estate planning briefs®

MAY 2015

Who must pay the estate tax?

Smoot's estate consisted of life insurance policies, deferred compensation/commission plan accounts, an IRA account, a 401(k) account, and an annuity. His ex-wife received \$5.4 million worth of these assets, his son \$2.2 million, and an ex-partner \$100,625. Perhaps because most of these are nonprobate assets, the executor (Smoot's son) initially reported to the IRS that the estate was insolvent and that no estate tax was due. Of course, the IRS didn't see it that way, as nonprobate property is also subject to the federal estate tax. After negotiations the executor agreed to pay \$1.2 million in estate taxes and \$145,425 in accrued interest.

Smoot's will provided for apportionment of estate taxes among the assets that generated the tax liability. As the ex-wife's legacy was not shielded by the marital deduction, she was responsible for nearly 70% of the tax. When she declined to pay, the executor brought a lawsuit seeking her contribution to the estate taxes, interest, and costs of the litigation, which the executor thought should not have been needed.

The Georgia District Court sustained the executor's claim for a proportionate share of estate taxes, but it denied the request for pre-judgment interest and litigation costs. Plaintiff's damages were uncertain when the trial commenced, and Defendant's conduct in resisting the claims was neither vexatious nor unreasonable.

—Thomas H. Smoot III v. Dianne Smoot; No. 2:13-cv-00040

COMMENT: The ex-wife claimed that \$1 million of her legacy should be excluded from the calculations because it was owed to her under the terms of the divorce settlement. As such, it was a debt of the estate. The executor resisted the argument, but took the matter up with the IRS. The Service agreed with the wife, which reduced the estate tax due by \$476,986. That also altered the proportion of tax allocable to the ex-wife. The District Court cited this fact in confirming the uncertainty of the initial claim and reasonableness of the wife's litigation posture.

In terrorem clause does not negate *Crummey* power

In 2007 Israel and Erna Mikel each transferred \$1.6 million to a family trust. The trust had 60 beneficiaries, and each had a *Crummey* power of withdrawal. Accordingly, when they filed their gift tax returns, Israel and Erna each claimed \$720,000 in annual exclusions (\$12,000 per beneficiary in 2007). Each beneficiary was notified of his or her

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right to demand $24,000 from the trust, a right that lapsed after 30 days. The record does not indicate whether anyone exercised his or her demand right, and whether any such demand was satisfied.

The family trust provided that the trustees had "sole and absolute discretion" in making distributions for the health, education, maintenance, or support of any beneficiary or family member. The trustees also had "absolute and unreviewable discretion" to assist a beneficiary in defraying "reasonable wedding costs, . . . purchasing a primary residence, or . . . entering a trade or profession." Then the trust had two unusual provisions.

In the event of a dispute over the trustees' decision, the dispute "shall be submitted to arbitration before a panel consisting of three persons of the Orthodox Jewish faith." The panel was directed to abide by New York law in its deliberations. Second, any beneficiary who challenged the trustees' decisions in court would cease to be a beneficiary of the trust, an *in terrorem* clause.

The IRS asserted that those two clauses rendered the *Crummey* power illusory, and it denied the annual exclusions. The Tax Court disagreed.

Both of those clauses apply to challenges to the trustees' discretionary decisions over income and principal, not to the *Crummey* powers, over which the trustees have no discretion. The *in terrorem* clause bars a beneficiary from enjoying benefits under the trust if he or she files suit in any court to oppose or challenge a decision by the trustees to distribute trust property to another beneficiary. That doesn't alter the beneficiary's right to exercise a *Crummey* power, or to seek judicial redress if the trustees resist such a demand.

—Israel Mikel et ux. v. Commissioner; T.C. Memo. 2015-64

COMMENT: The key precedent here is *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991), which permitted *Crummey* powers for minor beneficiaries when the trustee did not have a legal right to resist a beneficiary's demand for payment. In 1992 the IRS published an action on decision (AOD) acquiescing in the result of *Estate of Cristofani* [AOD 1992-9 (Apr. 6, 1992)]. In 1996 it published a second AOD explaining its position [AOD 1996-10 (July 15, 1996)]. The IRS "does not contest annual gift tax exclusions for *Crummey* powers where the trust instrument gives the power holders a bona fide unrestricted legal right to demand immediate possession and enjoyment of trust income or corpus." However, the IRS "will deny the exclusions for *Crummey* powers . . . where the withdrawal rights are not in substance what they purport to be in form." Annual exclusions will be challenged if "there was a prearranged understanding that the withdrawal right would not be exercised." No such arranged understanding was asserted in this case.

Reformation approved

At his death, Grantor's revocable trust became irrevocable, providing life income for his mother and another beneficiary, with the remainder passing to charity. As such, the trust does not qualify for an estate tax charitable deduction. Within 90 days of the date that the estate tax was due, the estate's executor sought a reformation of the trust, transforming it to a charitable remainder unitrust, in order to secure the deduction.

The IRS agrees that this will work. The original trust included a "reformable interest" that was ascertainable and severable from the noncharitable interests. It would have qualified for the charitable deduction before enactment of IRC §2055(e)(2). Furthermore, on the facts presented, the value of the qualified interest will be within 5% of the reformable interest.

—Private Letter Ruling 201450003

No deduction without segregation

A recent Tax Court decision shows how estates of well under $1 million can run into tax trouble.

Eileen Belmont's 1994 will left all of her property to her mother, Wilma. It further provided that should Wilma die first, Eileen's brother David was to receive $50,000, and the balance of the estate would pass to the Columbus Jewish Foundation. Wilma died in 2001, and Eileen died in 2007, so the contingent disposition applied.

Eileen's estate consisted of $243,463 in the State Teacher's Retirement Pension Fund, a home in Ohio that was sold by the executor for $217,900, and a condo in Santa Monica, California. The condo originally was owned by Wilma, and brother

David had moved in with Wilma to help care for her. Both of them returned to Ohio about a year before Wilma died. Eileen purchased the condo from Wilma's estate. David moved back into the condo in 2006, living there rent free for about nine months until Eileen died.

David asked the executor about exchanging his $50,000 bequest for a life tenancy in the condo. The condo was to pass to the Foundation under the terms of the will, and the Foundation refused David's offer. They countered with a "$10,000 stipend" if David would vacate the premises immediately.

He did not vacate the premises and, instead, filed a creditor's claim in Los Angeles County Probate Court, alleging breach of an oral contract between himself, Eileen and Wilma. He claimed that he had been promised lifetime use of the condo in exchange for his services in caring for Wilma. His claim was filed April 2, 2008, and rejected by the estate May 13, 2008. (David was a client of a local mental health organization, and his case was taken pro bono by an attorney who was a board member of the organization.)

In its fiduciary income tax filing of July 17, 2008, the estate claimed a charitable deduction of $219,850 for the amounts passing to the Foundation. However, that amount had not been paid yet, nor had it been segregated from other funds used to pay administrative expenses. Apparently, the CPA who completed the Form 1041 was not advised by the executor of David's lawsuit.

The probate court accepted David's claim to the condo in October 2011. The estate appealed the verdict, but it lost in February 2013. David was awarded the life tenancy in the condo, which was converted to a life estate, remainder to the Foundation.

The IRS denied the estate's charitable deduction because no amount of money had been permanently set aside for the Foundation as of the date of the tax filing. The estate argued in the Tax Court that as of that date, the chance that it would not have sufficient funds to pay the charitable bequest was so remote as to be negligible. The Court disagreed, noting that the estate was on notice of the pending litigation, even if its CPA was not. Because there was a real possibility that the estate would be depleted before payment to the charity was made, no charitable deduction was permitted.

—Estate of Eileen S. Belmont et al. v. Commissioner; 144 T.C. No. 6

COMMENT: As a matter of fact, as of the date of the Tax Court litigation, the estate's assets had dwindled to $185,000, largely because of the intervening litigation expenses, so there wasn't enough money left to satisfy the charitable transfer.

Alternate valuation for a late estate tax return

Executor was unaware that an estate tax return was due for the estate that he was settling. He consulted an attorney after the due date for the return, and he was advised to file immediately. The estate tax return was filed within one year of the due date for the return.

Evidently, the executor did not elect the alternate valuation date, and he now would like to do so on an amended return. Under IRC §2032 the executor may choose to value assets six months after the decedent's death instead of at the date of death, provided that the election results in a smaller estate and a smaller estate tax. (In other words, nontaxable estates can't make the election to get a larger step-up in basis.) Assets that are sold within six months of the decedent's death are valued as of the date of sale.

In private advice the IRS grants the request for an extension, telling the executor that he has 120 days to file the new, lower estate values. The key was making certain that the original return was not more than a year late (including extensions).

—Private Letter Ruling 201503003

Contingent trust beneficiary permitted to purchase trust assets

Grantor 1 created Trust 1 for the benefit of his descendants, and Grantor 2 created Trust 3 for his. Each trust owns farm property. The farms are contiguous, but some acreage is landlocked. The agricultural property in both trusts has been on the market for several years.

A limited liability company owned by A, a licensed real estate broker, has offered to buy the farms. The sale is complicated by the fact that A is descended from both grantors, is a contingent beneficiary of Trust 3, and is trustee for a trust that is itself a current beneficiary of Trust 1. However, the trustees of Trust 1 and Trust 3 are independent; everyone was represented by separate counsel; and a Court will oversee the transaction. The sales price was reached at arm's length, and it is fair. Accordingly, the IRS holds that:

- completion of the sale will not change the GST-exempt status of either trust;
- entering the transaction and completing it will not cause any taxable gifts among the beneficiaries; and
- no part of either trust will be includable in the estate of any beneficiary, unless trust property is distributed to that beneficiary before death.

—Private Letter Ruling 201509012

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