Proskauer

Wealth Management Update

May 2024

May 2024 Interest Rates for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split-Interest Charitable Trusts

The May Section 7520 rate for use in estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 5.40%, an increase from the April rate of 5.20%. The May applicable federal rate (“AFR”) for use with a sale to a defective grantor trust or infra-family loan with a note having a duration of:

- 3 years of less (the short-term rate, compounded annually) is 4.97%, up from 4.89% in April.
- 3 years to 9 years (the mid-term rate, compounded annually) is 4.42%, up from 4.30% in April.
- 9 years or more (the long-term rate, compounded annually) is 4.55%, up from 4.45% in April.

Treasury Releases "Greenbook" for Fiscal Year 2025

The Biden Administration (the "Administration") recently released its fiscal year 2025 revenue proposals. Notable proposals include:

- **Transfers of Appreciated Property:**
  - Transfers of appreciated property by gift or on death would be treated as realization events. The capital gains tax at death would be deductible against the estate tax.
  - Assets in a trust or partnership must be marked to market every 90 years, beginning from January 1, 1944.
  - There would be a $5 million dollar exclusion per person on transfers of property made by gift or at death, indexed for inflation after 2024. For married couples, any amount of exclusion unused by a spouse at death would be eligible for portability to the surviving spouse.

    - Tax on certain family-owned and operated businesses would be deferred until the interest is sold or the business ceases to be family-owned and operated.
    - Tax on appreciated assets, other than liquid assets, could be paid over 15 years.
    - ***Similar provisions were included in the 2024 proposed regulations but were not enacted.***

- **Grantor Retained Annuity Trusts ("GRAT"):**
    - A GRAT would be required to a have a minimum term of 10 years and a maximum term equal to the life of the annuitant plus 10 years. The remainder interest must have a value at least equal to the greater of 25% of the value contributed to the GRAT or $500,000, but not more than the value of the assets contributed.
    - The annuity payments may not decrease during the term and the grantor would be prohibited from engaging in a tax-free exchange of any assets held in the trust.
    - ***Similar provisions were included in the 2023 proposed regulations but were not enacted.***

- **Grantor Trusts:**
    - If a taxpayer creates a grantor trust that is not fully revocable, sales between the grantor and the trust would be taxable.
    - Grantor's payment of income tax on the trust's income and gains would be treated as a taxable gift made by the Grantor.
    - ***Similar provisions were included in the 2024 proposed regulations but were not enacted.***

- **Valuation of Promissory Notes:**
    - A discount applied to a promissory note for estate and gift tax purposes must be limited to the greater of the interest rate of the note or the applicable federal rate for the remaining term of the note.
    - ***Similar provisions were included in the 2024 proposed regulations but were not enacted.***

- **Valuation Discounts:**
    - Intrafamily transfers of partial interests in property in which a family collectively owns at least 25% of must be valued based on the interest's pro rata share of collective fair market value of the interests held by the taxpayer

and the taxpayer's family members. In the case of an interest in a trade of business, the passive assets would be valued separately from the trade or business assets.

- **Administration of Trusts and Estates:**
  - For estate tax purposes only, if no executor is appointed, any person in actual or constructive possession of any property of the decedent is considered a "statutory executor."
  - An estate may elect special use valuation to reduce the value of the estate by up to $14 million.
  - Liens would be extended during any deferral or installment period for unpaid estate and gift taxes.
  - Trusts with an estimated value over $300,000 or gross income over $10,000 would be required to report their value, in each case indexed after 2024.
  - ***Similar provisions were included in the 2024 proposed regulations but were not enacted.***

- **Gift Tax Annual Exclusions and *Crummey* Powers:**
  - Total annual exclusions for certain transfers would be limited to $50,000 per year, indexed for inflation after 2025. The limit would not provide annual exclusion in addition to the annual per done exclusion, but it would be a further limit on those amounts that would otherwise qualify for the annual per-donee exclusion. Essentially, this would make a donor's transfers in the new category in a single year more than a total amount of $50,000 taxable, even if the total gift to each individual done did not exceed $18,000.
  - The new category would include transfers in trust (other than to a Section 2642(c) trust for one beneficiary included in that beneficiary's estate), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property, without regard to withdrawal, put or other rights in the donee, cannot be liquidated by the donee.
  - ***Similar provisions were included in the 2024 proposed regulations but were not enacted.***

- **Limitation on Duration of GST Exemption:**
  - GST exemption would only apply to (a) direct skips and taxable distributions to beneficiaries no more than two generations below the transferor and to younger generation beneficiaries who were alive at the creation of the trust

and (b) taxable terminations occurring while any person described above is a beneficiary.

- ***Similar provisions were included in the 2024 proposed regulations but were not enacted.***

- **Charitable Lead Annuity Trusts ("CLAT"):**
  - Annuity payments would be required to be level over the term of the CLAT and the remainder interest must be at least 10% of the value of the property contributed to the CLAT.

Aldridge v. Commissioner of Internal Revenue, No. 13742-10 (U.S.T.C. Feb. 21, 2024)

In 1992, Mr. and Mrs. Aldridge attended a seminar held by National Trust Services ("NTS"). During the seminar, NTS advised the attendees that they could reduce their personal income taxes using an NTS "family trust". NTS instructed attendees of the seminar on how to devise a family trust system that would allow them to control the amount of tax they would pay and convert their living expenses into business expenses. By the end of the two-day workshop Mr. and Mrs. Aldridge had executed trust documents (the "Aldridge Family Trust System"), transferred their property into the trusts and applied for employer identification numbers. The Aldridges or their related entities served as Trustees for each of the trusts comprising the Aldridge Family Trust System.

Under the Aldridge Family Trust System, Mr. Aldridge's income funneled through the trusts and ultimately wound up in the Aldridge Family Trust (the "Family Trust"). The Family Trust would then deduct the Aldrige's personal expenses, including mortgage payments, utility payments, groceries, clothing expenses and vehicles. If the Family Trust had remaining income after the payment of these various expenses, the Aldridges would direct it to the Aldridge Foundation. The Aldridge Foundation would thereafter loan funds received from the Family Trust back to the Aldridges' various other trusts as "loans".

Each of the Aldridges personal income tax returns for 1999 through 2004 reported Mr. Aldridge's income as $0 and failed to report any of the activities of the Aldridge Family Trust System.

The IRS issued a notice of deficiency to them regarding their 1999 through 2004 personal income tax returns and sought more than $1 million in taxes and fraud penalties.

The Aldridge's filed a petition with the tax court challenging the deficiencies. The IRS argued that the court should disregard the Aldridge Family Trust System's six various trusts because they lacked "economic substance" and were therefore "sham trusts". In deciding whether to disregard a trust for lack of economic substance, the Court considered four factors: (1) whether the taxpayer's relationship to the property transferred to the trust materially changed after the trust's creation; (2) whether the trust has an independent trustee; (3) whether an economic interest passed to the other trust beneficiaries; and (4) whether the taxpayer feels bound by the restrictions imposed by the trust agreement of law of trusts.

In examining the Aldridge Family Trust System in light of the four factors, the Court sided in favor of the deficiencies and the civil penalties, stating (1) the Aldridges continued to use the property that they transferred to the Aldridge Family Trust System after the trusts were created, (2) none of the trusts comprising the Alderidge Family Trust System had independent trustees and that the Aldridges managed and made all decisions with respect to the trusts, (3) no economic interest had passed to the beneficiaries of the trust, but rather the trusts only benefited the Aldridges and (4) even though the Aldridge's did establish separate bank accounts for each of the trusts under the Aldridge Family Trust System, the Aldridge's did not make any effort to make the make the trusts' property productive.

Proposed New Regulations for Charitable Remainder Annuity Trusts

On March 25, the IRS issued proposed regulations (REG-108761-22) requiring the reporting of certain Charitable Remainder Annuity Trust ("CRAT") transactions with the goal of limiting the abuse of certain CRATs used to avoid recognizing income.

Specifically, the proposed regulations target CRATs funded with appreciated assets that are then sold, and the sale proceeds then used to buy a single premium immediate annuity ("SPIA"). A SPIA is a type of annuity contract that provides a fixed stream of payments for a specified period or for life, in exchange for a single lump-sum payments. The payments from a SPIA are generally taxable to the recipient under Section 72 of the Internal Revenue Code (the "IRC"), which allows a portion of each payment to be excluded from gross income as a return of the original investment. The proposed regulations would classify CRATs utilizing this type of transaction as "listed transactions," requiring reporting to the IRS or be subject to severe penalties. Additionally, the advisors or promoters who recommend these types of transactions would also be subject to reporting requirements, or they too, could face penalties.

Under Prop. Reg. 1-6011-15, a transaction is a "listed transaction" (thereby requiring reporting) if:

1. The grantor creates a trust purporting to qualify as a CRAT under IRC Section 664;
2. The grantor funds the trust with property having a fair market value in excess of its basis (the "Contributed Property");
3. The trustee sells the Contributed Property;
4. The trustee uses some or all of the proceeds from the sale of the Contributed Property to purchase a SPIA; and
5. On a federal income tax return, the trust's beneficiary treats that amount payable from the trust as if it were, in whole in art, an annuity payment subject to Section 72 instead of as carrying out the beneficiary amounts of ordinary income and capital gains of the trust in accordance with Section 664(b) of the IRC.

If required to be reported, Form 8886 must be completed to disclose information for each reportable transaction and must be attached to the taxpayer's federal income tax return. Material advisors must also disclosure any reportable transaction on Form 8918, in detail along with any potential tax benefits resulting from the transaction. The material advisor's disclosure must be filed by the last day of the month that follows the end of the calendar quarter in which the advisor becomes a material advisor with respect to the reportable transaction. Material advisors include those who provide material aid, assistance or advice related to carrying out the transaction and who receive direct or indirect income from it. A material advisor can also include a charitable remainderman.

Taxpayers and material advisors who fail to report these transactions are subject to penalties. The proposed regulations provide that certain organizations whose only role or interest in the transaction is as a charitable remainderman will not be treated as participants in the transaction or as parties and therefore will not be subject to excise taxes and disclosure requirements.

Connelly v. United States (No. 23-146)

On March 27, 2024, the United States Supreme Court heard oral arguments over whether the estate of a deceased building supply company owner should be taxed on $3 million in life insurance proceeds the company used to buy his shares after his death.

Brothers, Michael and Thomas Connelly, owned all of the shares in Crown C Corporation ("Crown C"). Crown C acquired life insurance of $3.5 million on each brother.

Michael Connelly died in 2013 and Crown C received the life insurance proceeds. Crown redeemed Michael's shares pursuant to an agreement between Thomas and Michael's sons, in which they agreed that Michael's shares would be worth $3 million. Crown C used the remaining $500,000 to fund its operations. Thomas, as Executor of Michael's estate filed an estate tax return and reported Michael's shares as having a value of $3 million as of his date of death and paid an estate tax of approximately $300,000.

The IRS determined that Michael's shares were undervalued, insisting that Crown C's fair market value should include the insurance proceeds and therefore, Michael's estate was deficient on $1 million in additional estate tax.

The IRS issued a deficiency notice to Michael's estate. Michael's estate paid the deficiency and sued the IRS for a refund.

Michael's estate, using the willing-buyer/willing-seller test, argued a willing buyer of the shares would take into account that the $3 million in life insurance proceeds were an asset that is directly offset by the liability of the redemption agreement. Further, Michael's estate argued that the redemption transaction fixes the value of Michael's shares for estate tax purposes based on the stock purchase agreement, in line with Section 2703(b) of the IRC. On the contrary, the IRS argued the redemption is not a liability and that a willing buyer at Michael's death, who seeks to purchase all of the shares would expect to pay roughly $7 million for all of them, and then either extinguish the redemption agreement, or redeem the shares from himself.

The district court granted summary judgement in favor of the IRS ruling that the stock purchase agreement did not influence the valuation process and that the life insurance proceeds were substantial corporate assets, necessitating their inclusion.

The estate appealed and the Court of Appeals for the Eighth Circuit affirmed the district courts ruling, determining that the life insurance proceeds increased shareholder's equity. The estate petitioned for a writ of certiorari which was granted by the United States Supreme Court on December 13, 2023.

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