Wealth Management Update

November 2018

November 2018 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 3.6%, an increase from 3.4% in 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 semiannually) is 3.02%, also increased from 2.81% in October.

The still relatively low § 7520 rate and AFRs 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 semiannual compounding) used in connection with intra-family loans are 2.68% for loans with a term of 3 years or less, 3.02% for loans with a term between 3 and 9 years, and 3.19% 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 3.02%, the child will be able to keep any returns over 3.02%. These same rates are used in connection with sales to defective grantor trusts.

Federal District Court holds that FBAR claims against a decedent can be brought against a distributee of the decedent's estate *U.S. v. Schoenfeld*, No. 3:16-cv-01248-J-34PDB (Middle Dist. Fla 9/25/2018)

The Federal District Court for the Middle District of Florida held that a tax penalty claim enforceable against a decedent could be brought after his death against a distributee of said decedent's estate, solely in such person's capacity as distributee.

Steven Schoenfeld, a U.S. citizen, established a foreign brokerage account for which he was required to file an annual Foreign Bank Account Report ("FBAR") but failed to file FBARs from 1993-2010. On September 30, 2014, the IRS assessed a civil penalty against Steven for willfully failing to file. Steven died testate on August 21, 2015, naming his son, Robert Schoenfeld, as the sole distributee of his estate (the "Estate"). Robert was also named as personal representative in Steven's will, but did not present the will for probate.

On September 29, 2016, the government initiated an action to obtain a judgment for its assessed FBAR penalties. In October of 2016, the Government learned that Steven had died. Subsequently (and outside the statute of limitations), the government amended its complaint to name as defendants (a) the Estate and (b) Robert Schoenfeld, as a distributee of the Estate. Robert was not named in his capacity as personal representative because the will was not admitted to probate.

Robert and the Estate moved to dismiss, arguing, among other things, that: (a) the complaint could not be brought against Steven because he was dead, rendering the claim a legal nullity, and (b) Robert, in his capacity as a distributee, was an impermissible defendant under USC § 2404 ("Section 2404"), which sets forth the rule for when claims against decedents are enforceable against successors in interest and when they abate.

The court (treating the motion to dismiss as a motion for summary judgment) held that the claim was not a legal nullity—although Steven was dead and lacked the capacity to be sued, the government's amended complaint (naming Robert and the Estate as defendants), satisfied procedural requirements for amendment and relation back. The Estate, however, did not have capacity to be sued—an estate's capacity to be sued is governed by the state where it is located, and Florida law provides that only a personal representative, and not an estate, has the capacity to be named as a defendant in a lawsuit.

The Estate did not have an appointed personal representative. However, the court held that Robert was a permissible defendant in his capacity as a distributee of the Estate under Federal Rule of Civil Procedure ("FRCP") 17, which governs which parties have the capacity to be sued. The court's reasoning proceeded by analogy to FRCP 25, which permits a court to substitute for a deceased party to a lawsuit such party's "successor or representative" when litigation continues following said party's death. In that context, a "successor" can include "a distributee of a decedent's estate." For consistency of interpretation, the court interpreted FRCP 17 to include a distributee of a decedent's estate, at least in respect of a claim against the decedent. Accordingly, the court held that Robert was a proper party to the lawsuit.

In so holding, the court also analogized to a common practice of substituting distributees for decedents when no personal representative is yet appointed and a claim must be filed before the expiration of a statute of limitations. In this case, however, Robert was named as a distributee despite the fact that there was no indication that a personal representative would ever be appointed. Note, however, that Robert was not only the sole distributee, but also the personal representative named in Steven's will—this fact, while not explicitly the basis for the court's reasoning, was raised at key points in the opinion.

Settlement in *Cahill* case follows the Tax Court's implication that the estate tax value of an intergenerational split-dollar life insurance receivable could be equal to the cash surrender value of the underlying policy
Estate of Richard Cahill, US Tax Court Docket No. 10451-16, Joint Stipulation of Settled Issues, August 16, 2018.

Estate of Cahill v. Commissioner (summarized in greater detail in the October 2018 Wealth Management Update) involved a series of intergenerational split-dollar life insurance arrangements entered into on behalf of various trusts of Richard Cahill (an incompetent 90-year-old man) by Richard's son, Patrick, acting as trustee of Richard's revocable trust and as Richard's attorney-in-fact (Patrick was also a beneficiary and executor of Richard's estate). The relevant insurance policies were on the lives of Patrick and Patrick's wife, with Richard's revocable trust as the payor in exchange for a receivable. Richard died shortly after these arrangements were put in place.

For estate tax purposes, Richard's estate (the "Estate") sought to value the receivables at $183,700, the present value of the right to be repaid. This figure was based in part on a 98% discount due to the long life expectancy of the insureds. The IRS argued instead that the full cash surrender value of the policies ($9,611,624) was includible in the decedent's estate, applying Internal Revenue Code Sections 2036, 2038 and 2703 and noting the right of Richard's revocable trust, together with other trusts involved in the structure, to designate the persons who would possess and enjoy the property.

The Estate moved to dismiss, arguing that that the discounted value was appropriate due to the decedent's limited rights to terminate the split-dollar arrangements and that Internal Revenue Code Sections 2036, 2038 and 2703 did not apply—rather, the economic benefit regime (Treas. Reg. § 1.61-22) should be used to value the receivables for estate tax purposes. The Tax Court denied summary judgment on the estate tax valuation issue, despite an apparently favorable ruling in *Estate of Morrissette v. Commissioner*, 146 T.C. 171 (2016), regarding the general **income** and **gift** tax treatment of such arrangements under the economic benefit regime. In so doing, the Tax Court noted that the economic benefit regime applies to gift tax, not estate tax, thus distinguishing the ruling in *Morrissette*.

On August 16, 2018 (following the above-referenced denial of summary judgment), the Cahill Estate settled. Among the terms of the settlement, the Estate conceded the value of the split-dollar receivables, accepting the cash surrender value of the policies as of the decedent's death ($9,611,624) rather than the present value of the decedent's rights to be repaid ($183,700).

While this settlement may appear to be a victory for the IRS, it should be noted that the *Cahill* case involved particularly "bad facts," including (among many others) the steep discount rate used by the Estate, Richard's advanced age and incompetency, and the fact that Richard's son set up the split-dollar arrangements on Richard's deathbed, while acting as Richard's trustee and attorney-in-fact.

It also should be noted that the *Cahill* settlement is not a statement of law—two similar cases are currently before the court, either one of which may resolve this issue on better facts*. Estate of Clara M. Morrissette*, US Tax Court Docket No. 4415-14, a continuation of *Morrissette* specifically litigating the estate tax valuation of the split-dollar receivable, is scheduled to go to trial in April 2019. *Estate of Marion Levine*, US Tax Court Docket No. 13370-13, went to trial in November 2017 but has not yet been decided.

In the Matter of the Petition of Wiesen, Tax Appeals Tribunal, Dkt. No. 826284, 09/13/2018

On a New York personal income tax audit, the Tax Appeals Tribunal found that taxpayer Jeremy Wiesen failed to relinquish his New York domicile and establish Florida domicile, in part because Mr. Wiesen had continued to maintain a rent-controlled apartment to ensure the transition to his son as successor tenant. The court's ruling primarily was based on Mr. Wiesen's failure to provide enough evidence for the factors indicating a domicile change. The evidence Mr. Wiesen did provide was unpersuasive to the tribunal, because it took the form of "self-serving" declarations of domicile (such as writing declaration letters, filing New York nonresident tax returns, and applying for a Florida homestead exemption) as opposed to the more persuasive "informal" indicators (e.g., pay stubs, bills, proof of use of country clubs).

The court noted that a different taxpayer prevailed in a domicile controversy involving a key fact in the *Wiesen* matter—the maintenance of a rent-controlled apartment—because that taxpayer introduced concrete evidence and "credible" testimony (including affidavits). Accordingly, this case underscores the importance of generating and preserving detailed evidence in support of any contemplated change in domicile and the significance of informal (as opposed to formal and declarative) indicators of domicile.

Tax Cuts and Jobs Act ("TCJA") – Changes to the Alimony Tax Regime Effective after December 31, 2018

The TCJA's changes to the taxation of alimony will take effect for alimony payments made pursuant to divorce or separation instruments executed after December 31, 2018. Alimony payments under agreements executed after that date will no longer be deductible by the paying ex-spouse, nor will they be included in the gross income of the recipient ex-spouse. This change is expected to affect divorce negotiations in cases where one spouse earns significantly more than the other, potentially reducing the use of alimony in favor of increased planning based on the division of assets. The imminent change also may result in a rush to conclude separation and divorce negotiations prior to 2019.

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