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FAMILY ESTATE TRUSTS
— by Neil E. Harl

The recent attention to revocable living trusts has led to some confusion with a far less useful concept, the trust referred to variously as the "family estate" trust, "pure" trust, and "constitutional" trust. The latest version of these trusts, all of which are valued as substantially less than worthless, is the two-trust off-shore version or the foreign tax haven double trust. The trusts are mostly sold door-to-door through local contacts who tout the trusts as devices to solve all of one's estate-planning problems. The trusts are purportedly irrevocable, generally for a 25-year term.

Grounds for challenging the trusts.

• One of the arguments offered in support of the trusts is that the taxpayers can assign their lifetime services to the trust and thus avoid paying income tax on their earnings. It is a fundamental principle of taxation that such assignment of income is ineffective. That is the Internal Revenue Service position and more than 115 litigated cases agree with the IRS position.

A number of cases have held the trusts to be shams and without economic substance. Some of the taxpayers have argued that the trusts were "business trusts" but the outcome has been the same with the arrangements considered to be shams and lacking in economic substance.

• The promoters of the trusts often argue that those setting up the trusts save on federal estate tax because the trust owns the property at death and the ownership interests are either not included in the estate or are included at a greatly discounted value. The IRS position since 1975 has been that the units of beneficial ownership, whatever they are called, are taxed in the grantor's estate. The outcome has been the same where the taxpayer has set up foreign trusts with foreign entities as trustees. The Tax Court has upheld the IRS in a case where it was established that the decedent had an implied agreement that income and corpus of the trust would be distributed to the decedent upon request. IRS agrees with the promoters that transfers to the trusts are not subject to federal gift tax. The retention of control prevents the transfer from being a completed gift.

• IRS maintains that the trusts may have a preponderance of corporate over noncorporate characteristics and thus would run the risk of being treated as an association taxable as a corporation. The 1986 revision of corporate liquidation rules makes this possibility a more serious problem than was the case for many years.

Deductibility of costs to create trusts

The IRS position for years has been that the expenses incurred in creating family estate trusts are not tax-deductible. The IRS has been successful in more than three dozen suits to date.

Some have claimed a theft deduction for payments on worthless trust materials, but that approach, likewise, has been unsuccessful.

Actions against promoters

The promoters of the trusts have been subjected to fines and injunctions. Income tax return preparers have been fined for understatement of income on income tax returns claiming deductions from family estate trusts and for reliance on the advice of family estate trust promoters. Taxpayers have been assessed negligence penalties.

In conclusion

Trusts known as pure trusts, constitutional trusts and family estate trusts rank easily as the most troublesome estate-planning scam in several decades. Individuals should be encouraged to avoid them at all costs.

FOOTNOTES

See Rev. Rul. 80–74, 1980–1 C.B. 137. See Akland v. Comm'r, T.C. Memo. 1983–249, aff'd, 767 F.2d 618 (9th Cir. 1985) (total of 7 trusts established; all were shams); Zmuda v. Comm'r, 79 T.C. 714 (1982), aff'd, 731 F.2d 1417 (9th Cir. 1984) (three trusts established; all were paper entities established to avoid taxes); Sandvall v. Comm'r, T. C. Memo. 1989–56 aff'd, 898 F.2d 455 (5th Cir. 1990) (taxpayer maintained total control over foreign-based sham trust; negligence and substantial understatement penalties properly imposed and damages for delay and frivolous appeals upheld); Able Co., A Business Trust Organization v. Comm'r, T. C. Memo. 1990–500 (trusts were shams where grantor owned and controlled trusts for own benefit).

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6. For a list of litigated cases, see 8 Harl, supra note 1, § 62.09[2][a][i], n. 32.
7. See, e.g., Neely v. U.S., 775 F.2d 1092 (9th Cir. 1985) (family grantor trust held to be sham for income tax purposes.
8. Chase v. Comm'r, 91–1 U.S. Tax Cas. (CCH) ¶ 50,090 (8th Cir. 1991) (trusts irrevocable for 25 years; beneficial interests evidenced by trust certificates).
10. Ltr. Rul. 9043074, July 12, 1990 (corpus of trust ostensibly established by nonresident alien in foreign country with foreign entities as trustees includible in U.S. decedent's gross estate because decedent was real transferor of property to trust; trust was sham and functioned as alter ego of decedent in personal capacity).
20. Neely v. U.S., 775 F.2d 1092 (9th Cir. 1985) (taxpayer assessed penalty for negligence in setting up family trust as flagrant tax avoidance scheme); Kerr v. Comm'r, T.C. Memo. 1987-470 (taxpayers liable for negligence penalty where taxpayers relied on legal advice from promoters of family trust).

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

POSSESSION. Due to recording errors, a timberland lot transferred by patent was not included on the assessor’s real property tax rolls. The patent owner did not claim ownership of the lot and never paid taxes for the lot. The trial court, an employee in the assessor’s office, began to use and improve the lot over five years and filed a quiet title action, claiming ownership by adverse possession. The patent owner did not claim ownership of the lot and never paid taxes for the lot. The court held that the sufficiency of the improvements was a jury question.

In re Cluff v. Bonner

PROCEEDS OF LAWSUIT. During the debtors' Chapter 7 case, the debtors claimed $6,000 as the value of an exempt interest in a lawsuit for damages. The trustee did not object to the exemption and the debtors received a discharge, although the case remained open while the trustee prosecuted the lawsuit through independent counsel. A settlement was reached in the lawsuit which provided a recovery for the debtors of almost $20,000. The court held that the additional recovery was not an appreciation of the original claimed amount and limited the

BANKRUPTCY

GENERAL

AUTOMATIC STAY. The debtor corporation alleged a violation of the automatic stay by a creditor which raised the price of a manufacturing component as to the debtor. The debtor argued that the price rise was an improper attempt to collect a pre-petition debt. The court held that the remedy provided by Section 362(h) applied only to debtors who were individuals and not to business organizations. In re Shape, Inc., 135 B.R. 707 (Bankr. D. Me. 1992).

EXEMPTIONS.

OBJECTIONS. The trustee filed a motion for turnover of estate property which the debtor had claimed as exempt. The motion was filed after the date for filing objections to the exemptions. The court denied the motion as untimely. In re Okoinyan, 135 B.R. 691 (Bankr. S.D. Fla. 1991).

PENSION PLAN. The court held that the Florida exemption for interests in an ERISA qualified pension plan was not pre-empted by ERISA. In re Seslowsky, 135 B.R. 692 (Bankr. S.D. Fla. 1991).

The court held that the Massachusetts exemption for interests in ERISA qualified pension plans was pre-empted by ERISA but that the debtor's interest in the pension plan was exempt under ERISA as a nonbankruptcy federal exemption. In re Hennessey, 135 B.R. 711 (Bankr. D. Mass. 1992).

The court held that the additional recovery was not an appreciation of the original claimed amount and limited the