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Change of heart

An irrevocable trust gave the trustee discretionary power to distribute income and principal to Child and Child's descendants. The trust included a power retained by A, the grantor of the trust, so that all items of income and deduction were included in A's income—it was a typical grantor trust.

At some later time, the income taxes on the trust became burdensome for A, and he asked the trustee for reimbursement. The trust was amended to give the trustee the discretionary power to make such a reimbursement.

In *Private Letter Ruling 201647001* the IRS held that such a modification was administrative in nature, and did not result in a change of beneficial interests. On December 29, 2023, the IRS changed course with *ILM 202352018*, which held that such an amendment *would* change beneficial interests, so that it would result in a taxable gift from the trust beneficiaries to A. The earlier private letter ruling no longer reflects the IRS' view of the tax effects of such a change.

Private letter rulings are not precedential, of course, but *Rev. Rul. 2004-64* also held that there are no unfavorable tax consequences from having a reimbursement clause in a grantor trust. That Rev. Rul. was distinguished, on the basis that in the examples in that ruling the reimbursement clause was in the original trust instrument, not added by amendment.

No guidance was provided on how to value the taxable gift, which the memo acknowledged would be difficult in a footnote. However, "Child and Child's issue cannot escape gift tax on the basis that the value of the gift is difficult to calculate."

— ILM 202353018

COMMENTS: This reversal has caused considerable consternation in the estate planning community. Examples of observations from *Tax Notes*:

Robert Keebler: "What should a CPA that has to deal with this issue literally in the next 105 days do? Because undoubtedly there were plenty of reformations in the United States in 2023. No one thought we'd have to be doing gift tax returns for those."

Martin Shenkman: The legal memorandum "opened a Pandora's box of worries that we now have to caution clients about in order to protect ourselves."

Jonathan Blattmachr: "It's in the Service's worst interest, and it's certainly in the taxpayers' worst interest."

Lock-ins, past and future

The amount exempt from the federal estate and gift tax has never gone down, but on the three occasions the law has threatened such a reduction by making temporary an increase in the exempt amount—in 2010, 2012, and now in 2025. In the first two cases, planners recommended making lifetime gifts to "lock in" favorable tax benefits before the expiration took effect. As it turned out, each time the Congress changed the law at the last minute.

The question is, how many taxpayers took the advice of their estate planners and accelerated the implementation of their estate plans? Professor Hugh Lambert looked at federal gift tax data to find answers ["Can Government Inaction Result in Rising Gift Tax Revenue?" *Tax Notes*, January 9, 2024].

The number of federal gift tax returns filed in 2011 for 2010 gifts did not show a major increase from the prior year, but the dollar value of reported gifts rose 30%, from $38 billion to $51 billion. The changes for gifts in 2012 were more dramatic. There were 369,000 gift tax returns, compared to 258,000 the prior year. The dollar value of the gifts rose from $135 billion to $421 billion.

Total gift tax paid changed from year to year roughly parallel with those figures, going from $2.5 billion for 2009 gifts to $6.2 billion for 2010 gifts, falling to $1.8 billion for 2011 gifts, then jumping to $4.7 billion for 2012 gifts.

In short, a very substantial number of taxpayers heeded the advice to lock in tax savings with lifetime transfers.

Will that happen again, with the pending expiration of the doubling of the exempt amount from the 2017 tax reform law? Perhaps not.

Those with a projected estate of less than $7 million will remain free of federal estate tax obligations under current law, even if the scheduled reduction in the exemption occurs. Estate planners Beth Shapiro Kaufman and Meghan Muncey Federman argue that those with estates in the $15 million to $20 million range also are not good candidates ["Sunsetting Gift Tax Exemption Is No Reason for a Large Donation," Bloomberg Tax, https://news.bloombergtax.com/daily-tax-report/sunsetting-gift-tax-exemption-is-no-reason-for-a-large-donation]. The reason is that in making lifetime transfers, one first uses any available deceased spousal unused exemption (DSUE), then one's basic exemption, and only then will additional transfers lock-in the "bonus" exempt amount.

As an example, the authors posit a married couple with $15 million in assets. To obtain the desired lock-in, they will have to transfer about $14 million worth of their wealth, leaving them with just $1 million. That does not sound reasonable, especially given that even if the sunset of the larger exemption occurs, they will each have a $7 million exemption to work with.

What if the couple has $25 million? At this level the strategy may make better financial sense, but how many couples are willing to part with 60% of their wealth immediately for a speculative future estate tax savings after their deaths?

COMMENT: Out of every 10,000 deaths in 2019, only 8 estates owed federal estate taxes, according to the most recent IRS data. The Institute on Taxation and Economic Policy published "The Estate Tax is Irrelevant to 99% of Americans" in December 2023, summarizing the IRS report [itep.org/federal-estate-tax-historic-lows-2023/]. From 1997 to 2001, over 2% of estates paid were affected by the federal estate tax, a high-water mark, and the share fell below 1% in 2004. It continued to sink, breaking the 0.10% level in 2018. Although the statutory estate tax rate is 40%, according to the report the average taxable estate in 2019 paid 19.7% of its assets to the IRS, after taking into account the exempt amount, charitable legacies (averaging 10.7% of the estate) and state death taxes (2.5%). That left 67.0% of the estate for the heirs.

Extension granted

Decedent's estate was small enough that a federal estate tax was not required to be filed. However, the only way to claim a Deceased Spousal Unused Exemption (DSUE) is to file an estate tax return and make the portability election. At some point, the surviving spouse or one of the spouse's advisors realized that this oversight should be corrected, and asked for an extension of time to make the election via a private letter ruling.

The ruling does not explain the factual basis for the failure to make a timely election, nor is the amount of time that has elapsed since Decedent's death specified. The ruling simply says that based upon the submitted information the estate acted in good faith, and so an additional 120 days is allowed to file a return to make the DSUE election.

—Private Letter Ruling 202405004

COMMENT: The ruling also warned that no opinion was being expressed about the accuracy of the claim for the DSUE. Should it turn out that further examination suggests that Decedent's estate was not so small as to excuse the filing of an estate tax return, the IRS has no discretion for granting an extension. In that event, this ruling would be null and void, and there would be no DSUE.

The case of the greedy in-laws

Mathew and Sara married in 1992 and divorced in 2019. They had no children, neither remarried. Mathew's will left his assets to Sara, but under state law (Minnesota) that provision was revoked by the divorce. That made an alternate residuary clause important. It read: "If any interest is not effectively disposed of by the preceding provisions of this article, one half (1/2) [sic] to my heirs-at-law and one-half (1/2) to my wife's heirs-at-law."

After Mathew's death, his personal representative presented his will for probate, listing only Mathew's relatives as heirs. Sara's parents objected. They admitted that Sara was no longer a beneficiary of Mathew's estate, but that as Sara's heirs-at-law they were still entitled to their half.

The district court dismissed the parents' plea, but a divided appellate court reversed. Then the Minnesota Supreme Court reversed again, holding that at his death Mathew had no wife, so there could be no class gift to the heirs of someone who did not exist.

—Matter of Estate of Tomczik, 992 N.W.2d 691

COMMENT: The court further held that the legislature intended that a divorce would revoke dispositions to an ex-spouse's relatives.

What is the purpose of a valid trust?

Lawrence Saccato was in the storage business. Over the years, he created a variety of legal entities, and he managed them with his long-term girlfriend. What he failed to do was file a tax return, a failure that recurred for 14 straight years.

When the IRS attempted to audit Mr. Saccato, he was not cooperative. He claimed that he was neither the trustee nor the beneficiary of the various trusts he had set up in connection with his business. The IRS therefore used his bank account records to reconstruct Saccato's income.

Before the Tax Court, Saccato continued to maintain that he did not own the business property, that he was not the trustee of the trusts (although he had so described himself to a bank and the state authorities). Saccato also made a number of assertions similar to those made by tax protesters, which the Tax Court characterized as "gibberish."

COMMENT: What's more, Saccato persisted in making nonsense arguments after he was warned to desist. The Court added a $10,000 penalty to the overdue taxes for wasting its time.

The Court held that "We find that these 'trusts' do not exist and that, if they did exist, they would be shams. The sole purpose of these fictitious entities was to obscure petitioner's true ownership of the assets they purportedly held." The IRS determinations recreating Saccato's income from bank records were sustained.

—Saccato v. Comm'r, T.C. Memo 2023-96

Division of property in a divorce.

Wife received an advance on her inheritance of $830,000 from her mother. She kept this money separate, investing it in a brokerage account. As a “buy and hold” type of investor, she chose four mutual funds to invest in, and did nothing more with the portfolio. The strategy was a good one, because the value of the account grew by some $892,000.

Unfortunately, the marriage did not work out. In the divorce proceedings, Husband laid claim to half of the increase in the account value, as it came about as the result of efforts by either party during the marriage. The divorce court agreed, holding that only the $830,000 was nonmarital property, and Husband should share half the growth.

The Florida District Court of Appeal reversed, holding that passive growth in an investment account is not the result of efforts by either marital partner, but is attributable to the conduct of the managers of the mutual fund. Wife will get to keep her entire brokerage account.

—Naranjo v. Ochoa, 366 So. 3d 11

Tax or penalty?

An executive owned shares in an ESOP and had a nonqualified deferred compensation arrangement. After a corporate reorganization and his termination, the executive agreed to accept a payment of $26 million to his IRA in satisfaction of his claims. The transfer was reported on his income tax return as an IRA rollover contribution.

The IRS didn’t see it that way, as payments from the deferred comp were not eligible to be rolled over. Some $25 million was held to be an excess IRA contribution, subject to a payment of 6% to the government every year until the amount was disgorged from the IRA to be fully taxed as ordinary income.

Is the 6% payment an additional tax, or is it a penalty for the “bad behavior” of making an excess contribution? The distinction is important, because the taxpayer in this case claimed that the IRS had not followed its own required procedures for imposing penalties. Unfortunately for him, the Tax Court held that the 6% is an excise tax, so those procedures are not required.

—Couturier v. Comm’r of Internal Revenue, No. 19714-16 (U.S.T.C. Jan. 22, 2024)

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