Aston Asset Management

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The Estate Analyst

WHEN ESTATES GO WRONG

AND: TESTAMENTARY RESTRAINT OF SAME-SEX MARRIAGE

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Prevention of problems is more effective than trying to reform a wayward estate

We plan and plan and plan yet the best laid plans go wrong! We plan for contingencies and provide for flexibility yet people can end up bewitched, snafued, flummoxed, and frustrated.

How does a train jump the carefully laid out tracks? Here we have a few examples of such derailment including an executor's worst nightmare of personal liability for estate tax, a will that stymied a lucrative building sale (after 99 years!) and trusts that needed to be terminated by hook or by crook.

THE EXECUTOR'S EXPOSURE

"No good deed shall go unpunished."

That great honor of being an executor wears off quickly. The executor gets swept off into the first wave of unfamiliar paperwork with demands for answers and decisions that don't have ready answers. There are meetings with attorneys and accountants, complaints from creditors and beneficiaries and it never seems to be concluded. A constant concern.

Thanks a lot.

As for the grateful family, mostly an executor hears from folks when they aren't happy, and they aren't happy when they are waiting around for money. So the temptation arises to quickly satisfy all the beneficiaries by giving out all of the liquid assets.

And then, let's say, hypothetically, that it all unravels right then and there. It all goes wrong. Maybe it seemed to make sense at the time; give out all the liquid assets because the estate has so much value and so little debt, why even worry?

And that's how it begins. Then comes a financial surprise. There were more taxes due than anyone predicted. It is a major tax surprise. The IRS seizes and auctions off the assets to pay the tax. However, now because the IRS has auctioned off the assets for a song, they failed to generate enough to fully pay the taxes. Guess who is left holding the bag?

The executor is personally liable. It comes as a shock to many people, including the executor. In fact, the executor's personal liability under IRC Section 3713 is not even dischargeable in bankruptcy.[1]

It should be noted, however, that although the executor is personally liable for unpaid tax of an estate under certain circumstances, he may have recourse against transferees of the estate, and the Treasury may also choose to pursue the transferees under IRC Section 6324. The executor may have had beneficiaries execute refund bonds and releases which may be applicable. Equitable claims for contribution from the transferees or other cross claims might be asserted.

And let's just interject here that the process of the IRS getting that property and auctioning it and then skewering the executor personally isn't accomplished instantly by any means. As this unfolds the executor has opportunities to avoid the ultimate remedy.

However, an estate with serious assets and tax liabilities has to have advance planning in minimizing taxes, providing sources of liquidity for payment of those taxes, apportioning tax liabilities, and selecting fiduciaries who will not fall victim to the trap of appeasing beneficiaries at the expense of liquidity.

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NO REFORMATION TO SELL ASSETS

Elmer Smathers died in 1928. A testamentary trust under his will provides annual income of $60,000 to Testator's niece-in-law and her descendants. The niece in law (now deceased) and a grand nephew (now 92) were the measuring lives of the trust.

The primary assets of the testamentary trust are two buildings in Manhattan, one at 18 Broadway (downtown near Wall Street) and one at 562 Fifth Avenue (at 46th Street). In 1920, Testator entered into a 99-year lease with Standard Oil for the Broadway property for rent of $250,000 annually. That expires in 2019. The Fifth Avenue property was leased in 1977 and is subject to expiration in 2011 subject to a tenant option that expires in 2026.

Upon the death of the second measuring life, the trust property is to go to a corporation, Elmer E. Smathers, Inc. The then-living income beneficiaries are to receive shares of Elmer E. Smathers, Inc. There are approximately 100 income beneficiaries and 200 contingent beneficiaries waiting in the wings.

Trustees of the trust had negotiated a sale of the Broadway property for $23,400,000 subject to court approval of reforming the testamentary trust, which prohibits any sale of the property. The trustees also sought reformation of the trust to authorize the sale of the Fifth Avenue property.

The Westchester Surrogate's Court declined to reform the terms of Elmer Smathers' will. The circumstances were not unforeseen. The income was sufficient so there was no frustration of purpose. There was no measurable change in the administration of the trust. The bottom line test was not the "best interests" of the beneficiaries but whether the decedent's presumed intent was incapable of fulfillment. That wasn't the case. The terms of decedent's will were upheld 80 years after his death.

Here's an educated guess. A group of so many beneficiaries were probably getting annual payments of $10,000 when they might be able to cash out in one shot and get their hands on $600,000.

The Court was, however, convinced that the estate should be permitted to create the Elmer E. Smathers, LLC and utilize that entity rather than a corporation to receive the property interests. This reformation would avoid double taxation and would better effectuate the decedent's plan for transfer of the trust assets.[2]

A COMPROMISED TRUST

Mr. Feisty loved investing and hated paying taxes. With future tax savings in mind, Mr. Feisty shifted portions of his estate into trusts for many years. He transferred large portions of his stock portfolio to irrevocable Crummey trusts set up for each of the four Feisty children.

Although Mr. Feisty's long-time bookkeeper, Mr. Bombast, was made the Trustee, Mr. Feisty continued to make all the investment decisions. Mr. Bombast received bookkeeping fees but not trustee fees.

Then Mr. Feitsy was no longer able to serve in that capacity and Mr. Bombast, found himself as a real trustee, making investment decisions and having conflicts with Mrs. Feisty. He found her too feisty. She found him too bombastic. There was another problem as well, and when the dust settled, independent legal and tax advisors concluded that trust needed to be terminated.

Termination of a trust has consequences and risks. A judicial reformation was a long shot and would require scrutiny that neither party desired.

Fortunately, the trusts themselves included a termination clause that allowed the transfer of trust funds to custodial accounts. Such a termination triggered a realization of gains, but taxes were offset by expenses such as trustee fees and legal fees.

As a result, judicial reformation was avoided and replaced with a private agreement that was completely in keeping with an escape clause built into the terms of the trust itself. The trust anticipated the need for termination due to unforeseen events.

A NOT SO SIMPLE ESTATE

Mr. Meticulous was a skillful investor who loved to calculate the best approaches with financial techniques. And he implemented them, several per year, until he had three file drawers full of them.

In the 1950s he started purchasing life insurance policies and annuities with face values of $500, or $1,000 with various companies. He would make purchases every two or three years. In the 1960's he set up various annuities and investment accounts. In the 1980's he had built up quite a few assets and lived in a strict probate jurisdiction.

By 1992, an estate planner looked at the $1.6 million estate, healthy income, age, and family circumstances of Mr. Meticulous and set up a 42-page revocable trust and a 34-page will. Every asset went into the trust. It was a plan that prioritized probate avoidance, asset protection and tax reduction.

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By 2008, a lot had changed. Mr. Meticulous had moved to a probate-friendly state and had a much smaller, shrinking estate. There was no longer a need for sophisticated estate tax planning.

Although the estate of Mr. Meticulous was modestly sized, it had 75 separate investments, accounts, or policies that, ironically, made administration a longer and more expensive process than any probate process that the estate plan had been so concerned about. Nor were the elaborate will and trusts from 1992 useful or efficient.

The Meticulous beneficiaries learned a valuable lesson. For the surviving spouse's estate, the will was simplified, more focused trusts were utilized, and assets were consolidated. Changing course could have been a more complex process but a family agreement and the use of revocable trusts for the surviving spouse keep the plan adaptable after many years.

IN SUMMATION

Planning ahead with a well-drafted trust is the first line of defense. A trust can withstand judicial scrutiny after many decades. On the other hand, an escape clause can be a Godsend and when all else fails, a family contract can reboot and start over.

TECHNICAL REFERENCES

1. David Blain Carroll v. U.S., No. 5:08-cv-01181 (2009). Estate elected installment payments of $2.55 million of estate tax. Executor took over decedent's business, lost it, and filed for bankruptcy. The Alabama District Court affirmed a Bankruptcy Court decision that the estate tax liability of the executor was not dischargeable. There was intentional and deliberate disregard of the estate tax debt as an element of the burden of proof. For a discussion of transferee liability, see "Transferee Liability for Taxes of an Estate, or Honey, I Shrunk Our Wealth," by Robert E. McKenzie, Esq., available on the McKenzielaw.com website.

2. In Re Smathers, 19 Misc. 3d 337, 852 N.Y.S. 2d 718 (2008).

Testamentary Restraint of Same Sex Marriage

Love and marriage, love and marriage,
goes together like a horse and carriage.
This I tell ya, brother,
you can't have one without the other.

When does a condition on a bequest become impermissible as against public policy by attempting to limit marriage in some way?
"To my darling daughter, I leave my summer cottage unless she remains married to a pirate."

This clause encourages divorce and would most likely be struck down. Yet another more specific clause, "I condition this gift on my daughter not marrying John Smith the Pirate," would be considered valid in certain jurisdictions.

KEEPING THE FAITH

Consider a recent estate that gave rise to several cases, including In re Estate of Feinberg, 229 Ill. 2d 667, 900 N.E.2d 1118 (2008) and In re Estate of Feinberg, 383 Ill. App. 3d 992, 891 N.E.2d 549 (2009). A wealthy couple tried to limit marriage of family members by conditioning bequests on whether they marry within the faith. The clause read:

"A descendant of mine other than a child of mine who marries outside the Jewish faith (unless the spouse of such descendant has converted or converts within one year of the marriage to the Jewish faith) and his or her descendants shall be deemed to be deceased for all purposes of this instrument as of the date of such marriage."

Precedents in a number of states do allow a gift to be conditioned on the beneficiary accepting and adhering to a particular religion. But when that condition is worded in a way that encourages divorce, then it is not enforceable. Not all jurisdictions treat all restraints on marriage

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the same way, but the clause above was found to be void under Illinois state law as well as the Restatement (Third) of Trusts.

WHAT ABOUT SAME SEX MARRIAGE?

A notable exception to full faith and credit was created under the federal Defense of Marriage Act (1996). That law allows a state to refuse to recognize a same sex marriage from another state. But the growing number of jurisdictions recognizing same sex marriage indicate a future where marriage is gender neutral.

More to the point: Can a testator impose a testamentary restriction on a bequest that prohibits the potential beneficiary from entering a same-sex marriage? The answer might depend on where you are. If a jurisdiction doesn't sanction same sex marriage, then a prohibition against it may be valid since it is not recognized anyway. But if the jurisdiction recognizes such marriages if originating from a jurisdiction where it is sanctioned, then the prohibition could be voided.

SPOUSES OF CONVENIENCE

As more jurisdictions allow same sex marriages or at least recognize them when they originate from a valid jurisdiction, there is a chance that more marriages of convenience may start to crop up to accomplish tax benefits, health benefits, etc.

In time, concerns about the faith or sex of whom a descendant will marry may become less important than keeping money in trust for beneficiaries to keep it separate from any claims by various transitory spouses of convenience.

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