November 23, 2015

2015 Year-End Estate Planning Advisory

Overview

In 2015, we continued to experience a period of relative stability in our federal transfer tax system and have been able to plan without expecting imminent significant changes to the system. Under the American Taxpayer Relief Act of 2012 (ATRA 2012), the estate, gift and the generation-skipping transfer (GST) tax exclusion amounts (the "applicable exclusion amounts") were initially set at $5 million, indexed for inflation. The current $5.43 million applicable exclusion amounts are set to increase to $5.45 million in 2016. ATRA 2012 made permanent the so-called "portability" provisions of the federal gift and estate tax laws, which, under certain circumstances, allow a surviving spouse to utilize the deceased spouse's unused applicable exclusion amount (DSUE) toward amounts gifted or transferred at death (but does not increase the surviving spouse's federal GST exemption). The historically high exclusion amounts and the portability provisions under ATRA 2012 continue to create many new estate planning opportunities.

Our new emphasis on achieving basis step-ups to decrease income tax liability continues. Income tax planning is now a critical part of overall effective tax planning for the transfer of wealth as we plan to address the substantially higher income tax rates introduced by ATRA 2012.

Although we are enjoying the respite from annually changing transfer tax rates, President Obama has included a call for a reduction of the applicable exclusion amounts to the more modest 2009 levels in his 2016 budget proposal, which sets forth reduced estate and GST applicable exclusion amounts of $3.5 million and a gift tax applicable exclusion amount of only $1 million, with no inflation indexing to any of the applicable exclusion amounts. We continue to monitor these proposed changes, as well as many others that the administration has targeted, which are addressed below.

This year we also have seen some significant cases that affect planning and wealth transfer, including *Obergefell v. Hodges*, in which the Supreme Court held that state bans on same-sex marriage are unconstitutional. New legislation also implemented basis consistency requirements for recipients of inherited property and new information reporting requirements for executors.

There have been many changes at the state law level as well, such as in California, where a bill advanced the state's conformity to federal tax laws, and in New York, where amendments were passed to several previously enacted laws.

These are just a few of the significant developments at the federal and state levels this year, and Katten's Trusts and Estates practice is pleased to provide you with a summary of those and other developments, along with a number of important, time-sensitive recommendations for you to consider for planning before year-end.

Federal Estate, GST and Gift Tax Rates

For 2015, the estate, gift and GST applicable exclusion amounts are $5.43 million. For 2016, the estate, gift and GST applicable exclusion amounts will be $5.45 million. The maximum rate for estate, gift and GST taxes will remain at 40%.

Annual Gift Tax Exemption

Each year individuals are entitled to make gifts (the "Annual Exclusion Amount") without incurring gift tax or using any of their lifetime applicable exclusion amount against estate and gift tax. The Annual Exclusion Amount will remain at $14,000 per donee in 2016. Thus, a married couple together will be able to gift $28,000 to each donee. The limitation on annual gifts made to noncitizen spouses will increase from $147,000 to $148,000 in 2016.

Federal Income Tax Rates

- Individual ordinary income tax rates will remain the same in 2016, with a maximum rate of 39.6%. The 39.6% tax rate will affect single taxpayers whose income exceeds $415,050, and married taxpayers filing jointly whose income exceeds $466,950. Estates and trusts will reach the maximum rate with taxable income over $12,400.
- For taxpayers whose ordinary income is taxed at the maximum 39.6% level, long-term capital gains will continue to be taxed at 20%. Long-term capital gains for taxpayers in lower ordinary income tax brackets will continue to be taxed at 15% or 0% if the taxpayer's ordinary income is taxed at 10% or 15%. Qualified dividends are taxed at the long-term capital gains rate.
- The threshold for the imposition of the 3.8% Medicare surtax on investment income and 0.9% Medicare surtax on earned income will remain the same in 2016 for individuals ($200,000 for single filers, $250,000 for married filers filing jointly, $125,000 for married filers filing separately), but rises to $12,400 for trusts and estates.

The President's Budget Proposal for Fiscal Year 2016

The President's budget proposal for Fiscal Year 2016 includes a number of transfer tax-related items, many of which have been proposed in prior years, the most relevant of which are summarized below.

Simplify and Limit Gift Tax Annual Exclusion for Present Interests

The 2015 budget proposal first proposed eliminating the "present interest" requirement for gifts in order to qualify for the gift tax annual exclusion. The 2015 proposal creates a new category of transfers and imposes an annual limit of $50,000 per donor on the donor's transfers of property within this new category that will qualify for the annual gift tax exclusion. The new category includes: (1) transfers to trusts; (2) pass-through entity interest gifts; (3) transfers of interests subject to a prohibition on sale; and (4) other transfers of property that, without regard to withdrawal right, put right or other such rights to the donee, cannot immediately be liquidated by the donee. The $14,000 per donee per year annual exclusion would still apply to most outright gifts. The 2016 proposal clarifies that the $50,000 per-donor limit would not provide an exclusion in addition to the annual per-donee exclusion. Instead, the $50,000 per-donor limit would be a further limit on those amounts that otherwise would qualify for the $14,000 annual per-donee exclusion. The proposal could significantly affect current planning techniques, particularly as to the purchase of large insurance policies, because even if individual gifts do not exceed the $14,000 (or $28,000 per couple) limit, gifts within the new category that exceed $50,000 in the aggregate would constitute taxable gifts.

Required Minimum Distribution (RMD) Rules Applicable to Roth IRAs and Payments to Non-Spouse Beneficiaries of Inherited IRAs

This proposal requires most non-spouse beneficiaries of traditional IRAs and Roth IRAs to take distributions over no more than five years for taxpayers after age 70-1/2. The proposal would be effective with respect to plan participants and IRA owners dying after 2015, and would apply to Roth IRAs only if the owner reached age 70-1/2 after 2015 and to owners who die after 2015 after reaching age 70-1/2. There would be an exception for a beneficiary who is disabled, chronically ill, not more than 10 years younger than the participant or IRA owner, or a minor child.

60-Day Rollover for Inherited Retirement Benefits

A new taxpayer-friendly proposal allows a non-spouse beneficiary to roll distributions over to an inherited IRA within 60 days, effective for distributions after 2015. Currently, only a plan participant, IRA owner or spouse can receive distributions of qualified plans or IRA benefits and roll them over tax-free into another qualified plan or IRA within 60 days. A beneficiary other than a spouse may only make a trustee-to-trustee transfer from the decedent's IRA to an inherited IRA.

Eliminate RMDs for Qualified Plans and IRAs Less Than $100,000

Under the proposal, the minimum distribution rules would not apply if the aggregate value of the IRA or qualified plan does not exceed $100,000 (indexed for inflation after 2016). The proposal applies to individuals reaching age 70-1/2 after 2015 or who die after 2015 before attaining age 70-1/2.

Reduce Exclusion Amounts and Increase Tax Rate

As was the case in the 2014 and 2015 proposals, the 2016 proposal also provides for a permanent return of the estate, gift and GST tax regimes to their 2009 levels, i.e., a 45% top tax rate and maximum $3.5 million applicable exclusion amounts for estate and GST tax and $1 million for gift tax. Unlike the prior years' proposals, the current proposal moves the effective date of the return to 2016.

Change the Treatment of Intentionally Defective Grantor Trusts (IDGTs)

The budget proposal again contains a provision that significantly would undermine the utility of IDGTs, used frequently as a highly effective tax planning technique. The grantor of an IDGT is treated as the owner of the trust assets for income, but not estate tax purposes. The grantor pays the income tax liability on the IDGT assets, which allows the principal to grow undiminished by the payment of income taxes. The grantor's payment of the IDGT's income taxes is not treated as a gift to the trust beneficiaries even though it effectively results in an increased amount of trust assets available for distribution. Under the proposal, the assets in IDGTs (other than insurance trusts) would be included in the grantor's estate and subject to estate tax, except to the extent consideration is received by the grantor from the IDGT. In addition, distributions from an IDGT would be subject to gift tax and if the trust ceases to be a grantor trust, the remaining assets would be subject to gift tax. The proposal applies to any IDGTs that engage in a described transaction after the enactment date.

Require Consistency of Basis Valuation

The proposal to require consistency in value for transfer and income tax purposes requires that the basis for income tax purposes be the same as that determined for estate and gift tax purposes. The proposal requiring consistency with estate tax values for inherited property (but not for gifted property) was signed into law on July 31, 2015, and is discussed below.

Impose New Requirements for Grantor Retained Annuity Trusts (GRATs)

The proposal adds additional requirements that would be imposed on GRATs: (1) they must have a 10-year minimum term; (2) they must have a maximum term of life expectancy plus 10 years; and (3) the annuity amount cannot decrease in any year during the annuity term. Additionally, the remainder interest in the GRAT at the time the interest is created must have a minimum value equal to the greater of 25% of the value of the assets contributed to the GRAT or $500,000 (but not greater than the value of the assets contributed to the GRAT). The proposal also provides that GRATs would be prohibited from engaging in any "tax-free exchanges" of any assets held in the trust (e.g., the purchase of assets by the grantor).

Limit the Duration of the GST Exemption Term—Applicable to Long-Term "Dynasty" Trusts

Under the proposal, the exclusion from the imposition of GST tax would last only 90 years for additions to pre-existing trusts and trusts created after the date of enactment, regardless of whether the trust has a longer duration.

Extend Liens on Estate Tax Deferrals

Currently, the law allows a deferral for estate tax on closely held business interests for up to 14 years and nine months from the date of death. The proposal would extend the current 10-year lien that is imposed on estate assets to secure the full payment of the estate tax through the full period of the estate tax deferral.

It is impossible to say which, if any, of these proposals, other than the consistency of basis valuation, may ever be enacted, but it is important to keep in mind those areas targeted by the administration and consider whether planning prior to possible enactment would avoid any new legislation.

Important Cases Decided in 2015

The Supreme Court of the United States Holds in **Obergefell v. Hodges** *That State Bans on Same-Sex Marriage Are Unconstitutional*

On June 26, 2015, the Supreme Court of the United States ruled that a state ban on same-sex marriage is unconstitutional as a violation of the equal protection clause of the Fourteenth Amendment. This decision struck down every state ban on same-sex marriage in the country, and by virtue of the ruling, also struck down Section 2 of the Defense of Marriage Act (DOMA), which declared that states have the right to deny recognition of same-sex marriages licensed in another state. As a result of this ruling, all 50 states and Washington, DC must now recognize same-sex marriages and issue marriage licenses to same-sex couples. As a result of *United States v. Windsor*, decided in 2013, the federal government also must recognize these marriages as valid.

Windsor and *Obergefell* create many planning opportunities for same-sex couples. These couples should consider getting married to take advantage of the unlimited marital deduction for estate tax purposes, review their current estate planning documents and beneficiary designations to ensure that the amount and structure of any bequests to the spouse are appropriate, and consider replacing individual life insurance policies with "second-to-die" survivor policies. Additionally, same-sex spouses should consider splitting gifts between spouses, and should determine if amending previously filed federal estate, gift and income tax returns and state income tax returns would be advantageous.

On October 21, 2015, the IRS issued proposed regulations to implement the *Obergefell* decision. The proposed regulations clarify that the terms "husband" and "wife" in the federal tax code will be interpreted neutrally to include same-sex spouses as well as opposite-sex spouses.

Tax Court Holds Annual Gift Tax Exclusion Available for Gifts to Crummey Trusts with Arbitration or In Terrorem Provisions

The Tax Court held that the gift tax annual exclusion may be available for gifts to Crummey trusts that have arbitration or *in terrorem* provisions. In *Mikel v. Commissioner*, spouses each gave $1,631,000 to a Crummey trust with 60 beneficiaries holding withdrawal rights over contributions. The spouses asserted that a portion of the transfer qualified for the annual gift tax exclusion because each of the 60 beneficiaries had a withdrawal right over contributions to the trust, and therefore had a "present interest" in the trust. The trust also contained (1) a provision requiring arbitration of any disputes, and (2) an *in terrorem* provision stating that a beneficiary's beneficial interest would cease if he instituted or participated in any proceeding to oppose or challenge a trust distribution, or filed any action in a court of law. The Tax Court held that the presence of the arbitration clause and *in terrorem* clause did not negate the beneficiaries' present interests in the trust. As a result, a portion of the transfer qualified for the annual gift tax exclusion.

Charitable Deduction Denied for Conservation Easement Authorizing Limited Swaps of Property

In *Balsam Mountain v. Commissioner*, the Tax Court held that a conservation easement that allowed the grantor to make alterations to the boundaries of the protected area was not eligible for a charitable deduction. The grantor of the easement reserved the right to remove up to 5% of the land from the easement in exchange for a similar amount of land for a period of five years. Because the grantor could change the property subject to the easement, the Tax Court held that the easement was not a restriction on the use of real property which would be eligible for a deduction.

Trust Can "Materially Participate" in a Business for Purposes of the Passive Loss Rules

In *Frank Aragona Trust v. Commissioner*, the Tax Court held that (1) a trust can qualify for the real estate professional exception so that rental losses are not disallowed as passive activities under the passive loss rules, and (2) a trust can "materially participate" in a real estate business based on the activities of its trustees. In *Aragona Trust*, a trust managed real estate through a wholly owned LLC, of which three of the six co-trustees were employees. The trust deducted rental real estate losses from nonpassive income, and the IRS disallowed the deduction. The court held that the activities of the trustees, including as employees, should be considered in determining whether the trust materially participated in real estate operations.

Important Planning Considerations for 2015 and 2016

Review and Revise Your Estate Plan to Ensure It Remains Appropriate

You should review your estate planning documents to make sure that those documents still make sense in light of recent gifting you may have done and given your current life circumstances and level of assets. For example, your estate planning documents may assume that you will have a high applicable exclusion amount remaining to be used at the time of your death. If you made large lifetime gifts, that assumption is likely no longer true.

You should consider whether property held in an irrevocable trust should be distributed prior to death so that it may obtain a step-up in basis upon the death of the beneficiary to whom it was distributed. Whether such a distribution is advisable depends on a careful analysis of the beneficiary's assets and applicable exclusion amounts, as well as the possibility that the stepped-up basis is eliminated as proposed in the President's budget proposal.

You should continue to be cautious in relying on portability for your estate planning, as it is unclear that the portability provisions under existing laws will remain in place. In addition, a deceased spouse's DSUE will not be available upon remarriage of the surviving spouse.

You also should review any provisions in your will and trust agreements that distribute assets according to tax formulas and/or your applicable exclusion amounts to ensure that the provisions, when taking into account the higher applicable exclusion amounts, continue accurately to reflect your desires.

Your allocation of your GST applicable exclusion amount should be reviewed to ensure that it is utilized most effectively if you wish to plan for grandchildren or more remote descendants.

Now that same-sex marriages must be recognized by every state as well as the federal government, same-sex couples should review and revise their estate planning documents and beneficiary designations to ensure that the amount and structure of any bequests to the spouse are appropriate, as well as consider the benefits of split gifting for gift tax purposes and amending previously filed federal estate, gift and income tax returns and state income tax returns.

Avoid the Medicare Surtax With Trust Income Tax Planning

A complex, non-grantor trust with undistributed annual income over $12,300 (or $12,400 in 2016) will be subject to the 3.8% Medicare surtax. However, some or all of the Medicare surtax may be avoided by distributing such income directly to beneficiaries who are below the individual net investment income threshold amount for the Medicare surtax ($200,000 for single filers, $250,000 for married couples filing jointly and $125,000 for married individuals filing separately).

Careful evaluation of beneficiaries' circumstances and tax calculations should be made to determine whether trusts should distribute or retain their income.

Make Gifts To Take Advantage of the Increased Applicable Exclusion Amount

This year you now have a total of $5.43 million ($10.86 million for a married couple) that you can gift in the aggregate during your lifetime, subject to reduction for any gifts in excess of the Annual Exclusion Amount you have previously made. Gifts in excess of these amounts are subject to a maximum federal gift tax rate of 40%. If you are a surviving spouse and your deceased spouse left you with any DSUE, you may add such unused applicable exclusion amount to your own applicable exclusion amount from gift tax. It is less expensive to make lifetime gifts rather than make gifts at death, because you do not pay a tax on the dollars used to pay gift tax, but you do pay estate tax on the dollars used to pay estate tax. In addition, you will benefit by removing any income and appreciation on the gift from your estate.

A countervailing consideration of lifetime gifting is that the gifted assets will not get a step-up in basis upon your death (as will assets you hold at your death) and will thus generate capital gains tax if they are subsequently sold for an amount higher than their basis. Accordingly, the decision of whether and how to embark on a lifetime gifting strategy depends on a number of factors, including the bases of your various assets, their projected income and appreciation, the total amount of your assets, and your remaining applicable exclusion amount. For individuals with assets far exceeding their applicable exclusion amounts, lifetime gifting of high-basis assets generally will be recommended. However, individuals with total assets close to or below their applicable exclusion amounts should consider holding their assets until death in order to achieve a step-up in basis upon death while minimizing estate taxes. Of course, maintaining a comfortable standard of living is a factor that also must be considered. We are available to discuss this analysis with you in more detail.

Note that your applicable exclusion amount will increase by $20,000 ($40,000 for a married couple) in 2016. Therefore, even if you use some or even all of the applicable exclusion amount available to you before the end of 2015, you may still make additional gifts in 2016 without paying any gift tax. Based on current law, your applicable exclusion amount also will be adjusted for inflation in future years.

Grantor Retained Annuity Trusts (GRATs)

GRATs remain one of our most valuable planning tools, particularly in this time of continuing historically low interest rates. Because the President's budget proposal proposes adverse changes in how GRATs may be structured and due to rising interest rates, GRATs should be created as soon as possible. An important point to note is that under current law, GRATs may be structured without making a taxable gift, so even if you have used all of your applicable exclusion amount, GRATs may be used without incurring any gift tax. In addition, while interest rates are projected to begin rising sometime next year, they are still relatively low, which further increases the effectiveness of GRATs.

A GRAT provides you with a fixed annual amount (the annuity) from the trust for a term of years (which may be as short as two years). The annuity you retain may be equal to 100% of the amount you use to fund the GRAT, plus the IRS-assumed rate of return applicable to GRATs (which for transfers made in November 2015 is 2%). As long as the GRAT assets outperform the applicable rate, at the end of the annuity term you will be able to achieve a transfer tax-free gift of the spread between the actual growth of the assets and the IRS assumed rate of return. Although you will retain the full value of the GRAT assets, if you survive the annuity term, the value of the GRAT assets in excess of your retained annuity amount will then pass to whomever you have named, either outright or in further trust, with no gift or estate tax.

Sales to IDGTs

Because the President's budget proposal eliminating the benefit of IDGTs may be enacted, we recommend implementing these trusts as part of immediate planning.

You would sell assets likely to appreciate in value to the IDGT in exchange for a commercially reasonable down payment and a promissory note from the trust for the balance. From an income tax perspective, no taxable gain would be recognized on the sale of the property to the IDGT because it is a grantor trust, which makes this essentially a sale to yourself. For the same reason, the interest payments on the note would not be taxable to you or deductible by the trust.

If the value of the assets grows at a greater pace than the prevailing applicable federal rate (which for sales in November 2015 is as low as 0.49% for a short-term sale), as with a GRAT, the appreciation beyond the federal rate will pass free of gift and estate tax. The current near record-low interest rates make sales to IDGTs most opportune to structure now.

Complete Planning Using Valuation Discounts

The United States Treasury Department is expected to issue proposed regulations under Internal Revenue Code §2704 in the near future, which may limit valuation discounts that apply to some or possibly all family owned businesses such as family limited partnerships and limited liability companies. Under current law, the value of non-managing, non-controlling interests in these entities, regardless of whether or not they own operating assets, may be subject to discounts based on the lack of marketability and lack of control associated with these minority interests. As of the date of this advisory, the proposed regulations have not been issued, and their scope and effective date remain unknown. Because of these uncertainties and the potential impact that these regulations may have on estate planning techniques that involve valuation discounts, we recommend implementing strategies that involve valuation discounts as soon as possible.

Consider a Swap or Buy-Back of Appreciated Low Basis Assets From Grantor Trusts

If you sold or gave (through a GRAT or other grantor trust) an asset with a low basis, when that asset is sold, the gain will trigger capital gains tax. However, if you purchase the asset back from the grantor trust for fair market value, no gain or loss is recognized. The trust would then hold cash or other assets equal to the value of the asset that was repurchased. Alternatively, many grantor trust instruments give the grantor the power to substitute the trust's assets with other assets, which would allow the low-basis assets to be removed from the trust in exchange for assets of equal value that have a higher basis. Then on your death, the purchased or reacquired asset will be included in your taxable estate and will receive a step-up in basis equal to fair market value, eliminating the income tax cost to your beneficiaries.

Consider the Use of Life Insurance

Life insurance presents significant opportunities to defer and/or avoid income taxes, as well as provide assets to pay estate tax or replace assets used to pay estate tax. Generally speaking, appreciation and/or income earned on a life insurance policy accumulates free of income taxes until the policy owner makes a withdrawal or surrenders or sells the policy. Thus, properly structured life insurance may be used as an effective tax-deferred retirement planning vehicle. Proceeds distributed upon the death of the insured are completely free of income taxes. You may want to consider paying off any outstanding loans against existing policies in order to maximize the proceeds available tax-free at your death, although potential gift tax consequences must be examined. Note that the decision to pay off such loans requires a comparison of the alternative investments that may be available to you with the assets you would use to repay the loans and the interest rate on the loans.

Use Intra-Family Loans and Consider Re-Financing Existing Intra-Family Loans

Because interest rates are so low, many techniques involving use of intra-family loans should be considered, including:

- The purchase of life insurance on the life of one family member by an irrevocable life insurance trust, with premium payments funded by loans from other family members.
- The creation of trusts by older generation members for the benefit of younger family members, to which the older generation members loan funds. The spread between the investment return earned by the trust and the interest owed will create a transfer tax-free gift.
- Forgiving loans previously made to family members. The amount that is forgiven in excess of the annual gift tax exclusion amount will be a gift, and thus will use a portion of your applicable gift tax and/or GST tax exclusion amount.

Consider Charitable Planning

A planning tool that is very effective in a low-interest-rate environment is a Charitable Lead Annuity Trust (CLAT), which combines philanthropy with tax planning. A CLAT is an irrevocable trust that pays one or more named charities a specified annuity payment for a fixed term. At the end of the charitable term, any remaining assets in the CLAT pass to the remainder, noncharitable beneficiaries. As with a GRAT, to the extent the assets outperform the IRS assumed rate of return (2% for November 2015), those assets can pass transfer tax free to whomever you would like.

Unfortunately, there is much uncertainty as to whether you can make IRA Charitable Rollover gifts this year and in future years. There is presently no law permitting such gifts, as the Charitable Rollover provision of the Code expired on December 31, 2014. Congressional action is still required to revive the law for 2015 and beyond.

Until Congressional results are certain, it is difficult to decide whether or not to give from your IRA. However, depending on your individual circumstances, it may make sense for you to go ahead and make the charitable gift from your IRA assets.

If the provision is extended, then the IRA gift could be made without incurring income tax on the distribution.

Because this provision has not been extended, the IRA distribution would not qualify for exclusion from gross income, but the gift would qualify for an income tax charitable deduction, subject to the applicable limitations on charitable deductions. Therefore, if you need to take your required minimum distribution for 2015 and want to make a charitable gift of that amount, then arranging for it to be directly contributed to your favorite charity in accordance with the above requirements should not adversely impact you and may be beneficial if the provision is extended for 2015 and future years.

Plan for Deferred Compensation

Previously deferred compensation from services performed for offshore funds generally must be paid to the fund manager and included in the fund manager's income before 2018. There are steps which may be taken now to begin planning for the associated tax burden.

Year-End Checklist for 2015

In addition to the above planning ideas, consider the following before the end of 2015:

- Make year-end annual exclusion gifts of $14,000 ($28,000 for married couples).
- Make year-end IRA contributions.
- Create 529 Plan accounts before year-end for children and grandchildren, and consider front-loading the accounts with five years' worth of annual exclusion gifts, taking into account any gifts made during the year to children and grandchildren.
- Pay tuition and non-reimbursable medical expenses directly to the school or medical provider.
- Consider making charitable gifts before year-end to use the deduction on your 2015 income tax return.

Below is an overview of national, international and local developments that occurred in 2015.

Important Legislation in 2015

Basis Consistency With Estate Tax Values

Basis consistency provisions for inherited property were enacted as party of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (the "Act"). Under Section 2004 of the Act, recipients of inherited assets must use the values of assets that were reported for federal estate tax purposes to determine their basis in the assets. If an estate is required to file an estate tax return with the Internal Revenue Service (IRS) (other than to elect portability of a decedent's estate tax exemption), the executor is required to provide valuation information to both the IRS and the recipients of assets within 30 days after the filing of the return. An heir or beneficiary who reports a higher basis than the estate tax value may be subject to accuracy-related penalties on underpayments. Additionally, penalties may be assessed if the executor does not provide these information statements to the IRS and to the property recipients. The Act applies to returns filed after July 31, 2015, but the deadline for providing information statements has been delayed until February 29, 2016.

Until Regulations or other guidance is published by the IRS, there are many unanswered questions about the applicability and implementation of this legislation. For example, Regulations are needed to clarify if the requirements apply to estate tax returns that were due but not filed before the effective date, if all beneficiaries (including those receiving only cash bequests) are entitled to the information statement, and if the information statement must be provided to a beneficiary is also the executor.

Modification of Tax Return Due Dates and Extension Periods

The Act also modified the original and extended due dates of several tax returns for tax years beginning after December 31, 2015.

Trusts. Income tax returns for trusts and estates (Form 1041) will remain due on April 15, but the maximum extension for these filings has been extended from September 15 to September 30 for calendar year taxpayers. The due date of Form 3520-A (Annual Information Return of a Foreign Trust with a U.S. Owner) will be the 15th day of the third month after the end of the trust's taxable year, and the maximum extension will be six months. The due date of Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts) will be April 15 for calendar year filers, with a maximum six-month extension until October 15.

Partnerships and S Corporations. Partnership tax returns (Form 1065) will be due on March 15 for calendar year partnerships (or the 15th day of the third month for fiscal year partnerships), with a maximum six-month extension until September 15. The due date and extended due date for S Corporation returns will remain unchanged (March 15 deadline with an extension until September 15). This change may ease the burden of individuals who have partnership interests and must wait for partnership income tax returns to file their personal tax returns, often until the last day to file.

Tax-Exempt Organization Filings. Form 990 series returns will be eligible for an automatic six-month extension, providing an extension until November 15 for calendar year filers. Prior to the Act, the Form 990 series returns were only granted an automatic three-month extention.

Employee Benefit Plans Filings. The maximum extension for the returns of employee benefit plans filing Form 5500 will be an automatic 3.5-month period (formerly, a 2.5-month period), from a due date of the last day of the seventh calendar month after the end of the plan, ending on November 15 for calendar year plans.

International Developments in 2015

New Filing Deadline for FBAR Forms

FinCEN Report 114 ("FBAR") for taxable years beginning after December 31, 2015, are now due April 15 and are allowed a maximum six-month extension. This is a change from the previous June 30 due date, with no extension permitted. For any taxpayer required to file an FBAR for the first time, any penalty for failure to timely request for, or file, an extension may be waived by the secretary.

IRS Issues Guidance on Limiting FBAR Penalties

The IRS issued guidance to its employees regarding the procedure and administration of FBAR penalites. These procedures clarify that where an FBAR violation has been determined to be non-willful and is over multiple years, the penalty that may be imposed is limited to 50% of the highest aggregate balance of all unreported foreign accounts during all of the years under examination. Where the violation has been found to be willful, the IRS guidance imposes a limit of 100% of the highest aggregate balance of all unreported foreign accounts during the years under examination.

EU Succession Regulation

The European Succession Regulation (the "Regulation"), also known as Brussels IV, enacted on July 4, 2012, became effective on August 17, 2015.

The Regulation, which has been adopted by 25 countries throughout the European Union, does away with the potential application of different succession laws of each EU Member State and provides for the application of one uniform law governing succession across all EU Member States.

The Regulation impacts:

- Citizens of EU Member States;
- Estates of persons with a habitual residence in an EU Member State at the time of death; and
- US citizens with assets located in an EU Member State.

Under the Regulation the law of the jurisdiction in which the decedent had a "habitual residence at the time of death" will govern the decedent's entire estate unless the decedent makes an election in his or her will to have the law of his or her nationality govern the worldwide estate instead.

The ability to choose the law of nationality to govern one's estate presents an interesting planning opportunity for those with citizenship from non-Member States because such individuals can now bypass the local laws of the EU Member States (such as community property and forced heirship rules) where their property is located.

Proposed Regulations for Covered Gifts and Bequests Made by Covered Expatriates

The IRS has issued long-awaited proposed regulations that provide guidance to taxpayers who receive gifts or bequests from individuals who relinquished their citizenship or long-term residence on or after June 17, 2008, and who are considered covered expatriates.

FATCA Intergovernmental Agreements

The following countries signed Model 1 Intergovernmental Agreements with the United States in 2015:

Belarus	Cambodia	Colombia	Croatia
Georgia	Holy See	Iceland	India
Kosovo	Kuwait	Montserrat	Philippines
Portugal	Qatar	Romania	St. Kitts and Nevis
St. Vincent and the Grenadines	Slovak Republic	South Korea	Turkey
United Arab Emirates	Uzbekistan		

Local Developments in 2015: State-Specific Considerations

California

Revocable Transfer on Death Deed

California enacted AB 139 (taking effect on January 1, 2016), which creates a revocable transfer on death deed (aka revocable TOD deed), that would transfer real property on the death of its owner without a probate proceeding. The deed is required to be recorded, but during the homeowner's life it does not affect his or her ownership rights and specifically is part of the owner's estate for the purpose of Medi-Cal eligibility and reimbursement. A revocable TOD deed is void if, at the time of the owner's death, the property is titled in joint tenancy or as community property with right of survivorship.

Extrinsic Evidence Allowed To Prove Testator's Intent in Unambiguous Will

In *Estate of Duke*, the California Supreme Court ruled that extrinsic evidence may be introduced to reform an unambiguous will if clear and convincing evidence establishes an error in the expression of the testator's intent, and also establishes the testator's true intent, at the time the will was drafted. This is a dramatic shift in California law as the previous rule under *Estate of Barnes* (1965) was that extrinsic evidence may never be introduced to reform an unambiguous will.

Positive Development for *Heggstad* Petitions

In California, a so-called "*Heggstad*" petition (named after the 1993 case by the same name) is a mechanism to petition the court to transfer title of real and personal property held in the settlor's individual name to a trust after the settlor's death if the settlor's intent that such property be administered under the trust is sufficiently expressed in the trust instrument. In *Ukkestad v. RBS Asset Finance*, a California appeals court ruled that sufficient intent is expressed if the trust instrument recites that the settlor transfers to the trust his "right, title and interest" to "all of his real . . . property." Previously California law was unclear, but it was widely understood that the trust would have to specifically identify the property (such as the physical address of real property) in order to succeed on a Heggstad petition. As a result of the *Ukkestad* decision, Heggstad petitions are given a boost as a probate avoidance technique if the settlor neglected to transfer title to assets to a trust during his or her lifetime.

Conformity to Federal Tax Laws

California enacted AB 154 that advances California's federal tax conformity to the Internal Revenue Code (IRC) as enacted on January 1, 2015. Prior to this bill, California conformed to the IRC as of January 1, 2009. Some changes include those under the Patient Protection and Affordable Care Act, Dodd-Frank Wall Street Reform and Consumer Protection Act, Small Business

Jobs Act, American Taxpayer Relief Act and several other measures. However, the new law does not conform to several federal changes made since 2009, including requirements for certain tax preparers to file returns electronically, inflation indexing on many penalty amounts and an increased penalty for failing to file partnership or S-corporation returns.

Also under this legislation, California law now conforms to federal net operating loss (NOL) rules that allow corporations expecting an NOL carryback to extend the time for tax payments for the preceding taxable year, according to an analysis of the bill prepared by the state Franchise Tax Board (FTB).

The new law also includes unrelated provisions giving taxpayers some relief from the California Large Corporate Underpayment Penalty (LCUP), under which corporations face a 20% penalty if they understate their California income tax liability by $1 million or more. Taxpayers will not be subject to the LCUP if their tax liability is adjusted because the FTB imposes an alternative apportionment formula or if the Secretary of the Treasury changes the taxpayer's accounting method. Taxpayers that have an increase in tax liability due to an election under IRC Section 338 related to acquisitions also would be exempt from the penalty.

Court Approves Payment of Trustee's Litigation Expenses Defending Trust Contest

In *Doolittle v. Exchange Bank*, the trust's no contest clause directed the trustee to defend a contest at the expense of the trust estate. A contestant filed a claim to invalidate the trust, and also argued that the trustee could not pay expenses to defend the litigation until a determination was made that her claims fall within the no contest clause. Under California Probate Code Section 21311, a no contest clause is only triggered if a contestant brings a claim without "probable cause." Thus, if the contestant's argument would have prevailed, the court would have been required to find that the contest was without probable cause before approving any payment of fees for the trustee to defend the litigation. A California appeals court affirmed a lower court's decision that the defense of claims provision was not a no contest clause, and it was not necessary to first determine that the contestant's claims were asserted without probable cause before it granted authorization for fees to defend the trust. If the rule were otherwise, it would render the defense directive meaningless.

Illinois

Statutory Health Care Power of Attorney

Effective January 1, 2016, Illinois again has revised its power of attorney for health care statute, which was overhauled one year ago. The revised statutory form moves the list of successor health care agents to follow the initial named agent near the beginning of the form, rather than at the end. The revised statutory form adds a third option to the choices regarding when and to what extent the named agent has authority to act during the life of the principal. The revised form also removes and adds additional persons whose relationship to the principal prohibits them from serving as witnesses to the signing of the form. The general term "mental health service provider" was eliminated from the list of prohibited persons, and advanced practice nurse, dentist, podiatric physician, optometrist and psychologist were added to the list.

Certification of Trust Form

Illinois enacted a new statute, effective August 10, 2015, which provides a statutory form for a "Certification of Trust" to be given to a third party, such as a bank or other financial institution, in place of a complete trust instrument. Previously, Illinois did not have a statute specifically authorizing the furnishing of a Certification of Trust in place of a full trust. The third party must accept the Certification of Trust in lieu of a complete trust instrument. At least one trustee must sign the certification.

Illinois Probate Code

Effective January 1, 2016, the Illinois Probate Code provides that as a default rule, a child of a decedent born after the decedent's death must have been conceived before (i.e., in utero) the decedent's death in order to qualify for a share of the decedent's intestate estate. This law contrasts with similar laws of other states, including California and New York, that grant children of a decedent who are conceived after the death of the decedent rights under various circumstances. Note that no corresponding change was made to Illinois trust law.

New York

There were several New York state developments this year, though they were largely amendments to already previously enacted changes. Of particular note are the following areas.

Non-Profit Revitalization Act of 2013

On December 18, 2013, New York adopted the Non-Profit Revitalization Act of 2013, which dramatically changed and updated New York laws affecting governance, oversight, formation and administration of non-profit organizations incorporated, authorized to do business, or soliciting charitable contributions in New York. The act is intended to simplify certain archaic procedures of administering non-profit organizations in New York, and to streamline and strengthen the oversight and governance processes of such organizations. Most of the provisions of the act came into effect as of July 1, 2014. However, the effective date of the law prohibiting employees from acting as chair of a non-profit organization has again been postponed, now until January 1, 2017. For greater detail, see our client advisory on the subject here.

Changes to the New York Estate Tax and Trust Income Tax Regimes

On April 1, 2014, the New York State 2014–2015 budget became effective and made several significant changes to: (1) New York's estate tax regime; (2) the income tax treatment of trusts created by New York residents that were exempt from tax under prior legislation ("exempt trusts"); and (3) incomplete gift nongrantor trusts (INGs) created by New York residents. Perhaps most notably, the exemption from New York state estate taxes will increase by the year 2019 to match the federal exemption from estate tax (i.e., $5 million indexed for inflation), but the full benefit of this increase is available only for estates that do not exceed the federal exemption amount, with this new benefit phasing out once an estate exceeds the federal exemption amount by 5%. Additionally, (1) certain gifts made by a New York resident between April 1, 2014 and January 1, 2019, and within three years of death, will be included in the decedent's New York gross estate; (2) New York's generation-skipping transfer tax was repealed; (3) the accumulated income of exempt resident trusts now will be subjected to a so-called "throwback" tax once distributed to a New York-resident beneficiary; and (4) the current net income of an ING created by a New York resident will be included in his or her New York state income tax. Technical corrections awaiting enactment will extend the applicability of the tax rate table to incorporate decedents dying after April 1, 2015; clarify the gift add back provision to exclude any real or tangible personal property located outside of New York state at the time the gift was made; and clarify that the add back does not apply to decedents dying after January 1, 2019. The corrections also will clarify a disallowance of deductions relating to intangible personal property for estate of nonresident decedents. These changes, once enacted, will take effect immediately and be deemed to have been in effect on and after April 1, 2014. For greater detail, see our client advisory on the subject here. On October 27, 2015, the New York State Tax Department of Taxation and Finance issued a bulletin clarifying that deductions taken with regard to out-of-state real and tangible property not part of the New York gross estate must be excluded in calculating the New York estate tax.

Public Access to Surrogate's Court Documents

Certain confidential documents, and certain confidential information contained in other documents, will be restricted from public access.

Decanting

New York's state-of-the art decanting statute will be amended under a bill awaiting enactment to clarifying that a trustee may recant a decanting within either the thirty day notice period provided by law or the effective date set forth in the written consents.

Posthumously Conceived Children

In 2014, posthumously conceived children were given inheritance rights provided that (1) the decedent authorizes the use of genetic material for posthumous conception in writing within seven years of death and appoints a person to make such decisions posthumously; (2) such person gives notice to the personal representative of the decedent's estate within seven months of the issuance of letters; (3) such person records the writing in the New York Surrogate's Court within seven months of the decedent's death; and (4) the child is in utero within 24 months or born within 33 months of the decedent's death. Under a bill awaiting enactment, the right to interest on delayed legacies to children of the decedent who are conceived after the decedent's death will begin on the later of seven months from the date of death and the child's date of birth.

North Carolina

Living Probate

On August 11, 2015, North Carolina adopted the "Act to Amend the Law Governing Estate Planning and Fiduciaries" (the "Act"). The Act adopts a procedure by which a petition can be filed during the testator's lifetime to obtain an order that a will is valid. The petition must provide notice to all interested persons and fully disclose the terms of the will. If a court order is issued declaring the will valid, the order would generally bar actions after death contesting the will. This procedure gives a testator the ability to testify during his or her lifetime as to intent, competency and lack of undue influence, but it also requires notifying all heirs and potential beneficiaries of the content of the will.

Decanting

In 2010, North Carolina enacted legislation allowing decanting of trust property to a new trust for the benefit of the same trust beneficiaries. The trustee's ability to decant trust property is subject to several requirements and qualifications. The Act expands the trustee's authority to decant trust property, most notably to permit the appointment of trust property to a qualified special or supplemental needs trust for the benefit of a disabled beneficiary. This ability to decant to a qualified special or supplemental needs trust can be advantageous if a beneficiary becomes disabled and the original trust provides for distributions that might cause the trust property to be considered in the beneficiary's qualification for governmental benefits. The decanting provisions were effective on October 1, 2015.

Fiduciary Income Tax

In *Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, the North Carolina Business Court held N.C.G.S. 105-160.2 unconstitutional as applied to the income taxation of a trust. In *Kaestner*, a New York resident created a trust and appointed a New York resident as trustee. The beneficiary of the trust later moved to North Carolina, but the trust itself had no connection to or activity in North Carolina. The trustee filed North Carolina fiduciary income tax returns and paid state income tax based on N.C.G.S. 105-160.2, which imposes tax on the taxable income of a trust for the benefit of a North Carolina resident. The trustee later filed claims for refund of the tax paid on the basis that the taxation statute was unconstitutional. The court agreed that the statute was unconstitutional as applied to the trust, as neither the trustee nor the trust had any connection to or physical presence in North Carolina. Although the court did not hold that the statute was unconstitutional on its face, this decision is significant for trusts whose only connections to North Carolina may be the residence of a beneficiary. The Department of Revenue has appealed this decision, and as of the date of this advisory, the appeal is still pending.

We Can Help

We hope that this advisory helps you with your year-end estate and gift tax planning, and also provides you with some interesting ideas to consider for the future. As always, the Trusts and Estates practice stands ready and able to assist you with these matters at any time.

CHARLOTTE

A. Victor Wray, Charlotte Head	+1.704.444.2020	victor.wray@kattenlaw.com
Diane B. Burks, Associate	+1.704.344.3153	diane.burks@kattenlaw.com

CHICAGO

Charles Harris, Chicago Co-Head	+1.312.902.5213	charles.harris@kattenlaw.com
Michael O. Hartz, Chicago Co-Head	+1.312.902.5279	michael.hartz@kattenlaw.com
David M. Allen, Partner	+1.312.902.5260	david.allen@kattenlaw.com
Victor H. Bezman, Of Counsel	+1.312.902.5204	victor.bezman@kattenlaw.com
Hadar R. Danieli, Special Counsel	+1.312.902. 5581	hadar.danieli@kattenlaw.com
Stuart E. Grass, Of Counsel	+1.312.902.5276	stuart.grass@kattenlaw.com
Royelle M. Kashiwahara, Associate	+1.312.902.5335	royelle.kashiwahara@kattenlaw.com
Melvin L. Katten, Senior Counsel	+1.312.902.5226	melvin.katten@kattenlaw.com
Tye J. Klooster, Partner	+1.312.902.5449	tye.klooster@kattenlaw.com
Andrew L. McKay, Associate	+1.312.902.5315	andrew.mckay@kattenlaw.com
Allan B. Muchin, Of Counsel	+1.312.902.5238	allan.muchin@kattenlaw.com
Aaron J. Newell, Associate	+1.312.902.5397	aaron.newell@kattenlaw.com
Kelli Chase Plotz, Staff Attorney	+1.312.902.5347	kelli.plotz@kattenlaw.com
Bonita L. Stone, Partner	+1.312.902.5262	bonita.stone@kattenlaw.com
Allison Bailey Tanton, Associate	+1.312.902.5302	allison.tanton@kattenlaw.com
Philip J. Tortorich, Partner	+1.312.902.5643	philip.tortorich@kattenlaw.com
Neil H. Weinberg, Partner	+1.312.902.5646	neil.weinberg@kattenlaw.com

LOS ANGELES – CENTURY CITY

Abby L. T. Feinman, Los Angeles Head	+1.310.788.4722	abby.feinman@kattenlaw.com
Scott C. Cutrow, Associate	+1.310.788.4630	scott.cutrow@kattenlaw.com
Steven L. Guise, Of Counsel	+1.310.788.4695	steven.guise@kattenlaw.com
Carol A. Johnston, Partner	+1.310.788.4505	carol.johnston@kattenlaw.com
Casey C. Verst, Associate	+1.310.788.4612	casey.verst@kattenlaw.com

NEW YORK

Joshua S. Rubenstein, National Head	+1.212.940.7150	joshua.rubenstein@kattenlaw.com
Ronni G. Davidowitz, New York Head	+1.212.940.7197	ronni.davidowitz@kattenlaw.com
Mal L. Barasch, Of Counsel	+1.212.940.8801	mal.barasch@kattenlaw.com
Arielle L. Buss, Associate	+1.212.940.6359	arielle.buss@kattenlaw.com
Lawrence B. Buttenwieser, Of Counsel	+1.212.940.8560	lawrence.buttenwieser@kattenlaw.com
Neil V. Carbone, Partner	+1.212.940.6786	neil.carbone@kattenlaw.com
Alexandra B. Copell, Associate	+1.212.940.8588	alexandra.copell@kattenlaw.com
Lauren G. Dell, Associate	+1.212.940.6344	lauren.dell@kattenlaw.com
Marla G. Franzese, Of Counsel	+1.212.940.8865	marla.franzese@kattenlaw.com
Robert E. Friedman, Of Counsel	+1.212.940.8744	robert.friedman@kattenlaw.com
Zvi Hahn, Partner	+1.212.940.8517	zvi.hahn@kattenlaw.com
Milton J. Kain, Of Counsel	+1.212.940.8750	milton.kain@kattenlaw.com
Theresa A. Kraker, Associate	+1.212.940.6678	theresa.kraker@kattenlaw.com
Dana B. Levine, Special Counsel	+1.212.940.6668	dana.levine@kattenlaw.com
Shelly Meerovitch, Partner	+1.212.940.8680	shelly.meerovitch@kattenlaw.com
Cynthia C. Reed, Associate	+1.212.940.6710	cynthia.reed@kattenlaw.com
Arnold I. Roth, Of Counsel	+1.212.940.7040	arnold.roth@kattenlaw.com
Marianna Schwartsman, Associate	+1.212.940.8581	marianna.schwartsman@kattenlaw.com

Katten

Katten Muchin Rosenman LLP www.kattenlaw.com

AUSTIN | CENTURY CITY | CHARLOTTE | CHICAGO | HOUSTON | IRVING | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SAN FRANCISCO BAY AREA | SHANGHAI | WASHINGTON, DC