November 21, 2016

2016 Year-End Estate Planning Advisory

Overview

In 2016, 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 generation-skipping transfer (GST) tax exclusion amounts (the "applicable exclusion amounts") were initially set at $5 million, indexed for inflation. The current $5.45 million applicable exclusion amounts are set to increase to $5.49 million in 2017. 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 include 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-elect Donald Trump has proposed significant changes to the federal tax laws. We continue to monitor these proposed changes, as well as many others that the new administration has targeted, which are addressed below.

This year we also have seen some significant cases that affect planning and wealth transfer, including *Estate of Purdue v. Commissioner*, which addresses three important issues that are often on the radar of the Internal Revenue Service (IRS) for estate and gift tax audits, such as the inclusion of LLC assets in a decedent-transferor's taxable estate. Additionally, new proposed regulations may have significant impacts on both estate planning as well as estate administration. Regulations proposed in 2016 may curtail the use of minority discounts when valuing interests in closely held businesses, as well as provide clarification on basis consistency requirements for recipients of inherited property and information reporting requirements for executors.

There have been many changes at the state law level as well. For example, in 2016, many states enacted a version of the Revised Uniform Fiduciary Access to Digital Assets Act, which addresses the ability of fiduciaries to access an individual's digital assets during lifetime or upon death.

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 2016, the estate, gift and GST applicable exclusion amounts are $5.45 million. For 2017, the estate, gift and GST applicable exclusion amounts will be $5.49 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 using 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 2017. 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 $148,000 to $149,000 in 2017.

Federal Income Tax Rates

- Individual ordinary income tax rates will remain the same in 2017, with a maximum rate of 39.6%. The 39.6% tax rate will affect single taxpayers whose income exceeds $418,400, and married taxpayers filing jointly whose income exceeds $470,700. Estates and trusts will reach the maximum rate with taxable income over $12,500.
- 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 if the taxpayer's ordinary income is taxed at 10%, at 0%. 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 2017 for individuals ($200,000 for single filers, $250,000 for married filers filing jointly, $125,000 for married filers filing separately), but rises to $12,500 for trusts and estates.

Potential Republican Tax Reform

Now that Donald Trump is President-elect and Republicans have control of Congress, it is possible that new tax legislation may be passed. Trump has released his proposal for tax reform, and the House Republicans released their own proposal for tax reform in June. These proposals are markedly different from President Obama's 2017 Budget Proposal (see "**President Obama's Budget Proposal for Fiscal Year 2017**", discussed later). The following is a summary of these tax proposals, which may be considered by the new administration and Congress. Please note that these proposals are lacking in detail, so what follows is only the gist that can be gleaned to date of what may be under consideration.

Individual Income Tax

Both Trump and the House Republicans propose to reduce the number of tax brackets from seven to three, and to reduce the highest marginal rate. Both proposals call for rates of 12%, 25%, and 33%. Under Trump's proposal, the maximum 33% rate would apply at $225,000 of income for joint filers ($112,500 for single filers). Both proposals would also eliminate the alternative minimum tax (AMT) and all itemized deductions, with the exception of the deduction for mortgage interest and the charitable deduction. Trump's plan would increase the standard deduction for joint filers to $30,000, eliminate personal exemptions, and cap itemized deductions at $200,000 for joint filers ($100,000 for single filers). This cap on itemized deductions would serve to limit the charitable contribution deduction. Additionally, Trump proposes adding a deduction for child care and elder care for a dependent, which would be available for joint filers with adjusted gross income under $500,000 ($250,000 for single filers).

Trump's plan would retain the existing capital gains rate structure, with a maximum rate of 20%. Carried interest would be taxed as ordinary income. Trump's proposal would also eliminate the Net Investment Income Tax. As a result, the current top rate of 23.8% would be reduced to 20%. Under the House Republicans' proposal, interest, dividends and capital gains would be taxed as ordinary income, but subject to a 50% exclusion. This would be equivalent to taxing interest, dividends, and capital gains at half of the ordinary income rates (with a top rate of 16.5%).

Estate and Gift Tax

Both Trump and the House Republicans propose to repeal the estate and gift tax. Trump's plan proposes the imposition of capital gains tax at death on estate assets in excess of $10 million for married couples. The proposal provides an exemption for small businesses and family farms. To prevent abuse, contributions of appreciated assets into a "private charity" established by a decedent or the decedent's family would be disallowed. There is much uncertainty on whether these estate and gift tax proposals will be passed, as well as how they may be implemented. For example, the estate and gift tax could be repealed with an immediate effective date, or could take effect over a phase-out period (e.g., the phase-out that was introduced in 2001). Additionally, the estate tax may be repealed, but the gift tax may continue to apply to prevent income-shifting to lower bracket tax taxpayers.

While there may be much discussion on estate tax repeal in the coming months, there are many impediments to the passage of this legislation (including the significant complications that would result from the imposition of carry over basis and the government's loss of both estate tax and estate fiduciary income tax revenues). Historically, estate tax repeal has been unsuccessful; the estate tax repeal that was set in motion by George W. Bush did not come to fruition. Even new legislation that does repeal the estate tax may be overturned or modified to reinstitute the estate tax in the future. Due to these uncertainties, we do not recommend delaying estate planning based solely on the possibility of a repeal.

Important Cases Decided in 2016

Tax Court Holds in Estate of Purdue that LLC Assets Not Included in Estate Under §2036, Gifts of LLC Interest Qualify for Gift Tax Annual Exclusion, and Interest of Loan to Pay Estate Tax is Properly Deductible

Estate of Purdue v. Commissioner (T.C. Memo 2015-249) addresses three important issues that are often on the IRS's radar for estate and gift tax audits. In Purdue, Mrs. Purdue and her husband transferred marketable securities, an undivided interest in a building, and several additional assets to a limited liability company (LLC). In addition, Mrs. Purdue made gifts of interests in the LLC to a trust in 2002-2007, which were intended to qualify for the annual exclusion for gift tax purposes. Mrs. Purdue died in 2007. Following her death, the beneficiaries of her estate loaned money to the estate to pay estate taxes, and the estate deducted the interest payments as an expense of administration. The Tax Court issued three significant holdings. First, it held that the LLC assets were not included in Mrs. Purdue's estate under §2036 because the contribution to the LLC was a bona fide sale for full and adequate consideration. The court acknowledged that the LLC was created for the legitimate nontax reason of centralized asset management, and highlighted the significant change in management of the assets after the LLC was formed. Second, the Tax Court held that the gifts of LLC interest qualified for the gift tax annual exclusion because the donees actually received income from the LLC attributable to their membership interest. Finally, the Tax Court held that the interest on the loan was properly deductible as necessary and bona fide because the LLC was unable to obtain unanimous consent for an LLC distribution to pay the estate taxes. This case is a taxpayer victory on three issues that are frequently audited by the IRS, and provides a strong guide for the formation and operation of family entities when the entity's assets are intended to be excluded from the transferor's taxable estate.

IRS Attacks Sales to Grantor Trusts in Estate of Donald Woebling v. Commissioner and Estate of Marion Woelbing v. Commissioner

In *Estate of Donald Woebling v. Commissioner* (Docket No. 30261-13) and *Estate of Marion Woelbing v. Commissioner* (Docket No. 30260-13), the IRS attacked transactions involving sales to grantor trusts by a husband and wife. Mr. Woebling sold non-voting stock valued at $59,004,508.05 to a grantor trust in exchange for a promissory note in the principal amount of approximately $59 million. The purchase agreement contained a "defined value clause" providing that the number of shares purchased should equal the face value of the note. Two of the Woeblings sons signed personal guarantees to the trust for 10% of the purchase price. The IRS claimed that the transaction was a gift, rather than a sale, by asserting that the note should have zero value under §2702. The IRS also contested the valuation of the stock. Mr. Woebling died in 2009, and Mrs. Woebling died in 2013. Ultimately, the IRS asserted that the stock should be included in Mr. Woebling's taxable estate at a date of death value of $162.2 million. The IRS issued Notices of Deficiency for both gift and estate taxes of an aggregate of over $125 million and penalties over $25 million. On March 25, 2016, a stipulated decision was entered in the Estate of Donald Woelbing indicating that no additional gift or estate tax is due. Three days later on March 28, 2016, a stipulated decision was entered in the Estate of Marion Woelbing indicating that no additional gift tax is due, but the decision did not address estate tax. Despite the lack of published resolution to these cases, the Woebling cases serve as a reminder that the IRS highly scrutinizes sales to grantor trusts, and these transactions require careful planning.

Tax Court Approves Intergenerational Split-Dollar Life Insurance Arrangement

In *Estate of Morrissette v. Commissioner* (146 T.C. No. 11 [April 13, 2016]), the Tax Court held that an intergenerational split-dollar insurance arrangement was governed by the split-dollar final regulations and the economic benefit regime. In 2006, Mrs. Morrisette's revocable trust (the "Revocable Trust") paid $29.9 million in lump sum premium payments to three dynasty trusts (each a "Dynasty Trust") to purchase life insurance policies on the lives of her three children. A split-dollar arrangement between the Revocable Trust and each Dynasty Trust provided that upon the death of a son, the Revocable Trust would receive a portion of the death benefit equal to the greater of the aggregate premiums paid or the cash surrender value of the policy. The balance of the death benefit would be retained by the Dynasty Trust. From 2006-2009, Mrs. Morrissette reported gifts to each Dynasty Trust under the economic benefit regime. Under the economic benefit regime, the premium payor is treated as making a gift each year of the current value of the life insurance coverage (based on the carrier's rates or IRS Table 2001) minus the amount of any premiums paid by the policy owner. Additionally, under this regime, the estate of the family member owning the reimbursement right (here, Mrs. Morrissette) may receive a discount on the value of the reimbursement right included in her estate. After Mrs. Morrissette died in 2010, her estate asserted that her reimbursement right under the split-dollar arrangement, at a discounted value of $7.5 million, was includable in her taxable estate. Alternatively, the IRS characterized the arrangement as a loan and asserted that the full amount of the premium payment ($29.9 million) was a gift, resulting in a large tax deficiency. While the IRS regulations are highly technical, they generally authorize two distinct split-dollar regimes—the economic benefit regime and the loan regime—and the tax treatment depends on which regime applied. The court ultimately granted summary judgment for the Morrissette estate, concluding that the arrangement was properly taxed under the economic benefit regime because each Dynasty Trust received only the value of life insurance protection in any given year. The Morrissette case is significant because it validates the use of intergenerational split-dollar transactions without immediate gift tax liability for the upfront premium if the transaction is structured properly.

Tax Court Holds FLP Assets Includable in Transferor's Estate under §2036

In *Beyer v. Commissioner* (T.C. Memo 2016-183), the Tax Court held that the assets of a family limited partnership (FLP) were included in the transferor's taxable estate. In 2003, Mr. Beyer created two revocable trusts that funded the FLP; a "Management Trust" held the 1% general partner interest, and a "Living Trust" held the 99% limited partner interest. Six months later, Mr. Beyer (as Trustee of his revocable trust) transferred the majority of his assets to the FLP. The FLP Agreement listed 28 boilerplate purposes for the FLP's creation. Mr. Beyer retained approximately $4 million of assets outside of the FLP. In 2005, he created an irrevocable grantor trust, which purchased the Living Trust's 99% limited partnership interest with a secured note. Also in 2005, the FLP signed a restricted management agreement requiring the FLP to transfer 75% of its assets to a restricted management account with an investment advisor, which restricted any withdrawals from the account for four years. However, over time, the FLP made distributions for Mr. Beyer's benefit. In 2006, the FLP paid Mr. Beyer's gift tax liability, and, after his death in 2007, directly paid his estate tax liability to the IRS. The FLP also made quarterly interest payments on the grantor trust's secured note.

The Tax Court held that the FLP assets were included in Mr. Beyer's taxable estate under §2036(a)(1). The transfer to the FLP was not deemed to be a bona fide sale for full and adequate consideration. While the nontax reasons for creating the FLP were said to be keeping Mr. Beyer's stock and investment portfolio intact and providing management transition and continuity, these reasons were not stated in the FLP's governing documents. Neither these reasons nor the boilerplate reasons listed in the FLP Agreement were deemed to be legitimate and significant nontax purposes for the FLP's creation in this case. The court also held that the FLP failed to maintain and administer proper capital accounts. Finally, due to the actual distributions made to Mr. Beyer and on behalf of his estate, and because Mr. Beyer did not retain sufficient assets outside of the FLP, the court held that Mr. Beyer had an implied agreement of retained enjoyment of the transferred property. This case highlights the need to have and properly articulate legitimate nontax reasons for the creation of family limited partnerships and to strictly abide with the formalities of the entity structure.

Important Planning Considerations for 2016 and 2017

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 may be eliminated by the new administration's tax reform.

You should continue to be cautious in relying on portability for your estate planning, as portability may not be the most beneficial strategy based on your personal situation. In addition, a deceased spouse's DSUE may 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 to accurately 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 $12,400 (or $12,500 in 2017) 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 $5.45 million ($10.90 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 previously have 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 making 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 exercise caution before making gifts of low basis assets. Instead, those individuals 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 $40,000 ($80,000 for a married couple) in 2017. Therefore, even if you use some or even all of the applicable exclusion amount available to you before the end of 2016, you may still make additional gifts in 2017 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 presidential budget proposals frequently call for 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, 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 2016 is 1.6%). 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 Intentionally Defective Grantor Trusts (IDGTs)

Because presidential budget proposals frequently call for elimination of the benefit of IDGTs, 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 2016 is as low as 0.68% 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.

Consider Planning Using Valuation Discounts

On August 2, 2016, the United States Treasury Department issued long-awaited proposed regulations under Internal Revenue Code (hereafter, the "Code") §2704, which would have the effect of limiting 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. The proposed regulations seek to curtail the use of minority discounts when valuing these interests. The proposed regulations are discussed in full detail below (see "***Valuation of Transfers of Closely Held Business Interests***"). While the effective date of these regulations is still unknown as of the date of this advisory, there is still time to take advantage of existing estate planning techniques with closely held businesses.

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. Clients whose estates may not be subject to estate taxes due to the current high exemption amounts may utilize swaps or buy-backs to "undo" prior planning strategies that are no longer needed in today's environment.

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 (1.6% for November 2016), those assets can pass transfer tax free to the beneficiaries you choose.

The Qualified Charitable Distribution rules were made permanent by the Tax Hikes (PATH) Act of 2015 on December 18, 2015. The PATH Act permanently extended the ability to make IRA charitable rollover gifts, which allow an individual who is 70-1/2 or over to make a charitable rollover of up to $100,000 to a public charity without having to treat the distribution as taxable income. Other types of charitable organizations, such as supporting organizations, donor advised funds, or private foundations, are not eligible to receive the charitable rollover. Therefore, if you need to take your required minimum distribution for 2016, you may arrange for the distribution of up to $100,000 to be directly contributed to your favorite public charity and receive the income tax benefits of these newly permanent rules.

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 2016

In addition to the above planning ideas, consider the following before 2016 is over:

- 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 (including charitable IRA rollovers) before year-end to use the deduction on your 2016 income tax return.

Below is an overview of national, international and local developments that occurred in 2016.

Important Legislation in 2016

Tax Hikes (PATH) Act of 2015

Though passed on December 18, 2015, the PATH Act has implications on 2016-2017 estate planning, including the following:

- The PATH Act permanently extended the qualified charitable distribution rules. As discussed above, this extension allows an individual who is 70-1/2 or over to make a charitable rollover of up to $100,000 to a public charity without having to treat the distribution as taxable income.
- The PATH Act also made changes to the legislation on Section 529 Plans. Qualified higher education expenses will now include computer equipment and related expenses (such as software and internet access). Additionally, the tax treatment of non-qualifying distributions will be based only on the amount of gain in a specific Section 529 Plan account, rather than aggregating all Section 529 Plan accounts.
- The PATH Act also addressed valuation rules upon early termination of charitable remainder unitrusts with a net income limitation (NIMCRUT or NICRUT) that apply to the unitrust amount distributable to non-charitable beneficiaries during the lead term of the trust. Under existing law, the income limitation cannot be considered in valuing the charitable remainder at the creation of the trust. Reversing the IRS's prior position, the PATH Act provides that the net income limitation also cannot be considered in valuing the charitable remainder if the trust is terminated early to determine the actuarial value of the unitrust (non-charitable) interest.

Definition of Married Couples

Final regulations were issued effective September 2, 2016 to define marital status for the purpose of federal tax laws. Under the final regulations, marriages of couples of the same sex are to be treated the same as marriages of couples of the opposite sex for federal tax purposes. These Regulations reflect the holdings of the US Supreme Court in *Obergefell v. Hodges* and *Windsor v. United States*.

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 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 was delayed until June 30, 2016.

Temporary and proposed Regulations were published on March 4, 2016, which provide guidance regarding the basis consistency rules and information reporting requirements, including: (1) the reporting requirement does not apply to estates that are not required to file an estate tax return but do so to make a portability election; (2) property qualifying for the marital or charitable deduction is not subject to basis consistency requirements, but is subject to reporting requirements; (3) tangible personal property of which an appraisal is not required for federal estate tax purposes (i.e., tangible personal property that does not have a marked artistic or intrinsic value over $3,000) is not subject to the basis consistency nor reporting requirements; and (4) property that is omitted from the return or discovered after filing receives a zero basis unless the property is reported on an estate tax return before the period of limitations on assessments has expired. The regulations also provide guidance on which information may be omitted on an information return provided to beneficiaries (e.g., cash, income in respect of a decedent, tangible personal property discussed above, and property sold before the information reports are due), what property an executor must disclose on the information return to a beneficiary prior to distributions, as well as who should receive the information return on behalf of a trust-beneficiary. Additionally, the regulations impose reporting requirements on certain beneficiaries/recipients: if the recipient of an estate asset makes a subsequent gift or distribution to a "related transferee" (including a grantor trust as to the recipient), the recipient also must file an information return with the IRS and the transferee reporting the ownership change and final estate tax value of the property. These regulations will be effective when finalized, but may be relied upon prior to final publication.

Valuation of Transfers of Closely Held Business Interests

On August 2, 2016, the Treasury Department issued proposed regulations under the authority provided in Code §2704(b). Code §2704 provides certain rules for valuing intra-family transactions of closely held business interests.

Under the current §2704, "lapses of voting or liquidation rights are treated as a transfer of the excess of the fair market value of all interests held by the transferor, determined as if the voting or liquidation rights were non-lapsing, over the fair market value of such interests after the lapse." However, the exceptions to §2704 limit the effectiveness of the general rule. For example, if an individual relinquished liquidation control of a closely held family business on his death bed, and if the transferred shares had the same rights as prior to the transfer, the general rule would not apply. Effectively, the individual would receive a discount in his estate on the retained shares (as he no longer had liquidation control) simply because he transferred a certain amount of shares immediately prior to his death. Additionally, the transfer would not be defined as a lapse of a right under §2704 because the transferred shares had retained all of the same rights as before the transfer.

There are many other exceptions in the regulations that allow a well-planned transaction to circumvent application of §2704. Appraisers were able to value the interests transferred (or, conversely, the interest retained) at a discount to the going-concern value of the business. For decades, the IRS has sought to curtail the use of minority discounts when valuing interests in closely held family businesses. The IRS largely lost the valuation battles, both in the courts and legislatively. Left with unfavorable case law and a Congress unwilling to act upon the IRS's advice to curtail the use of minority discounts in the areas of gift tax, estate tax and generation-skipping transfer tax, these proposed regulations are an administrative solution to curtail the use of these discounts.

The proposed regulations would curtail the use of the "death-bed" transfer as described above by adding a three-year lookback period. Under the new proposed rule, transfers within three years of death will be disregarded in determining the value of the interest held by a decedent's estate. Accordingly, only de-controlling transfers made more than three years before death may be considered in determining the value of a decedent's interest.

Section 2704 also uses the term "applicable restriction" to define certain aspects of interests in a closely held family business that will be disregarded for purposes of determining the value of such interest for transfer tax purposes. An "applicable restriction" is defined by §2704(b)(2) as a restriction that effectively limits the ability to liquidate the entity. However, the rule previously only applied if that restriction was more restrictive than the limitations that would apply under state law. States revised the applicable statutory restrictions so that state law would provide a default rule concerning liquidation, but allow other liquidation rights to be established in the entity's operational agreements. To remedy the issue, the IRS now determines that an applicable restriction only exists if the restriction is mandatory under state law, effectively eliminating the exception to "applicable restriction" for reliance on state law.

With the proposed regulations, the IRS has created a new classification of restrictions on closely held business interests that will not be considered when valuing those interests. Case law interpreting §2704 has held that the application of §2704 is permissible only when dealing with the liquidation rights of the entity as a whole, as opposed to the liquidation rights that may be present with regard to individual interests in the entity. The proposed new class of "disregarded restrictions" deals with individual interests in the entity. In essence, the regulations constructively create a "put right" for all interests in an entity which, prior to a transfer, was controlled by the family, and after the transfer restrictions on liquidation or transfer could be removed by family members or lapse by their inaction. This has the practical effect of completely eliminating many discounts, as the owner of a minority interest would have a "deemed" right to liquidate the interest at any time. Additionally, the IRS would disregard certain other restrictions on the manner and form of the payout on the exercise of a put right. This new group of "disregarded restrictions" severely limits many of the techniques currently used for obtaining a minority discount upon the transfer of minority interests in closely held family businesses.

While these much-anticipated proposed regulations could become final as early as the beginning of 2017, they are sufficiently controversial that it may be years before they become final. Since the issuance of the proposed regulations, there has been public outcry by practitioners and estate planning professionals on their overreaching scope and the potential impacts on valuation discounts for family-owned businesses. Congressional legislation has even been introduced to nullify the proposed regulations and cut federal funding for their enforcement. Due to the sweeping nature of the proposed regulations, the objections by the professional community and Congress, as well as the outcome of the election, it seems unlikely that the proposed regulations will become effective in their current form in the short term.

IRS Changes to Issuance of Estate Closing Letter

On June 16, 2015, the IRS quietly announced on its "Frequently Asked Questions on Estate Taxes" webpage (the "FAQ Webpage") that it would no longer be automatically issuing Estate Closing Letters (IRS Letter 627), in contrast to its historical practice. The change is effective for estate tax returns filed on or after June 1, 2015. Subsequent modifications to the FAQ Webpage on November 2, 2015 and then again on December 4, 2015 have provided further guidance.

Obtaining the Estate Closing Letter has been an important and necessary step in administering a decedent's estate for many reasons. Most notably, the Estate Closing Letter signals to the Personal Representative that a US Estate (and Generation-Skipping Transfer) Tax Return (IRS Form 706) (an "Estate Tax Return") has been accepted as filed or has been accepted after an adjustment to which the taxpayer agreed. Until the Estate Closing Letter was issued, the Estate Tax Return remained under review by the IRS and potentially subject to audit. Therefore, a Personal Representative is advised to retain a portion of the estate's assets until an Estate Closing Letter is issued in order to have sufficient funds to pay any unexpected federal estate tax liabilities that might arise. The IRS would usually issue an Estate Closing Letter within four to six months of the filing of an Estate Tax Return, unless the return was selected for further review.

Instead of automatically issuing Estate Closing Letters for all Estate Tax Returns, an Estate Closing Letter must now be affirmatively requested by the Personal Representative by calling the IRS and providing the IRS with the name of the decedent, the decedent's social security number and the date of death of the decedent. The IRS asks that Personal Representatives not request an Estate Closing Letter until four months after filing the Estate Tax Return to allow time to process the return. Alternatively, the Personal Representative, or an authorized representative of a taxpayer or registered tax professional, may obtain an account transcript of the estate, which will now reflect that an Estate Tax Return has been accepted and that any examination of the return has been completed (i.e., the account transcript will bear transaction code 421 and note "closed examination of tax return"). If transaction code 421 does not appear on the transcript, the return remains under review by the IRS. The transcript can be obtained using IRS Form 4506-T or online using the IRS' Transcript Delivery Service.

Some practitioners have been slow to utilize the new "transcript" in determining the progress of the IRS' review of an Estate Tax Return for fear that an account transcript of an estate is not equivalent to an Estate Closing Letter. For example, the Code and the regulations thereunder make reference to the Estate Closing Letter; a technical reading of those provisions does not include an account transcript. Additionally, some state laws make reference to the Estate Closing Letter (e.g. a probate proceeding cannot be closed until an Estate Closing Letter has been issued). Again, to the extent that the account transcript is not equivalent to an Estate Closing Letter, there may be issues in closing state probate proceedings.

It is widely suspected that the change in the procedure for obtaining an Estate Closing Letter is a result of an increase in the number of Estate Tax Returns filed without any attendant estate tax liability. Specifically, due to a regulatory requirement under §2010 of the Code, a deceased spouse's Personal Representative must file an Estate Tax Return as a condition to porting any of the decedent spouse's unused federal estate tax exemption amount (often referred to as "DSUEA") to the surviving spouse. As a result, the IRS has seen a significant number of Estate Tax Returns filed merely calculating and requesting portability of DSUEA. To curtail the administrative burden of issuing an Estate Closing Letter for all Estate Tax Returns filed (i.e., even the Estate Tax Returns filed for the sole purpose of porting DSUEA), the IRS now requires Personal Representatives to affirmatively request the Estate Closing Letter, or affirmatively obtain an account transcript.

President Obama's Budget Proposal for Fiscal Year 2017

Though a change in the administration is forthcoming, earlier in 2016, President Obama released a budget proposal for Fiscal Year 2017, which includes a number of transfer tax-related items. Many of these items have been proposed in prior years, and the most relevant of these items 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, put 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. Similar to the 2016 proposal, the 2017 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. Under the 2017 proposal, the proposal would be effective with respect to plan participants and IRA owners dying after 2016, and would apply to Roth IRAs only if the owner reached age 70-1/2 after 2016 and to owners who die after 2016 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.

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 2016 or who die after 2016 before attaining age 70-1/2.

Reduce Exclusion Amounts and Increase Tax Rate

As was the case in the 2014-2016 proposals, the 2017 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. The current proposal moves the effective date of the return to 2017.

Change the Treatment of IDGTs

The budget proposal again contains a provision that would significantly 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 requiring consistency in value of basis for estate and income tax values for inherited property (but not for gifted property) was signed into law on July 31, 2015, and is discussed below. The 2015 legislation did not enact the provision applying basis consistency to gifts, nor to estates paying no estate tax due to the marital deduction. The 2017 proposal would expand the basis consistency rules to both of those situations.

Impose New Requirements for Grantor Retained Annuity Trusts (GRATs)

As in prior years, 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).

Treat Gifts and Bequests as Realization Events

This proposal would cause an immediate realization of gain for income tax purposes upon making gifts or upon death. The proposal would also eliminate the stepped-up basis that is available at death, which currently allows an heir or beneficiary to receive the decedent's basis in an asset for income tax purposes.

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 rather than just 10 years after the date of death.

Increase Capital Gains Rates

The proposal would increase the maximum rate on capital gains and qualified dividends to 25% (which includes the 3.8% tax on net investment income).

Revise Charitable Deduction Limitations

Under the proposal, a 50% contribution limitation would apply for contributions of cash to public charities, but a 30% contribution base limitation would apply to all other contributions (except for qualified conservation contributions, which are subject to special rules). The 30% limitation would no longer depend on the type of the recipient charitable organization or the type of property contributed, or on whether the contribution was to or for the use of the organization. In addition, the proposal would extend the carryforward period for excess contributions from five years to 15 years.

It is impossible to say which, if any, of these proposals, may ever be enacted, especially due to the impending change in administration. However, it is important to keep in mind those areas targeted by the current administration and consider whether planning prior to possible enactment would avoid changes imposed by any new legislation.

International Developments in 2016

<u>New Filing Deadline for FBAR Forms</u>

FinCEN Reports 114 ("FBAR") for taxable years beginning after December 31, 2015, are now due April 15. Similar to individual income tax returns, FBARs will be allowed a maximum six-month extension for a due date of October 15. 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.

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.

UK Tax Reform

The UK government has published legislation that affects the imposition of inheritance tax (IHT) on UK residential property, as well as shortens the amount of time after which an individual may become deemed to be domiciled in the UK. Currently, UK non-domiciliaries can shelter UK assets from IHT by holding them through foreign entities. As a result, the property is "excluded property" outside the scope of IHT. The new legislation would bring shares in foreign companies and similar entities within the scope of IHT if the value of any interest in the entity is derived from residential property in the UK.

Additionally, the UK will now treat any individual who has been resident in the UK for at least 15 of the past 20 tax years as deemed domiciled in the UK for tax purposes. Once deemed UK domiciled, an individual will no longer be able to use the remittance basis of taxation, and their foreign and UK assets will be subject to IHT. The new legislation will take effect on April 6, 2017.

Common Reporting Standard (CRS)

The Common Reporting Standard (CRS) is part of an initiative introduced by the Organisation for Economic Co-operation and Development (OECD) aimed at facilitating the exchange of financial information on a global scale. Introduced in 2014, the new standard will be implemented by 54 countries who have committed themselves to the initial exchange of information by September 2017, with an additional 47 countries committed to the initial exchange by September 2018. Under the new standard, the financial institutions of the subscribing jurisdictions will be required automatically to exchange information such as the identity and nationality of the ultimate beneficial owners of accounts in the country and the account balances at the end of the relevant fiscal year. Noticeably absent from the long list of countries that have signed on to the CRS is the United States. According to the OECD, the United States has indicated that it intends to create a similar free flow of financial information by supplementing the provisions of the Fair and Accurate Credit Transactions Act (FACTA) with intergovernmental agreements (IGAs) requiring reciprocal automatic exchange with partner jurisdictions, but whether or not, and if so how soon, the United States does so remains to be seen.

Final Regulations on Controlled Foreign Corporations

The IRS issued new final regulations concerning the amount that a United States shareholder of a controlled foreign corporation (CFC) must include in gross income with respect to the CFC. Under Code §956, this includable amount is determined in part based on the average amount of US property held (either directly or indirectly) by the CFC at the close of each quarter during its taxable year. In an effort to prevent avoidance of §956 through indirect investments by entities controlled by the CFC, the final regulations state that in certain circumstances, property held by the CFC may include US property held by any other foreign corporation or partnership that is controlled by the CFC. The final regulations also provide an aggregate rule whereby, effective for property acquired after November 3, 2016, the CFC is generally deemed to own its proportionate share of US property held by a partnership in which the CFC is a partner. The CFC's interest in the partnership for purposes of §956 generally shall by measured by the CFC partner's liquidation value percentage, rather than its interest in partnership profits. Additionally, the final regulations treat an obligation of a foreign partnership as an obligation of its partners in proportion to the partners' liquidation interest in partnership. These rules are generally effective for taxable years ending on or after November 3, 2016, with some provisions having retroactive applications.

Local Developments in 2016: State-Specific Considerations

California

End of Life Option Act

California enacted the End of Life Option Act (taking effect on June 9, 2016), which permits terminally ill adult patients with capacity to make medical decisions to be prescribed an aid-in-dying medication if certain conditions are met. To be eligible to request a prescription for the aid-in-dying drugs, an individual must: (1) be an adult, (2) be a California resident, (3) have a diagnosis from his/her primary physician of an incurable and irreversible disease that will, within reasonable medical judgment, result in death within six months, (4) be able to make medical decisions for themselves as determined by health professionals, (5) voluntarily request a prescription for an aid-in-dying drug without influence from others, and (6) be able to self-administer the aid-in-dying drug.

California Resale Royalty Act Preempted by Federal Law

On April 11, 2016, in *Estate of Robert Graham v. Sotheby's Inc.*, the Federal District Court for the Central District of California held that the California Resale Royalty Act is entirely preempted by federal copyright law. The California Resale Royalty Act was passed in 1976 and requires resellers of fine art to pay a royalty of 5% to the artists behind the works. The Act was already partially invalidated by a Ninth Circuit decision in May 2015 which held that a portion of the law that extended to sales that took place out of the state of California violated the commerce clause of the US Constitution. As a result of this decision, the entire law has been determined to be unconstitutional. The case has been appealed to the Ninth Circuit.

Child Support Orders May Attach to Irrevocable Trusts

In *Pratt v. Ferguson*, the court held that an order for child support payments could be satisfied from an irrevocable trust for the benefit of the debtor, even though the trust contained a "shutdown" clause that prohibited distributions by the trustee if such distributions would be subject to claims of creditors. Specifically, the court held that California Probate Code Section 15305, which gives the court discretion to order a trustee to make distributions of income and principal to satisfy child support orders, takes precedence over the "shutdown" clause in the trust instrument. The court also found that Code of Civil Procedure Section 709.010 gives the court discretion to direct the trustee to satisfy a community property judgment lien from the debtor/beneficiary's share of the trust.

Record Title on Real Property Not Necessarily Determinative of Testamentary Intent

In *Carne v. Worthington*, certain real property was determined to be a trust asset even though record title was vested in the name of a different trust. The decedent executed a revocable living trust in 1985 (the "1985 Trust") and another revocable living trust in 2009 (the "2009 Trust"), which contained different testamentary dispositive provisions. Title to certain real property (the "Real Property") was held by the 1985 Trust, but the 2009 Trust stated that the property listed on Schedule A to the 2009 Trust, which listed the Real Estate, was transferred to the 2009 Trust. The court held that the language of the 2009 Trust was sufficient to convey the Real Property to the 2009 Trust, and the decedent was not required to execute a deed from the 1985 Trust, notwithstanding that record title was in the 1985 Trust. The court found that even though the decedent did not own the Real Property individually at the time of execution of the 2009 Trust, because the 1985 Trust was a revocable living trust and the decedent owned the property as sole trustee of the 1985 Trust, he had the power to transfer the Real Property to the 2009 Trust.

<u>Court Cannot Compel Accounting of Revocable Trust to Third Party</u>

In *Babbitt v. Superior Court*, the Court held that where a trust was divided upon the death of a spouse into two subtrusts, one of which remained revocable by the surviving spouse and the other of which became irrevocable, a remainder beneficiary of the trust can compel an accounting only of the irrevocable subtrust and was not entitled to an accounting of the subtrust that remained revocable by the surviving spouse.

Illinois

<u>Revised Uniform Fiduciary Access to Digital Assets Act</u>

Effective August 12, 2016, Illinois enacted the Revised Uniform Fiduciary Access to Digital Assets Act (RUFADAA). RUFADAA, which has been enacted in 20 states (including Illinois) and introduced in another 12 states, governs a fiduciary's access to the digital assets and electronic communications of another. Until the enactment of RUFADAA there had been a tremendous amount of variance in the laws of the different states governing access and authority to access the digital assets and electronic communications of another. Importantly, prior to the enactment of RUFADAA, laws in many states (including Illinois) failed to account for the "internet age" (i.e., assets that may be held in exclusively digital or electronic form) and the increased privacy concerns that this new age brings. RUFADAA brings clarity to handling and accessing these digital and electronic assets and specifically attempts to balance a user's privacy interest with a fiduciary's need for access to digital assets and/or electronic communications.

RUFADAA grants a fiduciary access to digital assets if the original account holder expressly consented (i.e., made some sort of affirmative action) to the disclosure (such as in a will, trust, power of attorney or other record). Under RUFADAA, if the original account holder has not given express directions regarding disclosure to the fiduciary after death, the service provider's terms-of-service agreement will control.

In addition to providing rules for accessing digital assets, RUFADAA also provides legal protection for fiduciaries. Federal and state laws criminalize or create civil liability for the unauthorized access of digital assets. For example, a person would violate Illinois' computer tampering law if that person accessed a computer, program or data without the authorization of the computer's owner or in excess of authority granted. The Federal Stored Wire and Electronic Communications and Transactional Records Access Act also prohibits certain digital asset providers, like Facebook and Google, from disclosing electronic communications to anyone unless an exception applies, and there is no explicit exception for fiduciary access upon death or disability.

<u>Transfer of Real Property to Trust</u>

Effective January 1, 2017, the Trusts and Trustees Act will be amended to clarify that the transfer of real property to a trust requires a written instrument of conveyance that is accepted by the Trustee. Additionally, if the transferor of property to a trust is a Trustee of the Trust (which is the case for a substantial majority of revocable trusts), the real property does not become an asset of the trust unless the written instrument of conveyance is also recorded in the county in which the property is located. This amendment to the Trusts and Trustees Act is intended to statutorily overturn the holding in the 2015 decision concerning *Estate of Mendelson* ("*Mendelson*"), in which the Appellate Court of Illinois held that a grantor who declares a trust naming herself as trustee is not required to separately and formally transfer real property into the trust in order for the real property to be an asset of the trust. The result in *Mendelson* was subsequently overturned in a later decision concerning the same case, although the holding from *Mendelson* remained viable. This amendment to the Trusts and Trustees Act statutorily overturns the holding in *Mendelson*.

Guardians for Adults with Disabilities

Effective January 1, 2017, the Probate Act of 1975 will be modified with respect to notification and visitation of a ward's adult children. On and after the effective date, the guardian of a ward must use reasonable efforts to notify the ward's adult children who have requested notification and have provided contact information, of the ward's admission to a hospital or hospice program, the ward's death and the arrangement for the disposition of the ward's remains. Additionally, the modification provides that if the guardian unreasonably prohibits a ward's adult children from visiting the ward, the ward's adult children may petition the court for visitation rights, which will be granted if visitation of the ward's adult children is in the ward's best interests.

Illinois Transfer Tax Return

Effective July 15, 2016, an Illinois transfer tax return must be filed only with the Illinois Attorney General. Prior to July 15, 2016, an Illinois transfer tax return was required to be filed with both the Illinois Treasurer and the Illinois Attorney General.

Duty of Successor Agents

In a case of first impression, the Illinois Appellate Court of Illinois in *Estate of Shelton* held that a successor agent named in a power of attorney document does not have a fiduciary duty to the principal until he or she becomes the acting agent. The court held that "it is the power to act as a principal's attorney-in-fact that creates a fiduciary duty as a matter of law. Until that power is actually conferred, there can be no corresponding fiduciary duty to use that power for the principal's benefit." Contrarily, however, the court also interpreted provisions of Illinois statutory law to create a statutory duty on behalf of successor agents to notify the principal and, if the principal is incapacitated, to take whatever actions may be reasonably appropriate in the circumstances to safeguard the principal's best interest, if the successor agent has knowledge of a breach or imminent breach of fiduciary duty by another agent.

Attorney-Client Privilege

It has long been settled in Illinois that the attorney-client privilege extends beyond the death of the client. A long-held exception to the attorney-client privilege concerns testamentary dispositions. That is, a party with an interest in the property of an estate had a right to view estate files after the decedent's death. The State of Illinois has consistently upheld this exception in the context of a decedent's last will and testament, but has never had occasion to apply this exception in the context of a testamentary trust. In *Eizenga v. Unity Christian School of Fulton*, the court finally had occasion to determine whether the exception to the attorney-client privilege for testamentary dispositions applied in the context of trusts. The court held that, like a will, the files concerning testamentary dispositions made in a revocable trust are not attorney-client privileged after the client's death with respect to parties interested in the assets of such trust.

New York

Digital Assets

Effective September 29, 2016, New York enacted a new statute to deal with the administration of digital assets, which are defined to embrace an electronic record in which an individual has a right or an interest. The Estates, Powers and Trusts Law has been amended to add a new article 13-A to deal with the administration of digital assets, which are defined to embrace an electronic record in which an individual has a right or an interest. Electronic records, in turn, are defined to relate to technology having electrical, digital, magnetic, wireless, optical, electromagnetic or similar capabilities.

The new law applies to (1) fiduciaries acting under a will, trust or in the case of a power of attorney, where specifically authorized by such instrument, executed before, on, or after the effective date of this new law, (2) an executor, administrator or personal representative acting for a decedent who died before, on, or after the effective date of this new law, (3) a guardianship proceeding started before, on, or after the effective date of this new law, (4) a custodian (person who carries, maintains, processes, receives, or shares digital assets of a user) if the user resides in New York or resided in New York at the time of death of the user. Specifically, the law does not apply to any digital asset used by an employee in the ordinary course of an employer's business.

A user may use an online tool to direct a custodian to reveal some or all of the user's digital assets, including the content of any electronic communication. If the online tool allows for modification of any instructions at all times, the online tool takes precedence over any contrary direction in a will, trust or power of attorney. If the user did not give any direction on an online tool or if no online tool was offered by the custodian, a will, trust or power of attorney may designate a fiduciary to receive or prohibit a fiduciary from receiving any or all of the user's digital assets, including the content of any electronic communication. Note that these provisions do not give either the user or the custodian any greater right than exists in a terms-of-service agreement.

If a deceased user had consented to disclosure or a court so orders disclosure, upon receipt of (1) a written request in physical or electronic format, (2) a death certificate of the user, (3) a certified copy evidencing fiduciary appointment and (4) where relevant, a copy of the governing instrument, the custodian must make disclosure.

The law specifically enumerates a fiduciary's duty of loyalty and care in administering a user's digital assets, including a duty of confidentiality.

Guardian for a Person Who Is Intellectually Disabled

Effective July 21, 2016, New York expanded the Surrogate's Court Procedure Act provisions relating to when a guardian of a person may be appointed to include persons who are intellectually disabled. This is in direct response to the unfortunate litigations surrounding some well-known celebrities, including Peter Falk of "Colombo" fame. A guardian of an intellectually disabled person may make health care decisions for such an individual, including decisions to withhold or withdraw life-sustaining treatment or nutrition and hydration. The guardian must act in good faith in coming to any decision.

Section 1751, et. seq. of the Surrogate's Court Procedure Act was amended to conform to the changes in Section 17-A to reflect that a petition for appointment of a guardian may be brought for a person who is intellectually disabled and that such petition must include detailed information set forth in the statute. Section 1757 extends the concept of an intellectually disabled person to standby guardians.

Service of Process in Limited Liability Corporations and Limited Liability Partnerships

Effective June 1, 2016, New York modified its Surrogate's Court Procedure Act Section 307 to include CPLR 310-a and 311-a referencing limited liability corporations and limited liability partnerships.

Changes to Not-for-Profit Law

Effective July 21, 2016, Section 404 of the Not-for-Profit Corporation Law is amended to require the consent of the adjutant general for every certificate of incorporation of a corporation whose purpose is to solicit funds or other benefits for the US Armed Forces or of any foreign country or its auxiliary, or of this or any other state or territory.

Effective September 26, 2016, a new paragraph was added to Section 1502 of the Not-for-Profit Corporation Law to define "pet cremated remains" to mean the ashes or other residue of any domestic animal after cremation in a pet crematorium. Section 1510 of the Not-for-Profit Corporation Law was amended to allow interment of pet cremated remains with a lot owner provided that written authorization from a cemetery corporation was obtained in advance of such burial. This section does not apply to religious unincorporated or incorporated cemeteries, religious associations or societies.

Civil Practice Law and Rules

Effective August 19, 2016, Section 4503 of the Civil Practice Law and Rules is amended to extend the exception to attorney-client privilege disclosure to, after a grantor's death, revocable trusts in any contested probate action.

Tax Law

Effective June 30, 2016, New York made technical changes to the Tax Law to amend Chapter 538 of the Tax Law to extend from July 1, 2016 to July 1, 2019 the provisions eliminating the need to create a qualifying domestic trust (QDOT), where no federal estate tax return is required. This is a technical amendment to avoid any confusion on a premature sunset of earlier changes.

Domestic Relations Law

Brooke S.B. v. Elizabeth A.C.C., No. 91, NYLJ 120276631212 at 1 and *In the Matter of Estrellita A., Respondent v. Jennifer L.D.*, Appellant No. 92 decided by the New York Court of Appeals expanded the definition of parent embodied in New York's Domestic Relations Law Section 70 to include a non-biological, non-adoptive parent and to allow such individuals to petition for custody and visitation of a child. Best interests of the child prevail.

North Carolina

On June 23, 2016, North Carolina enacted the Revised Uniform Fiduciary Access to Digital Assets Act (NC RUFADA) in Session Law 2016-53, which allows individuals to determine who can access their digital assets during lifetime or upon death. NC RUFADA allows digital account holders to provide directions in their powers of attorney, wills or trusts instructing custodians to disclose or not disclose their digital assets to the fiduciaries named in those documents. Owners of digital assets may use the online tools, where available, to direct custodians on the management of digital assets upon death or to name a "designated recipient" who may have access to or receive information on those assets. The online tools take precedence over instructions provided in a legal document. Under NC RUFADA, individuals may supplement the use of online tools by specifically consenting to a fiduciary's access of digital assets. Without consent, a fiduciary may still be able to access a "catalogue" of digital assets (e.g., the "to", "from", and subject lines on emails) with additional information or possibly court approval. However, providing authority in an online tool or legal document is necessary to allow the fiduciary to access the "content" of digital assets (e.g., the substance of the communications), but, even then, this access may still require additional information or court approval.

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

Diane B. Burks, Special Counsel	+1.704.344.3153	diane.burks@kattenlaw.com
Joseph R. Shealy, Associate	+1.704.344.3076	joseph.shealy@kattenlaw.com
A. Victor Wray, Of Counsel	+1.704.444.2020	victor.wray@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
Kelli Chase Plotz, Special Counsel	+1.312.902.5347	kelli.plotz@kattenlaw.com
Bonita L. Stone, Partner	+1.312.902.5262	bonita.stone@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 Feinman, Los Angeles Head	+1.310.788.4722	abby.feinman@kattenlaw.com
Whitney M. Schwartz, Special Counsel	+1.310.788.4514	whitney.schwartz@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
Lawrence B. Buttenwieser, Of Counsel	+1.212.940.8560	lawrence.buttenwieser@kattenlaw.com
Jonathan C. Byer, Associate	+1.212.940.6532	jonathan.byer@kattenlaw.com
Neil V. Carbone, Partner	+1.212.940.6786	neil.carbone@kattenlaw.com

Alexandra 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
Milton J. Kain, Of Counsel	+1.212.940.8750	milton.kain@kattenlaw.com
Dana B. Levine, Special Counsel	+1.212.940.6668	dana.levine@kattenlaw.com
Cynthia C. Reed, Associate	+1.212.940.6710	cynthia.reed@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