Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1032

Date: 10-Oct-06
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Davenport Annuities Paid to Minor as Part of Personal Injury Settlement Included In Gross Estate**

At first glance, the Estate of Sarah M. Davenport seems to be nothing more than an everyday case heading in the Daily Tax Report: It said that the Tax Court denied a deduction for $3,639 for a "funeral luncheon."

Now, you really have to read any case where an estate and the IRS bother to fight about a $3,639 deduction relating to a funeral luncheon.

As suspected, there was a lot more to the story. Indeed, the deduction issue was a "free ride" on a larger and more interesting issue regarding estate tax inclusion of two annuities from a minor's personal injury ("PI") settlement. But as you'll see, the funeral luncheon part of this decision may be the real indigestible part of this case!

Our very able guide to Davenport is **Jeffrey A. Baskies** of **Ruden McClosky** in Fort Lauderdale, Florida. Jeff represents wealthy families and entrepreneurs in multiple-generation wealth transfer and asset protection planning.

Jeff served as President and CEO of a national legal publishing company which he first helped grow and then oversaw its sale to a larger publisher. So Jeff has a unique insight and empathy in working with family business owners on their succession and business planning. Jeff also is heavily involved in probate and estate litigation - which triggered his particular interest in this case.

EXECUTIVE SUMMARY:

Annuities payable to the decedent under a settlement agreement were considered to be owned by the decedent for estate tax purposes and included in her gross estate. The IRS's valuation of those annuities was sustained. The estate's funeral expense deduction for the reception was denied.

FACTS:

Sarah M. Davenport was born on August 16, 1988. Things did not go well in the delivery room.

The following year, in August of 1989, her parents filed a complaint for malpractice in connection with her birth. The complaint alleged Sarah sustained serious physical injuries resulting in cerebral palsy and other problems requiring special care for the rest of her life, and it also alleged her parents sustained personal injuries.

The parties resolved the lawsuit by means of a settlement agreement executed on September 17, 1991.

In the settlement agreement, the various defendants agreed to pay a lump sum of money to the parents.

Additionally, the following periodic payments were required to be paid by the defendants:

- $2,500 per month, beginning November 15, 1991, for Sarah's life, compounded annually at 5%, guaranteed for 30 years. This part of the settlement was assigned to Allstate Settlement Corporation and funded through a commercial annuity.

- $2,500 per month, beginning November 15, 1991, for Sarah's life, compounded annually at 5%, guaranteed 30 years. This part of the settlement was assigned to Safeco Assigned Benefits Service Company and funded via a commercial annuity.

As specified in the Settlement Agreement, the periodic payments constituted damages on account of personal injuries within the meaning of Code Section 104(a)(2) and thus were not subject to income tax.

The periodic payments could not be accelerated, deferred, increased or decreased sold, mortgaged, encumbered, anticipated or assigned by the recipient(s).

After Sarah's death, any payments still due were to be made to such person or entity as designated in writing by the recipient or if no person or entity was so designated, the payments were directed to be made to Sarah's estate. Sarah's parents, as co-conservators for Sarah, had the power to designate in writing the person or entity to whom periodic payments should be made in the event of Sarah's death.

As noted, the periodic payments were funded by the purchase of two single premium immediate life annuities (with payments commencing as of November 15, 1991, and 5% annually compounding adjustments and 30 year certain guarantees).

The insurer was designated as the owner and Sarah's life was the "measuring life." Sarah's parents were, as "conservators", the payees for the monthly checks. Both annuities listed Sarah's estate as the beneficiary in the event of her death.

Sarah died intestate in Michigan on October 31, 2000.

Her father, Richard was the executor of her estate. He took the position that the annuities were not part of her taxable estate, but he obviously had some concern as he filed a Form 706 on July 31, 2001.

The return reported a non-taxable gross estate of $414,937.05 (it was reported that Sarah's unified credit exceeded the gross estate).

On Schedule I, he reported the annuities but showed the includable value of each as zero.

Also, the return showed total deductions of $51,253.19, including funeral expenses of $3,638.92 for a "Funeral luncheon."

Presumptively, Sarah's executor knew the position he was taking was controversial, and thus apparently decided to file the 706 to start the statute of limitations.

Although the Form 706 showed no tax due, it was nevertheless examined by the IRS.

After the audit, on June 10, 2004, the IRS issued a statutory notice determining a deficiency of $507,103. The determined deficiency was based upon the inclusion in the gross estate of the Allstate and Safeco annuities at a combined value of $1,514,572 and the disallowance of $3,639 in deductions for the funeral luncheon.

The estate petitioned the Tax Court for redetermination.

COMMENT:

Many of us have worked with PI lawyers in structuring settlements for cases involving minors. Indeed, many times these are very large cases involving huge damages for malpractice, wrongful birth and other causes of action. Often these settlements involve complex agreements including long-term payouts, lifetime annuities, and lump sum payments to trusts.

These cases are often further complicated by over-lapping claims by the minor and the parents, which are often satisfied together and without clear delineation.

As a result, some settlements – based on their terms - might lead to estate tax inclusion on the minor's death while other settlements might not.

In Davenport, the estate took the position that two annuities were not includable in the minor's estate, while the IRS argued for inclusion. The Tax court, as noted above, held for the IRS, advising that the annuities were includible under Code Section 2033. The Tax Court also described how to value the annuities by applying Code Section 7520 and Estate Tax Reg. Section 20.2031-7(d).

Then, for good measure (or piling on – it might appear), the Tax Court also sided with the IRS on denying a deduction for a funeral luncheon.

Let's look at each of those elements in more detail:

I. INCLUSION OF THE ANNUITIES.

CODE SECTIONS 2033 AND 2039:

The Tax Court wrote about the background of annuity inclusion as follows:

> Section 2033 states broadly that
>
> *"The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."*
>
> As alternately expressed by regulation, the gross estate encompasses all property *"beneficially owned by the decedent at the time of his death."*

Code Section 2039 specifically requires inclusion of annuities and, in pertinent part, reads as follows:

SEC. 2039. ANNUITIES.

(a) General.--The gross estate shall include the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement entered into after March 3, 1931 (other than as insurance under policies on the life of the decedent), if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death.

(b) Amount Includible.—

Subsection (a) shall apply to only such part of the value of the annuity or other payment receivable under such contract or agreement as is proportionate to that part of the purchase price therefor contributed by the decedent. * * *

In considering the inclusion of an annuity in the gross estate, the conflation of sections 2033 and 2039 casts a wide net.

Section 2033 and its predecessors have long been construed to reach annuities payable to a decedent's estate upon his or her (death).

Section 2039 was enacted to broaden the reach of the gross estate to draw in annuities payable to surviving beneficiaries, such as joint and survivor annuities and annuities to be received by designated third persons.

APPLYING THE LAW TO THE FACTS:

Then, applying the law to the facts of Davenport, the Tax court concluded the annuities were includible in Sarah's taxable estate. However, to reach this conclusion the court stipulated it needed to look at the Settlement Agreement to consider what rights existed and were being supported by the annuities.

Further, it agreed under Michigan state law to admit parol evidence to consider what rights were settled by the agreement.

ESTATE'S POSITION:

In favor of its position to avoid inclusion, the estate argued that the settlement agreement created in all the plaintiffs (including the parents) a joint beneficial interest in all the payments to be made, and all of their claims collectively provided the consideration for all of the relief paid.

This argument may be the crux of a problem for many clients settling minor's PI cases:

"Was the settlement fully paid to satisfy the minor's claims and thus fully part of the minor's estate?"

"Was the settlement agreement clear in allocating beneficial interest/ownership to the payments?" If not, then the inclusion issue may be murky for many clients.

However, after examining the facts of this case, and most importantly noting that the lump sum payout was made specifically to the parents and their attorneys but the annuities were exclusively for the benefit of Sarah, the Tax Court found the annuities includible in Sarah's taxable estate, holding:

> *On these facts, there can be little doubt that decedent possessed at least some beneficial interest in the annuities. Moreover, even the estate does not appear seriously to contend to the contrary. Rather, the estate focuses on arguing that decedent's parents likewise held beneficial interests in the annuities. This nuance goes more properly to the question of the extent of decedent's interest for purposes of inclusion in her gross estate, not the antecedent issue of some interest includable under section 2033.*

Concerning this issue of the extent of decedent's interest, the documentary record as a whole leans distinctly in the direction of decedent alone as the intended beneficiary of the annuities.

Highly probative is the structure of the settlement agreement which explicitly names Sarah's parents individually, and not her, as payees of the lump sum. Then, it names Sarah as the *sole* payee of the annuities.

II. VALUING THE ANNUITIES.

After concluding the annuities were includible in Sarah's estate, the Tax Court turned to the issue of valuing them.

The court cited to Code Section 7520 and the regulations under Code Section 2031 (20.2031-7) as the general rules for valuation. The regulations generally provide for valuing annuities by applying actuarial tables and factors to be computed using floating interest rates as proscribed in Section 7520. (These computations can be performed by **NumberCruncher** software.)

The estate argued for a lower value of the annuities. It contended that rather than using the tables, comparable commercial annuities should be the basis for valuing the annuities in Sarah's estate. As stated in the opinion:

> *The estate's argument on this point is limited to a few sentences, the substance of which is contained in the following: "Petitioner takes the position that commercial annuities were purchased in connection with the settlement arrangement. Therefore, the proper method for valuation of such annuities would be comparable commercial contracts as of the Decedent's date of death, the method of valuation specified under Treas. Reg. 20:2031-8."*

Interestingly, the Tax Court did not squarely address this issue. On the one hand, the court held that the rights and obligations under the agreement (to payments) should be examined when considering value, not the annuities used

to fulfill the obligations. This part of the holding seems to support section 7520 and section 20.2031-7 as the sole valuation methodology.

However, on the other hand, the court also noted that the estate failed to offer any legally supportable argument for an alternate valuation, and held that:

"even if the Court were to accept the estate's position that the annuities should be valued under section 20.2031-8, Estate Tax Regs., the estate has failed to show that such value would in fact differ from the amount determined by respondent under section 20.2031-7, Estate Tax Regs. The Court is thus constrained to uphold respondent's $1,514,572 valuation."

While the Tax Court had a chance for a bright-line ruling that section 7520 is the only proper way to measure such annuities, this holding does not squarely eliminate the argument against applying section 7520 for valuing similar annuities.

So does the Tax Court's conclusion mean there is potential in a similar case to argue for a lower valuation based on comparable commercially available annuities? That issue was side-stepped by the Tax Court and perhaps holds an opening for a similarly situated case in the future.

III. DEDUCTION FOR FUNERAL LUNCH.

The issue that initially caught my eye was addressed last.

Code Section 2053(a)(1) generally provides an estate tax deduction for funeral expenses. These are usually defined as the reasonable expenses as allowed by the laws of the state where the probate estate is being administered.

The Tax Court noted:

> *Regulations promulgated under section 2053(a)(1) offer only limited guidance. Although neither the statute itself nor the regulations define "funeral expenses", section 20.2053-2, Estate Tax Regs., highlights "A reasonable expenditure for a tombstone, monument, or mausoleum, or for a burial lot, either for the decedent or his family, including a reasonable expenditure for its future care" and "the cost of transportation of the person bringing the body to the place of burial" as examples of deductible costs.*
>
> *Case law interpreting the term has in turn provided the following touchstone: "The basis of this deduction is the necessity of the expense in connection with the decedent's funeral." Estate of Berkman v. Commissioner, T.C. Memo. 1979-46; see also Estate of Tuck v. Commissioner, T.C. Memo. 1988-560 ("As we interpret the term 'funeral expenses', it means expenses incurred in connection with the decedent's funeral.").*

In this case, the total deductions relating the funeral were broken down as follows:

- Funeral Home $2,475.20;
- Cremation $105.00;
- Soloist $150.00;

- Priest $250.00;
- Organist $150.00;
- Obituary notice $316.84;
- Cemetery (niche for urn) $250.00;
- Funeral luncheon $3,638.92; and
- "Various related expenses (holy picture cards, acknowledgments, postage)" $460.42.

The IRS allowed all of the deductions - except for the funeral lunch.

First, the Tax Court noted the record was insufficient to describe the lunch expenses in particular. Without a breakdown, it could not determine the reasonableness of the claimed deduction and had to deny it.

It is not clear from the opinion, but it seems like the Court made an issue of who was paid how much (including if any amounts were paid for venue or services – perhaps to the family).

Second, the Court stressed the father's testimony that the lunch was primarily to thank teachers, health care providers, and others who helped care for Sarah. The court said this focus indicated a lack of "necessity" in connection with the funeral and thus also used it to deny the deduction.

To be blunt, this part of the opinion seems unduly harsh.

Further, if the decision were broadened from its factual trail, it might spell doom for many funeral deductions filed on most estate tax returns. Indeed, for many families a funeral reception is a standard aspect of the funeral and burial process and the expenses for such are often deducted.

I guess clients now need to be clear that receptions are part of the process of eulogizing and laying to rest the decedent (text taken directly from the opinion) and the executor must be prepared to detail each item of expense.

PLANNING TIPS:

First, Davenport offers a good primer on the inclusion of annuities from PI cases. For all involved both in planning a minor's PI settlement and administering an estate with issues relating to one, this case is informative. Davenport shows the Tax Court's willingness to examine the terms of the settlement to flesh out the rights and interests of the parties – particularly the decedent's.

The court also showed a generally liberal view of how to interpret such agreements and whether to admit parol evidence. From a planning perspective, Davenport is a key reminder of how the language in settlement agreements can influence the tax results years later.

Second, in Davenport, the Tax Court defined the generally acceptable manner for valuing such annuities (sections 7520 and 20.2031 of the Regs.). However, as noted, the Tax Court had a chance to say that this is the only acceptable method for valuing such annuities, but it did not do so. Indeed, the court did not squarely quash the argument for analogizing to comparable commercial annuities. Thus, if an estate might save some money by taking that position, the Tax Court's opinion does not seem to preclude it.

Third, and finally, the decision offers a very harsh reading of what is reasonable for purposes of deducting meals in connection with funerals. If this holding were to be taken to its extremes, many clients' claimed deductions would be in jeopardy.

To support a claimed deduction, clients should be prepared to itemize all of the expenses and to confirm that the expenses were all reasonably related to and a necessary part of their funeral and burial process.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Jeff Baskies

Edited by Steve Leimberg

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CITES:

Estate of Sarah M. Davenport vs. Commissioner, TC Memo 2006-215.

For its position against inclusion of the annuities, the estate cited Kegel v. State, 830 P.2d 563 (N.M. Ct. App. 1992).

Supporting its position for inclusion, the IRS cited to Arrington v. United States, 34 Fed. Cl. 144 (1995).

For deduction of funeral expenses and related meals, the Tax Court cited to Estate of Berkman v. Commissioner, T.C. Memo. 1979-46; and also Estate of Tuck v. Commissioner, T.C. Memo. 1988-560.

For 2033 inclusion, see Millard v. Maloney, 121 F.2d 257, 259 (3d Cir. death. 1941); Equitable Trust Co. v. Commissioner, 31 B.T.A. 329, 333- 334 (1934), revd. on another issue sub nom. Commissioner v. Chase Natl. Bank, 82 F.2d 157 (2d Cir. 1936); Arrington v. United States, 34 Fed. Cl. 144, 147-148, 150 (1995), affd. without published opinion 108 F.3d 1393 (Fed. Cir. 1997).

For 2039 inclusion, see Gray v. United States, 410 F.2d 1094, 1096-1097 (3d Cir. 1969); Estate of Gribauskas v. Commissioner, 116 T.C. 142, 149 (2001), revd. on another issue 342 F.3d 85 (2d Cir. 2003).