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ESTATE PLANNING **REPORT**[®]

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PLANNING THOUGHTS

Inherited IRAs in bankruptcy

The importance of IRA rollovers has grown significantly in the composition of estate assets as workers have rolled over their 401(k) money at retirement to extend its tax-deferred status. Planning for the inheritance of this money is assuming greater and greater importance in the estate planner's advice. In particular, can this money be shielded from the claims of beneficiaries' creditors?

In general, ERISA's anti-alienation rules put beneficial interests in qualified retirement plans beyond the reach of creditors in bankruptcy [*Patterson v. Shumate*, 504 U.S. 753 (1992)]. However, that portion of ERISA does not apply to IRAs. State spendthrift statutes then come into play, with mixed results.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 revisited the rules, adding an exemption for "retirement funds." Under Bankruptcy Code §522(n), the exemption for a Roth IRA or a traditional IRA may be limited to \$1 million in some circumstances. However, "retirement funds" was not defined in the Act. What about an inherited IRA? Does it constitute "retirement funds" when the beneficiary did not contribute the money to the account?

Beneficiary wins

An inherited IRA was held to be an exempt asset in bankruptcy under the new law in *In re Nessa* [No. BKY 09-60081, 2010 WL 128313 (Jan. 11, 2010)]. Nancy Nessa was the beneficiary of her deceased father's IRA. He died in 2008, so the new Bankruptcy Code was applicable. Nessa claimed that the IRA was exempt in bankruptcy under 11 U.S.C. §522(d)(12).

The Bankruptcy Court held for Nessa, stating that the plain language of the statute compelled the

conclusion that the inherited IRA was "retirement funds." The Court also observed that the IRA was not legally owned by the beneficiaries, but remained in the name of the decedent.

The decision was affirmed by the United States Bankruptcy Appellate Panel For the Eighth Circuit [No. 10-6009, April 9, 2010], and *Nessa* has become a leading case on this question of law.

Beneficiary almost loses

Another court that considered the question initially came to the opposite conclusion [*In re Chilton*, No. 08-43414, 2010 WL 817331 (Mar. 5, 2010)]. Janice Chilton inherited her mother's IRA, worth \$170,000, in 2007. Like Nessa, she opted for the federal bankruptcy rules.

This time the Court held that an inherited IRA is fundamentally different from an ordinary IRA. The fact that the inherited IRA shares the same tax preference as an IRA does not make it a "retirement fund" within the meaning of the Bankruptcy Code. After referencing the dictionary for the meaning of "retirement," the Court concluded, "the funds contained in an inherited IRA are not funds intended for retirement purposes but, instead, are distributed to the beneficiary without regard to age or retirement status." As such, they are not exempt assets in bankruptcy under 11 U.S.C. §522(d)(12).

However, on March 16, 2011, the District Court reversed course and adopted the reasoning of *Nessa* [*Chilton v. Moser*, 107 AFTR2d 1391].

Florida case

Marilynn and James Mathusa inherited an IRA when Marilynn's mother died. A trustee-to-trustee transfer moved the money to an inherited IRA in their names. When the couple declared bankruptcy, they sought to protect the IRA money from the

claims of their creditors.

Because Florida opted out of the federal exemption scheme, the Court looked to §522(b)(3)(C) rather than §522(d)(12) of the bankruptcy code. However, the language is identical, so the Court relied upon decisions interpreting the latter section, the *Nessa* decision specifically. Once again, because the inherited IRA qualified as “retirement funds” and was exempt from current taxation under IRC §408, it

was an exempt asset in bankruptcy. A direct transfer of the assets to the trustee of another account does not change that result [*In re Mathusa*, No. 6:10-bk-13336-KSJ (March 28, 2011)].

When the inheritance is an IRA, the heir accepts the burden of future income taxes along with the legacy. But these cases show that the IRA may have built-in asset protection features that offset the tax negatives.

CASES AND RULINGS

Filing deadline extended for 2010 basis adjustments.

76 F.R. 12416-12417; IR 2011-33

The majority of estates of 2010 decedents will be covered by the retroactive estate tax enacted last December. Those few larger estates that opt out of the estate tax in favor of carryover basis will communicate that decision to the IRS with Form 8939, “Allocation of Increase in Basis for Property Acquired From a Decedent.”

The IRS received many technical comments in response to its initial draft of a Form 8939. In March the Service extended the comment period for Form 8939 to May 6, 2011. Accordingly, on March 31 the IRS followed up with an announcement that Form 8939 would not be due on April 18, 2011, for 2010 decedents’ estates. April 18 remained the deadline for filing the decedent’s final Form 1040. No due date for Form 8939 was specified, but presumably it will be well after May 6. The Service also promised “a reasonable period of time for preparation and filing” the Form once the guidance is released.

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Bona fide settlement yields charitable deduction.

Estate of Palumbo v. U.S., USDC PA, No. 2:10-cv-00760

Palumbo executed various wills and trusts with testamentary provisions throughout his life. His last will and testament failed to include an express residuary provision. Accordingly, Palumbo’s son claimed the residue as an intestate heir. However, a charitable trust lodged its own claim to the residuary, stating that the absence of a residuary clause was due to a scrivener’s error. After lengthy negotiations, a compromise was struck. The charitable trust accepted \$11.7 million dollars, while the son received \$5.6 million and

certain real property in Wheeling, West Virginia. The settlement was approved by the Attorney General for the Commonwealth of Pennsylvania and ordered by the Orphan’s Court.

That was not good enough for the IRS. After the settlement was reached, the estate filed a claim for the charitable deduction for the \$11.7 million that went to the trust. IRS denied the claim, stating that because the charity did not have an enforceable claim against the estate, the transfer to it was from the settlement agreement itself, not from Palumbo’s will.

The District Court does not agree. The controversy here arose through an admitted scrivener’s error, which resulted in the disinheritance of the charitable trust. There was no evidence that the negotiations were anything other than held at arm’s length, or that there was any collusion between the parties. Finally, all of Palumbo’s earlier wills included a residual charitable bequest, establishing his charitable intentions. In these circumstances, the charitable deduction under IRC §2055 will be allowed.

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Court finds an intention to pay rent, rescues QPRT estate exclusion.

Estate of Sylvia Riese et al. v. Comm’r, TC Memo 2011-60

Upon the advice of her son-in-law, Sylvia Riese transferred her multimillion-dollar home to a Qualified Personal Residence Trust (QPRT) in 2000. She was advised that upon the expiration of the term of the trust, she would have to pay rent to remain in the home. Sylvia was offered the alternative of three or five years for the trust term. She chose the three-year term, though it increased the amount of gift tax due on the transfer to the trust. A gift tax return was filed for 2000 reporting the transfer.

Three years later, when the trust term expired in April 2003, Sylvia did not start to pay rent immediately. Her daughter called the lawyer who

drafted the trust about how to determine a fair rent. He advised her to consult with local real estate agents on a figure before the end of the year. Unfortunately, Sylvia died unexpectedly of a stroke in October.

The estate did not include the home's value of more than \$6 million on Sylvia's estate tax return. The IRS challenged that decision, arguing that the failure to pay rent proved Sylvia had an implied life estate in the property. Looking at the entire record, the Tax Court sided with the estate, accepting the evidence that Sylvia intended to pay rent, that initial steps to determine a proper rent were taken, and that a gift tax was paid when the QPRT was established. The value of the home was excluded from the estate.

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Ignorance is now an excuse?

Bonnie Haggar et al. v. U.S., USDC SD, No. 4:09-cv-04101

In 1998 William Haggar gave \$200,000 to his daughter, \$60,000 to her two children and her grandchild, and \$40,000 to his wife's two children. Mrs. Haggar signed a gift tax return and consented to having Haggar's gifts "considered as made one-half by each of us." Haggar's accountant filed the gift tax return.

After Haggar died, Mrs. Haggar took his tax records to an attorney for the preparation of the estate tax return. Unaccountably, the tax records did not include a copy of the gift tax return. Additionally, when questioned by the attorney, Haggar's accountant stated that there had been no taxable gifts. Accordingly, the attorney answered "No" on the estate tax return to the question about prior taxable gifts.

Upon audit, IRS noticed the discrepancy. In addition to assessing more estate tax, the Service levied a 20% penalty for negligence. The estate does not contest the added tax or interest, only the penalty. The widow claims that although she signed the gift tax return, she

was not aware that the form had been filed; she did not know that there are gift tax implications for large gifts; and she had no idea that major gifts are relevant for preparing the estate tax return. In her state of ignorance, she claims that she acted in good faith and with reasonable cause.

The District Court denied motions for summary judgment, holding that the credibility of the witness must be judged through her testimony. A genuine issue of material fact remains, so the trial will proceed.

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Value of pending malpractice claim too speculative to support deduction for claim against the estate.

Estate of Gertrude H. Saunders et al. v. Commissioner; 136 T.C. No. 18

At one time, apparently in the 1960s, lawyer William Saunders represented Harry Stonehill. In the 1990s, Stonehill had extensive litigation against the IRS. Through Freedom of Information Act requests, Stonehill's new lawyers learned that in 1960 Saunders may have acted as a confidential informant for the IRS against his client, Stonehill. Stonehill died in 2002, but his lawyers decided to bring a malpractice claim against Saunders, seeking \$90 million in compensatory damages. Saunders died in 2003, so the suit was filed against his estate. His widow, Gertrude, died 64 days later, in 2004. The litigation continued over the next several years.

Gertrude's executors took a deduction for \$30 million as the value of the Stonehill claim against the estate. IRS disallowed the deduction and asked for an additional \$14.4 million in estate taxes. The Tax Court now agrees that the value of the claim was too speculative at the date of Saunders' death to support the deduction, but the estate is allowed a deduction for all the costs of defending the suit during the course of estate administration.

WASHINGTON TALK

Estate tax collections would grow by \$19 billion under President Obama's proposed budget, according to a March report published by the Congressional Research Service [<http://openncrs.com/document/R41699>]. The budget included a number of changes in the estate tax area. Estate tax collections were projected to rise by \$19 billion over ten years, if all the proposals were adopted. The changes include:

- Return to the 2009 estate tax parameters, with a \$3.5 million exemption and 45% top tax rate, begin-

ning in 2013. No inflation indexing.

- Make permanent the new spousal portability of unused federal exempt amounts.
- Require consistent basis treatment of assets for estate and income tax purposes.
- New restrictions on discounts for intrafamily transfers.
- Limits on Grantor-Retained Annuity Trusts (GRATs) and changes to the generation-skipping transfer tax. These two provisions "are in response to popular tax planning techniques intended to reduce estate tax liability."

H. R. 1259, the “Death Tax Repeal Permanency Act of 2011,” was introduced in late March by Rep. Kevin Brady (R-Tex.). The bill eliminates both the estate tax and the generation-skipping transfer tax. However, the federal gift tax would be retained, with a top tax rate of 35% and subject to a \$5 million lifetime gift exemption.

The bill has 17 cosponsors and enjoys bipartisan support. At a press conference, Rep. Brady argued: “Can you imagine working your whole life to build up a nest egg or family business—only to see Uncle Sam swoop in to take more than half of it upon your death? The Death Tax is still the #1 reason family farms and businesses in America aren’t passed down to the next generation. It’s the wrong tax at the wrong time and hurts the wrong people.”

Rep. Mike Ross (D-Ark.) chimed in: “We pay taxes all our lives, so it just doesn’t make sense to be taxed again when we die. I’ve heard from farmers and small business owners all over Arkansas who are concerned that when they die, their loved ones won’t be able to afford the estate taxes in order to keep the family farm or business in their family. The death tax is unfair and punishes those Americans who work hard all their lives so they can pass their family business down to the next generation when they die. I have long supported the repeal of the death tax and I’m proud to join this bipartisan effort to finally and fully repeal the death tax once and for all.”

Concluded Rep. Dan Boren (D-Okla.): “Estate taxes are especially harmful to farmers, ranchers, and other small businesses because these operations tend to be capital-intensive with a high concentration of assets tied up in land, buildings, and equipment. I look forward to working on this important legislation to bury the death tax for good.”

Just five days before the tax filing deadline, the IRS extended until final regulations are published the interim guidance on the deductibility under IRC §67 of costs paid to an investment advisor by a non-grantor trust or estate. Under the U.S. Supreme Court’s decision in *Knight v. Commissioner*,

552 U.S. 181 (2008), bundled fiduciary fees paid to investment advisors may be subject to the 2% floor of IRC §67(a). The Service offered interim guidance on complying with the decision and stated that unbundling of fees would not be required for years beginning before January 1, 2008. The newest guidance, *Notice 2011-37*, extends that protection pending issuance of the final regulations. Given the IRS workload, and the many projects that have higher priority, no one seems confident about predicting when these regs. might be completed.

The IRS has targeted Form 709 filing non-compliance (federal gift tax returns). The focus is on real estate transfers between related parties without adequate consideration. According to a report in *Forbes* magazine (March 24, 2011), 12 states already have provided the IRS with data on related-party transfers—Connecticut, Hawaii, Nebraska, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, Tennessee, Texas, Washington and Wisconsin. In some states there has been no gift tax compliance at all, and overall the noncompliance rate is projected to be above 60%. The program has yielded 323 audits to date, with another 217 examinations in progress and 250 identified for future action.

The matter came to a head in California when the Board of Equalization refused an IRS information request on privacy grounds. That forced the Service to seek a John Doe summons from the U.S. District Court. Under Proposition 13, California property tax increases are limited to 2% until the property is sold. Propositions 58 and 139 extend this protection in some cases to children, even grandchildren, provided extensive paperwork has been filed. That is exactly the data that IRS is looking for.

Fiduciary income tax return audits are up sharply as well, reports *Trust Regulatory News*. The audit rate for Form 1041, 1 in 800 in 2007, now is 1 in 600.



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