Proskauer

Wealth Management Update

October 2019

October 2019 Interest Rates for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split-Interest Charitable Trusts

The October Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 1.8%, which is lower than the September rate. The October 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 to 9 years (the mid-term rate, compounded annually) is 1.51%, down slightly from 1.78% in September.

The low Section 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 annual compounding) used in connection with intra-family loans are 1.69% for loans with a term of 3 years or less, 1.51% for loans with a term between 3 and 9 years, and 1.86% for loans with a term of longer than 9 years. With the mid-term rate now less than the short-term rate, clients will likely prefer the mid-term rate in their estate planning transactions.

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 1.51%, the child will be able to keep any returns over 1.51%. These same rates are used in connection with sales to defective grantor trusts.

The Tax Court blesses a "tax affected" appraisal in Estate of *Aaron Jones v. Commissioner*, T.C. Memo 2019-101

After a series of opinions rejecting the technique of "tax affecting" the transfer tax appraisals of pass-through entities, the Tax Court blessed the use of tax affecting in the valuation of two interrelated companies, Seneca Sawmill Co., an Oregon S corporation ("SSC"), and Seneca Jones Timber Co., an Oregon limited partnership ("SJTC"). Tax affecting accounts for the benefit of using a pass-through structure by (a) reducing a variable in the valuation (e.g., net earnings) based on the contrary-to-fact assumption that the pass-through pays entity level corporate taxes, essentially treating it like a C corporation, and (b) adjusting the valuation by a premium to account for the dividend taxes avoided by the entity's pass-through status. This technique results in a substantially lower valuation of a pass-through entity than the previous Court-favored technique of assuming that the company pays a 0% entity level rate.

In *Estate of Jones v. Commissioner*, the taxpayer made net net gifts of interests in SSC and SJTC to various family members and family entities in May 2009. In 2013, the IRS assessed a deficiency in gift tax of $44,986,416 based on the valuation of SSC and SJTC. The taxpayer died in 2014. The Tax Court ruled in favor of the taxpayer's Estate on all issues.

The primary dispute was whether SJTC, the partnership, should be valued using an income-based approach (like an operating company) or an asset-based approach (like a holding company). SSC was a high end lumber manufacturer, while SJTC owned and managed timberlands, selling 89% of its logs to SCC directly or indirectly. Over the IRS's objection, the Tax Court concluded that SJTC should be valued using an income-based approach because SJTC was more like an operating company than a holding company due to its relationship with SSC (which effectively controlled SJTC) and its own robust operations managing timberlands and harvesting logs.

In addition, the Tax Court notably blessed the Estate's tax-affected valuation of SJTC. The Estate's appraiser had assumed a 38% tax rate as a proxy for federal and state entity level taxes, and adjusted its valuation with a premium for dividend taxes avoided. The IRS objected and proposed a 0% tax rate. Despite a long line of cases rejecting tax-affected valuations, the Court found in favor of the Estate, stating that a fair market valuation must take into account the tax savings of various corporate forms, and that it was a factual question whether tax-affecting was appropriate in a given case. Here, tax-affecting was more persuasive that the IRS's 0% rate. We note, however, that the fact-based nature of the Court's conclusion makes it unclear whether tax affecting will be approved in any particular case going forward.

The court also found, in favor of the Estate, that (i) the Estate's appraiser's use of "pessimistic," but recent, cash flow projections generated during the housing recession was appropriate; (ii) the Estate's appraiser properly treated intercompany loans between SSC and SJTC as operating assets; and (iii) the Estate's 35% discount for lack of marketability was reasonable.

The New York County Surrogate's Court continues to draw the boundaries of subject matter jurisdiction in Matter of Radio Drama, Opinion and Order (Sur. Ct., NY County, July 15, 2019)

In *Matter of Radio Drama*, the Surrogate's Court indicated its willingness to hear claims for fraud, fraudulent concealment, undue influence, and unjust enrichment against an individual's former estate planning attorney and provided insight into the limits of Surrogate's Court subject matter jurisdiction.

During much of the life of Himan Brown (deceased), a successful producer of radio programs, the presumptive remainder beneficiary of Brown's estate was Radio Drama Network, Inc. ("Radio Drama"), which Brown founded in 1984. However, when Brown died in 2010, his will directed his residuary (probate) estate to Radio Drama (less than $1 million), while his funded revocable trust directed its nearly $100 million remainder to a newly-created Charitable Trust of which Richard Kay, Brown's longtime lawyer, was sole Trustee. In 2015, Radio Drama brought an action against Kay, alleging that he carried out a "fraudulent scheme" to alter Brown's estate plan and divert assets away from Radio Drama by misleading and confusing the elderly Brown into amending his revocable trust so the Charitable Trust (controlled by Kay) would replace Radio Drama as remainder beneficiary and Kay would receive an additional $1.7 million in fiduciary commissions. On Kay's motion to dismiss (which was, in most part, denied), the Court ruled on the various claims and motions as follows:

> Radio Drama adequately plead claims for fraud, fraudulent concealment, undue influence, and unjust enrichment.
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> Radio Drama did not plead sufficient facts for its claim that Kay violated Judiciary Law § 487 (dismissed).
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> None of Radio Drama's claims are dismissed for being tantamount to "tortious interference with prospective inheritance." While New York does not recognize this cause of action at law, Radio Drama's claims could proceed because they were at equity, requesting equitable relief (in this case, constructive trust over the assets of the Charitable Trust).

Radio Drama's claim that Kay, as a director of Radio Drama, had breached his fiduciary duty to Radio Drama was dismissed for lack of subject matter jurisdiction, because this claim was an "independent matter[] involving controversies between living persons" rather than a matter "affecting" an estate or trust. The court noted that the breach of duty and the relief sought (removal of Kay as a director of Radio Drama) would only affect Radio Drama's "internal governance, a matter in which neither the estate nor the Revocable Trust has an interest." We note, however, that the Court distinguished various other cases in which seemingly similar claims were heard in the Surrogate's Court "recognizing the importance of avoiding needless fragmentation of litigation among the same parties." Accordingly, the bounds of Surrogate's Court subject matter jurisdiction, particularly in the context of corporate entities, continue to be clarified.

Radio Drama's claims are not time-barred, because Radio Drama's causes of action only accrued at Brown's death (within the six-year statute of limitations for fraud), prior to which, Radio Drama did not have any legally enforceable rights against Brown's Estate.

Radio Drama's request for a preliminary injunction against certain distributions from the Charitable Trust was denied because monetary damages would adequately compensate Radio Drama for further injury.

The Westchester County Surrogate's Court reminds estate planners to include digital assets provisions in Matter of Coleman's Estate, 63 Misc.3d 609 (Sur. Ct., Westchester County, New York, March 11, 2019)

Ryan Coleman died intestate at age 24. The administrators of Ryan's estate (his parents) sought a court order granting them access to *all* the digital assets associated with Ryan's iPhone. The administrators' motivations included identifying and marshalling Ryan's assets (digital and otherwise), as well as the apparent goal of shedding light on his undetermined cause of death.

Because Ryan did not leave any direction concerning his digital assets, the Court required the administrators to demonstrate under EPTL § 13-A-3.1 and 13-A-3.2 that access to Ryan's digital assets was necessary to administer his estate. The Court found that that Ryan's *content-based* digital assets (such as the text of his messages) had *not* been proven reasonably necessary under EPTL § 13-A-3.1, but Ryan's *non-content* digital assets (such as calendar information, contact lists and the times/dates of messages), were reasonably necessary under EPTL § 13-A-3.2. If the non-content digital assets indicated that the content-based assets would, in fact, be necessary to administer the estate, the Court would hear another motion.

The takeaway from this case is to consistently include digital assets provisions in all clients' documents—if Ryan had left written consent for his administrators or Executors to access his digital assets, the administrators would likely only need to prove this consent under EPTL 13-A-3.1(e) and 13-A-3.2(d), rather than the content's necessity for estate administration.

Soltani-Amadi v. Commissioner, T.C. Summary Opinion, 2019-19 (August 8, 2019) reminds planners to remember the differences between various types of retirement plans

In this case, a taxpayer took an early withdrawal from her 401(k), relying on the "first-time homebuyer" exception to the extra 10% tax on early distributions from an IRA. IRC § 72(t)(2)(F). In a straightforward application of Code provisions, the Tax Court found that this exception applies only to IRAs, and was not applicable to the taxpayer's 401(k). This outcome is a reminder to keep track of the differences in the technical rules affecting various retirement plans.

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