment of the gift by prohibiting retransfer of the donated property within five years and retaining the right to transfer the property to another charity.

The taxpayer, Mr. Fakiris ("Fakiris"), was a 60% member of Grou Development LLC ("Grou"), which rented and developed real estate. Grou acquired a dilapidated but historic theatre on Staten Island with plans to raze it and erect a new high-rise building. The community opposed the plan and eventually Grou decided to offset its costs by donating the theatre to a tax exempt organization and getting a charitable deduction.

A recently organized dance company called Richmond Dance Ensemble, Inc. ("Richmond") showed interest in acquiring the theatre, but because it had not yet received recognition by the IRS as a tax-exempt organization, Fakiris was unsure the donation would qualify for the charitable deduction. Richmond had a relationship with WEMGO Charitable Trust, Inc. ("WEMGO"), which did have tax-exempt status. With the understanding that Grou ultimately would transfer the theatre to Richmond, the parties determined that Grou would officially sell the theatre to WEMGO and when Richmond received its tax-exempt status Grou, in essence, would be able to take the theatre back from WEMGO and donate it to Richmond. In the contract of sale the parties memorialized these terms, specifically agreeing that WEMGO could not transfer the theatre to anyone other than Richmond within five years of the sale and that Grou retained the right to take the theatre back when Richmond received its tax-exempt status. The contract stated the agreed-upon provisions would "survive closing," but the provisions were not memorialized in the deed between Grou and WEMGO.

In November 2003 Grou had obtained an appraisal for the theatre at $4.5 million. In June 2004, just before the transfer, Grou obtained a new appraisal that estimated the theatre's value at $5 million. Grou sold the theatre to WEMGO for approximately $470,000 in June 2004 and WEMGO transferred the theatre to Richmond (on a date before Richmond received its determination letter from the IRS but after the "effective as of date" of tax-exempt status once it did receive the determination letter). Grou reported a bargain sale of $470,000 on its Form 1065 return but no charitable contribution. Fakiris then reported a charitable contribution of $3 million on his 2004 income tax return.

The court noted that for a bargain sale to be a charitable contribution (i) the seller must have requisite charitable intent and (ii) the fair market value of the property must exceed the selling price. The contribution is not deductible unless it constitutes a completed gift, meaning the donor has relinquished dominion and control over the contributed property. Treasury Regulation § 1.170A-1(e) provides that no deduction is allowed where the transfer is subject to a condition or power that is not so remote as to be negligible. The IRS argued Grou's transfer wasn't a completed gift because it retained dominion and control over the theatre when it sold to WEMGO. Fakiris argued that since the restrictions weren't memorialized in the deed, they weren't determinative as to whether Grou retained dominion and control and, under the terms of the deed, the sale to WEMGO evidenced a completed gift.

Under New York law, the provisions of a contract for sale generally merge with the deed, with the deed extinguishing any claims arising under the contract after closing of title. However, where there is clear intent evidenced by the parties that a particular provision survives delivery of the deed, that rule does not apply. Here, in the contract for sale, the parties clearly had manifested their intent to transfer the theatre from WEMGO to Richmond when the latter received its IRS determination letter. Therefore, the contract for sale did not merge with the deed, and the provisions in the contract for sale evidencing Grou's retention of dominion and control prevailed.

Thus, the court held that Grou's transfer wasn't a charitable contribution because it was not a completed gift. Where a taxpayer is not entitled to a claimed charitable deduction, the value of the property contributed is deemed to be zero, and any claimed value above that is considered a valuation misstatement. Since the misstatement was 400% over the amount of the actual value of zero, an accuracy-related penalty of 40% for gross misstatement of valuation was assessed against Grou.

Tax Court punishes taxpayer for voluntarily submitting proof that statute of limitations was suspended for a period of time that avoided a time bar of filing suit to collect tax deficiencies in *United States v. Holmes*, 2017 WL 2458923 (5th Cir., June 6, 2017)

In *United States v. Holmes*, Shirley Bernhardt died in 1997 and her nephew Kevin Holmes and his wife Barbara (the "taxpayers") became responsible for paying the entire estate tax liability. The taxpayers paid the amount of tax they claimed was due, but when the IRS assessed a deficiency the taxpayers failed to pay or respond for six years. In June 2004, a U.S. Tax Court entered a stipulated decision that the estate owed an additional tax and on July 16, 2004 the IRS entered the new assessment on its books (thus restarting the statute of limitations period). The taxpayers still did not pay and on October 6, 2013, after the government had begun placing liens on their property, they mailed in a request for a due process hearing. In May 2014 the taxpayers renewed their request for a due process hearing, attaching their October 2013 letter as evidence that they already had requested a hearing. The hearing was held and on June 2, 2014, the Office of Appeals sustained the levy amount. Then, in May 2015, the IRS commenced a federal court proceeding against the taxpayers to foreclose outstanding liens and obtain a money judgment for the unpaid taxes, penalties and fees. At that point the taxpayers argued the 10-year limitations period for assessing a tax deficiency had expired.

It is an accepted rule of law that the statute of limitations is suspended during the pendency of a due process hearing; the issue was when the pendency began. The IRS argued that while the IRS filed its case 10 years and 237 days after the limitations period began anew, the period was suspended for 241 days in the interim (between October 6, 2013 and June 2, 2014). The taxpayers had argued the limitations period was suspended only in May and June 2014, but the IRS pointed to the taxpayers' own submission of proof that they had initiated the hearing process back in October. On eventual appeal, the Fifth Circuit sided with the IRS's version and held the government could sue to collect the unpaid estate taxes.

$33 million charitable contribution deduction denied due to improper method of valuation in *RERI Holdings, LLC I v. Commissioner*, 149 T.C. 1 (July 3, 2017)

When a taxpayer donates property and claims a charitable contribution deduction in excess of $500, the donor must file a Form 8283; if the claim is in excess of $5,000 the donor must obtain a qualified appraisal and the charity must sign the Form 8283 acknowledging the gift. A Form 8283 requests information about the donated property, including (i) the date of the contribution, (ii) the date and method of acquisition by the donor, (iii) the donor's cost or adjusted basis, (iv) the fair market value at the time of contribution and (v) the method used to determine fair market value.

In *RERI Holdings, LLC I v. Commissioner*, a partnership owned an LLC that owned real property. The partnership split its LLC interest into a term-of-years interest and a remainder interest and then sold the remainder interest to the donor (another partnership) for $3 million. A year later, the donor gifted its LLC remainder interest to a university and claimed a $33 million deduction. The donor filed a Form 8283, complete with a qualified appraisal and the university's acknowledgment of receipt, but failed to note the donor's cost or adjusted basis. The Tax Court denied the donor's entire $33 million deduction, arguing that the omission of the donor's $3 million cost basis was an intentional omission hiding a potential overvaluation, and thus its absence did not permit application of the substantial compliance doctrine.

The Court also found that the taxpayer's qualified appraisal of $33 million was faulty. First, the donor used an eighteen-month-old appraisal, which was too old to be used to determine the value of the remainder interest. Second, the appraiser used the Section 7520 tables, which was not the appropriate method of valuation. These tables only apply when the donor retains a present interest in the property and has an obligation to preserve its value. Since the tables could not be used, the appraiser should have determined the actual fair market value of the interest based on what a willing buyer and willing seller would have agreed upon. This value would have been a number much lower than the $33 million value at which the appraiser arrived. As a result, the IRS imposed a Section 6662(h) gross valuation misstatement penalty for claiming a deduction equal to 400% or more of the property's actual value.

IRS simplifies the portability election for executors who do not need to file an estate tax return in Rev. Proc. 2017-34 (June 26, 2017)

Generally a portability election is effective only if made on an estate tax return that is timely filed within nine months of the date of death. Estates that were not required to file any estate tax return often did not timely file simply to elect portability. As a remedial measure, the IRS began requiring executors to seek a private letter ruling to file a late estate tax return electing portability. However, in light of an onslaught of ruling requests, the IRS now has eliminated that requirement if (i) the executor did not have to file an estate tax return because the estate was under the filing threshold and (ii) the decedent was a U.S. citizen or resident. In such a circumstance, the executor now has until before the second anniversary of the decedent's death to file an estate tax return and state at the top of the Form 706 "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER SECTION 2010(C)(5)(A)."

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