TAX COURT CASE UPDATE

Citation:

Estate of Helen A. Trombetta, et al. v. Commissioner, T.C. Memo 2013-234, October 21, 2013.

Overview:

The Tax Court has ruled that a taxpayer's lifetime transfers of her residence to one trust and rental properties to another trust were transfers with a retained life estate and thus the properties were includible in her gross estate. It also ruled against the taxpayer with respect to a purported charitable deduction.

The Facts:

Helen Trombetta ("the decedent") was the grantor and sole beneficiary of an "annuity trust." She was a trustee of the trust together with some of her children and had 50 percent of the trust's voting rights. She transferred two rental properties to the trust in return for a 180-month annuity. The properties were both subject to mortgages. After the transfer, the trust paid the mortgages, but the trust never assumed the mortgages. The annuity trust agreement provided that, if the trust's income exceeded the periodic payment due, the co-trustees could distribute the excess income to the decedent or allow the income to accumulate in the trust. At the later of the end of the annuity trust term or the date of her death, the annuity trust property would pass to decedent's surviving children or grandchildren. In her role as trustee, the decedent continued to manage the properties as actively as she had before the transfer. The decedent filed a gift tax return in connection with the transfer to the trust, in which she showed that the properties had a value of $1.4 million, that the decedent had a retained interest of $0.9 million, and that the amount of her gift was the difference ($0.5 million).

The decedent was also the grantor, trustee and sole beneficiary of the "residence trust." The residence trust agreement provided that decedent had the right to use any trust property as a personal residence and the right to receive the net income from the trust. The term of the trust was 180 months, subject to decedent's power to reduce the term, and the only asset in the trust was the decedent's residence. The residence trust provided that: a) if the decedent was living at termination, the trust property would be distributed equally to her children or their children; and b) if the decedent was deceased at termination, the trustee would distribute the balance of the trust property as directed by the decedent's will or, if not so directed, equally to the decedent's children or their children. Similar to the case with the annuity trust, the decedent filed a gift tax return with respect to the transfer of the residence in which she indicated that she had a retained interest in the residence.

At some later date, the decedent became ill and believed she would die before the termination of the residence trust. As a result, she amended the residence trust such that it would end right after her death. She also amended that trust to instruct the trustee to, after her death, transfer her residence to a charitable remainder trust.

The decedent died on September 16, 2006. The executor created the charitable remainder trust and transferred the residence to it. Thereafter, the executor filed a petition for reformation (i.e., correction) of the residence trust term to provide that the residence trust would terminate on the last day of the month before the decedent's death. The decedent's estate tax return showed that the properties in the two trusts were not part of the estate, and it took a charitable deduction with respect to the charitable remainder trust.

The IRS disagreed with each of these positions.

Discussion:

The IRS argued that the decedent's transfers to the annuity trust were includible in the gross estate under Code Section 2036(a), and the Court agreed. The issues were: (1) whether the decedent's transfers of the rental properties were bona fide sales for adequate and full consideration; and (2) whether the decedent retained an interest in the transferred properties during her life.

On the issue of bona fide sale for adequate and full consideration, the taxpayer argued, quoting the *Estate of Bongard* (2005, 124 TC 95), that the crux of the bona fide transfer inquiry is whether the taxpayer can demonstrate that he had legitimate and significant nontax reasons for entering the transaction. The Taxpayer argued that its nontax purposes were to relieve the decedent of the burden of managing the properties and to have her receive an assured income. The Court first disagreed that this rule applied here, noting that in the *Estate of Bongard* and all other cases, this rule applied to transfers to family limited partnerships (FLPs) and that FLPs and the annuity trust are not sufficiently similar. Then it also said that the taxpayer had not established that the decedent had substantial nontax reasons for the transfer, reasoning that she continued to manage the properties, that there were more efficient ways for her to get an assured income, and that the transfer to the trust was part of a series of tax-related transactions including executing her will.

The Court then said that the transaction was not a bona fide sale in the sense of an arm's length transaction because, in effect, the decedent was on both sides of the transaction because she was the grantor of the trust and the only trustee involved in the transfer transaction.

In ruling that there was a retained interest, the Court noted that the decedent made all decisions with respect to the rental properties and that the co-trustees generally acted on the decedent's recommendation. She took the lead role in negotiating the refinancing of the properties following their transfer to the annuity trust. The decedent alone retained signatory authority with respect to the disposition of the properties. She thus retained de facto control over the properties and their disposition. In addition, the annuity trust agreement provided that any additional income could be distributed to the decedent at the direction of the trustees, and the decedent retained 50 percent of the voting rights. Because the decedent and her children could make distributions of additional income to the decedent when and in the amount they pleased, the decedent maintained the same enjoyment of the properties and their income stream as she had before she transferred the properties to the annuity trust.

The Court treated the entire value of the residence as part of the estate, pursuant to Code Section 2036(a) and ruled that the estate was not entitled to an estate tax charitable contribution deduction because the residence trust term ended before decedent's death, and therefore, the

decedent did not possess the right to direct the disposition of the residence to a charitable organization.

The residence trust agreement, both before and after its amendment, provided that if the decedent was living at termination, the trust property would be distributed equally to her children or their children, but if the decedent was deceased at termination, the trustee would distribute the balance of the trust property as directed by decedent's will. The residence trust terminated before the decedent's death pursuant to judicial reformation. The decedent provided for the creation of the charitable remainder trust in the amendment to her will. Because the residence trust terminated before the decedent's death, however, the residence should have been distributed equally to decedent's children or grandchildren rather than distributed as directed by the decedent's will, i.e., into the charitable remainder trust.

Conclusion:

The Court agreed with the IRS that all of the assets were includible in the decedent's gross estate under Code Section 2036(a) and that no charitable deduction could be claimed.