Proskauer

Wealth Management Update

September 2021

September 2021 Interest Rates for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split Interest Charitable Trusts

Federal interest rates decreased slightly for September of 2021. 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 annually) is .86%, down from 1.00% in August but up from .35% in September of 2020.

The August 2021 Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 1.0%, is down from 1.2 in August but up from .4% in September of 2020.

The AFRs (based on annual compounding) used in connection with intra-family loans are 0.17% for loans with a term of three years or less, 0.86% for loans with a term between three and nine years, and 1.73% for loans with a term of longer than nine 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 1.73%, the child will be able to keep any returns over 1.73%. These same rates are used in connection with sales to defective grantor trusts.

Ellis v. Hurley – No. B3000799, 2020 WL 6816605 (Cal. Ct. App.) ? California Court of Appeal, Second District Case on the Definition of a Grandchild

Peter Bing, the Settlor, created 6 identical trusts in 1980 for the benefit of his future grandchildren. Each trust was for an unborn grandchild. He initially funded them each with $15,000. Under the terms of each trust, the Trustee has discretion to make distributions of income and principal when the respective trust beneficiary reaches the age of 18. Each trust terminated on October 31, 2020, at which time the entire principal and all undistributed income became distributable to the beneficiaries. The trust agreements provided the following definition:

"*The words 'child,' 'children,' and 'issue' whenever used herein, shall include legally adopted persons, whether adopted by the Grantor or by the Grantor's natural or adopted children.*"

The words "grandchild" or "grandchildren" were not defined.

Section III Powers of the Trustee of the trust agreements provided, in pertinent part, as follows:

"*The Trustee shall have the power to construe this Declaration of Trust, and any reasonable construction adopted after obtaining the advice of responsible legal counsel shall be binding on all persons claiming an interest in the trust estate as beneficiaries or otherwise.*"

The Settlor's son, Stephen, is the father of two children born out of wedlock, Kira and Damian. Stephen never met Damian and only met Kira after she became an adult. Both Kira and Damian were each raised by their respective mothers. DNA tests proved that Stephen was their father.

On September 18, 2018, the Settlor signed an affidavit stating that when he created the 1980 grandchildren trusts, he believed that they would not benefit any person born out of wedlock unless that person had lived for a substantial period of time while a minor as a regular member of the household of the natural parent who is a child of his.

With this affidavit, the Trustee obtained the advice of legal counsel who concluded that under California law, it is reasonable to construe 'grandchild' as the term is used in the grandchildren's trusts, to exclude a person born out of wedlock to a child of the Settlor who never resided while a minor as a regular member of that child's household. The legal counsel relied on California Probate Code Section 21115, subdivision (b), a statutory rule of construction for terms of class gifts and relationships which provides that, although persons born out of wedlock are considered children for purposes of intestacy, [i]n construing a transfer by a transferor who is not the natural parent [*e.g.*, grandparent], a person born to the natural parent shall not be considered the child of that parent unless the person lived while a minor as a regular member of the household of the natural parent or of that parent's parent, brother, sister, spouse, or surviving spouse."

When this matter went to court, the trial court found the Settlor's affidavit to be irrelevant, declining to accept his attempt decades later to define a term that, on its own, expresses no doubt as to its meaning. The definition of a grandchild is the child of your child. There is no ambiguity. The trial court also did not want to rely on a statute that was not in effect at the time that the trust agreements were established (California Probate Code Section 21115 is based on former section 6152 which was adopted in 1983).

However, on appeal the California Court of Appeal, Second District, reversed the trial court's decision and found the Trustee's interpretation to be reasonable. The court found that the use of the term "grandchild" in the trusts was reasonably susceptible to the Trustee's interpretation which is that it applied to grandchildren born out of wedlock only if they lived, a substantial time, while minors, in the home of the natural parent. The court relied on the Settlor's affidavit and the current legal authority. The court ruled that the Settlor's affidavit is relevant here and a reasonable basis for the Trustee's interpretation in that it could be perceived as a statement of the Settlor's unspoken intent regarding a circumstance he had not expressly considered because he never imagined it could be otherwise. The court also stated that it is reasonable to conclude that this was the Settlor's intent at the time of the establishment of the grandchildren's trusts, given that the Legislature adopted the legal authority only three years after the grandchildren's trusts were created.

This case reminds us why, with each estate planning matter, it is so important to define terms in the documents that we may think might cause ambiguity in the future based on the individual facts and circumstances surrounding the matter as terms may be construed differently in the future if they are not specifically defined in the trust agreement.

In the Matter of the Appeal of J. Bracamonte and J. Bracamonte (OTA Case No. 18010932) Change of Domicile

The issue in this case was whether the couple were California residents on July 18, 2008 (the date they sold their business) so that the proceeds from the sale of their business are subject to California taxation.

The couple argued that they ceased being residents of California and established their domicile in Nevada on February 26, 2008, the day they secured their apartment in Nevada. Also, after they secured the apartment, and before July 18, 2008, they performed a number of changes showing an intention to move, including opening a Nevada post office box (to which they forwarded their mail from their California post office box), registering to vote in Nevada, obtaining a Nevada cell phone number, establishing care with an eye-care provider, servicing their automobile, and purchasing and registering a trailer in Nevada. They also attended real estate auctions in Las Vegas, Nevada although they failed to purchase a home before the sale of their business.

An individual can only have one domicile at any given time. Domicile is the one location where an individual has the most settled and permanent connection, and the place to which an individual intends to return when absent. To change domicile, one must: (1) actually move to a new residence; and (2) intend to remain there permanently or indefinitely.

The court found that the couple did not change their domicile. While they eventually purchased a home in September 2008, in the interim they retained their large California home and left much of their personal property at their California home and spent a majority of their time there from February 25, 2008 through July 18, 2008. The couple testified that they only took essentials to their Nevada apartment, such as linens, towels, dishes, and some basic furniture, but they left their precious mementos and other valuable items in California until they acquired a "permanent home" in Nevada. The court viewed the couple's possession of a rental apartment as part of their plan to find a permanent home, but that was not the actual move to a new residence with the intent to remain there permanently.

As such they retained their California domicile through July 18, 2008, the date of the sale of the business.

The determination of domicile is based on factors that can be separated into 3 categories: (1) registrations and filings with a state or other agency; (2) personal and professional associations; and (3) physical presence and property.

This married couple began to increase their contacts with Nevada, but their contacts with California remained significant. They had numerous vehicles and vessels registered with California, including a Harley Davidson that was purchased in June 2008 and registered in California (which was only a month before the sale of the business). They maintained their California PO box, numerous bank accounts, and established care with healthcare professionals in California. Prior to the sale of their business they conducted business in San Diego, including the holding of meetings with attorneys about ongoing litigation and meetings that ultimately led to the sale of the business. These connections favor California residency.

This case reminds us that changing one's domicile is not always easy when you have lived in a state for a long period of time and have formed strong connections with ties to that state. In this case, the temporary renting of a Nevada apartment was insufficient, even when combined with changing mailing address, registrations and licenses.

IRS News Release: EIN Holders Must Update Responsible Party Contact Information (IRC §6109)

Entities (businesses and charities) with Employer Identification Numbers ("EINs") are urged to update their applications if there has been a change in the responsible party or contact information. Treasury regulations require EIN holders to update responsible party information within 60 days of any change by filing *Form 8822-B, Change of Address or Responsible Party-Business.* The IRS is stepping up its awareness efforts aimed at businesses, partnerships, trusts and estates, charities and other entities that are EIN holders. Starting in August, the IRS will begin sending letters to approximately 100,000 EIN holders where it appears the responsible party is outdated.

Estate of Kwang Lee v. Commissioner (TC Memo 2021-92) Executor personally liable for estate taxes because he made distributions of estate assets knowing that the estate owed the taxes

Kwang Lee died testate on September 30, 2001, and Mr. Frese, a licensed attorney and municipal court judge, was named executor of the estate.

In April 2006, the IRS sent Mr. Frese a notice of deficiency claiming the estate owed over $1,000,000 in estate tax (the "Estate Tax Claim"). Mr. Frese promptly filed a petition in the Tax Court disputing the Estate Tax Claim.

In February 2007, while the Tax Court case was pending, Mr. Frese distributed $640,000 of estate assets to the estate beneficiaries. As a result of the distribution, the estate retained assets of only $183,000, which was not enough to satisfy the Estate Tax Claim.

In March 2010, the Tax Court issued a decision finding that the estate owed $536,151 in estate tax.

In 2013, the IRS sent Mr. Frese a Notice of Federal Tax Lien. In response to the lien notice, Mr. Frese submitted an offer-in-compromise, based on doubt as to collectability, to settle the Estate Tax Claim.

The IRS declined the offer-in-compromise as too low, because it determined that the estate's reasonable collection potential included amounts it could collect from Mr. Frese under the Federal Priority Statute. The Federal Priority Statute states that an executor may be held personally liable for the unpaid estate tax claims to the extent the executor distributes assets from the estate to the beneficiaries before satisfying and paying a claim owed to the government (31 USC sec. 3713).

The Tax Court ruled that Mr. Frese had both knowledge and notice of the Estate Tax Claim in February 2007 when he distributed the estate's assets.

First, the Tax Court found that Mr. Frese had notice of the Estate Tax Claim because in April 2006 he received a deficiency notice from the IRS before the distribution of estate assets.

Second, the Tax Court determined that Mr. Frese had actual knowledge of the Estate Tax Claim because he was a named party in the Tax Court petition the estate filed disputing the deficiency notice it received in April 2006.

The Tax Court also noted that the Executor, a licensed attorney, made the February 2007 distribution knowing that the IRS had determined an estate tax deficiency against the estate, and that an action disputing that deficiency claim was pending before the Tax Court.
Under these circumstances, the Executor "made the February 2007 distribution at his own peril, and any advice he may have received" from a tax professional regarding the distribution did not absolve him from liability.

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