Proskauer

Wealth Management Update

November 2020

November 2020 Interest Rates for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split Interest Charitable Trusts AFRs

Certain federal interest rates increased slightly for November of 2020, while others remained the same. 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 annually) is 0.39%, up from 0.38% in October and down from 1.59% in November of 2019.

The November Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 0.4%, is unchanged from October and down from 2.0% in November of 2019.

The AFRs (based on annual compounding) used in connection with intra-family loans are 0.13% for loans with a term of 3 years or less, 0.39% for loans with a term between 3 and 9 years, and 1.17% for loans with a term of longer than 9 years.

Thus, for example, if a 10-year loan is made to a child, and the child can invest the funds and obtain a return in excess of 1.17%, the child will be able to keep any returns over 1.17%. These same rates are used in connection with sales to defective grantor trusts.

Artificial Gifts, New York State Estate Tax Deduction Inconsistency and Anti-Abuse Rules

The so-called "Anti-Clawback Regulations" will allow taxpayers to lock in the current high gift/estate tax exemption if they make gifts using the higher exemption and then die after the exemption is reduced.

In light of this potentially temporary opportunity to use the high exemption, but acknowledging that many individuals are hesitant to forfeit complete control over and use of such a large amount of assets, some practitioners are recommending certain estate planning strategies that taxpayers and attorneys would have previously avoided. For example, the special valuation rules under Chapter 14 of the Internal Revenue Code inflate the value of certain gifted interests, which, in the past, have disincentivized individuals from retaining a life estate in gifted property or maintaining control over gifted entity interests. Now, however, the possible prospect of losing the high exemption serves to encourage the use of these gifting techniques because, even though the value of the gift is inflated, the donor retains use and/or control and is using gift tax exemption that he will eventually lose.

A tax-free overvalued gift is, in many ways, more attractive than an appropriately valued, fully-taxed gift.

For example, a parent may wish to make a gift of property to a trust for his descendants while retaining a life estate. Similarly, clients may wish to create a partnership or limited liability company and intentionally run afoul of the Section 2701 valuation rules by gifting common, subordinate interests to children while retaining a preferred interest.

As mentioned above, one such technique involves the gifting of inferior or junior entity (*e.g.*, partnership or limited liability company) interests to children or descendants. A wealthy client can create a partnership or LLC with preferred interests and common interests. The preferred interest, which could provide the interest holder with guaranteed, non-cumulative dividends, would be a so-called "applicable retained interest". The common interest holders would be entitled to any entity return in excess of that received by the preferred interest holders. If an individual gifts these common interests, while retaining the preferred interests, the value of the gift is equal to the value of both the preferred interests and the common interests. Structuring a gift in this manner enables a donor to use the current high gift tax exemption while simultaneously retaining control of an entity and enjoying preferred, often guaranteed, returns. At death, the value of the preferred interest, as of the date of death, is included in the donor's estate, and, as a result, the donor receives a corresponding step-up in basis. In order to avoid double taxation of the preferred interest, at death, the lifetime gift is reduced by the value of the preferred interest as of the date of the gift or as of date of death, whichever is lower.

The Tax Section of the New York State Bar Association has expressed concern to the Department of the Treasury regarding the potential increased use of these so-called "artificial gifts" in which the donor does not actually relinquish control or use of the gifted property. The preamble to the Anti-Clawback Regulations reserves space for anti-abuse rules that disallow the use of the increased exemption with respect to certain lifetime gifts that are pulled back into the donor's estate at death and/or that exploit the special valuation rules under Chapter 14, such as the gift of common entity interests illustrated above. The reference to these rules is brief and vague, and therefore, there is concern among practitioners that, if and when enacted, they could be over-inclusive and disallow the use of the increased exemption for common gifting techniques, such as grantor retained annuity trusts (GRATs) and qualified personal residence trusts (QPRTs), as well as techniques for New York residents that address an inconsistency between the federal gross estate and the New York gross estate.

For example, it has been suggested that, in the case of a gift of a subordinate interest with a simultaneous retention of a preferred interest, as described above, future anti-abuse rules, if enacted, will disallow the adjustment of the value of the taxable gift at death, resulting in a double taxation of the preferred interest. Alternatively, the anti-abuse rules could prohibit the use of the increased exemption amount on the value of the retained preferred interest.

There is also confusion as to whether such anti-abuse rules would affect only the donor's personal exemption or whether it would affect gifts made using the Deceased Spousal Unused Exclusion "ported" from a predeceased spouse. Similarly, we do not know whether the anti-abuse rules will disallow all gifts that are deemed to be artificial or abusive made before the exemption is reduced or just the portion of the gifts made using the increased exemption that will disappear in 2026 (or possibly sooner).

Until we know whether and when these anti-abuse rules will be enacted, and what types of lifetime gifts they will affect, which, if history is any indication, could take some time, clients can still safely use other gifting techniques, such as spousal lifetime access trusts ("SLATs") in order to use their exemption before it is reduced.

Gomez v. Smith, 54 Cal.App.5th 1016 (COA, 3d Dist. Sept. 22, 2020)

Frank Gomez, a widow with adult children, re-kindled a romance with a girlfriend, Louise, with whom he was briefly engaged prior to leaving the country to serve in the Korean War. They married, and as his health deteriorated, he wanted to make sure that Louise would be taken care of financially after his death. He told his daughter, Tammy, who was not fond of Frank's new wife, that he wanted Louise to be able to live in the marital home until her death. During a meeting in which Louise was present, Frank discussed with his attorney and financial advisor the revocation of his current Revocable Trust and the establishment of a new Revocable Trust in which Louise would have a life estate. He also instructed the attorney to disinherit all of his children except his son, Richard, in the new Revocable Trust. (According to Louise, Frank was quite impulsive and would often decide to disinherit one or more of his children after disagreements, only to change his mind a few days later.)

Frank's condition became terminal quickly, and he began to receive hospice care in his home. Frank never had the opportunity to review a draft of the Revocable Trust, but the attorney did draft the Trust, and an appointment was made for the attorney to go to Frank's home for the document signing. When the attorney arrived with his paralegal, Tammy would not allow them to enter. Despite receiving a call from Frank's close friend and financial advisor instructing her not to interfere with her father's wishes, Tammy called the sheriff, and the attorney and paralegal eventually left. Frank died twelve hours later without signing his new documents. Louise sued Tammy for intentional interference with expected inheritance. She won at the trial level, and a constructive trust with a life estate was established for her benefit. Tammy appealed.

The six elements of intentional interference with expected inheritance are: (i) expectancy of an inheritance, (ii) causation, (iii) intent, (iv) interference conducted by independently tortious means, (v) damages and (vi) tortious conduct directed at someone other than the plaintiff/claimant.

Of the six elements, the Court of Appeals focused on causation and independently tortious conduct. Louise had the burden of proving that, absent Tammy's actions, Louise would have received a life estate in the marital home. Tammy argued that Louise would not have inherited anything even absent Tammy's interference because she did not think that the documents would have ever been signed. According to Tammy, the attorney would have, upon entering the home and speaking to Frank, determined that Frank did not have sufficient legal capacity to sign the estate planning documents. However, even if the attorney decided to move forward with the signing, Tammy pointed out that Frank became quite ill within two hours of his scheduled appointment with the attorney, which would have interrupted the signing of the documents. Finally, Tammy argued that, even if the new Revocable Trust were signed, a court in the future would, after considering the evidence, have deemed her father incapacitated because, among other reasons, Frank received two doses of morphine a few hours before his meeting with the attorney. Tammy had the burden of proving her father's incapacity, and both sides proffered expert witnesses to discuss both the effects of morphine (in general and specifically with respect to Frank), as well as Frank's general mental state on his date of death. All of the expert witnesses testified that Frank was physically weak but cognitively aware. With respect to the effects of morphine on capacity, the expert witness testified that morphine has different effects on different people, and it can increase cognitive awareness in some and have the opposite effect on others. The Court, in rejecting Tammy's argument, pointed to Tammy's own behavior on the day of her father's death as proof of his capacity. That day, Tammy and her brother were discussing how the family could say goodbye to Frank telephonically without upsetting him; according to the Court, if he were unresponsive or cognitively incapacitated, his children would not have had to worry about his possible reactions to a telephone call.

Furthermore, in order to prevail on a claim of intentional interference with expected inheritance, Louise had to prove that Tammy's interference was conducted by independently tortious means and that such independently tortious conduct was directed at someone other than Louise. Louise argued that Tammy (i) breached her fiduciary duty under a durable power of attorney by placing her own interests above those of Frank, and (ii) exercised undue influence over her father by preventing Frank, who, at that time, was physically incapacitated and bedridden, from interacting with his lawyer by forbidding access to the home. Tammy's defense was that her behavior was appropriate because any action by an agent under a valid power of attorney was permissible. The Court, of course, disagreed, emphasizing the fiduciary duties that arise from acting as attorney-in-fact. The Court pointed out Tammy's self-serving behavior, namely that her physical prevention of the document signing not only resulted in the disinheritance of her step-mother but prevented Frank from revoking his current Revocable Trust, of which Tammy was a beneficiary, and enacting a new Revocable Trust, which eliminated Tammy as a beneficiary.

Louise won on appeal, and the constructive trust for her benefit remained intact.

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