Proskauer

Wealth Management Update

December 2021

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

Federal interest rates increased slightly for December of 2021 but remain fairly low historically. The December Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 1.6%, which is 0.2% higher than the November rate. The December applicable federal rate ("AFR") for use with a sale to a defective grantor trust, self-cancelling installment note ("SCIN") or intrafamily loan with a note having a duration of three to nine years (the mid-term rate, compounded annually) is 1.26%, up slightly from 1.08% in November.

The AFRs (based on annual compounding) used in connection with intrafamily loans are 0.33% for loans with a term of three years or less, 1.26% for loans with a term between three and nine years and 1.90% for loans with a term of longer than nine years. With the short and mid-term rates remaining low, clients who have the liquidity to repay loans within three years will likely prefer the short-term rate for their estate planning transactions, and clients seeking a broader time horizon will likely prefer to use the mid-term rate.

Thus, by way of 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 1.90% the child will be able to keep any returns over 1.90%. These same rates are used in connection with sales to defective grantor trusts.

Fifth Circuit Court of Appeals Upholds Finding of Gift Tax Deficiencies After Taxpayer's Failed Attempt to Use Self-Adjusting Formula Clauses. *Mary P. Nelson et al. v. Commissioner* (5th Cir., No. 20-61068, November 3, 2021)

In *Nelson*, the federal Fifth Circuit Court of Appeals upheld the IRS's imposition of gift tax deficiencies relating to a client's attempted use of a formula clause to make separate gifts and sales of limited partnership interests. The taxpayer in this case entered into separate transactions where she and her husband sought to sell and gift separate limited partnership interests with a specified fair market value "as determined by a qualified appraiser within ninety days of the effective date of the [Agreement]."

The court acknowledged that self-adjusting formula clauses have been accepted by other courts in various forms. In particular, the court references self-adjusting formula clauses that refer to either (a) a specified fair market value "as finally determined for transfer tax purposes," as in *Wandry v. Comm'r,* T.C. Memo. 2012-88 (2012 Tax Ct) or (b) a specified fair market value "as finally determined by the willing-buyer/willing-seller" test used in the relevant Treasury regulation in *Succession of McCord,* 461 F.3d 614 (5th Cir. 2006).

However, the clause used by the taxpayer in *Nelson* was determined by reference to the *initial appraisal*, and therefore was not subject to adjustment in the event that the IRS determined that the transferred interests had a different value. Accordingly, once the initial appraisal was finalized, the value of the transferred interest was established for purposes of the transfer instruments. The Court thus held that the IRS's subsequent determination that the value of the transferred interests was greater than the value stated in the initial appraisal properly resulted in the taxpayer being found to have made additional gifts and subject to a corresponding gift tax liability.

Federal District Court Imposed Constructive Trust Over Estate Assets and Granted a Temporary Injunction Preventing Estate Dispositions Based on Allegations of Decedent's Embezzlement From Employer. *Van Horn, Metz & Co. v. Crisafulli,* 2021 WL 4317186 (D.N.J. Sept. 23, 2021)

The United States District Court for the District of New Jersey held in favor of a decedent's former employer who sued the decedent's New Jersey estate alleging that the decedent embezzled over $4.3 million while working as the employer's Controller.

The employer provided significant evidence that the estate could not refute regarding the decedent's embezzlement, including forensic accounting showing that the decedent took excessive compensation, made improper ACH transfers from the employer and improperly used the employer's credit card without authorization. This evidence of wrongful acts that benefitted the decedent were strong support that the employer would be successful on the merits in its efforts to recover assets from the estate. Moreover, the employer showed that it would suffer irreparable harm without the imposition of a temporary restraining order based on a showing of the executor's (the decedent's surviving spouse) consumption and dissipation of the estate assets, including real estate and tangibles allegedly purchased with the embezzled funds. In particular, the court referred to the executor's sale of the family's second home during the litigation without notice to the court or the employer and directed approximately $500,000 of the proceeds (about 1/3 of the sales price) to be used to pay creditors as the type of consumption that would result in further irreparable harm to the employer.

Ultimately, the court imposed a constructive trust over a significant portion of the decedent's estate and granted a temporary injunction against the estate, preventing the estate from disposing of or otherwise a portion of its assets.

Case of the Month
From Proskauer's Fiduciary Litigation Group

New York's Second Department Affirms Order Denying Probate Based on Lack of Testamentary Capacity and Undue Influence. *Matter of Falkowsky*, 197 A.D.3d 1300 (N.Y. 2d Dept., September 29, 2021)

New York's Second Department affirmed an order denying a Will to probate based on lack of testamentary capacity and undue influence where the proponent of the Will (being the decedent's sister) failed to prove that the decedent had capacity. The decedent in *Falkowsky* executed a Will leaving half of his estate to the proponent (substantially cutting out his children). The Will was executed only five months after the decedent was admitted to a hospital for rehabilitation and less than two weeks after the proponent contacted the attorney-draftsman (who was the proponent's own attorney) to meet with the decedent for the first time.

The objectant in *Falkowsky* provided evidence that the decedent was entirely dependent on hospital staff while at the hospital for rehabilitation. The proponent did not offer any doctor testimony regarding the decedent's capacity on the day the decedent executed the relevant Will, while the objectant was able to refer to months of medical records regarding the decedent's deteriorating physical and mental condition.

Additionally, when the decedent met with the attorney-draftsman, the decedent believed his estate was about $1.5mm but did not provide information regarding an $884,447 tax deferred annuity that he was entitled to collect upon his wife's death almost nine years prior, but which he never actually collected. Ultimately, the fact that the decedent did not discuss the uncollected annuity with the attorney-draftsman or collect the annuity was strong evidence relied upon by the court to deny the Will to probate and uphold the finding that the decedent lacked testamentary capacity.

Takeaway: When thinking about whether an individual has testamentary capacity people often think about whether the testator is alert and healthy. But testamentary capacity requires more: a testator must understand the "nature and extent of the property she is disposing," a requirement in New

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