The Advisor

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ESTATE PLANNER'S TIP

Homes might be called the most popular of all tax shelters, not only because most mortgage and home equity interest is deductible, but also because capital gain can be excluded upon the sale of a principal residence (up to $250,000 for a single taxpayer, $500,000 for a married couple who have lived in the home for at least two of the five years prior to the sale) [Code §121]. The step-up in basis at death can shelter additional capital gains, but this tax break may require special planning. Take Anna, age 74 and in poor health, and her husband, Ed, age 75. The basis in their jointly owned home is only $60,000, but the fair market value is $1,300,000. If they sold the home today, they would face a tax on $740,000 ($1,300,000 - $60,000 - $500,000). If one of them were to die, the survivor would have a somewhat lower tax upon a sale, thanks to the stepped-up basis in the decedent's one-half. If Anna died, Ed's new basis would be $680,000 (his $30,000 share of the original basis plus the $650,000 fair market value of Anna's interest). That would still leave Ed with a taxable gain of $370,000 when he sells the home ($1,300,000 - $680,000 - $250,000). However, there is a way that Ed may be able to avoid tax altogether. He can make a gift to Anna of his interest in the home. At Anna's death, the home would pass to Ed with a stepped-up basis equal to its full fair market value. When Ed later sells the residence there would be no taxable gain. The one hitch would be if Anna died within one year of Ed's gift, in which case Ed's basis would be limited to Anna's basis immediately before her death [Code §1014(e)]. But even this leaves Ed no worse off than he would have been if no gift had been made. The rules are different for residents of community property states, where the surviving spouse is entitled to a stepped-up basis in his or her own half interest if at least half the value of the property is included in the gross estate of the deceased spouse [Code §1014(b)(6)].

SOCIAL SECURITY HOLDS STEADY IN 2016

Lower gasoline prices mean Americans have more money in their pockets, but they also mean that the Consumer Price Index hasn't risen. As a result, there will be no 2016 cost-of-living adjustment for the nearly 65 million people receiving Social Security. This is only the third time in the last

four decades that benefits have stayed the same from one year to the next.

Also remaining unchanged will be the Social Security wage base. Employees and their employers will pay into the system until wages reach $118,500. There is no earnings limit on the Medicare portion.

Recipients under the full retirement age of 66 will be able to earn up to $15,720 in 2016 – the same as in 2015 – without loss of Social Security benefits. Above $15,720, recipients lose $1 in benefits for every $2 of earnings. Benefit cutbacks do not apply to retirees age 66 or older who continue working.

The approximately 30% of Medicare beneficiaries who are not yet receiving Social Security payments are likely to see a jump in their premiums. A "hold harmless" law protects Social Security recipients who have their Medicare Part B premiums withheld from their checks, to avoid reducing their net benefit.

BEFORE OR AFTER – IT MAKES A DIFFERENCE

Sixty percent of the residue of Leo Davis' will was to pass to three named charities at his death in 2010. In the accounting filed by his executor, the estate proposed to pay the $1,500 Pennsylvania inheritance tax from the residue prior to allocation and distribution. The Commonwealth objected, requesting that the orphans' court reallocate the inheritance tax to those bequests that generated the liability for the tax.

PHILANTHROPY PUZZLER

Pamela owns two paintings that have appreciated several-fold since she purchased them 12 years ago. She has received offers to buy the artwork, but held out due to the steep capital gains rates that apply (28% for collectibles and 3.8% net-investment income tax). She has asked whether there are tax advantages to using the paintings to fund a charitable remainder trust.

The court denied the estate's request to present testimony of the drafting attorney regarding Davis' intent or to accept consents filed by the three charities agreeing to the estate's proposed allocation of tax. The estate appealed the court's order to reallocate the tax to the non-charitable beneficiaries.

Davis' will provided that all taxes, "together with the expenses," were to be paid out of and charged to his estate. The executor argued that this provision rebutted the contrary statutory presumption that beneficiaries pay the inheritance tax for their bequests. The Commonwealth countered that the language did not unambiguously require payment of taxes from the residue before allocation to the named beneficiaries, adding that the will would have to "designate the source of the fund from which the inheritance taxes would be paid to rebut the statutory presumption."

The Superior Court of Pennsylvania found that Davis' will "unambiguously requires that the taxes be paid from the residuary of the estate prior to allocation among or distribution to, the residuary beneficiaries." Taxes are to be paid "together with" administrative expenses, which are paid from the residue prior to allocation, noted the court (*In re Estate of Davis*, J-A19027-15).

Note: In estates subject to federal estate tax, the deduction for a charitable bequest is reduced to the extent death taxes are payable out of the bequest property [Code §2055(c)].

WILL REJECTED ON TESTAMENTARY CAPACITY GROUNDS

The Probate Court declined to admit the will of Charles Galatis, finding that he lacked testamentary capacity on the date the will was signed. Galatis had numerous medical problems for which he was taking a variety of prescription medications, including antidepressants and narcotics for pain relief. He was admitted to the hospital in January 2000, where he was diagnosed with advanced lung cancer.

Galatis, who had no will, asked a friend to record his thoughts about the disposition of his property. The friend transferred the information to a will template found on the Internet. Galatis signed this will on February 1, naming the town of Skiathos, Greece, as his principal beneficiary. An attorney was asked to draft another will, also providing for the creation of a charitable trust, which Galatis signed on February 9.

Galatis died February 25. Two cousins contested the February 9 will, which was the only one offered for probate.

The Appeals Court of Massachusetts affirmed the Probate Court, finding that, even prior to his hospitalization, Galatis suffered from medical conditions that impaired his ability to think clearly, orient himself, think logically and remember information. The court added that because the February 1 will was not presented for probate, the lower court judge correctly concluded that whether it should be admitted as Galatis's will was not before the court (*In re Estate of Galatis*, No. 14-P-579).

Note: A gift to a foreign city would not be eligible for an *income* tax charitable deduction [Code §170(c)(2)(A)], but a bequest might be deductible for *estate* tax purposes [Code §2055], provided the use of the property was limited exclusively to charitable purposes (Rev. Rul. 74-523).

NO PERSONAL JURISDICTION OVER BAHAMIAN TRUSTEE

Robert Hoag, an Arizona resident, established charitable remainder unitrusts in 1994, 1999 and 2000, serving as trustee of each. Wells Fargo Bank obtained a $2.5 million default judgment against Hoag and against his living trust in 2012 and began garnishment proceedings in 2013. On February 4, 2014, Hoag met in Florida with the president of International Benefits Management Corp. (IBMC) to transfer trusteeship and provide all required documents. IBMC operates out of the Bahamas.

Wells Fargo attempted to subpoena records from several institutions it believed were holding assets or distributions from Hoag's unitrusts. When IBMC said it would not provide the documents requested, Wells Fargo filed suit, claiming Hoag fraudulently concealed his assets by transferring them to IBMC. IBMC moved to dismiss, saying the court lacked personal jurisdiction over the company and the unitrusts. The trial court determined it had jurisdiction.

The Arizona Court of Appeals noted that a trustee submits to personal jurisdiction by (1) accepting the trusteeship of a trust having its principal place of administration in Arizona, (2) moving the principal place of administration to Arizona or (3) declaring that the trust is subject to Arizona jurisdiction. Because Hoag's unitrusts are administered in the Bahamas, IBMC is not subject to personal jurisdiction. IBMC also lacks "sufficient contacts" that would subject the company to the state's jurisdiction. It has no offices or employees and does not transact business in the state, said the court. The mere act of sending payments and documents to an Arizona resident is insufficient to constitute minimum contacts (*Hoag Charitable Remainder Unitrust v. French*, No. 1 CA-SA 15-0167).

PUZZLER SOLUTION

Pamela's charitable deduction will be calculated with reference to her basis in the paintings, not their fair market value, because the artwork is considered put to an unrelated use [Reg. §1.170A-4(b)(3)(i)]. The deduction is available in the year the trustee sells the paintings, when Pamela's "intervening interest" ends [Code §170(a)(3)]. However, when the paintings are sold by the trustee, there is no depletion due to capital gains or net-investment income tax. Trust payouts can be calculated on the full fair market value of the assets (Ltr. Rul. 9452026).

TIMELY FIXES ALLOWED FOR CHARITABLE REMAINDER TRUSTS

The estate tax code recognizes that an error in trust or will language resulting in the creation of a nonqualified split-interest bequest to charity may not be discovered until after the donor's death. To salvage the charitable deduction and ensure that the trust will be tax-exempt, Code §2055(e)(3) allows for reformations in certain situations. In general, a reformation is allowed only where there is a "reformable interest," meaning any interest for which a deduction would have been allowed at the decedent's death but for the requirement that a split-interest trust be in the form of a charitable remainder trust or pooled income fund [Code §2055(e)(3)(C)].

A qualified reformation is one in which a reformable interest is changed into a qualified interest, but only if (1) the difference between the actuarial value of the qualified interest and the actuarial value of the reformable interest does not exceed 5% of the actuarial value of the reformable interest, (2) in the case of a charitable remainder interest, the income interest ends at the same time, or for any other interest, the reformable interest and qualified interests are for the same period and (3) the change is effective as of the date of the decedent's death [Code §2055(e)(3)(B)]. In order to reform an income interest, it generally must be in the form of either a specified dollar amount or a fixed percentage of the fair market value of the property. For example, a testamentary trust that reserves all net income from the trust for the life of an individual would not be a specified dollar or a fixed percentage. However, if judicial reformation proceedings are initiated no later than the 90th day after the due date (with extension) of the estate tax return, the income interest may be reformed to a qualified unitrust or annuity interest [Code §2055(e)(3)(C)(iii)].

The IRS has been surprisingly lenient in permitting reformations, even in the case of inter vivos trusts that do not comply with the donors' intent. The IRS has, for example, allowed reformations where state courts have found scriveners' errors. In Ltr. Rul. 200244011, the donors intended to fund a fixed percentage charitable remainder unitrust but, due to a drafting error, the trust included net-income language. The IRS said a reformation would not cause the trust to lose its exempt status or be an act of self-dealing.

The IRS has also allowed an inter vivos charitable remainder trust to be reformed by deleting a reference to Code §170(b)(1)(A) organizations as permissible remainder beneficiaries. The donors intended the remainder to pass to one or more private foundations, which do not qualify under Code §170(b)(1)(A) (Ltr. Ruls. 9818027, 9826021).

A donor was allowed to reform an otherwise qualifying inter vivos unitrust where, through a scrivener's error, language that would have allowed all post-contribution gain to be allocated to income was not included (Ltr. Rul 9833008). The IRS also allowed the reformation of a charitable remainder annuity trust to provide that income in excess of the annuity payout be distributed to the remainderman and the trustee be given the discretion to make distributions of trust corpus to the remainderman (Ltr. Rul. 200010035).

In some situations, the reform may require the donors to adjust past tax returns. For example, where the reformation corrected a scrivener's error, creating an annuity trust rather than the intended unitrust (Ltr. Rul. 200251010), or where the valuation date is amended from the last day of the trust tax year to the first day (Ltr. Rul. 200233005).

While it is clearly better to avoid drafting errors, the ability to reform a trust to conform to the donor's wishes and preserve the charitable deduction is a valuable tool where a mistake is discovered.

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