estate planning briefs®

September 2018

In This Issue

- Inhertiance protection and divorce
- Post mortem damage control
- Perils of the amateur fiduciary
- Tax receipts climb after TCJA
- Marital trust avoids §4947 taxes
- The IRS and the Tea Parties

Wealth Management

Santa Barbara:
1106-E Coast Village Rd.
Montecito, CA 93018
(805) 564-0298

montecito.bank

Inheritance protection and divorce

Joseph and Terry were married in 1985. During the course of the marriage, Terry's father established six different irrevocable trusts for his descendants. Terry and her four sisters were co-trustees of all six trusts. The sisters and their children were discretionary beneficiaries of the trusts. No beneficiary could force a trust distribution, and any distributions required a majority vote of the trustees. In 2013, 2014, and 2015 each co-trustee took a $50,000 distribution.

Joseph sued for divorce in October 2015. In June 2016 he petitioned to include Terry's trust interests in the marital assets. Terry counter-sued for divorce in July 2016, and she argued that her interest in the trusts was too remote to be touched by the divorce proceedings.

The trial court agreed that Terry's trust interest was speculative, and the Indiana Court of Appeals now affirms.

—Harrison v. Harrison, 88 N.E.3d 232 (Ind. App. 2017)

Post mortem damage control

Charles Sukenik executed his will on November 4, 2004. His estate was to be divided between his surviving spouse, Vivian, and the couple's private foundation. His revocable trust was restated at the same time, giving Vivian certain real property and the balance to the foundation.

Roughly five years later, in 2009, Charles designated Vivian as the beneficiary of his IRA, worth some $3.2 million.

When Charles died in 2013, the heirs discovered that the estate plan was not very tax efficient. Vivian was looking at potential income taxes of $1.6 million on the IRA distributions. She proposed to reform the estate plan, giving the IRA to the private foundation in exchange for other estate assets of equal value. The charity was not opposed to the plan. Being tax exempt, the new plan would make the income tax obligation that comes with an inherited IRA disappear. Certainly, this approach would more effectively implement Charles' testamentary intentions.

The lower court, however, couldn't swallow this one, because "the reformation requested here is prompted by neither a drafting error

nor a subsequent change in law. Several years after executing his will and trust, decedent himself thwarted the tax efficiency of his own estate plan by making [Vivian] the beneficiary of the IRA. There is nothing in the record indicating why, after executing these estate planning instruments, [Charles] chose to leave additional assets to his wife in this manner or why, in the four years before his death, he did not take steps to cure the unfavorable tax consequences of his choice of IRA beneficiary."

The court concluded that if reformation were allowed in these circumstances, the decision "would expand the reformation doctrine beyond recognition and would open the flood gates to reformation proceedings aimed at curing any and all kinds of inefficient tax planning." [*Matter of Sukenik*, 2016 N.Y. Slip Op.31217U (Surr. Ct. N.Y. Co. June 28, 2016)].

Now the Appellate Division of the Supreme Court of New York has come to the rescue, reversing the lower court's ruling. The Appellate Court noted that there is a presumption that testators intend to take advantage of all available tax benefits and a presumption in favor of widows. What's more, neither the Foundation nor the New York Attorney General opposed Vivian's plea for reformation. The "open the floodgates to reformation" problem was not addressed.

—In re Charles Sukenik, Deceased, 2018 NY Slip Op 04658

*COMMENT***:** *Did Charles have any understanding of the tax time bomb included in his estate plan? It appears probable that he did not consult his attorney before designating his wife as his IRA beneficiary, which is an ordinary, everyday occurrence. According to a footnote to the decision, at some point Charles' estate planning attorney suggested to him that he make a change, designating the foundation as the IRA beneficiary and substituting additional property of comparable value for Vivian. Unfortunately, soon after the advice was given, Charles became too ill to make changes to his plan. The estate planning attorney died soon after Charles did, so he was not available to testify.*

Perils of the amateur fiduciary

Glenn Forgey created a revocable living trust to manage his assets, naming his oldest child, Lyle, as trustee. The trust owned bank stock and agricultural property. At Glenn's death in 1993, the trust was to be divided into equal shares, one for Lyle, one for his brother Wayne and one for his sister Bessie. The bank stock was to be allocated to Lyle's share. However, Lyle did nothing about creating the new trusts.

An accountant prepared an estate tax return for Glenn's $3 million estate, but Lyle failed to sign the return and submit it in a timely fashion, resulting in substantial penalties and interest. Wayne and Lyle continued a ranching operation on the property, but they did not pay any rent to the trust for the use of the land. Lyle did not provide any trust accounting to the other beneficiaries, although he did share fiduciary income tax returns with them beginning in 2003.

In order to pay estate tax, Lyle lent the trust some money personally, and the rest was borrowed from the bank that Lyle owned.

When Bessie asked for money from the trust, Lyle provided her with cash distributions in 2008, 2009, and 2010. No earlier distributions were made because the trust was still paying off the tax-forced debts.

After Wayne died (the date is not given, but likely in 2012), his surviving spouse, Marvel, brought a lawsuit to remove Lyle as trustee, secure administration of the trust, value the trust assets, divide those assets into separate trusts for the beneficiaries, and determine liabilities for alleged breaches of fiduciary duties by Lyle.

By that time the trust had grown in value to $25 million. Thus, the trial court held that the beneficiaries had not been harmed by Lyle's several violations of fiduciary duty, except to the extent of the penalties and interest due on the late estate tax. Failing to charge rent for the agricultural land, for example, meant that none of the land had to be sold to pay the taxes. The court ordered the division of the trust into three trusts, taking into account the advances to Bessie and the estate tax penalties.

The Supreme Court of Nebraska held that when Wayne and Lyle failed to pay rent, they breached their duty of impartiality to Bessie, and so it ordered an additional adjustment to her share. The Supreme Court also ordered

Lyle to pay a portion of the attorney's fees for Marvel and Bessie, because "if we do not impose a penalty such as attorney fees in the instant case, then future trustees may believe that the statutory requirement to report [to beneficiaries] has no significance."

—In re Estate of Forgey, 906 N.W.2d 618 (2018)

Tax receipts climb after TCJA

The Congressional Budget Office reports that income and payroll tax collections rose 5% through the first nine months of this fiscal year, a whopping $105 billion. This more than offset the decline in corporate tax collections of $66 billion. Overall tax receipts are up 1%. CBO attributes the increase to a faster-growing economy.

—CBO Monthly Budget Review for July 2018

COMMENT**:** On the other hand, spending is up 4% through the first ten months of the year, so the deficit continues to grow.

Marital trust avoids §4947 taxes

H and W created a charitable foundation. At H's death, an irrevocable QTIP trust was established for W for her life, with the remainder passing to the foundation at her death. The QTIP trustees are concerned about the application of the self-dealing restrictions of the tax code.

The IRS provides reassurance. Because no charitable deduction was taken for the QTIP trust, IRC §4947 does not apply to it. The entire value of the QTIP trust will be included in W's estate at her death, and it will avoid estate taxes by virtue of IRC §2055 at that time. The executors of W's estate will have a reasonable time to manage the settlement of the estate.

However, the IRS warns that "during this reasonable period of settlement, transactions with respect to Foundation's interest or expectancy in Trust may result in indirect self-dealing between Foundation and a disqualified person with respect to Foundation." No opinion is expressed on that issue.

—Private Letter Ruling 201831009

The IRS and the Tea Parties

The controversy over the IRS' targeting of conservative groups was resolved with a settlement of $3.5 million. Now the District Court has awarded attorney's fees of $1.75 million and litigation expenses of at least $231,802.63. Said the Court: "The contribution by NorCal Tea Party Patriots, South Dakota Citizens for Liberty, Inc., Americans Against Oppressive Laws, Inc., Texas Patriots Tea Party, and San Angelo Tea Party has been active and meaningful throughout the five years of this litigation. Their continuous efforts made certification of the Class possible, which not only served to protect the rights and interests of more than 400 organizations, but also allows for distribution of relief to every Class Member that files a valid claim."

—NorCal Tea Party Patriots et al. v. IRS et al.; No. 1:13-cv-00341

© 2018 M.A. Co. All rights reserved.