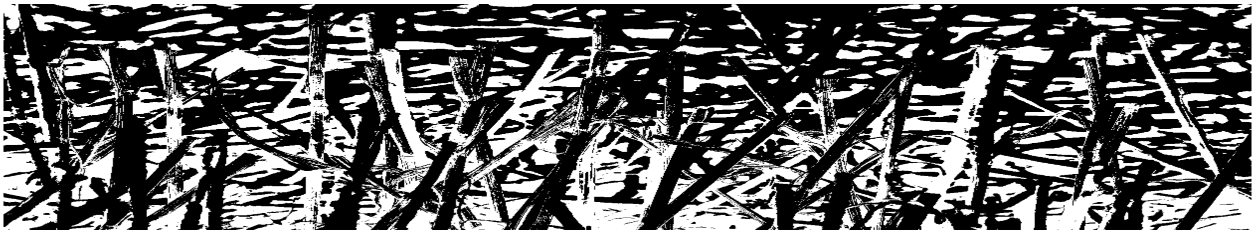

Jack Straw Fortnightly*

waxing gibbous

The section 7520 rate continues to fall.

For October the rate is 1.8 pct., not quite two full points off the crest at 3.6 pct. last November and December, and the lowest rate since December 2016, when we were crawling out of a trough at 1.4 pct. in August and September of that year.

Down a hundred forty basis points from April 2018, when the ACGA announced a significant increase in recommended gift annuity rates.

At the time, the yield on ten-year Treasuries was closing in on three pct., a rate we had not seen since October 2013. It has been since April 2007 that we have had rates at five pct. or higher.

Right now we are down around one point five pct., the lowest rate since July 2016 -- and before that, August 2012. We did peak at about three and a quarter last October.

The rate on long-term Treasuries is still below the federal funds "overnight" target rate, despite the recent quarter point cut, meaning there is not much or any incentive for banks to be buying these.

Again, Jack is not an economist, or a market analyst or whatever, but some folks who do claim relevant expertise are saying this is not a good sign.

tilting at windmills

After a couple of false starts several years ago, the Connecticut legislature has enacted, finally, significant portions of the uniform trust code.

With a couple of other items tacked on. Self-settled spendthrift trusts, of course, which we can talk about some other time, but also an amendment to the statutory rule against perpetuities to extend the "wait and see" period from ninety years to eight hundred.

Jack has expressed himself at length elsewhere on the subject of the race to the bottom among states to abrogate the common law rule against perpetuities.

Reversing this trend is a significant part of the ~~quixotic~~ stated mission of the Greystocke Project, of which this newsletter is in effect the house organ.

In brief, Jack's argument is that the predictable social consequences of abrogating the rule include

- multiple generations of beneficiaries insulated from civil liability for their actions because their assets are tied up in perpetual spendthrift trusts, and

- large pools of financial assets permanently withdrawn from the federal transfer tax system -- and after *Kaestner*, from state income taxation as well -- controlled by a handful of players who can then manipulate the mechanisms of government through their armies of bankers and lawyers,

and so on.

But somehow these policy questions never come up in the legislative committee hearings through which these measures are cleared. Instead we hear

- other states are doing it, and if we do not follow along we will lose trust business to our neighbors, and/or

- the rule is an anachronism from the seventeenth century, when the primary form of wealth was land.

The second argument assumes that the entire rationale for the rule is to forbid an "unreasonable" restraint on alienation, *i.e.*, that remote vesting is not in itself a concern of the rule.

If a trust is invested in financial assets -- assuming the trustee has a power of sale, though the Connecticut statute does not literally require this --, there is not a restraint on alienation. Of the financial assets. Or so the argument goes. Unless this is a straw man.

But clearly there is a restraint on alienation of the nonvested future interest itself. So the second argument fails unless the proponent can articulate a reason why the rule's concern for remote vesting is in fact an anachronism, *i.e.*, why it should not apply to a trust holding financial assets.

The first argument, standing alone, is simply unworthy. And yet it is mostly what you hear.[1]

Obviously a state legislature could make an informed policy choice to allow accumulations in spendthrift trusts until the end of time. Unless there was a state constitutional prohibition on perpetuities, which is not the case here.

Jack's claim is that legislators are not getting enough information to make these choices. And the organized bar, which has a responsibility to provide that information, is instead pursuing a self-interested agenda.

another flawed letter ruling

A few weeks ago, IRS released a batch of three related letter rulings, numbered consecutively PLRs 201938004, 005, and 006, each confirming that a modification to the terms of a multi-generational trust would not be treated as a "constructive addition," causing the trust to lose its "grandfathered" status as exempt from the generation-skipping transfer tax.

IRS issues a dozen or two of these in a year, often in batches of two or three or more. Usually these rulings have to do with post-1985 trusts that are said to be exempt from the generation-skipping transfer tax because the transferor has allocated sufficient exemption amounts to give the trust a zero inclusion ratio, and often they amount to "comfort" rulings.[2]

For a dozen years, IRS has had in place a "no rule" policy with respect to modifications of pre-1985 trusts that fall squarely within any of the examples illustrating reg. section 26.2601-1(b)(4)(i)(D).

That reg. says a modification will not cause the trust to lose its "grandfathered" exempt status if it does not (a) shift a beneficial interest to a lower generation or (b) extend the time for vesting beyond that stated in the original trust instrument.

Because we are looking here at pre-1985 trusts, the implicit premise of the ruling requests is that the particular modification might not fall within the illustrated exceptions.

So let's have a look.

Apparently there were three separate trusts, each created under the will of a different decedent. The initial beneficiary, since deceased, was a son of one decedent, a grandson of another, and a great nephew of the third. But the dispositive terms of the trusts were very similar, possibly identical.

Each trust was to distribute income currently to the initial beneficiary for his life, and then to his descendants, *per stirpes*, until the expiration of 21 years after his death, or until the youngest descendant[3] attained age 21, if earlier. At which point the remainder was to be distributed outright to descendants, *per stirpes*.

The initial beneficiary had one son, referred to in the letter rulings as "son," who in turn had a daughter and a son, referred to as "granddaughter" and "grandson." At all times relevant to the present discussion, all three of these folks were alive and over age 21.

the first foray

While the initial beneficiary was still alive, he and the trustee petitioned a state court to modify the trust so that at his death, rather than distributing outright to his son, the trust would continue as a purely discretionary trust for the benefit of the son, with the remainder at the death of the son to be distributed half in further trust for the granddaughter and half in further trust for the grandson.[4] Or if either of them had predeceased the son, to his or her estate.

Hit pause.

And ask yourself, did this modification shift a benefit to a lower generation or postpone vesting of an interest?[5]

Before the modification, the scenario was that if the son survived the initial beneficiary by 21 years, he would receive the remainder outright, and the grandchildren would receive nothing. If he did not survive by 21 years, the grandchildren would each receive half the remainder outright.

The son's remainder was contingent. The grandchildren had something like a shifting executory interest, which would vest only if the son did not survive the initial beneficiary by 21 years. Whereas.

After the modification, if the son survives the initial beneficiary,

> (a) the trustee is authorized to distribute principal to the son, which would deplete the remainder to the two grandchildren, but also -- and Jack says, more likely[6] -- to accumulate income, which would enlarge the remainder,

so there is at least a potential for shifting a benefit to a lower generation, depending on facts and circumstances,

> (b) if the son survives the initial beneficiary by 21 years, the trust would continue rather than terminate, thereby preserving a potential remainder to the grandchildren,

in other words, a contingency that might have defeated their remainder interests -- outright distribution to the son 21 years after the death of the initial beneficiary -- has been removed, and

> (c) regardless who survives how long, the two grandchildren now have a vested remainder, albeit in trust,[7] subject only to defeasance by the exhaustion of the trust principal through discretionary encroachments to their father.

So we have not postponed vesting of the remainder to the grandchildren -- to the contrary, we have removed a contingency. But that contingency would itself have vested a remainder in the son, and certainly that has been "postponed," or more to the point, destroyed.

And we have at least created an opportunity to shift the beneficial interest in accumulated income to a lower generation.

on second thought

But wait, there is more. The initial beneficiary died, and then the son died, survived by both grandchildren. How much time had elapsed is not indicated, nor whether income had been accumulated in the interval.

The present ruling requests arise from a second state court proceeding, after the son's death, in which the trustee secured a "clarification" that the son had held a general power to appoint the remainder. Which presumably he did not exercise, as he probably did not know he had it. But no matter.

Therefore we have inclusion in his gross estate, and we need no longer worry about whether the earlier court order might have triggered a "constructive addition," because we have negated that, albeit long after the fact. So are we good?

And IRS says yes. Why? because in this case it is somehow appropriate to defer to the second state court order, despite *Bosch*, because, quote,

> an examination of the documents together with state law confirms that Decedent intended to give Son a power of appointment and the Date 5 order clarified such right[,]

end quote.

To which Jack says, what? "the decedent intended"?

Keeping in mind we are talking about three separate decedents, each of whom IRS is saying intended the same thing, and none of whom was contemplating that the son would have a general power if he did not survive to distribution.

Jack says each of them, yes, did intend that the remainder would be distributed outright to the son, if he survived the initial beneficiary by 21 years, and in that scenario the proceeds would have been includible in his gross estate. So each of the decedents had accepted the risk that the remainder might be taxable to the son under section 2033.

But it is not at all obvious from the facts recited in these rulings that each decedent, or any of them, intended to give the son a power to appoint the remainder if he did not survive to distribution, much less a general power. This became an issue only after the first judicial modification.

And there is no indication that either of the state court proceedings was controverted. To the contrary, it would appear that the trustee, presumably in cooperation with the son's executor, was trying to alter the transfer tax consequences of the earlier court order after the fact, and probably everyone was on board with that.[8] So there is no reason to defer to the court order.

litigation hazards none

And then there was a chief counsel memo, CCA 201939002, advising area counsel in San Francisco that in determining the present value of the remainder interest in a grantor retained annuity trust funded with publicly traded stock shortly before the public announcement of a pending merger, the transferor could not use the mean between high and low trading prices on the date of transfer, but would instead have to establish fair market value with reference to, how you say,

> the price that a hypothetical willing buyer would pay a hypothetical willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts[,]

quoting from reg. section 25.2512-1, and citing Rev. Rul. 59-60.

Why. Because the hypothetical parties would take the prospective merger into account in setting the price. On the first trading day after the merger was announced, the per share price did spike, but we are not told how far it might have settled back before the deal closed.

The advice is probably correct, but because of redactions we cannot be entirely certain what intervals were involved here.

The transfer to the GRAT did occur after the field of prospective merger candidates had been narrowed to one, but the deal had not yet been struck, and we are not told exactly how far in advance of the public announcement the transfer occurred.

The memo cites several cases, including *Estate of Kollsman*, T.C.Memo. 2017-40, *aff'd* No. 18-70565 (9th Cir. 06/21/19) (unpublished), in which the Tax Court has held that the "reasonable knowledge of relevant facts" principle applies "even if the relevant facts at issue were unknown to the actual owner of the property."

Which was certainly not the case here, but you get the point. The hypothetical purchaser would learn of the pending merger, even if this info was embargoed.

In any event, Jack finds it at least slightly curious that the portion of the memo in which the chief counsel is supposed to lay out what facts might still need to be developed and what are the litigation hazards is effectively blank.

Not redacted, just zero substantive content.

One supposes that there is significant money at stake here, and one might expect that if this goes to litigation a key question will be whether at the time the stock was transferred to the GRAT the merger was in fact "practically certain" to go through.[9]

detritus

[1]

In her testimony to the joint judiciary committee in support of HB 7104, the chair of the drafting committee, Kelley Galica Peck of Cummings & Lockwood, pushed the argument that Connecticut was losing trust business to neighboring states that had enacted legislation allowing self-settled spendthrift trusts.

It is a "zero sum game," she said.

She did not mention perpetuities at all, and no one asked. Nor did the office of legislative review provide any policy analysis on the issue.

[2]

By its express terms, reg. section 26.2601-1 is a transition rule, applicable only to pre-1985 trusts.

So although the modification of a post-1985 trust might otherwise fall squarely within one of the examples illustrating the regulatory exceptions, trustees and/or other interested parties will often seek a letter ruling applying an exception by analogy.

For whatever reason, IRS has not yet chosen to put these on the "no rule" list.

[3]

Presumably the youngest descendant who had already been born at the time of the first beneficiary's death, *i.e.*, not a class subject to open.

[4]

The dispositive terms of the trusts for the grandchildren are not detailed in the recitation of facts. We do not know, for example, whether each grandchild might have been given a limited power to appoint the remainder at her death in yet further trust.

[5]

Note that this first judicial modification is not itself the subject of the present rulings.

[6]

The trustee's discretion to accumulate income or to encroach on principal is said to be "absolute," which suggests that neither the son nor the grandchildren has enforceable rights, absent a breach of the trustee's duties to treat the beneficiaries impartially and to act in their respective, potentially conflicting, "best interests."

But Jack says it is reasonably clear here that the idea is to accumulate income that would otherwise have been distributed to the son for ultimate distribution to trusts for the grandchildren.

[7]

Assuming the trusts for grandchildren do not continue beyond their lives -- which is not made at all clear in the texts of these rulings.

[8]

After all, we get a basis adjustment to the date of the son's death, and even if we incur some tax in his estate, at least we get the benefit of a run up the marginal rate brackets.

And now he is the deemed transferor going forward, which may matter if in fact each of the grandchildren has a limited power to appoint the remainder at her death in further trust for yet more remote descendants.

[9]

The decisions cited in the memo on this point, *Silverman*, T.C. Memo. 1974-285, *aff'd*, 538 F.2d 927 (2d Cir. 1976), *cert. den.*, 431 U.S. 938 (1977), and *Ferguson*, 174 F.3d 997 (9th Cir. 1999), *aff'g* 108 T.C. 244 (1997), both had to do with whether at the date of transfer the public offering or merger was sufficiently certain to go through that the transfer should be treated as an anticipatory assignment of the proceeds of a sale of the stock.

That is not literally the question here. The GRAT is a "grantor" trust for income tax purposes, so the settlor will be paying tax on the realized gain.

And while it seems that similar policy considerations should apply in determining the present value of the remainder gift, the question probably should have been flagged as a litigation hazard.

Jack says, the altered world spells out your name