Estate Planning Briefs

February/March 2022

The Future Taxpayer Experience

The IRS has announced the opening of the Taxpayer Experience Office, the latest attempt to provide a level of customer service that comes closer to what taxpayers are hoping for. The Office will help to implement the Taxpayer First Act, enacted on July 1, 2019. Chief Taxpayer Experience Officer Ken Corbin said, "The IRS is committed to customer experiences that meet taxpayers where they are, in the moments that matter most in people's lives and in a way that delivers the service that the public expects and deserves."

The omnibus budget bill released by appropriators on March 9reduced the budget increase for the IRS from 14% to 6%. However, the budget for Taxpayer Services gets a 9% bump. The Business System Modernization account grows by 22%.

Hopefully, what that means is faster refunds.

- IR-2022-50

COMMENT: The first progress report to the Congress on the implementation of the Taxpayer First Act may be found at https://www.irs.gov/pub/irs-pdf/p5426.pdf.

Remaindermen Without Standing

Ben Calvin established a trust for his son, John, in 1955. John was to receive all the trust income, payable at least annually. At John's death, the trust assets were to be divided among John's children. The trust also included a provision permitting the trustee to make payments of income or principal to any trust beneficiary.

Two of John's children were co-executors of his estate after he died in 2019. After they looked at the books, they resigned and brought a lawsuit against the estate. It appears that in the ten years before his death, John owned $5 million to $6 million in liquid and marketable assets, yet he persuaded the trustee to make principal

Montecito Bank & Trust®
Wealth Management

1106-E Coast Village Road
Montecito, CA 93108

distributions to him in addition to the income payments. The principal distributions reduced the value of the trust by some $800,000, and they enlarged the estate by the same amount. The primary beneficiary of the estate was John's second wife, so there could have been an element of undue influence.

- In re Estate of Calvin, 963 N.W.2d 319 (2021)

Tardy QDOT Filing Allowed

Decedent's surviving spouse was not a U.S. citizen, and therefore a Qualified Domestic Trust (QDOT) was created for the spouse. The Form 706 filed for Decedent's estate properly elected to treat the trust as a QDOT.

Some time later, the surviving spouse did become a U.S. citizen. However, she did not know that her action triggered the requirement of a final Form 706-QDT, and so she never told the trustee about it. The trustee, being left in the dark, never filed the form either. But after the surviving spouse's death, the trustee did learn of the citizenship change, and so asked for an extension of time to file the Form so that the trust is no longer subject to the estate tax of IRC §2056A(b).

The IRS granted the trustee another 120 days to make the filing, holding that everyone had acted reasonably in these circumstances.

- Private Letter Ruling 202202006

How Much Compensation is "Reasonable"?

Clary Hood is an American success story. As a boy, he learned the land grading business from his father. He joined his father's firm when he graduated from high school in 1967, and worked there until 1980. That was the year Mr. Hood struck out on his own, founding Clary Hood Inc. with two employees and $60,000 worth of used equipment. The firm provided land grading and excavation services.

The company grew slowly. From 2000 to 2010, profits were irregular and net income was less than $1 million most years. The firm was hammered by the 2008 "Great Recession," suffering three straight years of operating losses. Clary Hood stayed afloat when other companies were going under because it did not have too much debt, employee pay was temporarily reduced, $800,000 of equipment was sold to offset losses, and Mr. Hood skipped his own salary when needed to meet payroll.

One of Clary Hood's biggest customers was Walmart. Projects for them provided about 20% of the firm's revenue from1999 to 2011. However, the company had to bid competitively to get each new project, and the profit margin on this work fell to unsatisfactory levels. In the summer of 2011, to the surprise of the firm's executives, Mr. Hood announced that they would no longer accept jobs from Walmart. It was a risky move, but it paid off. New projects were found to replace the lost business, and they had much better profit margins.

The company went from a net loss of $120,530 in 2011 to net income over $7 million from 2013 to 2015, and $14.5 million in 2016. The growth was substantially attributable to Mr. Hood's efforts as CEO.

In 2014 the company consulted with their accountants, and decided to award Mr. Hood a $5 million bonus in 2015. This was to compensate him for the success that year, as well as for the earlier years in which he had taken less compensation than he might have to help keep the company afloat. In 2016, which was even more profitable for the firm, the same $5million bonus was approved.

This caught the eye of the IRS, which believed that such compensation was unreasonable.

Dividends are not deductible by the corporation, and so a corporate income tax must be paid on them, 35% for the years in issue. Once paid, the dividends are again taxable to the shareholder at rates up to 39.6% for those years. It's much more sensible to pay the owners more in compensation, which has the potential to be taxed only once.

With large compensation payouts, the IRS argues that part of the compensation is a disguised dividend, and therefore not deductible by the corporation. In this case, the IRS said that reasonable compensation for Mr. Hood was $517,964 in2015 and $700,792 in 2016. For those two years, that meant the company owed over $3.2 million in additional corporate income tax and more than $330,000 in tax penalties for the understatements.

A trial ensued. The company argued for the "independent investor test" to determine reasonableness. That is, what would an independent investor be willing to pay someone to achieve the results that were accomplished? The successes Mr. Hood achieved in bringing the firm to $70 million in revenue with 150 employees by 2016 easily satisfied this test.

But that is only one factor, the Tax Court ruled, and it is not a test that has been accepted by all courts. In the battle of the experts that ensued, the testimony from the IRS witness was given the most weight. The deliberations with the accountants for the 2015 bonus were well documented, and it covered past as well as current services. Accordingly, $3.2million was reasonable for that year, the Court concluded, and there was no penalty for understatement of tax due. But for 2016, when the firm simply paid another $5 million bonus without stating the justification for it, only $1.3 million was reasonable compensation for doubling the firm's net profit from $7 million to $14 million, according to the Tax Court's crystal ball. And the penalty for understatement of taxes was in order.

- T.C. Memo. 2022-15

Tardy Portability Election is Accepted

Decedent's estate was not large enough to require the filing of a federal estate tax return, and none was filed "for various reasons." That necessarily meant that there was no election to preserve the Deceased Spouse's Unused Exemption amount. Now the spouse has become aware of the error, and has asked for an extension of time to make the election. The IRS says yes.

- Private Letter Ruling 202202008

COMMENT: The IRS has been getting many of these requests, and they are routinely granted for estates that were small enough that no estate tax return was required. See also Private Letter Rulings 202202003,202202005, 202203008, and 202203012.

Disappointed Beneficiaries Have No Standing to Sue for Breach of fiduciary Duty

Dr. Griffith had two daughters, a son, and a second wife. His 2008 will placed a 704 acre farm in trust for the wife if she survived him, and to his son if she did not. Dr. Griffith executed a new will in 2010, which provided 20-acre parcels in the farm to each daughter, with the remainder going to the wife and son. However, six months before his death Dr. Griffith executed a deed of gift, granting the entire farm to the son subject to a life estate held by the wife. The son was named personal representative of the estate.

The disappointed daughters filed a lawsuit alleging that undue influence was used by their brother and the second wife to get Dr. Griffith to make the gift. What's more, they alleged that undue influence was also used to convert $13 million of Dr. Griffith's assets. They asked that the property gift be declared void.

The circuit court dismissed the lawsuit, stating that only the personal representative of the estate could bring a lawsuit to set aside a lifetime transfer. The appellate court agreed, noting that the daughters did not ask to have their brother removed as personal representative.

- Platt v. Griffith, 858 S.E.2d 413 (2021)

A Will Doesn't Control Property Acquired After Death

William Keough was among the hostages held captive in Iran between 1979 and 1981. He survived the ordeal, but died in1985. William's wife, Katherine, died in 2004. Her will left her residuary estate to her stepson, Steven, who was William's son from an earlier marriage.

In 2015, Congress enacted the Justice for United States Victims of State Sponsored Terrorism Act. Under the Act Katherine was entitled to $600,000 as the spouse of a hostage. If a person entitled to compensation had died when the Act took effect, the money was paid to the estate's personal representative.

When Katherine died, her sole heir under the intestacy laws was her brother, Fred Schwarz. He died intestate in 2018. In2019 Fred's cousin, Eleanor, filed a lawsuit claiming the $600,000 should pass to Fred's estate. She was the administrator of his estate. The executrix of Katherine's estate argued that it should pass under the residuary clause of her will.

The Appellate Division of the Supreme Court of New York held for Fred's estate. Will provisions can only control the disposition of property that the decedent owns at death. "We are particularly persuaded by the decision in Shaw Family Archives Ltd., which involved a dispute over ownership interest in Marilyn Monroe's right of publicity after her death. The court determined that New York law did not permit a testator to dispose by will of property that she did not own at the time of her death," the Court wrote. As Katherine could not have known of the possibility of the future payment, her will is ineffective as to it, and the $600,000 must pass by intestacy to Fred's estate.

- Matter of Keough, 196 A.D.3d 160 (2021)