

## Is it too late to fund the unfunded trust?

**TRUSTS: Fund a credit shelter trust or QTIP as soon as possible to avoid problems later.**

By Richard B. Malamud, J.D., LL.M., CPA  
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Guest Contributors

Mr. Lee died several years ago, survived by Mrs. Lee. His share of the community property was worth \$2 million, and he had no estate tax liability. His revocable living trust stated that upon his death, a credit shelter trust (aka exemption trust) should be funded with the maximum amount that would not produce an estate tax — then \$3.5 million. (A qualified terminable interest property (QTIP) trust would have been required if the estate had exceeded \$3.5 million.)

Normally, following a short administration, the trust would be set up. But it never was.

In 2014, Mrs. Lee died, with all of their property worth \$6 million still in the name of the joint family living trust. If all of the property was owned by Mrs. Lee at her death, there is an estate tax because her estate is in excess of \$5.34 million. At 40%, that would produce an estate tax of \$264,000 ( $(\$6 \text{ million} - \$5.34 \text{ million}) \times 40\%$ ). (**Note:** Mr. Lee died prior to enactment of portability.)

The estate tax would be zero if the credit shelter trust had been funded and Mrs. Lee's estate reduced by the \$2 million. In that case, her estate would only have been \$4 million, well under the 2014 exemption of \$5.34 million.

Even if the estates have the same beneficiaries who share in the same percentages, an additional \$264,000 in estate taxes is due unless Mr. Lee's exemption trust can be retroactively funded under the Internal Revenue Code.

Interestingly, if the total estate is less than the \$5.34 million and Mr. Lee's assets have appreciated, not having funded his trust and having it subject to the estate tax at Mrs. Lee's death results in a free fair market value step-up at her death if they are properly included in her estate.

In addition, Mr. Lee's children could sue for breach of the trustee's fiduciary duty to fund the exemption trust according to the terms of his revocable living trust or his will.<sup>1</sup> The children would ask the state court to issue orders requiring that the assets held in the living trust be used to fund the exemption trust for their benefit.

Mrs. Lee's estate and third parties in possession of misappropriated trust property could also be sued for monetary damages, or ordered to turn over the misappropriated property using various equitable remedies including the imposition of liens, constructive trusts, and tracing.

### Retroactive funding

Several articles have been written on the IRS's position regarding the estate tax consequences of this retroactive funding.<sup>2</sup> One states that "... the IRS did indicate that if there were no transfers prior to the death of the second spouse — and a fair representation of the appreciable versus non-appreciable property still can be obtained — then it may be possible to still fund the bypass trust."<sup>3</sup>

Another said that, according to the IRS, if the trusts are funded retroactively, each trust should receive a representative share of appreciating and non-appreciating assets.<sup>4</sup> The article states that there can be complications if a pecuniary formula is used, but noted that if proportional allocations are made, that may solve the formula problem.

### Examples from case law

In a 1985 case, a father died and the trust for the son was never funded. When his wife died with title to the property, the IRS and the Tax Court denied the retroactive funding because they determined that state law would not allow a constructive trust after so many years.<sup>5</sup> Luckily

for the estate, the Court of Appeals reversed the Tax Court ruling and found that under state law, a constructive trust would have forced the estate to fund the son's trust.<sup>6</sup>

The court's statement of the applicable law is instructive:

*The IRS argues, however, that Texas courts would not have imposed a constructive trust in this case because Mrs. Bailey did not obtain — or retain — the property in question through any type of fraud. This argument simply overlooks the fact that Mrs. Bailey treated her son's inheritance as her own property and used it for her own purposes for thirty years. We cannot ignore that Texas courts impose a constructive trust upon the decedent's portion of the community funds after payment of the community debts. These cases recognize that at least constructive fraud is inherent in the act of retaining and using property to which another person is legally entitled in violation of a fiduciary duty.*

In a very strange factual case, Alice Porter was divorced in 1936 and died in 1953 with few assets in her name, and no estate tax return was filed. Shortly after her death and 17 years after the divorce, her sons filed suit against Alice's ex-husband, claiming that they were owed their mother's share of the community property as the divorce did not address that issue and the community property was never divided.

The New Mexico Supreme Court ruled that her estate had an interest in the community property and remanded the case to the trial court to determine the amount.<sup>7</sup> The IRS assessed the estate tax, penalty and interest on the value of that claim, which was affirmed by the Tax Court.<sup>8</sup>

A similar case involved a brother and sister. When they inherited from mom, the sister transferred her share to her brother, who was supposed to transfer it back to her when he died. Instead, to avoid his creditors, he transferred it to his wife, who left it to others when she died 26 years later. The IRS claimed that the misappropriated property was included in the wife's taxable estate even though the state civil court imposed a constructive trust in favor of the sister over the wife's estate.

The United States District Court in the tax case accepted the state court's conclusion and accordingly, the wife's estate was not required to include that property.<sup>9</sup>

These cases demonstrate that courts will sometimes allow claims for property many years after it is taken if it is clear it was supposed to be returned. They also demonstrate that the resolution of inheritance disputes between heirs may give rise to estate taxes, interest, and penalties. In the *Porter* case, the heirs won their State court claim shortly after their mother's death, but didn't include the property in her estate for estate tax purposes. They should probably have estimated a value (possibly discounted based on the odds of winning). Valuation of speculative claims is a whole separate article.

### **Taking it to court**

Each case will be decided based on its unique facts and the applicable state law. Even if heirs settle their disputes in a manner that appears to avoid estate tax, the IRS may disagree. That is because the IRS is not required to follow their settlement even if it is approved by a state trial or appellate court.<sup>10</sup> In effect, the IRS for tax purposes can contest the estate's settlement if it believes state law dictates a different result, unless it was the decision of the state's highest court.<sup>11</sup>

The judge in the tax case must decide what the state court would have decided had it decided the case. "While Federal law ... designates what interest or rights shall be taxed, Federal courts look to state law to determine what property interests or rights were possessed by the decedent at the time of her death."<sup>12</sup>

Many practical problems arise when trusts are not properly and timely funded. For example, how does the estate or the IRS determine which property should fund the retroactive \$2 million trust? If the estate consisted entirely of ABC stock and it has appreciated 50%, a retroactive trust of \$3 million would have a basis of \$2 million and unrealized gain of \$1 million.

If the estate consisted solely of taxable bonds and the son's trust is funded with \$2 million of bonds, would the retroactive trust receive interest subject to tax or would it get the net interest after tax, since the interest had already been reported and the tax paid by the original recipient?

The best time to fund a credit shelter or QTIP trust is as soon as possible. Waiting 20+ years as in the cases above is probably too long. At least that is what the defendant will claim — and what the IRS may claim if it is to their advantage.

#### About the authors

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- <sup>1</sup> A case that involved similar issues was remanded back to the bankruptcy court. See *Jacobs v. Pierce* (1994) U.S. District Court, Massachusetts. Case No. 89-13609
- <sup>2</sup> Davis, Mickey R. Funding Unfunded Bypass Trusts (October 13, 2006)
- <sup>3</sup> Woodford, John. Funding Stale Trusts: What You Should Know When Faced with an Unfunded Trust. California CPA (May 2005) Available at: [www.calcpa.org/Content/23505.aspx](http://www.calcpa.org/Content/23505.aspx)
- <sup>4</sup> Woodford, John; Gilbert, Richard; and Whiting, Jason. Stale Fund Refreshments. California CPA (March/April 2011) Available at: [www.calcpa.org/Content/26259.aspx](http://www.calcpa.org/Content/26259.aspx)
- <sup>5</sup> *Estate of Roberta L. Bailey v. Comm.*, TCM 1985-274
- <sup>6</sup> *Estate of Roberta L. Bailey v. Comm.* (1984) 741 F.2d 801
- <sup>7</sup> *Porter v. Porter* (1958) Supreme Court of New Mexico, Case No. 6329
- <sup>8</sup> *Porter v. Comm.* (1967) 49 TC 207
- <sup>9</sup> *Stansbury v. U.S.* (1982) 543 F.Supp. 154
- <sup>10</sup> *Comm. v. Estate of Bosch* (1967) 387 U.S. 456 cf. Rev. Rul. 73-142 where the settlement occurred prior to the death rather than after the estate came into existence
- <sup>11</sup> *Comm. v. Estate of Bosch* (1967) 387 U.S. 456
- <sup>12</sup> *Estate of Sholes v. Comm.*, TCM 1981-455. As stated, in *Stansbury*, the Judge accepted the state court decision because it was obviously adversarial

## It's not passive income when renting to your corporation

**TAX: Taxpayers frequently fall into this trap, and will most certainly lose in court.**

By **Tim Hilger, CPA**  
Senior Editor

A taxpayer's commercial rentals that generated net rental income from renting to his corporation in which he materially participated were recharacterized to nonpassive income and, therefore couldn't offset passive losses from his residential rentals.<sup>1</sup>

#### Facts

During each of the two years at issue, the taxpayer received over \$5 million in income from corporations in which he was sole owner and an employee. He personally owned two office buildings, which he rented to his corporations and from which he received net