Trombetta: The Two-Trust Tango

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Taite discusses Trombetta, in which the Tax Court held that the value of properties transferred to the annuity trust and residence trusts were properly includable in the gross estate of the decedent as retained interests. The court also held that the estate was entitled to deduct the full unpaid amount of a promissory note for mortgage indebtedness because the decedent was personally liable on the debt. Finally, the Tax Court concluded the estate was not entitled to a charitable deduction based on a postmortem trust reformation.

Estate Trombetta v. Commissioner involved lifetime property transfers to two trusts — an annuity trust and residence trust — and whether those trusts would be included in the estate of the decedent for estate tax purposes. The decedent, Helen A. Trombetta, was married to Joseph Trombetta, with whom she had four children: Joan Adele Clendenin, Carol Ann Carroll, G. Dole, and Thomas Leon Trombetta. In 1986 Helen and her husband purchased a 27-unit building known as Black Walnut Square, and in 1988 they purchased a 79-unit building known as Tierra Plaza. Both properties were purchased subject to significant debt secured by mortgages for which the couple was personally liable. In 1992 the couple divorced, and Helen received various rental properties, including Black Walnut Square and Tierra Plaza.

A. The Two Trusts

Helen died on September 16, 2006. Before her death, she developed a comprehensive estate plan, which included transferring properties to an annuity trust and a residence trust. Those two trusts, and the way they operated, are at the heart of this case.

1. The annuity trust. The annuity trust was established with Helen as the grantor and sole beneficiary. She served as co-trustee with three of her children and was vested with 50 percent of the annuity trust voting rights. The other co-trustees split the remaining voting rights. The annuity term was 180 months, subject to Helen's power to reduce the term. The trust provisions required the trustees to distribute an annual sum of $75,000 to Helen for the first 12 months, with an annual increase at the beginning of each successive year. No payments were permitted after the annuity term expired. At the end of the term or at Helen's death, whichever occurred later, the trust property was payable to her surviving children or grandchildren.

The annuity trust provided that the co-trustees were entitled to “manage, control, lease, grant options on, mortgage, sell, convey, exchange, partition, divide, subdivide, improve, change the character of, develop, repair, abandon, and demolish trust property.” Helen transferred Tierra Plaza and Black Walnut Square to the trust. Tierra Plaza was security for $2.02 million of indebtedness, and Black Walnut Square was security for $884,000 of indebtedness.

The annuity trust paid the mortgage note but never formally assumed the debt. Helen filed Form 709 reporting the gifts to the annuity trust. She reported that the properties had a value of $1,425,802 and that her retained interest was valued at $921,809. The value of her taxable gift was therefore $503,993. Helen intended for her retained interest in the property to qualify as a qualified interest. If the transfer had not satisfied the requirements as a qualified interest, the value of the net gift would have been $1,425,802, instead of the amount reported.

2The decisions by trustees were taken by a majority vote of the trustees.

3A qualified interest is defined under section 2702(b)(1) as “any interest which consists of the right to receive fixed amounts payable not less frequently than annually.” Section 2702(a)(2)(B) states: “The value of any retained interest which is a qualified interest shall be determined under section 7520.” If the retained interest was not a qualified interest, section 2702(a)(2)(A) would require that its value be treated as being zero.

T.C. Memo. 2013-234.
2. The residence trust. The residence trust was established with Helen as the grantor, trustee, and sole beneficiary.

The residence trust had only one asset, referred to as the Modesto property — Helen’s personal residence. The trust agreement provided that Helen was entitled to possession and use of the trust property as her personal residence, and she was entitled to the net income from the trust.

Similar to the annuity trust, the residence trust was limited to a term of 180 months, subject to Helen’s power to reduce the term, and it was intended to qualify as a personal residence trust under section 2702. According to the terms of the trust, at the end of the trust term or termination of the trust, Helen or her estate was entitled to the property and any accrued income. Helen reported the transfer to the residence trust on Form 709 as a gift valued at $150,000, and she valued her retained interest at $92,491 for a net gift of $57,509.

B. The Two-Trust Tango

Helen started receiving payments in August 1993 and continued to receive payments monthly. In 1994 she decided to reduce her payments “with the understanding that the deferred amounts would accrue interest and be paid later to Decedent or her estate along with the accrued interest.” From 1994 to 1997, the majority of the payments were less than the scheduled amount, and the shortages were recorded accordingly. On May 1, 1997, Helen received a payment that eliminated the balance due to her and created an outstanding balance she owed to the trust. Helen received excess payments until April 1998, when she returned to reduced payments. Even though Helen received reduced payments, the reductions were insufficient to eliminate her indebtedness to the trust.

In 1999, to preserve the value of the annuity trust, the trustees entered into a 34-year residential lease with Helen’s daughter, G. Dole, as follows: (1) Tierra Plaza at a monthly rent of $21,827.58 and a $3.3 million option to purchase; and (2) Black Walnut Square for $7,275.88 monthly rent and a $1.1 million option to purchase. Helen’s balance owed to the trust was paid in full, and she directed the trustees to make her future payments less than the scheduled amount. By the end of 2001, the annuity trust had paid off the mortgage on the Black Walnut property. Helen, on behalf of the annuity trust, then issued a promissory note to a limited partnership, Helen Properties LP.

In 2005 Helen was diagnosed with cancer, so she amended the annuity trust agreement to reduce the trust term to 156 months, thereby terminating the trust on July 31, 2006. She also amended the residence trust to a reduced term of “that number of months (not greater than 180) that is determined by making the month during which the ... [decedent] dies the last month preceding the Termination Date.” In furtherance of her estate planning, Helen created a charitable remainder unitary trust to receive the Modesto property after her death. She intended to create the trust consistent with federal requirements to qualify her estate to receive a charitable contribution deduction.

Helen still resided in the Modesto property when she died. After her death, G. Dole filed a petition to reform the residence trust to alter the date of termination from the month after Helen died to the last day of the month before her death. The state superior court ordered the reformation. The charitable remainder trust contributed $344,000 to qualified charitable organizations. The estate also reported the following:

Decedent had relinquished her right to receive periodic payments from the annuity trust for the final two years of the annuity trust term; (2) the total amount of the scheduled periodic payments for those years was $254,756; and (3) the present value of the relinquished periodic payments was $232,226. On the Schedule G the estate reported that in 1993 decedent had transferred to the residence trust the Modesto property valued at $150,000 and that the net value of the transferred future interest was $57,509.

A notice of deficiency was issued because the IRS determined that the estate had failed to report $14,365,823. The IRS asserted that the combined date of death fair market value of the Tierra Plaza and Black Walnut Square properties was $14,177,325 and should have been included in the estate, and that the FMV of the Modesto residence was $750,000. The mortgage on the Tierra Plaza property was $2,194,245.50, and the leased fee value of both Tierra Plaza and Black Walnut Square was $4.3 million. The IRS disallowed the charitable contribution deduction and the mortgage indebtedness deduction.

4An exception to the “zero value” retained interest is found in section 2702(a)(3)(A)(ii), which states: “If such transfer involves the transfer of an interest in trust all the property in which consists of a residence to be used as a personal residence by persons holding term interests in such trust.”

5The residential lease was secured at Helen’s direction. Both G. Dole and Helen were co-trustees.

6By the terms of the trust, the termination date was after the month of Helen’s death.

7The estate did not include the Tierra Plaza and Black Walnut Square properties.
C. Retained Interest

Section 2036(a)(1) requires that value of property purportedly transferred by the decedent be included in the gross estate if the decedent retains the right to receive income from the transferred property or continues to use or enjoy it. In Trombetta, the estate contended the property was not includable because the decedent retained an interest in the periodic payments, not the trust corpus. The estate also asserted that the transfer to the annuity trust was a sale and therefore did not qualify as a retained interest.

Whether a decedent had a retained interest is determined by facts and circumstances. The facts indicated that Helen (1) made all decisions regarding the properties; (2) had signature authority in the annuity and residence trusts; (3) had the right to receive income from the annuity trust; (4) had 50 percent of the voting rights; and (5) used income from the annuity trust to discharge her individual loan obligations on the properties.

Based on the facts and circumstances, the court found there was an implied agreement between Helen and the co-trustees that she would continue to have the same economic benefits after the transfer that she enjoyed before the transfer. The court also found that the bona fide sale exception did not apply. The bona fide sale exception would have applied if Helen had transferred the property for FMV.

FMV is the “price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts.” The court found that Helen did not receive full and adequate consideration on the transfer and that there was no serious bargaining or negotiating for the property. As a result, the court determined that the transfer to the annuity was not intended as a sale. Further evidence of Helen’s intent was the fact that she reported the transfer on Form 709 at the time of the transfer.

The court next analyzed the legal consequence of Helen reducing the trust term. It considered whether, when Helen reduced the annuity term and terminated her interest, her actions resulted in a transfer or relinquishment that would cause the property to be included under section 2035. The court concluded that when Helen reduced the annuity term, she relinquished her rights to the annuity trust, which included the right to receive periodic payments, the right to invade the corpus, and the right to change distribution to the remaindermen. Any of those rights, had she not relinquished them, would have been included in her gross estate under section 2036. Accordingly, the property was properly includable under section 2035.

The estate did not dispute inclusion of the residence trust but contested the amount of inclusion. The court considered significant the undisputed fact that Helen had the right to reside in the Modesto property and was so residing on the date of her death. As noted, section 2036(a)(1) provides for inclusion when the decedent retains the right to possess transferred property. In accordance with section 2036 and prior Tax Court decisions, the court held that the FMV of the residence trust on date of death was properly includable because Helen continued to reside in the Modesto property until her death.

D. Mortgage Payable and Charitable Deductions

There was no dispute regarding the deductibility of Tierra Plaza, but the IRS contested the deductibility of Black Walnut Square. The court considered whether the estate was entitled to deduct the mortgages associated with the Tierra Plaza and Black Walnut Square properties as administrative expenses.

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8Reg. section 20.2036-1(b)(2). The regulations provide that “use, possession, right to income, or other enjoyment of transferred property is considered as having been retained or reserved to the extent that the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit.” See also reg. section 20.2036-1(c)(1)(i), which provides that “an interest or right is retained if at the time of the transfer there was an understanding, express or implied, that the interest or right would be later conferred.”

9Section 2036 does not apply to property that was transferred as “bona fide sales for an adequate and full consideration in money or money’s worth.”


12Section 2035(a) requires that the gross estate include the value of any property transferred by the decedent within three years of death or the value of any power relinquished by the decedent during that period if “the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death.”

13The estate claimed the proper amount of inclusion was the fair rental value for the trust term. The IRS contended the proper amount inclusion was the FMV of the property as of the date of death.

14Trombetta at *17 (citing Estate of Trotter v. Commissioner, T.C. Memo. 2001-250; and Estate of Callahan v. Commissioner, T.C. Memo. 1981-357).
Actual and necessary indebtedness for which the estate is obligated to pay are deductible as administrative expenses.\footnote{Reg. section 20.2053-3(a) states: “The amounts deductible from a decedent’s gross estate as ‘administration expenses’ of the first category (see paragraphs (a) and (c) of section 20.2053-1) are limited to such expenses as are actually and necessarily, incurred in the administration of the decedent’s estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it.”} Helen was relieved of personal liability when the annuity trust paid off the mortgage in December 2001, but thereafter she issued a promissory note, on behalf of the annuity trust, to Helen Properties for which she was personally liable. Because the promissory note represented indebtedness for both properties, and both properties were included in the gross estate, the court logically held that the estate was entitled to deduct the expenses for both properties.

Finally, the estate claimed a deduction for a $250,000 charitable contribution of the residence trust property. The IRS contested the deduction because the residence trust ended before death. As the facts reveal, the residence trust agreement provided for distribution to Helen’s children or grandchildren if it terminated during her life. If the trust terminated after her death, the trust property would be distributed as directed by Helen’s will, which provided for a charitable remainder unitary trust to receive the Modesto property.

Therefore, the key to determining the proper distribution and tax treatment was establishing the termination date of the trust. According to the original trust terms, the trust terminated after Helen’s death. However, the trustee, M. Dole (Helen’s son-in-law), sought and received a trust reformation to treat the trust as having terminated during the month before Helen’s death. As such, the proper distribution was to Helen’s children or grandchildren, not the charitable trust. Because the transfer to the charitable trust was a trustee action and not based on directions by the decedent, the court denied the charitable contribution.

E. Conclusion

While we don’t have all the facts, a less complicated option available to Helen was to sell her interest in the residence trust for an amount equal to the remainder interest.\footnote{See generally Estate of D’Ambrosio v. Commissioner, 101 F.3d 309 (3d Cir. 1996), rev’g 105 T.C. 252 (1995).} Another option was to transfer the Modesto residence to an \textit{inter vivos} charitable remainder trust with a lease option. Either way, if Helen paid fair market rental value to the owner of the residence in exchange for her continued occupancy, she would have had a better chance of keeping these assets out of her estate.

This case is important because the Tax Court validated the continued relevance of the retained interest provisions of the code. Taxpayers who want continued benefits from properties they have purportedly transferred will continue to be treated as owners of those properties for estate tax purposes. The main lesson from this case confirms the adage, “you can’t have your cake and eat it, too.”