The Advisor

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ESTATE PLANNER'S TIP

More than seven million people each year move from one state to another. In addition to sending out change-of-address announcements and getting new driver's licenses, these transplants have estate planning needs that should be addressed. A will that is valid in the original state might not be in the new location – or the will may present problems. State laws may put up roadblocks to someone from out of state serving as executor, or the executor might prefer not to serve in a long-distance capacity. Another concern for clients could be moving from a community property state to a non-community property state, or vice versa. It's important, too, to consider any estate tax or inheritance tax that applies in the new location. Living wills and health care powers of attorney are integral parts of a complete estate plan. Just as a new will may be required in the new state, so too might advanced directives, particularly if the individual holding the power of attorney is not living in the new destination. If a client hasn't moved permanently but is merely dividing time between two states, it's important to determine whether his or her domicile has changed and to prepare the appropriate health care directives to apply in both locations.

TWO DEDUCTIONS ARE BETTER THAN ONE

Bruce Voss and Charles Sophy jointly owned two homes, both of which were encumbered with a mortgage and a home equity loan. The total average balance of the indebtedness on the homes was about $2.7 million in 2006 and 2007. Each co-owner claimed mortgage interest deductions, which the IRS disallowed on the grounds that Code §163(h) permits interest only on up to $1 million of acquisition indebtedness and $100,000 of home equity loans. The Tax Court agreed, saying that the deductible limits apply on a per-residence basis, not a per-taxpayer basis.

The U.S. Court of Appeals (9th Cir.) reversed, noting that the statute is silent as to unmarried co-owners. The court inferred from the statute's treatment of married co-owners who file separate returns that the debt limits apply to unmarried co-owners on a per-taxpayer basis.

Parenthetical language in Code §163(h) limits the deduction for married couples filing separate-

ly to $500,000 and $50,000, to ensure that all married couples are treated as one taxpayer, whether filing jointly or separately. Had Congress wanted, said the court, it could have drafted the parenthetical language to limit the deductions to a per-residence basis. The court acknowledged that its reading of the statute results in a marriage penalty, adding that "we are not particularly troubled." By expressly providing that a married individual filing separately is entitled to deduction interest on only $550,000 of home debt, "Congress implied that unmarried co-owners filing separate returns are entitled to deduct interest on up to $1.1 million of home debt each," said the court (*Voss v. Comm'r., Sophy v. Comm'r.*, 2015-2 USTC ¶50,427).

EXTRINSIC EVIDENCE MIGHT SHED LIGHT ON UNAMBIGUOUS WILLS

Irving Duke prepared a holographic will in 1984, when he was age 72 and his wife was age 58. The will left all his property to his wife, but provided that if the two died in a common accident, his estate was to be split into two equal shares. One share would go to the City of Hope in memory of his sister, the other would go to the Jewish National Fund, to plant trees in Israel in memory of his parents. The will included an in terrorem clause limiting anyone seeking to invalidate the will to $1.

Duke did not update his will after his wife's death in 2002. At Duke's death in 2007, the two charities sought to have the will probated. Duke's sole intestate heirs – two nephews – argued that because the will did not provide for the situation where Duke was the surviving spouse, his estate passed to them via intestacy. The probate court said the in terrorem clause did not apply, since the nephews were not challenging the validity of the will, but rather arguing that the will did not address the situation where Duke would survive his wife.

The charities sought to introduce extrinsic evidence showing that Duke intended his estate to pass to charities in the event his wife was not alive. The probate court said that because Duke's will was unambiguous, no extrinsic evidence would be allowed to rewrite the document. This followed the California Supreme Court's 1965 ruling in *Estate of Barnes* (63 Cal.2d 580).

The Supreme Court has reversed and remanded the probate court ruling (*Radin v. Jewish National Fund*, B227954), saying "the categorical bar on reformation of wills is not justified." Wills can be reformed, the court ruled, provided there is "clear and convincing evidence" of a mistake at the time the will was written and of the testator's actual specific intent.

Why the change from *Barnes*? The court noted that in the intervening years the state legislature has "codified judicial expansions of the admissibility of evidence with respect to a testator's intent" and pointed to the "evolution of the law of probate and modern theories of interpretation of writings." Extrinsic evidence is "generally admissible" to correct other types of documents, the court noted, adding that "evidentiary concerns do not explain or justify the bar on reformation of wills." Denial of extrinsic evidence in the case of an unambiguous will "may result in unjust enrichment if there is a mistake of expression in the will" (*Estate of Duke v. Jewish National Fund*, S199435).

PHILANTHROPY PUZZLER

Peter and Paul, 72-year-old twin brothers, share everything, including a favorite charity. The two heard about the benefits of charitable remainder trusts at a seminar and decided to create a trust that would provide them income for life. They plan to fund the trust with a beach home that they own as tenants in common and rarely use anymore. The charity's planned giving officer mentioned an IRS ruling that disqualified a trust funded jointly by nonspouses. The brothers have asked if there is another option.

FIRST SUBORDINATION, THEN DONATION

Walter Minnick had taken out a $1.5 million loan, secured by vacant land that he planned to develop. Two days after receiving county approval for his plans, he donated a conservation easement to the Land Trust of Treasure Valley over parts of the property that would not be developed. The existing mortgage was not subordinated to the easement.

The IRS disallowed Minnick's deductions, citing the lack of documentation of fair market value. In 2011, as the case was approaching trial, the bank, at Minnick's request, subordinated its loan to the easement. In a pre-trial motion, the IRS argued that Minnick was not entitled to any deduction because at the time of the easement gift, the bank had not subordinated its rights to those of the Land Trust to enforce the easement. The Tax Court agreed. Minnick appealed but in the interim, the U.S. Court of Appeals (10th Cir.) ruled that the mortgage must be subordinated at the time of the gift (*Mitchell v. Comm'r*., 775 F.3d 1243).

The U.S. Court of Appeals (9th Cir.) agreed with the Tenth Circuit and the IRS that the plain language of the regulations make subordination a prerequisite for a deduction. A conservation easement subject to a mortgage is at risk of extinguishment upon foreclosure, said the court, adding that requiring subordination at the time of the donation is consistent with the requirement that the easement be in perpetuity (*Minnick v. Comm'r*., 2015-2 USTC ¶50,430).

WHAT HAPPENS HERE STAYS HERE

Bloomsburg Hospital, founded in 1905 to care for the sick in the town of Bloomsburg, PA, was the beneficiary of several charitable trusts. Through various mergers, the hospital became Geisinger-Bloomsburg Hospital (GBH) and is affiliated with a larger health system. The state's attorney general found that despite the corporate changes, the trusts could be administered in conformity with the testators' intent because GBH continues to operate as a non-profit hospital in Bloomsburg.

The Orphans' Court, using the cy pres doctrine, placed accounting restrictions on the trust distributions to prevent the use of the funds through the entire Geisinger system. The court ordered the creation of a pour over endowment and limited trust spending to years in which GBH has an operating surplus. GBH appealed the restrictions.

The Superior Court of Pennsylvania ruled that the Orphan's Court abused its discretion. There is no evidence that money from the trusts is being diverted from the hospital or that the intent of the trusts is being thwarted, said the court. Therefore, the doctrine of cy pres does not apply. Similarly, none of the trusts restricted gifts based on the hospital's fiscal position, so the creation of the pour over endowment was an abuse of the Orphan's Court's discretion. The court did, however, agree that GBH must amend its bylaws, in accordance with the attorney general's recommendation, to restrict funds received from the trusts exclusively to the Geisinger-Bloomsburg Hospital in Bloomsburg (*In re: Shoemaker*, 2015 PA Super. 111).

PUZZLER SOLUTION

The IRS has ruled that a trust funded by nonspouses is an "association" and not a tax-exempt charitable remainder trust (Ltr. Rul. 9547004). However, Peter and Paul may be able to create two trusts using the home. Each could create a two-life trust with concurrent interests, funding them with their one-half interests in the home. The combined deductions from two trusts would be the same as the deduction from one trust for their joint lives, and although each would be considered to have made a gift to the other twin, they could make the gifts incomplete by retaining the right to revoke the other's survivor interest by will [Reg. §§1.664-2(a), 1-664-3(a)(4)].

IRS MAKES BASIS REGULATIONS PERMANENT

Charitable remainder trusts are often funded with appreciated securities, allowing the donors to avoid the immediate capital gains tax when the shares are sold by the trustee. Sale proceeds can then be reinvested in a more diversified portfolio to generate the income necessary to make payments to the income beneficiary. The capital gains from the sale of the shares are eventually distributed to the beneficiary under the four-tier system [Code §§664(b)(1) and (2)]. That's how charitable remainder trusts have operated since the 1969 Tax Reform Act.

But some donors joined the remainder beneficiary to sell their respective interests to a third party, with the donor and the charity receiving the actuarial value of their interests in the trust. The question became: How is the donor taxed on the receipt of the proceeds? Some income beneficiaries took the position that their basis was the value of the new assets acquired by the charitable remainder trust, rather than their basis in the assets contributed to the trust.

In 2009, the IRS gave notice that arrangements such as this were considered "transactions of interest," saying that a taxable beneficiary of a charitable remainder trust should not benefit from a basis step-up attributable to gains realized by a tax-exempt trust. To address the concern, the IRS issued proposed regulations in January 2014 (NPRM REG-154890-03). Under these regulations, a special rule made the income beneficiary's basis a prorated portion of the charitable remainder trust's adjusted uniform basis reduced by a prorated portion of (1) the amount of undistributed net ordinary income plus (2) the amount of undistributed net capital gain assignable to the interest. For example:

The grantor contributes stock worth $100, basis of $10, to a unitrust. The trustee sells the stock and uses the $100 sale proceeds to purchase other stock, which is later sold for $110. At a later date, when the value of the trust's assets is $150 and there is no undistributed net ordinary income, the grantor and charity sell their interests to a third party. The grantor receives $100 (66.7%) for the income interest and charity receives $50 (33.3%) for the remainder interest. The grantor's gain on the sale is determined under Code §1001(a). The unitrust's adjusted basis is $110. The grantor's 66.7% actuarial share of the unitrust's basis ($73.37) is reduced by applying the same factors to the sum of the unitrust's $0 of undistributed net ordinary income and its $100 of undistributed net capital gains. The grantor then subtracts 66.7% of $100, for an adjusted basis of $6.67 ($73.37 – $66.70). The IRS recently adopted final regulations that are unchanged from the proposed regulations (T.D. 9729), effective for sales and other dispositions of interest in charitable remainder trusts occurring on or after January 16, 2014. Because the regulations address the proper tax treatment of this type of transaction, the IRS said they are no longer considered transactions of interest.

A slight variation on this scenario – where the charitable remainderman agrees to buy the donor's income interest for its actuarial value – should result in the same tax situation for the donor. Where the donor relinquishes the income interest to the remainderman, thereby terminating the trust, the donor is entitled to an income tax charitable deduction (e.g., Ltr. Ruls. 9409017, 200524014, 200802024). Donors contributing all or part of an income interest must satisfy the appraisal requirements of Code §170(f)(11)(E) if the value of the interest is $5,000 or more.

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