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# ESTATE PLANNING REPORT

Orange Bank & Trust Company • Trust Services Division

Second Quarter 2023

## PLANNING THOUGHTS

### A strategy too good to be true

Albert and Gladys Gerhardt created a Charitable Remainder Annuity Trust (CRAT) in November 2015. They transferred real property worth $1.8 million to the trust, and reported the transfer on Form 709, the federal gift tax return. The adjusted basis of the property was reported to be $97,517. The trustee sold the property for $1.6 million, then used the proceeds to purchase a Single Premium Immediate Annuity (SPIA) for $1.5 million. The SPIA contract paid the Gerhardts $311,708 every April for five years.

The couple reported the annuity payment as a tax-free return of principal. Their view was that the CRAT was a tax-free entity, not subject to tax on the gain from the sale. They evidently believed that immunized them from taxation as well, rendering the CRAT a tax elimination scheme.

Similar arrangements were made in the same time frame by Alan and Audrey Gerhardt, Jack and Shelley Gerhardt, and Tim and Pamela Gerhardt. All the couples took the same tax position, that their annuity payments were tax-free returns of principal.

The IRS was not amused. Two years into the distribution period, deficiency notices were sent to all four couples. Their cases were consolidated in the Tax Court.

It is true, the Court held, that no gain is realized when appreciated property is transferred to a CRAT, and it is also true that the CRAT itself is not subject to tax when its appreciated assets are sold. But it is *not* true that the private beneficiaries pay no tax on distributions from the CRAT. "Distributions from a CRAT to income beneficiaries are deemed to have the following character and to be distributed in the following order:

(1) as ordinary income, to the extent of the CRAT's current and previously undistributed ordinary income;
(2) as capital gain, to the extent of the CRAT's current and previously undistributed capital gain;
(3) as other income, to the extent of the CRAT's current and previously undistributed other income; and
(4) as a nontaxable distribution of trust corpus."

Therefore, the capital gains of the CRATs became taxable to private beneficiaries when they were distributed. The Court upheld the IRS deficiencies [Gladys L. Gerhardt et al. v. Commissioner, 160 T.C. No. 9]. What's more, an accuracy-related penalty was imposed upon Tim and Pamela, because they failed to meet their burden of proving that they relied upon competent legal counsel for their tax positions.

### These taxpayers were duped

Why did these four couples all take these tax positions? This scheme, the CRAT tax elimination strategy, was created and promoted to the public by John Eickhoff, a licensed insurance agent and a senior advisor with Hoffman Associates. They learned of the scheme from him, and he referred them to a CPA for its implementation.

Last February, the U.S. Justice Department filed a complaint against Eickhoff and Hoffman Associates to end their peddling of the CRAT Tax Elimination Scheme. At least 70 other CRATs were organized under the abusive scheme, with an estimated $40 million going unreported, resulting in estimated lost tax revenue of $8 million.

In May, Hoffman Associates and Eickhoff were permanently enjoined from promoting this scheme. Hoffman Associates had to pay a judgment of $1.1 million, and Eickhoff, $400,00.

To get the word out on these abusive tax schemes, the IRS issued News Release 2023-65:

"In abusive transactions of this type, property with a fair market value in excess of its basis is transferred to a CRAT. Taxpayers may wrongly claim the transfer of the property to the CRAT results in an increase in basis to fair market value as if the property had been sold to the trust. The CRAT then sells the property but does not recognize gain due to the claimed step-up in basis. Next, the CRAT purchases a single premium immediate annuity (SPIA) with the proceeds from the sale of the property.

"By misapplying the rules under sections 72 and 664, the taxpayer, or beneficiary, treats the remaining payment as an excluded portion representing a return of investment for which no tax is due."

The scheme doesn't work, the IRS warned, and the taxpayer

remains liable for all taxes due. Whether the taxpayer has any recourse against the promoter of the scheme was not addressed.

For philanthropically minded taxpayers who own substantially appreciated property, the CRAT continues to be a sound planning alternative to explore. But it will not magically erase taxable gains, and the IRS is on the lookout for claims that it does.

## CASES AND RULINGS

### A cello may be seized by the IRS to pay estate taxes.

#### United States v. Omar G. Firestone et al., 2:22-CV-01201-TL (W.D. Wash. Mar. 28, 2023)

Omar Firestone was the executor of the estate of Ghaida Firestone. On January 17, 2012, he was notified that the estate tax return had been selected for audit. A recomputed estate tax of over $1.8 million was communicated to Omar by the IRS on April 16, 2013.

Omar owned a valuable cello, crafted in 1816. On May 17, 2013, a month after getting the bad news about the additional estate tax due, Omar created "The Firestone Irrevocable Cello Trust." He was the sole trustee. Ostensibly, ownership passed from him personally to him as trustee.

The estate stipulated to the additional estate tax liabilities in 2014, but Omar never paid them. By 2021, the tax debt had grown to over $2.5 million.

The IRS brought an action to foreclose on certain real property and to seize the cello to begin paying down the tax debt. Omar claimed he owned only a life estate in the cello now; it was no longer his property. Oddly, the trust did not name any beneficiary other than Omar, although he produced an unsworn e-mail from a rare instrument seller claiming to have the remainder interest.

The District Court was unpersuaded. Taking the trust at face value, Omar had both equitable and legal interests in the cello, and so is properly regarded as the real owner. The IRS may take it. In a footnote, the Court observed that it need not reach the issues of whether the Trust is merely Mr. Firestone's nominee or alter ego, was created for unlawful purposes, or was self-settled in order to avoid creditors.

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### An action for breach of trust must be brought promptly.

#### Kilian v. TCF National Bank, No. 358761, 2022 WL 12073427

Beryl Kilian created a trust for her three children, David, John, and Janice. David struggled with mental health issues. He had a 70% share of the trust, and he also had a 5x5 withdrawal power, that is, he could withdraw the greater of $5,000 or 5% of the trust corpus each year. He exercised the withdrawal power several times. Because the trust was worth some $1.7 million, these withdrawals were in the range of $50,000 to $60,000.

David was a co-trustee of the trust, and all the paperwork was handled by a bank trustee. He changed the bank trustee in 2000. The trust included a majority share of Three Pines Resort. Beginning in 2013, the bank trustee became concerned that the trust had insufficient assets to keep the resort in good repair, that David was overspending, and that his habit of creating overdrafts made him a difficult customer. The bank trustee resigned on October 13, 2017.

In November 2019, the three trust beneficiaries brought an action for breach of trust against the bank trustee. They alleged that the trust statements had not revealed deterioration of the resort, the major trust asset, and that the statements had included no metrics for assessing how well the assets were being managed.

There were two problems with this argument. The first was that the trust itself required that any complaints about trust management had to be lodged within 90 days. The second was that local (Michigan) law was changed in 2010, providing that claims for a breach of trust would have to be made within one year if the trust beneficiaries were informed of the deadline. Beginning in 2013, all the trust statements included the one-year time limit for lodging a complaint.

These beneficiaries filed their lawsuit too late, more than a year after the trustee had resigned and sent a final accounting. The probate court granted summary judgment for the bank, and the Court of Appeals now affirms. This issue is not whether there was a breach of trust, the Court stated, it is whether the beneficiaries had sufficient notice of the possibility of such a breach. The trust statements provided all the evidence and notice required by the law.

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### The case of the unexpected relative.

#### Wehsener v. Jernigan, 302 Cal. Rptr. 3d 916

In 2018, Loch David Crane, a California resident, died without having made a will. His reasons for not taking care of this important financial chore are unknown, but perhaps it was because he had no surviving spouse, children, siblings, or grandparents. Under California law, that meant his heirs were the descendants of his grandparents. The only such descendant from the paternal grandparents was Shannon Wehsener, a cousin.

Shannon was named the administrator of the Crane estate. On January 8, 2020, she filed her report and petition for distribution of the estate with the probate court. On February 21, 2020, Judy Scherber filed an objection, claiming that she also was an heir.

Mr. Crane's mother had an adopted brother, Charles Bloodgood. Judy's mother had abandoned her as an infant. When she was two years old, Judy's father asked Charles and his wife to babysit her—then never returned to pick her up. Charles and his wife raised Judy as their own daughter, but they never formally adopted her. When the family moved to Indiana, Charles said he was Judy's father when she was enrolled in school. In his will, Charles called Judy his daughter.

In his entire life Mr. Crane never met either Judy or Charles, as neither of them had been to California. Judy only learned about her potential inheritance when she was contacted by a company that locates missing heirs for a share of their inheritances.

The legal question is whether Judy is a descendant of Crane's grandparents. Had the adoption formalities been attended to, the

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answer would be yes in all jurisdictions. But under Indiana law, where Judy lives, the answer is no.

California has a more expansive, less formal rule, under which Charles is presumed to be Judy's "natural parent" unless clear and convincing evidence to the contrary is presented. No such evidence was offered, and Judy's attorneys persuaded the California courts that the California rule should apply. Judy gets half of the estate.

The Court's decision does not reveal how large the Crane estate was—but it was at least large enough to support four years of legal proceedings.

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## Statute of limitations begins to run when the IRS is on notice of the transfer.

### Ronald Schlapfer v. Comm'r, T.C. Memo 2023-65

A long-standing axiom in estate planning is that when a taxable gift is made, the gift should be promptly reported to the IRS, even if no gift tax is due because of the available lifetime credits. The reason is that the filing of the gift tax return starts the statute of limitations running. Absent fraud, the IRS can't challenge the value of the gift after three years.

The importance of this rule was illustrated in a recent Tax Court case with highly unusual facts. Taxpayer funded a life insurance policy in 2006, and assigned ownership of the policy to other family members in 2007. In 2012 Taxpayer entered into the IRS voluntary offshore disclosure program, to restate his tax obligations from 2004 to 2009. Included in his submission was a gift tax return for 2006, for the purchase of the insurance policy. However, the IRS decided in 2016 that there was no gift in 2006, the gift happened in 2007. The Taxpayer disagreed, and withdrew from the program. The IRS issued a gift tax deficiency of $4.4 million for the 2007 gift in 2019.

Too late, the Tax Court ruled. The gift tax statute of limitations runs from the time that the IRS is put on notice of the transfer, even if the transfer is not completed until a later year. In this case, the IRS became aware of the transfer when Taxpayer submitted his forms for the voluntary disclosure program in 2013, so the statute of limitations (including an extension) expired in 2017.

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## Savings bond interest may be taxable in the hands of heirs.

### Hitchman v. Comm'r, T.C. Summary Opinion 2023-18

Anthony inherited a substantial U.S. Savings Bond from his father. The father had not paid taxes on the accrued bond interest, but instead opted for income taxation upon bond redemption. The executor for the father's estate did not include that accrued income in the decedent's final income tax return.

Anthony had the bond reissued in his name, and he later redeemed it. On his income tax return, Anthony reported only the interest that accrued during the interval between reissuance and redemption, apparently believing that the bond received a basis step-up at his father's death.

It did not, the Tax Court informed him. The estate's executor had the option to report the income on the decedent's final tax return, but he did not do that. In that case, the bond becomes income in respect of a decedent, and is taxable to the heir. An additional $13,992 must be added to Anthony's reportable income, which will generate an additional $1,962 in income taxes due.

## WASHINGTON TALK

**SECURE 2.0 Technical Corrections are coming.** In May, four prominent Congressmen (two Democrats, two Republicans, both Houses) sent Treasury a letter warning them that technical corrections are in the works to better reflect Congressional intent. Specifically:

- The tax credit for employer plan contributions in Section 102 should be in addition to, not limited by, the credit for starting a plan;
- an ambiguity regarding the increase in RMD age to 75 needs clarification;
- contributions to Roth accounts in SIMPLE IRA and SEP plan are not to be taken into account for determining the Roth IRA contribution limit; and
- catch-up contribution rules were not intended to be modified for the rank and file. Under the new law, an individual who earned more than $145,000 the previous year would be required to make a catch-up contribution in a Roth account. What if the plan didn't provide for Roth accounts at all? Would that effectively mean that no one could make a catch-up contribution?

Tax observers have identified several more areas of SECURE 2.0 in need of a fix. Because the Technical Corrections bill is a tax bill, the time frame for passage is uncertain, and there is a possibility other tax amendments could be included.

**At the IRS, whistleblowers** come in two categories.

The first is the IRS employee who sees a problem in the agency. The two IRS employees who went to Congress with their concerns about how the tax investigation of Hunter Biden was handled are examples of this sort. In a July 7 internal memorandum, IRS Commissioner Daniel Werfel provided guidance confirming that whistleblowing is encouraged. "I want it to be clear that we will always encourage a 'see something, say something' philosophy," he wrote. Concerns are normally raised through the chain of command, he wrote, but when that is not appropriate, the alternatives include

- Treasury Inspector General for Tax Administration (TIGTA)
- Relevant Oversight Committees of the U.S. Congress
- U.S. Office of Special Counsel (OSC); and/or
- U.S. Department of Justice Office of Inspector General

The other category of whistleblower is those in the general public

who provide tips to the IRS, and who in turn may collect a portion of the increased taxes collected. It was thought that with the increased funding of the IRS last year, this area would grow smartly, but so far that has not been the case.

In fiscal 2022, the IRS Whistleblower Office paid $37.8 million in cash awards on $172.7 million in taxes collected, from 132 cases. Although that is a bit more than the $36.1 million paid the year before as rewards, it was a drop from the 179 cases in the earlier period. In fiscal 2018—the high-water mark for the program—the IRS made 217 award payments to whistleblowers totaling $312 million and collected a total of $1.44 billion for the government.

**Elder exploitation is a big problem** that is getting worse. It's been estimated that seniors lose $23.8 billion annually to financial exploitation, and that about three quarters of the exploiters are family, friends, or caregivers. Financial exploitation is defined as "the illegal or improper use of an older adult's funds, property, or assets," and that covers a lot of ground.

According to a study by the AARP Public Policy Institute, the rate of such exploitation has doubled since March 2020, possibly an effect of the isolation during the pandemic.

If the victim knows the exploiter, the crime goes unreported in an estimated 88% of the cases. The victim may be ashamed, or may want to avoid bringing shame upon the exploiter.

The average loss when the victim knows the perpetrator is $50,000, versus $17,000 when the exploiter is a stranger.

**Taxes are certain, even after death.** Gary Owens won the "Win For Life Spectacular" scratch-off ticket when he was 59, guaranteeing quarterly payments for a minimum of 20 years. However, Gary was impatient, and used the prize to borrow more money. Under the tax law, such loans are treated as ordinary income, which Gary didn't report. He also skipped filing his income tax at least one year.

The IRS assessed additional tax liabilities and penalties for the years 2009 to 2014. Gary died in 2021, at age 79, without paying those taxes. In June, the executor of Gary's estate paid the full $1.5 million due to settle the claim.

**In 2007, Leona Helmsley's will left $12 million** in trust to care for her dog after her death. The legacy was later reduced to $2 million. Now comes a story of a Tampa woman, Nancy Sauer, with a similar estate planning strategy. Her will bequeathed her $2.5 million mansion and an unspecified amount of cash to her seven Persian cats—Cleopatra, Goldfinger, Leo, Midnight, Napoleon, Snowball and Squeaky. The cats were to live in the house for their natural lives, with the house to be sold only after all had died.

As the cats were only five years old, that might be a long time. After six months alone in the mansion, a probate judge ruled that the cats needed to be moved to a place where they could be better cared for. The local humane society is arranging for adoption of the pets.


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**Trust & Estates Team**—117 Grand Street, Suite 100, Goshen, NY 10924

Glenn Wassermann
SVP / Senior Trust Officer

Michael Palanza
VP / Senior Trust Officer

Eileen Osterby
VP / Trust Officer

**Special Needs Trust Team**—510 South Columbus Avenue, Mount Vernon, NY 10550

Sinead Fitzsimons
1st VP / Senior Trust Officer
914-298-9374

Hilda Cabrera
AS / Trust Officer

Renisha Reid
Trust Administrator

Gisela Rodriguez
Trust Administrator

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