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**Wills, Trust and Probate. That's All We Do!**

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**NEWSLETTER**

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I am happy to announce that Jane Anastasia, Esq. has joined my firm. I have known Jane for many years and have a great deal of respect for her as an attorney and as a person. Not only has she become recognized for her abilities with special needs trusts and guardianships but she has done so while raising four children. I look forward to working with Jane. Learn more about Jane by visiting our website at [www.klenklaw.com](http://www.klenklaw.com).

As always, we have tried to provide you with some interesting articles that deal with taxes and estate planning.... that do not put you immediately to sleep.

The first article deals with recent tax code changes that may be useful in preparing your 2005 income tax returns. Though we do prepare tax returns for trusts and estates, we rarely prepare personal income tax returns. Never the less, Ahmad Gage did work for the IRS for eight years and has prepared some highlights. If you see something that might be useful, I encourage you to consult your CPA or log onto [www.irs.gov](http://www.irs.gov).

The second article is an interview with Jane Anastasia about choosing a trustee. Jane has a great deal of experience in the both selecting good trustees and in removing bad trustees.

The third article is a bit complex... dealing with income tax treatment of simple and complex trusts. It is advanced reading for those not versed in the taxation of trusts. For those who enjoy the subtle nuances of the tax code, this one is for you.

The fourth article is the summary of a recent Supreme Court case dealing with Disclaimers. Disclaimers are wonderful tools when doing tax and asset protection planning between a husband and wife. When used haphazardly and without prior planning they don't always work as the disclaimer would hope. In this case a woman dies without a will and her son hopes to avoid his creditor.... the IRS... by disclaiming the interest. Did it work?

I hope you enjoy our March issue. Stay warm out there!

## Federal Income Tax Changes for 2005\*

***Charitable Contributions of Automobiles:*** You have sent the ads in the newspaper asking you to contribute your old junker to charity. The IRS has found a lot of abuse in this area and has made changes to reign in the worst offenders. If you donated a vehicle with a claimed value of more than \$500 to a charitable organization in 2005, your deduction is limited to the gross proceeds from its sale by the organization. If you have made a contribution make sure you have collected the necessary paperwork or if you are planning to make a contribution, make sure the organization to which you are giving the car understands the new rules.

***A Child is a Child is a Child?:*** Not to the IRS. As odd as it might seem, the tax code is so convoluted that the definition of a "child" varies from code section to code section, depending on the tax issues. If you have any unusual issues regarding your child (such as divorce, adoption, foster parenthood, etc.), make sure you know and understand the rules and that your "child" is really a "child" to the IRS.

***Driving Clean:*** You can claim the maximum electric vehicle credit allowed for a qualified electric vehicle you placed in service in 2005, and the maximum deduction allowed for qualified clean-fuel vehicles or other clean-fuel property placed in service in 2005. If you are thinking of going "green" in 2006, consult your CPA to maximize the tax credits for this upcoming year.

***A Good Driving Record:*** If you deduct the expense for your car make sure you have all the necessary paperwork in order. There are now a number of different rates, depending on how and when you used your car. In order to claim the appropriate deduction, you'll have to track your mileage by dates ... both before and after Sept. 1.

***Contribute to the Cause:*** If you have a traditional individual retirement account (IRA) and are covered by a retirement plan at work, you can now have a greater amount of income without being affected by the deduction phase-out. The amounts vary, depending on filing status. Check with your financial professional and maximize what you can save.

***A Benefit to Teaching:*** The Educator's deduction was scheduled to have expired at the end of 2003, but was restored for two more years. Therefore, it's still available for qualified educators for 2005.

***Safe Those Receipts:*** Taxpayers who itemize deductions will have a choice of claiming a state and local tax deduction for either sales or income taxes on their 2004 and 2005 returns.

**\*Our intent is to keep you abreast in general terms of some of the many changes implemented by the IRS. For more information please contact your tax advisor or log on to [www.irs.gov](http://www.irs.gov).**

## **HOW TO CHOOSE A TRUSTEE**

### **An Interview with Jane Anastasia, Esq.**

Q. What qualities do you recommend that a person look for in choosing a trustee?

Jane: When a client names an individual trustee, the choice is typically based on a personal relationship. Often the trustee is a friend or family member. I point out the importance of responsibility and trustworthiness. The client must have absolute confidence that the trustee will perform his or her duties with the best interests of the beneficiaries in mind. Serving as a trustee is a job and a friend or family member serving as trustee needs to understand the responsibilities, including investing the trust and making discretionary distribution decisions.

If a corporate trustee is used, the added issue is how comfortable the client is with the representative or administrator with whom they will be dealing. Past performance and experience serving as a trustee is also important.

Q. What are the advantages and disadvantages of choosing a corporate trustee as opposed to an individual trustee?

Jane: For a small account, the fee charged by a corporate trustee may outweigh the benefits of professional service. If a trustee, friend or family member is qualified and willing to serve without compensation, that may be a good option. However, the trust may still need to hire an accountant and an investment advisor who will charge fees to the trust and thus the savings in fees may be minimal. The individual may not be experienced in investment decisions. In addition, a family member may be subject to the influence of the beneficiaries when faced with discretionary decisions, making those discretionary decisions more difficult.

A good corporate trustee will be a truly independent decision maker and will bring to the task a wealth of experience in investing and administering trusts.

Q. In your experience, what are some common mistakes made by trustees?

Jane: Not paying enough attention to the trust. In investments, letting the investments remain stagnant when attention to them would suggest that changes should be made. In distribution decisions, failing to consider a discretionary power the trustees have.

Q. What are the duties of a trustee?

Jane: To carry out the terms of the trust, to invest the trust principal and to distribute the property in accordance with the terms of the trust. The trustee must uphold his fiduciary duties to the beneficiaries of the trust, protecting each of their interests without favoring any one over the other.

**Thank you, Jane for sharing your knowledge and experience with our readers. If you have any other questions regarding this topic or any other topic, we encourage you to let us know. We may use it in our next newsletter.**

## THE PROPER TREATMENT OF SIMPLE TRUST INCOME

What is the difference between a simple trust and a complex trust? The answer to this question is very important because there are legal and tax consequences if the trust administrator and the trust tax advisor do not read the trust document properly and classify the trust correctly.

A **simple trust** is a trust that has the following characteristics:

- All of its income is required to be distributed currently, and
- Doesn't provide that any amounts are to be paid, permanently set aside, or used for the purposes specified in section 642 (c) (relating to deduction for charitable, etc., purposes).
- The income beneficiary is taxed with all the income.

A **complex trust** can:

- Make discretionary distributions of income and/or principal,
- Accumulate income and not make distributions and also have provisions for charitable disbursements, and
- The beneficiary is taxed on only the distributed net income (DNI) received.

Simple and complex trusts pay taxes on capital gains.

On June 20, 2002, the Internal Revenue Service's Chief Counsel released CCA 200240010. This opinion is significant because it addresses various issues about trusts and the proper treatment of trust income.

This was a matter involving several related trusts. Each trust had an income beneficiary and the trusts were irrevocable. The instrument specified that each trust pay out all the net income. Also, the instrument stated that the determination of principal and income was to be governed by the provisions relating to principal and

income under the law of the state in which principal administration of the trusts was located.

For four consecutive years, these trusts made no distributions of income and reported and paid tax on the income as if they were complex trusts. In Year 5, the trusts were treated as simple trusts, reporting the income to the beneficiaries.

The Chief Counsel identified three important issues:

**1. Are the Trusts in question properly classified as simple or complex trusts for federal tax purposes?**

As stated in section 1.651(a)-1 of the Internal Revenue Code, **the determination of whether a trust is either simple or complex is based on both the governing documents of the trust as well as the distributions actually made in a given taxable year. Section 651 specifies what determines a simple trust and section 661 specifies what is a complex trust.** In this case, the instrument states that all of the net income is required to be distributed; it made no provisions for the accumulation or the retention of income. These trusts, therefore, are simple trusts under section 651 of the IRC.

**2. Does state law govern the definition of income for purposes of the trusts' distribution requirements?**

Section 1.643 (b)-1 provides that **a trust cannot be considered to be simple, and thus must be classified as complex, if the trust's definition of income fundamentally departs from concepts of local law.** In this scenario, when the trusts' governing instrument specifies that the definitions and state law relating to income and principal are controlling, it is in accordance to federal tax regulations. In other words, state law not federal law determines what constitutes income under section 651 of the IRC.

**3. Is checking the box on the Form 1041 to indicate a simple or complex trust binding, or can it be changed on a later return?**

Section 1.652 (a)-1 of the IRC provides that a trust may be simple one year and a complex trust for another. The classification is made on an annual basis and is based upon the governing instrument of the trust and what distributions the trust actually made. Examples of this, which may cause a trust to change from simple to complex, include:

- Termination of a trust;
- The governing instruments makes provisions for principal distributions for health, medical, education and welfare of the income beneficiary and such distributions are actually made during the year and
- Attainment of age when the beneficiary receives part of the trust's corpus as stated in the instrument.

In this case, there were no provisions for principal distributions; therefore, these trusts should always remain classified as simple trusts.

In conclusion, 1) income from a simple trust should be distributed and the beneficiary will be taxed on it whether or not he/she receives it. \* In this case, the trustee accumulated the income for four years and taxed the income in the trust, which under section 651 was not the proper treatment of the trusts' income, 2) the definition of income in the document cannot vary substantially from state law. In the cited scenario, the Chief Counsel found that state law determines what constitutes income for tax reporting under section 651 of the IRC, and 3) a simple trust can become complex in one tax year provided that the governing instrument allows invasion of the trust corpus. In our scenario, the trust instrument made no provisions for principal distribution, therefore, these trusts should remain simple trusts.

**\*NOTE: Some income beneficiaries may refuse to accept the income for one reason or another. The trustee should inform the beneficiary that by law, the income not distributed to he/she is taxable. In other words, even if you do not take the income you are responsible for reporting the income on your own tax return and paying the income tax due.**

**An inheritance is a gift... and you do not have to accept a gift. Passing on an inheritance is a “disclaimer”. What happens when a son owes the IRS money and disclaims an inheritance from his mother? State law says the creditor cannot collect... as the son never accepted the gift. The IRS disagrees.... Who wins?**

**SUPREME COURT OF THE UNITED STATES  
NO 98-1101  
JOHN F. DRYE, JR., ET AL. V.  
UNITED STATES  
ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT**

**[DECEMBER 1999]**

There are occasions where Federal and State law have different implications for the very same issue. In *Drye vs. United States*, that fact becomes very clear. This case focuses on disclaimers and more importantly, the correlation between federal and state laws.

*STATEMENT OF FACTS*

On August 3, 1994, Irma Delilah Drye, the plaintiff’s mother, died intestate (without a will), leaving an estate worth \$233,000, of which \$158,000 was personalty and \$75,000 was realty located in Pulaski County, Arkansas. Irma’s son, John F. Drye, was her sole heir under Arkansas law (when someone dies without a will their assets pass to heirs as the state’s laws direct). On the date of his mother’s death, John F. Drye was insolvent and owed the IRS about \$325,000 having not paid his taxes from 1988-1990. The IRS had valid tax liens against all of Mr. Drye’s property and “right to property”.

Mr. Drye petitioned the Pulaski County Probate Court for appointment as administrator of his mother’s estate and was appointed August 17, 1994. Almost six months later, he filed a written disclaimer of all interests in his mother’s estate pursuant to Arkansas Code Ann. §§28-2-101, 28-2-107 (128). Two days later, he resigned as administrator.

On March 10, 1995, the Probate Court declared his written disclaimer valid. His disclaimer caused the estate to pass to his daughter, Theresa Drye. The Court ordered the final distribution of the estate to Theresa Drye. She, in turn, used the proceeds to fund the Family Trust naming herself and her parents (John F. Drye) beneficiaries. The trustee was the Drye’s attorney, Daniel M. Traylor, who had the right to make discretionary distributions. for only health, maintenance and support. The instrument had a spendthrift clause and under state law, was protected from creditors.

Meanwhile, while Mr. Drye was working out an arrangement with the IRS to pay his past due tax obligation, he revealed the beneficiary interest in the Trust. On April 11, 1996, the IRS filed federal tax lien with the Probate Court and also serve a notice of levy on

accounts held in the Trust's name by an investment bank and notified the Trust of the levy.

The Trust filed a wrongful levy action in the United States District Court. The IRS counterclaimed. On cross-motions for summary judgment, the District Court ruled in favor of the IRS. The case was appealed to the Eighth Circuit Court of Appeals and the previous ruling was affirmed. The case was granted certiorari by the US Supreme Court.

#### *ISSUES*

Does Mr. Drye's interest, as heir constitutes "property" or a "right to property to which the federal tax liens attached under 26 U.S.C. § 6321 despite his exercise of the state law accorded him to disclaim the interest retroactively?

#### *OPINION*

Judge Ruth Ginsburg delivered the opinion. The Court affirmed the lower courts ruling that the disclaimer did not defeat the federal tax liens. Even though the IRS does consider state law for "delineation" of the taxpayer's rights or interests, but federal law determines whether those rights or interests constitute property or rights to property within the meaning of §6321. "Once it has been determined that state law creates sufficient interests in the taxpayer to satisfy the requirements of the federal tax lien provision, state law is inoperative to prevent the attachment of liens created by federal statutes in favor of the United States." – *United States v. Bess*, 357 U.S. 51, 56-57 (1958).

Judge Ginsburg wrote the following:

**Drye emphasizes his undoubted right under Arkansas law to disclaim the inheritance, see Ark. Code Ann. §28—2—101 (1987), a right that is indeed personal and not marketable. See Brief for Petitioners 13 (right to disclaim is not transferable and has no pecuniary value). But Arkansas law primarily gave Drye a right of considerable value—the right either to inherit or to channel the inheritance to a close family member (the next lineal descendant). That right simply cannot be written off as a mere “personal right ... to accept or reject [a] gift.”**

**In pressing the analogy to a rejected gift, Drye overlooks this crucial distinction. A donee who declines an *inter vivos* gift generally restores the status quo *ante*, leaving the donor to do with the gift what she will. The disclaiming heir or devisee, in contrast, does not restore the status quo, for the decedent cannot be revived. Thus the heir inevitably exercises dominion over the property. He determines who will receive the property—himself if he does not disclaim, a known other if he does. See Hirsch, *The Problem of the Insolvent Heir*, 74 *Cornell L. Rev.* 587, 607—608 (1989). This power to channel the estate's assets warrants the**

**conclusion that Drye held “property” or a “righ[t] to property” subject to the Government’s liens.**

**In sum, in determining whether a federal taxpayer’s state-law rights constitute “property” or “rights to property,” “[t]he important consideration is the breadth of the control the [taxpayer] could exercise over the property.” *Morgan*, 309 U.S., at 83. Drye had the unqualified right to receive the entire value of his mother’s estate (less administrative expenses), see *National Bank of Commerce*, 472 U.S., at 725 (confirming that unqualified “right to receive property is itself a property right” subject to the tax collector’s levy), or to channel that value to his daughter. The control rein he held under state law, we hold, rendered the inheritance “property” or “rights to property” belonging to him within the meaning of §6321, and hence subject to the federal tax liens that sparked this controversy.**

### **CONCLUSION**

The very fact that the US Supreme Court would hear this case shows the importance of understanding federal and state laws. Even though the disclaimer controversy is important, it is imperative that we understand the line between federal and state law and jurisdiction, especially when it applies to trusts and estates. It’s been one of the biggest legal struggles facing the courts today. Drye vs. US gives a clear understanding of the legal and tax consequences when one don’t understand the law. This is the message we want to convey to our clients. As Trust and Estate legal professionals, we are here to provide you with good advice. If you have questions regarding the benefits and the pitfalls of disclaimers or any other estate planning concerns, our office will be glad to answer your questions.

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