Proskauer

Wealth Management Update

May 2025

May 2025 AFRs and 7520 Rate

The May 2025 Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 5.00%, which is the same as the April 2025 Section 7520 rate. The May applicable federal rate ("AFR") for use with a sale to a defective grantor trust or intra-family loan with a note having a duration of:

- 3 years or less (the short-term rate, compounded annually) is 4.05%, down from 4.16% in April;
- 3 to 9 years (the mid-term rate, compounded annually) is 4.10%, down from 4.21% in April; and
- 9 years or more (the long-term rate, compounded annually) is 4.62%, up from 4.61% in April.

Estate of Kalikow v. Comm'r, 2025 WL 686037 (2nd Cir., March 4, 2025)

The Second Circuit determined that a liability associated with a qualified terminable interest property trust did not reduce the value of the assets from that trust included in the estate of the beneficiary spouse, nor did it generate an administration expense deduction for the estate of the beneficiary spouse.

In this case, Sidney Kalikow ("Husband") established a marital trust (the "QTIP Trust") for his wife, Pearl Kalikow ("Wife"), which consisted mainly of ten rental properties. The QTIP Trust was to distribute net income to Wife quarterly during her lifetime and be divided into further trusts for their children upon her death, however, Wife's will bequeathed the residue of her estate to a charitable foundation. Under § 2270A(a) and Wife's will, the estate tax on the QTIP Trust's assets included in Wife's estate was to be paid by the QTIP Trust.

Before Wife’s death, the ten rental properties were transferred to a limited partnership (the “LP”), in which the QTIP Trust held a 98.5% interest. Upon Wife’s death, the QTIP Trust included this LP interest and $835,000 in cash and securities; the parties stipulated that the 98.5% LP interest was worth $54,492,712 at the time of Wife’s death. During Wife’s probate, a dispute arose regarding the trustees of the QTIP Trust not paying the full income from the LP to Wife during her lifetime as was required by the QTIP Trust. The parties then agreed that a payment of $6,572,310 from the QTIP Trust to Wife’s estate would resolve the claim (the “Settlement”).

Ultimately, the Second Circuit reasoned that the Settlement does not affect the value of the underlying assets of the QTIP Trust, thus it would not alter the value of the assets included gross estate as reported on Wife’s estate tax return. It explained that a hypothetical purchaser of the LP interest (the largest asset of the QTIP Trust) would not consider the liability from the Settlement when purchasing the LP interest, as the liability did not encumber the LP interest (or other assets of the QTIP Trust) and was merely a liability of the QTIP Trust itself. Moreover, the parties previously agreed to a value of the LP interest and knew of the claim underlying the Settlement at the time the value was agreed upon.

The court further held that the Tax Court did not err in denying an administration expense deduction under § 2053(b) for the amount of the Settlement. It reasoned that the entity responsible for paying the Settlement is the QTIP Trust and not Wife’s estate. Wife’s estate also argued that the estate could be double taxed as it includes both the Settlement and the assets of the QTIP Trust, however, the court explained that the residuary of Wife’s estate goes to charity, thus it will receive a charitable deduction for the amount of the Settlement, thus the estate cannot be double taxed.

Estate of Galli v. Comm’r, Tax Ct. Dkt. Nos.: 7003-20, 7005-20

In relevant part, the Tax Court determined that an unsecured, interest-only loan to a related party at the Applicable Federal Rate (“AFR”) was not considered a taxable gift, even if the interest rate was lower than the market rate for comparable loans.

Specifically, Barbara Galli (the "Decedent") transferred $2.3 million to her son in 2013. Both the Decedent and her son signed a simple note (the "Note"), which specified a 9-year term and an interest rate of 1.01%, which was the mid-term AFR at the time. The Note stipulated annual interest payments with the principal due at the end of the term. The Decedent and her son treated this transfer as a loan, so the Decedent never filed a gift tax return to report the transfer of assets. Annual interest payments were made by the son and reported on the Decedent's income tax returns.

The Decedent passed away in 2016, and her son inherited the Note under her estate plan. On the Decedent's estate-tax return, the unpaid portion of the Note was reported using a value that discounted the future payments due under the Note and included an additional discount for the risk of non-payment. The Commissioner issued notices of deficiency for nonpayment of gift tax and underpayment of estate tax (collectively, the "Notices").

With regard to gift-tax, the Notices determined that the amount by which the value of money lent in 2013 exceeds the fair market value of the right to repayment set forth in the Note is a previously unreported and untaxed gift of $869,000. This determination was made using the valuation method employed on the Decedent's estate-tax return (e.g., including a risk of non-payment when discounting), and the Service argued that "[t]he principles of asset valuation are to be applied consistently for gift tax and estate tax purposes, consistent with the doctrine of *in pari materia*."

The applicable issue was whether there was a gift made by the Decedent in 2013 based on the present value of the Note exceeding the present value of all payments due under the loan and discounted back. Ultimately, the Tax Court granted full summary judgment to the taxpayer in the gift tax case, as § 7872 covers below-market loans for income and gift tax purposes and there was no gift made in 2013 when applying the principles of § 7872. Specifically, § 7872 simply uses the AFR to calculate the present value of a term loan and in order to determine if the loan is a below-market loan and, when using the applicable AFR, the present value of all payments due under the loan and discounted back was equal to the present value of the Note that required annual interest payments at the AFR. The Tax Court further explained that it had previously rejected the argument that a loan can be recharacterized as a partial gift if it carries an interest rate below market but equal to or above the AFR.

PLR 202509010

The early termination of a grandfathered trust did not have any negative gift or GST tax consequences; however, the termination had various income tax effects, including the triggering of taxable gain for the holder of a lifetime income interest in the trust.

The trust in question (the “Trust”) was an irrevocable trust established before September 25, 1985. The Trust required an annual annuity to be paid to the Settlor’s grandchild (the “Grandchild”), with no other current distributions permitted. Upon the Grandchild’s death, the annuity was to be divided among the Grandchild’s descendants, per stirpes. The Grandchild’s living descendants were two children (the “Current Remaindermen”) and four grandchildren (the “Successor Remaindermen”). The Trust was designed to terminate upon the death of the last of ten individuals, one of whom was the Grandchild. At that time, the remaining property would be divided among the Grandchild’s descendants, per stirpes.

The relevant parties entered into an agreement under the relevant state statute to terminate the Trust (the “Agreement”), contingent upon receiving a favorable letter ruling from the IRS. The Agreement stipulated that upon termination, the Trust property would be distributed to the Grandchild, the Current Remaindermen, and the Successor Remaindermen according to the actuarial value of each beneficiary’s interest in the Trust (the “Proposed Distribution”), as determined by a valuation company. Ultimately, a state court approved the Agreement.

The rulings requested were: (i) that the termination of the Trust and the Proposed Distribution would not cause the Trust or any distributions from the Trust to become subject to GST tax under § 2601; (ii) that the termination of the Trust and the Proposed Distribution would not cause the Trust or any of the beneficiaries of the Trust to be treated as having made taxable gifts under § 2501; and (iii) that the termination of the Trust and the Proposed Distribution would be treated as a sale of the Grandchild’s and the Successor Remaindermen’s interests in the Trust to the Current Remaindermen.

With regard to GST tax under § 2601, the service explained that as long as the actuarial values of the Trust accurately represent the actuarial value of each beneficiary's interest, there would be no adverse GST tax implications for the termination of the Trust and the Proposed Distribution, as the transaction neither causes a beneficial interest to be shifted to a lower generation beneficiary nor extends the time for vesting of any beneficial interest in the Trust beyond the period provided for in the original Trust.

For gift tax purposes under § 2501, the service similarly stated that if the actuarial values of the Trust accurately reflect the value of each beneficiary's interest, then the beneficiaries' rights, interests, and expectations would remain essentially unchanged before and after the termination of the Trust and the Proposed Distribution. Given this, the IRS concluded that no property transfer would be considered to have occurred due to the termination and Proposed Distribution for gift tax purposes, thus no gifts would be recognized under § 2501.

For income tax purposes, the service stated that the termination of the Trust and the Proposed Distribution would effectively constitute a sale of the Grandchild's and the Successor Remaindermen's interests to the Current Remaindermen, as well as an exchange of interests among the Current Remaindermen and other beneficiaries. For the Grandchild, the service cited Revenue Ruling 72-243, which clarifies that when a life tenant transfers their entire interest in a trust to the holder of the remainder interest, the proceeds received are treated as an amount realized from the sale or exchange of a capital asset under § 1222. Additionally, under § 1001(e), the Grandchild's basis in the income interest is disregarded when determining gain or loss, thus any amount the Grandchild would receive due to the early termination of the Trust would be classified as long-term capital gain under § 1222, as the Grandchild's holding period was in excess of one year. For the remaindermen, the IRS explained that their trust interests were similarly capital assets. As a result, any amounts received by the Successor Remaindermen in the Proposed Distribution would be treated as amounts received from the sale or exchange of a capital asset when determining the capital gains under § 1222. Lastly, the IRS noted that the amount realized by the Current Remaindermen from the exchange of property for Trust interests held by the Grandchild and the Successor Remaindermen would be equal to the fair market value of the Proposed Distribution made to both the Grandchild and the Successor Remaindermen. Notably, it did not outline what the actual amount of gain would be for the remaindermen, just that the gain determined under § 1001(a) would be long-term capital gain for each.

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