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Company-owned life insurance proceeds are taxable

Brothers Michael and Thomas Connelly were the sole shareholders of a corporation. The corporation obtained life insurance on each brother so that if one died, the corporation would have ready cash to redeem his shares without impairing the company operations. A buy-sell agreement was in place, giving each brother the right to buy the other’s shares at death, and the corporation would redeem the shares if the survivor declined to purchase. Although the agreement included a mechanism for valuing the shares, it was never used.

Michael died first, and the company received $3.5 million of life insurance proceeds. The corporation redeemed the shares for $3 million in an amicable agreement, and Michael’s interest in the business was valued at the same $3 million on the federal estate tax return. A $300,000 estate tax was timely paid, likely out of the remaining $500,000 of proceeds.

Upon audit, the IRS disagreed with the valuation of the company. The $3.5 million must be added to the value of the company, as it was a company asset. That brought the total value of the company to $6.86 million. Michael had owned 77.18% of the company, so the estate tax value of his interest came to about $5.3 million. That meant another $1 million in estate taxes were due.

In court, the estate argued that the value of the company was controlled by the shareholder’s agreement, and although the insurance proceeds were a corporate asset, they were offset by the obligation on the company to proceed with the redemption. The arguments were unavailing, first in the District Court, then in the Eighth Circuit Court of Appeals – and now, finally, in the U.S. Supreme Court. The Court held unanimously that life insurance proceeds must be included in valuing the company for estate tax purposes, and that a redemption agreement in this case did not reduce the value of the company, even though it drained the company of available cash.

—Connelly v. U.S., U.S., No. 23-146, Opinion 6/6/24

COMMENT: Owners of small businesses need to schedule an early conference with their estate planning advisors to assess the impact of this decision on their planning. Cross-purchase agreements, in which each shareholder owns life insurance on the other shareholders, should not be adversely affected, but that arrangement has its own drawbacks. Owners of very small businesses that are below the federal estate tax threshold have less to be concerned about, but even in that situation, using life insurance to fund a redemption will raise issues regarding the value of the company and the basis of inherited interests.

The limits of the taxing power

Under the U.S. Constitution, direct taxes must be apportioned among the states. An income tax is a direct tax, and the early attempts to create a federal income tax were declared unconstitutional as they were not apportioned, making a constitutional amendment necessary to create today's income tax regime. Indirect taxes, such as tariffs, which are passed along to consumers, do not need to be apportioned.

Charles and Kathleen Moore invested $40,000 in a start-up company that provided better tools to subsistence farmers in India. The company was a huge success, but it reinvested all of its profits in expanding its market. The firm grew to hundreds of employees, thousands of dealers, and millions of customers. The Moores never received a financial return from their investment, but were more than pleased with the success of the company that they helped to fund. The growing success of the Indian farmers was their reward.

In the 2017 Tax Cuts and Jobs Act, the taxation of multinational firms was reformed. One element of that change was the imposition of a one-time tax on accumulated foreign earnings. The Moores received a tax bill for $15,000 on the accumulated but undistributed earnings from their investment.

The couple paid the bill and sued for a refund. They argued that they received no financial reward from their investment, no "income" as that term is used in the tax law, and therefore that $15,000 was effectively a property tax, not an income tax. As such, it would have to be apportioned, and as it was not, the tax itself is unconstitutional.

The U.S. Supreme Court rejected that argument in a 7-2 opinion. The majority held that the transition tax operated in the same basic way as the taxation of partnerships, S corporations, and Subpart F income, under which an entity's undistributed income is attributed and taxed to the shareholders or partners.

— Moore v. United States, No. 22-800 (U.S. 6/20/24)

COMMENT: Lurking in the background of this case is the question of whether income must be realized to be taxable. There are some politicians who are advocating for a wealth tax on unrealized capital gains, and some observers hoped that the Court would slam the door on such proposals. That did not happen; the decision was narrowly drawn; the holding was that income had been realized at the corporate level – so there was no need to address the related question. The dissent felt the time was ripe to make clear that unrealized gains cannot be constitutionally taxed. Justice Thomas wrote: "Because the Sixteenth Amendment requires a way to distinguish between income and source, it includes a realization requirement. The text of the Amendment incorporates such a requirement, and the concept of realization was well understood at the time of the ratification. The Constitution thus limits unapportioned income taxes to taxes on realized income [italics in original]."

RMDs not needed from certain inherited IRAs this year

Once upon a time, distributions from an inherited IRA could be spread over the beneficiary's lifetime. For young beneficiaries, the RMDs might be small enough that the inherited IRA would continue to grow handsomely. This changed with passage of the SECURE Act. In general, subject to important exceptions, the assets of an inherited IRA must be distributed to the beneficiary over ten years.

Estate planners debated how to handle those distributions. Should they be deferred until the tenth year, for maximum tax-deferred buildup? Or would a program of taking 10% each year for ten years be better, as it avoids pushing the beneficiary into a higher tax bracket?

When the IRS proposed regulations to implement the new rules, the Service pointed out that most everyone had overlooked another rule. If the account owner was already taking required minimum distributions (RMDs), the beneficiary also had to take distributions at least that fast. Failure to take an RMD results in a substantial excise tax.

The proposal caught planners by surprise, and the IRS responded by waiving penalties for failure to take an RMD from certain inherited IRAs in 2021, 2022 and 2023. In this Notice, the penalties are again waived for 2024. The Notice suggests that the Reg. is now expected to take effect in 2025.

—IRS Notice 2024-35

Pet trust requirements

Teresa Jablonski executed a will in August 2013. The will left her entire estate to a testamentary pet trust for Teresa's cocker spaniel, Licorice. Any other pets owned by Teresa at her death were also to be beneficiaries of the pet trust. At the death of the last surviving pet, the trust assets were to pass to a charity, to be chosen by the trustee. Teresa's niece, Ann, was named executor of the will, but the trustees were not specified.

Unfortunately, Licorice died before Teresa did, and she acquired no other pets before her death. When Ann presented Teresa's will for probate, her other nieces and nephews objected. They argued that because there were no pets to be beneficiaries, the pet trust had lapsed, and so Teresa's estate should be divided among themselves under the laws of intestacy. Ann countered that the correct result was acceleration of the charitable interest in the trust remainder. The probate court ruled in Ann's favor, without holding a trial.

On appeal, this ruling was voided, because there is an issue of fact that requires a trial for determination. Whoever drafted Teresa's will did not do a very good job of it. When the pet trust failed, its assets passed to the residuary estate. But the residuary clause of the will then sent all remaining estate assets back to the pet trust, which no longer existed!

The appellate court held that Teresa's will failed to demonstrate a clear intent for the disposition of estate assets in the event all of Teresa's pets died before she did. The fact that no specific charity, or even type of charity, was mentioned in the will troubled the court. Additional fact-finding will be required to determine Teresa's intent. Unless it can be shown clearly at trial that Teresa really wanted her estate to go to a charity at her death, the estate will pass to her relatives under the law of intestacy.

— Matter of Estate of Jablonski, 214 N.E. 3rd 1051 (Mass 2023)

COMMENT: Had Teresa met with her lawyer after Licorice died, all ambiguities could have been resolved, and years of litigation would have been avoided.

Electronic signature on a will denied

After Susan Kittler was hospitalized for a fall in October 2020, her son consulted an estate planner to have her will drafted. Susan was removed to a nursing home, and visitors were prohibited during the height of the COVID-19 pandemic. The attorney was able to contact Susan remotely for an initial discussion on November 12. By November 18, Susan had learned that she had bone cancer, so the next telephone conference involved her financial planner as well. Her testamentary intentions were made clear at that time, and a will was drafted to reflect them.

On November 24, 2020, a video conference took place that included the services of a notary employed by the York County Bar Association. The notary utilized DocVerify, an online software vendor that met the Pennsylvania Department of State's requirements to serve as a secure electronic method for affixing a digital signature. The procedural requirements were followed to the letter, for the two witnesses as well as for the testator. In short, every possible step was taken to create a valid will, in circumstances in which the state had forbidden face-to-face contact.

Nevertheless, after Susan died a year later, the registrar of wills refused the probate of her will – not because anyone raised an objection to it, or that there was any doubt that it reflected Susan's testamentary wishes, but because the electronic method for signing a will had not been approved. The Orphan's Court agreed.

The appellate court noted that electronic signatures have been explicitly approved for guardianships, but no similar rule has been created by the legislature or the Pennsylvania Supreme Court for the execution of wills. Until that happens, to be valid in Pennsylvania, a will must be signed in ink on paper by the testator.

— In re Estate of Kittler, 303 A.3d 463 (Pa. Super. Ct. 2023)

When is a loan really a gift?

Mary was in the habit of advancing funds to her children as loans, then forgiving a portion of such loans each year in the amount of the gift tax annual exclusion. However, her advancements to her oldest son, Peter, were substantially larger, in order to help him establish his architecture practice. After some initial successes, Peter suffered some financial reverses and was not able to pay the interest on his loans.

In 1995, Mary had a legal document drafted which acknowledged that Peter owed her $771,628, that he would not be able to repay it, and that this amount would be considered an advancement of his inheritance. Peter signed the document.

After Mary died in 2010, that transaction became an estate-tax issue. At first, the IRS contended that the document was effectively a note whose value must be included in the estate. That issue was conceded, and the Service argued in the alternative that it was a taxable gift to be taken into consideration when calculating the estate tax.

The Tax Court agreed with the IRS that a gift occurred, but in looking at the entire record, the Court concludes that the gifts really began in 1990. That was when Peter's financial difficulties became severe enough that Mary must have realized his loans would never be repaid [Estate of Mary P. Bolles et. al. v. Comm'r, T.C. Memo 2020-71].

In a per curiam opinion, the Ninth Circuit Court of Appeals affirms the Tax Court decision.

— Estate of Mary P. Bolles v. Comm'r, No. 22-70192, (9th Cir. 2024)

COMMENT: The Court also affirmed the denial of a deduction for litigation costs associated with the case, because the IRS substantially prevailed.

Children are "relatives"

In Oklahoma, children who are not mentioned in a will are entitled to receive an intestate share of the estate unless it appears that the omission was intentional. Priscilla Shepherd signed a holographic will that left her house to a named granddaughter, and it did not specifically leave anything to her three children. The final line of the will was "All moneys owed by anyone is forgiven. This is my desire and will to be for all relatives."

Two daughters objected to the will and applied for their intestate share, arguing that there was no clear intent in the will to disinherit them. The District Court held that although they were not named, they were among the "all relatives" identified in the final line of the will. A divided intermediate appellate court agreed that the statute for pretermitted children did not apply.

— Matter of Estate of Shepherd, 534 P.3d 1061 (Okla. Civ. App. 2023)

COMMENT: A dissenter pointed out that the will was ambiguous at best, and it failed to provide evidence of intentional omission as required by state law.

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Personal Trust and Farm Services

Email: mail@ti-trust.com

Web: www.ti-trust.com

Quincy, Illinois
2900 North 23rd Street
Quincy, IL 62305
Phone: (217) 228-8060

St. Peters, Missouri
4640 Mexico Road
St. Peters, MO 63376
Phone: (636) 939-2200

Oak Brook, Illinois
600 West 22nd Street
Suite 308
Oak Brook, IL 60523
Phone: (630) 986-0900