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A Nightmare in *Elwood Estate*

By Phyllis C. Taite


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Taite discusses *Estate of Elwood H. Olsen*, in which the Tax Court held that the estate was required under section 2044 to include the value of assets in a trust created by the decedent's wife before her death, but she concludes that the IRS should have treated some of the withdrawals from that trust as having been made from marital trusts.

Even the most conscientious estate planner sometimes wakes up in the middle of the night bothered by the fear of having left something out. Like the hapless victims in the 1984 classic *A Nightmare on Elm Street*, estate planners might want to avoid sleep for fear of what their unconscious minds will reveal about the estate plan they just completed. The planners in *Estate of Elwood Olsen v. Commissioner*[1] might still be screaming.

Estate of Elwood Olsen involved reciprocal revocable trusts created in November 1994 by Elwood H. Olsen (the EHO trust) and Grace T. Olsen (the GTO trust). The substantive terms of the trusts were identical. Each trust provided for the creation of three separate and distinct trusts when either spouse died first. Specifically, the trusts directed the creation of a family trust (credit shelter) and two marital trusts.[2] The EHO and GTO trusts were amended in November 1995 without altering the requirement that three trusts be created. At Grace's death, her surviving spouse, Elwood, became trustee and made three substantial withdrawals without ever creating the separate trusts. At Elwood's death, the primary issue for resolution was whether to treat the withdrawals as distributed from the marital trusts or the family trust.

Entering Sleep Mode: Grace T. Olsen's Estate

Grace died on December 9, 1998, and her husband served as both the personal representative of her estate and trustee of the GTO trust. As personal representative, he filed Form 706, "Estate Tax Return," for Grace's estate and valued the GTO trust at $2,104,695. The assets were to be distributed as follows: (1) $600,000 to a family trust; (2) $1 million to marital trust A; and (3) $504,695 to marital trust B.

On Grace's estate tax return, Elwood reported $1,504,695 on Schedule M[3] as the total amounts in marital trusts A and B and made a QTIP election under section 2056(b)(7).[4] He reported no tax due on Grace's estate tax return after claiming the marital deduction, the applicable exclusion amount, other deductible expenses, and debts.

Dream State: Unrestricted Withdrawals

During his lifetime, Elwood, as trustee, had unrestricted access to the trust funds. In fact, he made significant withdrawals from the GTO trust totaling $1,474,780. On two different occasions, Elwood withdrew $249,550 and $831,252 to make charitable donations to Morningside College. He also withdrew $393,978 and deposited that amount into his own individual account.

Although the GTO trust directed the trustee to create three distinct trusts, there is no evidence that Elwood ever did so. After Elwood's death, Ty Olsen, as personal representative of Elwood's estate and successor trustee to the GTO trust, sought to determine the source of the withdrawals but was unable to do so.

Ty then created the three separate trusts as required by the GTO trust. In funding the trusts, he treated all three withdrawals made by Elwood as

[1]T.C. Memo. 2014-58.

[2]The two marital trusts were known as marital trust A and marital trust B. Marital trust A was designated as the qualified terminable interest property trust that was exempt from generation-skipping transfer tax, and marital trust B was designated as the QTIP trust not exempt from GSTT.

[3]Schedule M is a form submitted with Form 706 to list property that qualifies for the marital deduction.

[4]Section 2056(b)(7), in relevant part, defines QTIP as "property which passes from decedent to the surviving spouse with a qualifying income interest for life and to which an election is made."

having been withdrawn from the marital trusts.[5] Consequently, he allocated the entire remaining amount in the GTO trust to the family trust. The beneficiaries did not object to the allocation.

The Nightmare Unfolds: Notice of Deficiency

Ty filed Form 706 for the estate but did not include any of the GTO trust as part of the estate under section 2044.[6] The commissioner filed a notice of deficiency for $1,071,224, the value of the GTO trust allocable to marital trust A and marital trust B.

Ordinarily, the amounts in the marital trusts would be included in Elwood's gross estate, and the amount in the family trust would not be includable. In this case, the issue is confused because (1) Elwood never segregated the trusts into three separate, distinct trusts; and (2) he never funded the trusts in accordance with the trust provisions.

To make matters worse, when Elwood was trustee, he never provided any accountings for the GTO trust to the beneficiaries. Further, successor trustee Ty did not find any evidence indicating Elwood's intent regarding the source of the withdrawals or the authority he used to withdraw the funds.

False Awakening: Tax Positions

Ty, as personal representative, took the position that the marital trusts did not have any assets on the date of Elwood's death. Instead, all of the remaining assets in the GTO trust would be allocated to the family trust, and none of the assets in the GTO trust would therefore be includable in Elwood's gross estate.

The estate asserted that the withdrawals should be allocated to the marital trusts, consistent with both Grace's intent and the trustee's duty to minimize taxes. As a result, Ty contended that the marital trusts were effectively depleted and that the remaining funds were properly allocable to the family trust.

The commissioner instead allocated the withdrawn amounts to the family trust and took the position that any assets in the GTO trust should be considered part of the marital trusts. Consequently, the estate was required to include the value of the GTO trust in the gross estate under section 2044.

The commissioner indicated that the withdrawals were properly allocable to the family trust because of the *inter vivos* power of appointment Elwood had in the family trust, which permitted him to make *inter vivos* appointments to charity.[7] Specifically, the GTO family trust was unique in granting Elwood the ability to direct charitable donations.[8] Further, the marital trust could not provide such an *inter vivos* power of appointment and still qualify as a QTIP trust.[9]

In allocating the entire trust property to the marital trusts, the commissioner indicated that the burden was on the estate to establish that the commissioner made an improper allocation.[10]

The Actual Awakening: Court Decision

The court agreed with the commissioner that $1,080,802 of the withdrawals from the GTO trust was allocable to the family trust. The court also agreed with the estate that $393,978 of the withdrawals was allocable to the marital trusts. According to the GTO trust, Elwood had the special power to appoint the family trust property to one or more tax-exempt charitable organizations and the power to apply the property in the marital trusts to himself for his health, education, maintenance, and support.

The court determined that the $393,978 withdrawal was allocable to the marital trusts for several reasons. First, Elwood deposited the funds into one of his own accounts, so his power to withdraw was used for his own benefit. Second, the family trust gave Elwood a special power of appointment that limited his power to withdraw and distribute to himself, except for a discretionary power to pay expenses associated with his health, education, maintenance, and support.[11]

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[5]Ty allocated the amounts Elwood withdrew, a total of $1,474,780, between marital trust A and marital trust B.

[6]Section 2044 states, in relevant part, that "the value of the gross estate shall include the value of any property to which this section applies in which the decedent had a qualifying income interest for life. This section applies to any property for which a deduction was allowed with respect to the transfer of such property to the decedent under section 2056(b)(7)."

[7]The GTO trust, in Article X, paragraph 5, provided a special power of appointment permitting Elwood Olsen, as trustee, to distribute principal of the family trust to charitable trusts or other section 501(c)(3) organizations.

[8]The petitioner's brief describes Grace and Elwood as generous contributors to Morningside College and other charitable organizations. Based on their pattern of charitable giving, the charitable donations are consistent with the ability to direct charitable donations in the provisions of the family trust.

[9]Section 2056(b)(7)(B)(ii)(II) specifically indicates that to have a qualifying income interest, no person may have a power to appoint any part of the property to any person other than the surviving spouse.

[10]Elwood at *26, citing *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

[11]The court further found that the provisions of the family trust prohibited Elwood from appointing any of the property for his own benefit, except that he had the discretionary power to distribute to himself for his health, education, maintenance, and support.

Finally, the court found that — based on the record — Grace did not intend that discretionary power to be available until the trustee had exhausted the principal of the marital trusts. As a result, the court held that the estate was required to include $607,927.51 in Elwood's estate under the provisions of section 2044.[12]

Conclusion

This case reminds practitioners of three important aspects of estate planning. First, it highlights the importance of good drafting. In drafting estate planning documents, particularly those with unique provisions, it is wise to specifically state the settlor's intent. Precise drafting eliminates later speculation by trustees or courts and will facilitate the settlor's intent. This is a timeless lesson for even the most seasoned estate planner.

Second, the case shows how important it is for trustees to follow the trust directions and make appropriate accountings to beneficiaries. When making tax elections, particularly the QTIP election, it is imperative that trustees properly segregate marital property from other property for which the applicable exclusion amount applies. Also, detailed recordkeeping is just good business and helps avoid suspicion and second-guessing later on.

Finally, the case reminds beneficiaries to conduct their own due diligence to protect their interests. Part of the beneficiary's responsibility is to hold the trustee accountable for performing his duties. Beneficiaries need to be proactive, requesting and reviewing accountings early rather than later. It is easy for beneficiaries to become complacent when a parent is the trustee and primary beneficiary. Even for cases in which the trustee is trustworthy and seems to act in good faith, inaction or missteps could cost the beneficiaries millions in tax dollars.

The estate planner who remembers these three simple lessons probably won't have to worry about nightmares.

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[12]The parties stipulated that the value of the GTO trust was $1,001,905.51. With the court's finding that $393,978 was allocable to the marital trust, the balance, $607,927.51, was the proper amount to include under section 2044.

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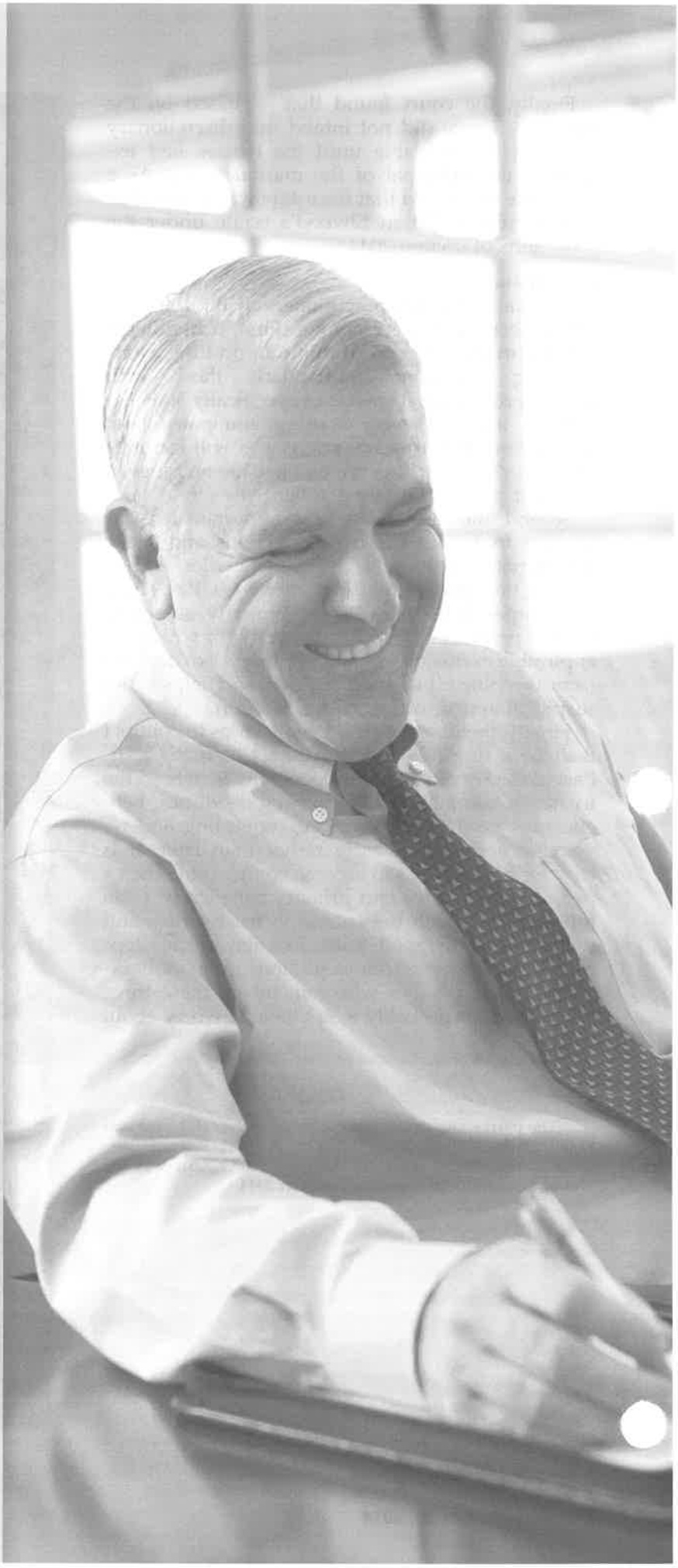

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— **Martin Sullivan,** PhD
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