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ESTATE PLANNING **REPORT**®

May/June 2015

PLANNING THOUGHTS

How to move considerable wealth within the family without gift taxes

In 2007 Israel and Erna Mikel each transferred $1.6 million to a family trust. The trust had 60 beneficiaries, including minors, 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 right to demand $24,000 from the trust, a right that lapsed after 30 days. The record does not indicate whether anyone exercised a demand right, and whether any such demand was satisfied.

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 prearranged understanding was asserted in this case.

Instead, the IRS took aim at another part of the arrangement.

In terrorem clause

The family trust provided that the trustees had "sole and absolute discretion" in making discretionary 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].

When the taxpayers each claimed $720,000 in annual exclusions in a single year, they perhaps attracted the attention of the IRS. That would be a startling element of a gift tax return. Fortunately for the taxpayers, the lawyers involved made certain that all the details for the *Crummey* powers, including notice to the beneficiaries, were handled flawlessly.

CASES AND RULINGS

Extension of time granted to certify citizenship of QDOT beneficiary.

Private Letter Ruling 201516055

When Decedent died, Spouse was not a U.S. citizen. In accordance with IRC §2056A, Spouse created a Qualified Domestic Trust (QDOT) and arranged for a corporate cotrustee of the trust. Assets that would have passed outright to Spouse from Decedent passed to the QDOT, and the marital deduction was saved.

Some years later, Spouse became a U.S. citizen. The corporate trustee was not immediately notified of the change of status and so did not file Form 706-QDT to let the IRS know about it as required. The trustee now asks for an extension of time to file the Form.

The IRS gives the trustee another 120 days to complete the paperwork. Everyone has acted in good faith; spouse was a continuous a resident of the U.S.; and there were no taxable distributions from the trust before the citizenship change.

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Recipient of nonprobate assets must contribute to estate tax payments

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

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.

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.

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Home sale proceeds may not be rolled into an IRA.

Michael H. Wu et ux. v. United States; No. 1:14-cv-03925

In 2007 Michael and Christina Wu sold their home, and each deposited $200,000 in an IRA to shelter the proceeds from further taxation. IRAs are a good deal for taxpayers, but they aren't *that* good. The normal contribution limits for IRAs and Roth IRAs in 2015 is $5,500, plus an extra $1,000 "catch-up" contribution for those 50 and older. One may "roll" money into an IRA from an employer's qualified plan, such as a 401(k) plan, or from another IRA. There is no dollar limit on such rollovers. But there is no provision for rolling the proceeds of a home sale into an IRA. Michael and Christina each had made an excess IRA contribution, which is subject to a 6% excise tax every year until they withdraw the excess from the IRA.

In March 2010 the couple filed tax returns acknowledging the excess contribution, and they withdrew the excess amounts on March 23 of that year. In computing several tax penalties and interest for them, the IRS applied the excess contribution penalty for tax year 2009, even though the couple had withdrawn the excess before tax-filing day. The couple paid the full penalty and sued for a refund in 2012. In the above-cited decision, the District Court holds that it has jurisdiction over the couple's case and refuses to dismiss it. The Court held that the rule that one has until tax-filing day to make a withdrawal applies regardless of the year of the initial excess contribution.

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Despite the fact that the U.S. savings rate is generally thought to be too low, the problem of excess IRA contributions is rather large. The Treasury Inspector General for Tax Administration (TIGTA) reported in March that 57,484 taxpayers without eligible compensation potentially made $125 million in the 2011 tax year. That implies $7.5 million owed in excise taxes.

Some of the overfunding of IRAs appears deliberate. TIGTA reported 2,585 cases of IRAs for children under age 10—IRA contributions are not allowed unless an individual has earned income. So a contribution for a child actor is fine, but a contribution by a parent to give a child a head start on retirement is not.

Other funding errors may be inadvertent. For example, taxpayers must take a required minimum distribution (RMD) every year once they reach age 70½ or pay a penalty tax. Let's say that someone in this position rolls the IRA from one financial institution into another before taking an RMD for the year. That transfer is treated as a distribution, so the amount of the RMD also will be an excess contribution to the new IRA. The penalty applies even if the RMD is taken later in the year.

One final note. Contributions to traditional IRAs are not allowed for taxpayers who reach age 70½, even if they have earned income. Therefore, any contribution by someone that age and up is an excess contribution.

WASHINGTON TALK

Could the federal estate tax be repealed? On April 16 the House of Representatives passed the Death Tax Repeal Act of 2015 (H.R. 1105) by a vote of 240 to 179. The vote came after substantial testimony before the House Ways and Means Committee about the continuing burden of the federal estate tax on family businesses and farms, including testimony by the Family Business Coalition, the National Federation of Independent Business, the National Cattlemen's Beef Association and the American Farm Bureau Federation. The recurring theme was that over the years family farms have been forced to sell off acreage to meet death tax duties at the federal and state level.

According to Tax Foundation, the U.S. has the fourth-highest estate tax rate among developed nations—only Japan, South Korea and France have higher rates. On the other hand, the U.S. has a high exemption rate, which has resulted in much-reduced estate tax collections, falling from $38 billion in 2001 to an estimated $20 billion in 2015 (after inflation adjustments). Thus, the "cost" of estate tax repeal is lower than it used to be. The Joint Committee on Taxation estimates the revenue loss at $269 billion over ten years.

The drive to repeal the federal estate tax was spearheaded by Rep. Kristi Noem (R-S.D.). From a press release issued by her office after passage in the House:

"Shortly after my dad passed away in a farming accident, my family got a letter from the IRS telling us that we owed a tax because he had died," said Noem. "I have never understood why the federal government thought it was appropriate to go after families with this double tax – especially in a time of crisis. My dad had already paid taxes on the equipment, the land, and any money we had in the bank. Now, we had to pay taxes on it again because he had passed away. It's not right. No family should have to go through that. I am committed to repealing the death tax and today we took a big step toward accomplishing that."

A parallel bill, S. 860, has been introduced in the Senate.

Democrats who oppose repeal of the estate tax found support from an unexpected source: millionaires. The Patriotic Millionaires for Fiscal Strength, a coalition of nearly 200 individuals earning more than $1 million a year or holding over $5 million in assets, called on Congress to reject estate tax repeal. In fact, they support going back to the 2009 estate tax regime with a 45% tax rate and a much reduced $3.5 million federal exemption. That's what President Obama has asked for in every budget during his presidency.

Two other noteworthy advocates for the federal estate tax, Warren Buffett and Bill Gates, have utilized private foundations to make certain that their own estates will largely avoid such taxes.

The House legislation repealing the estate tax contained two provisions that surprised many tax observers. First, although both the estate and generation-skipping taxes would be repealed upon enactment, the gift tax was retained. The rationale may have been to protect the income tax by preventing the tax-free transfer of income-producing assets within wealthy families.

Second, the step-up in basis at death of current law would be retained. Thus, there would be a double tax incentive to hold on to assets until death. The effect on estate planning could be profound for larger estates.

Proponents of estate tax repeal acknowledge that

there is little hope for success in the near term. They are unlikely to get 60 votes to overcome a filibuster in the Senate, and even if they did, the legislation faces a certain veto from President Obama.

A new study by the Treasury Inspector General for Tax Administration (TIGTA) found that in 2012 about 3.6 million taxpayers took more education credits than they should have, for a total tax shortfall of $5.6 billion. About $2.5 billion was for students who were at ineligible institutions. 419,827 taxpayers claimed the American Opportunity Tax Credit for more than four years, and 427,345 claimed it for a student who was attending school less than half time. Senate Finance Committee Chair Orrin G. Hatch (R-Utah) said, "The IRS owes it to American families and hardworking taxpayers to properly safeguard their hard-earned dollars and not dole them out to people who are not qualified to receive such credits."

A growing number of Americans are relinquishing their citizenship. The record for expatriation was set in 2014, at 3,417. In the first quarter of 2015, 1,336 Americans said good-bye forever, a third again higher than in the year-earlier quarter. The exact reasons for the surge in expatriation are not known, but it coincides with the advent of higher U.S. taxes on the "rich," coupled with the implementation of FATCA (the Foreign Account Tax Compliance Act). Compliance with FATCA is complicated, and the penalties for errors are severe—they may be larger than the balance in the offshore accounts. FATCA has proved so onerous that some foreign banks now decline to work with Americans altogether in order to avoid IRS filing requirements.

In response to the IRS "targeting" scandal, Senator Susan Collins (R-Maine) has introduced S. 965. The entire bill: "None of the funds made available under any Act may be used by the Internal Revenue Service to target citizens of the United States for exercising any right guaranteed under the First Amendment to the Constitution of the United States." One might wonder why the First Amendment doesn't inherently include such protection!

A revised Publication 559, *Survivors, Executors, and Administrators*, was released by the IRS in March to help executors with filing a decedent's final income tax return. For the majority of estates—those not affected by the federal estate tax—the decedent's final income tax return will be the most important tax responsibility of the executor.

Portability of a deceased spouse's unused exemption amount is a nice tax break, but the problem is that many people don't know about it or understand it. One big problem is that smaller estates that do not need to file a federal estate tax return will, nevertheless, need to file a return to make the portability election. The American Institute of Certified Public Accountants (AICPA) asked the IRS to make things easier for taxpayers by allowing an automatic extension of time to make the election, by creating a new Form 706 EZ for the sole purpose of making the election, and by allowing the surviving spouse (in addition to the executor) to make the election. The IRS has been receptive to AICPA's suggestions in the past in this area, notably with *Rev. Proc. 2014-18*.

The 2015 tax-filing season went much better than expected, according to those attending the spring meeting of the Council for Electronic Revenue Communication Advancement (CERCA). Many had been worried that the new filing requirements for the Affordable Care Act, coupled with late legislation and budget cuts at the IRS, would bring the computer systems to the breaking point. In the end, "The tax season 2015 worked really well, and kudos to the IRS team," reported Kathy Pickering, executive director of the Tax Institute at H&R Block.

The continuing shift to electronic filing may get some of the credit. Some 88% of returns were filed electronically this year, and 60% of these come from paid preparers. The number of taxpayers using software to file their own returns has grown to 49 million.

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