Proskauer

Wealth Management Update

December 2018

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

Important federal interest rates continue to rise. The December 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 3.07%, up from 3.04% in November.

The December § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 3.6%, holding steady from November. The relatively low § 7520 rate and AFR continue to present potentially rewarding opportunities to fund GRATs in December 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 2.76% for loans with a term of 3 years or less, 3.07% for loans with a term between 3 and 9 years, and 3.31% 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 3.07%, the child will be able to keep any returns over 3.07%. These same rates are used in connection with sales to defective grantor trusts.

The AFRs for December 2017 were 1.52%, 2.11%, and 2.64%, respectively. Thus, rates are rising, but remain historically low.

U.S. Department of Treasury 2018-2019 Priority Guidance Plan

On November 8, 2018, the Treasury Department and the IRS released the 2018-2019 Priority Guidance Plan (the "Plan"). The Plan contains guidance projects that are intended to be completed by June 30, 2019 and it "continues to prioritize implementation of the Tax Cuts and Jobs Act" and "continues to reflect the deregulatory policies and reforms described in Section 1 of Executive Order 13789 … and Executive Order 13777."

The following projects may be of interest to those involved in wealth management:

- Guidance clarifying the deductibility of certain expenses described in § 67(b) and (e) that are incurred by estates and non-grantor trusts.
- Guidance under §§ 101 and 1016 and new § 6050Y regarding reportable policy sales of life insurance contracts.
- Guidance under § 162(m) regarding the limitation on excessive employee remuneration, as amended by section 13601 of the TCJA.
- Guidance on applying the state and local deduction cap under § 164(b)(6) to passthrough entities.
- Final regulations on computational, definitional, and anti-avoidance rules under new § 199A and § 643(f). Proposed regulations on computational, definitional, and anti-avoidance guidance under new § 199A and § 643(f) were published on August 16, 2018 in FR as REG-107892-18 (NPRM) (Released on August 8, 2018).
- Regulations under § 199A and other guidance for cooperatives and their patrons.
- Regulations under § 2010 addressing the computation of the estate tax in the event of a difference between the basic exclusion amount applicable to gifts and that applicable at the donor's date of death.
- Final regulations under §§ 1014(f) and 6035 regarding basis consistency between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016.
- Guidance on basis of grantor trust assets at death under § 1014.
- Final regulations under § 2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on November 18, 2011.
- Regulations under § 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.
- Regulations under § 7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests.

Matter of Seiden, 2018 NY Slip Op. 32541(U) (Oct. 9, 2018)

The New York Surrogate's Court addressed the question of whether property claimed as qualified terminable interest property on the decedent's husband's New York estate tax return in 2010 must be included in the decedent's New York estate in 2014.

Mr. Seiden died in 2010. The executor of his estate did not file a federal estate tax return (as was allowed at the time), but he did file a New York estate tax return. On the New York return, the executor properly elected qualified terminable interest property ("QTIP") treatment for a trust for the benefit of Mrs. Seiden.

Mrs. Seiden died in 2014. The executor of her estate filed a federal estate tax return, in which he excluded the property in the QTIP trust. The executor took the position that there had been no marital deduction claimed or allowed in Mr. Seiden's federal estate for the QTIP trust, as is required to trigger inclusion in Mrs. Seiden's estate under IRC § 2044. The executor also filed a New York estate tax return, in which he excluded the QTIP trust because New York law defines the gross estate by reference to the federal gross estate.

The New York State Department of Taxation and Finance (the "Tax Department") issued a notice of deficiency in the amount of tax that would be due if the QTIP trust was included in Mrs. Seiden's estate. The Tax Department argued that the relevant New York state law, as it existed in 2010, required inclusion of the QTIP trust. The New York law at that time stated, "any reference to the Internal Revenue Code means the United States Internal Revenue Code ("IRC") of 1986, with all amendments enacted on or before July 22, 1998." Under the IRC existing on July 22, 1998, a marital deduction was allowed for any QTIP. Thus, the Tax Department argued that under IRC § 2044 the QTIP trust should be included in her estate.

The Surrogate's Court held that the QTIP was properly excluded from Mrs. Seiden's estate. First, the Court stated that the relevant state law for determining what is included in Mrs. Seiden's estate is that which existed in 2014, when Mrs. Seiden died. In 2014, the relevant New York law was rewritten to change references from the IRC in effect on July 22, 1998 to the IRC in effect on January 1, 2014. Under the law existing in 2014, no marital deduction was allowed for decedents dying in 2010.

Next, the Court stated that under no circumstance was a federal marital deduction "allowed" in Mr. Seiden's estate. To be "allowed", the Court stated, "it is necessary that the executor make a particular election on the federal estate tax return." No such return was filed; thus, no election was made.

The Tax Department argued that Tax Department Technical Services Bureau Memorandum TSB-M-10(1)(M) (the "Memo") controls the issue of inclusion. The Memo states that if an election was made on a New York return to qualify trust property for QTIP treatment, "the value of the QTIP property for which the election was made must be included in the estate of the surviving spouse." The Tax Department argued that the Memo plainly required the inclusion of the QTIP trust in Mrs. Seiden's estate. The Court stated that, on the contrary, such administrative memoranda "do not have legal force or effect, do not set precedent and are not binding." The enacted New York law, which overrides the Memo, requires the opposite result. The Court held for the estate and vacated the notice of deficiency.

Private Letter Ruling 201845029

In this Private Letter Ruling, the IRS allowed the reformation of an irrevocable trust to undo unwanted gift tax and GST tax consequences.

Settlor created an irrevocable trust (the "Trust") for three grandchildren and their descendants. Attorney 1 drafted the Trust. The Trust provided that all property transferred thereto was to be split into equal shares for the three grandchildren. The Trust also provided each grandchild with the right to withdraw the full value of any addition to his or her separate trust, which right lapsed at the end of each year. Settlor transferred property to the Trust in Year 1, and elected gift splitting with Wife. Settlor and Wife allocated GST exemption to the trust for the Year 1 transfer, though misreported the transfer as an indirect skip. In Year 2, Wife transferred property to the Trust, and the couple did not elect gift splitting.

After Year 2, Settlor's son consulted with Attorney 2, who realized (1) that each grandchild possessed a general power of appointment over all additions to the Trust and (2) the gift tax consequences of the lapses of said power. Settlor then filed an action in state court to retroactively reform the Trust to, among other things, limit the grandchildren's withdrawal rights to a typical 5x5 power. Settlor argued that this was his original intent, and that the Trust provision was a scrivener's error. Attorney 1 filed an affidavit affirming that position. The state court allowed the reformation and applied it retroactively to the creation date of the Trust.

Next, Settlor requested rulings from the IRS that (1) as a result of the reformation of the Trust, Settlor's grandchildren do not possess powers of appointment, (2) the reformation did not constitute a gift, (3) the lapses of the grandchildren's powers did not constitute taxable gifts, (4) the Trust property would not be includible in the grandchildren's estates, and (5) Settlor and Wife effectively allocated GST exemption to the Trust, in spite of misreporting the transfers as indirect skips.

The IRS granted all five rulings. On the basis of the trust instruments, affidavits, and representations of the parties, the IRS was persuaded that the original withdrawal powers were a result of scrivener's error. Thus, it adhered to the state court's reformation of the Trust to the date of its creation. Rulings 1 through 4 above were then granted. Ingredient in these rulings was Attorney 1's affidavit that the errors in the original trust agreement were his fault.

Finally, the IRS ruled that, although Settlor and Wife erroneously reported their transfers to the Trust as indirect skips, they had substantially complied with the gift tax return requirements. Thus, their GST exemptions were properly allocated to the Trust.

In Case You Missed It: *Sveen et al. v. Melin*, 584 U.S. [TBD] (June 11, 2018)

In *Sveen et al. v. Melin*, the Supreme Court of the United States held that Minnesota's "revocation on divorce" law does not violate the Contracts Clause of the United States Constitution, even when applied retroactively. Many states have "revocation on divorce" ("ROD") laws that, in the event of a divorce, effectively void any beneficiary designations and provisions in wills and trusts that would benefit the former spouse. In *Sveen*, an ex-wife brought suit to recover the proceeds of a life insurance policy in place prior to the enactment of Minnesota's ROD law. She argued that the retroactive application of Minnesota's law impaired existing contract rights, in violation of the Contracts Clause. However, the Supreme Court upheld the retroactive application of the Minnesota law because:

First, the statute is designed to reflect a policyholder's intent—and so to support, rather than impair, the contractual scheme. Second, the law is unlikely to disturb any policyholder's expectations because it does no more than a divorce court could always have done. And third, the statute supplies a mere default rule, which the policyholder can undo in a moment.

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