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Client Advisory

2008 Year-End Estate Planning Advisory

December 2008

In 2008 there were many developments—legislative, regulatory, case law and economic—that affect estate planning and related areas on the national, local and international levels. The Trusts and Estates Practice at Katten Muchin Rosenman LLP is pleased to provide you with a summary of some of the most significant developments and expected future developments in this critical election year, along with recommendations for you to consider for year-end.

Federal Estate, Gift and Generation-Skipping Transfer Tax Exemptions

The estate tax exemption, called the "applicable exclusion amount," will increase from $2 million to $3.5 million per person in 2009—the single biggest increase ever. In 2010, under current law, the estate tax is to be repealed—so that you may leave an unlimited amount to anyone free from estate tax. In 2011, the estate tax is scheduled to return, with only a $1 million applicable exclusion amount. It is widely expected that the law will have changed before the 2010 repeal.

The generation-skipping transfer ("GST") tax exemption, which tracks the increase in the estate tax applicable exclusion amount, will therefore also increase to $3.5 million in 2009. In 2010, the GST tax exemption will be unlimited. In 2011, the GST tax exemption is to return to $1 million, with an annual inflation adjustment.

The amount of lifetime gifts that may be made free from gift tax using the gift tax applicable exclusion amount (above and beyond the Annual Gift Tax Exclusion) remains frozen at $1 million. Even in 2010, when there is no estate tax, the gift tax applicable exclusion amount will stay at $1 million.

Federal Estate, GST Tax Rates

The top Federal estate tax and GST tax rates will remain at 45% for 2009. As stated above, current law calls for the estate tax and GST tax to be repealed in 2010, for that year only. In 2011, the estate tax and GST tax are to return, with a top rate for each of 55%. As noted, it is expected that Congress and the new administration will make changes that will eliminate the one-year repeal.

The top gift tax rate also remains at 45% for 2009. However, while the estate tax and GST tax are scheduled to be repealed, the gift tax will remain in place in 2010, with any gifts beyond the applicable exclusion amount and Annual Gift Tax Exclusion amounts subject to tax at the top individual income tax rate, which is currently 35%. However, in 2011, the top gift tax rate will return to 55%, like the estate tax and GST tax rate.

Annual Gift Tax Exclusion

Each year individuals are entitled to make gifts of the "Annual Gift Tax Exclusion Amount" without incurring gift tax or using any of their lifetime applicable exclusion amount against estate and gift tax. The amount of the annual gift tax exclusion is adjusted for inflation and will increase from $12,000 to $13,000 per donee in 2009. Thus, a husband and wife together will be able to gift $26,000 to each donee.

The amount of the Annual Gift Tax Exclusion with respect to gifts made to non-citizen spouses is also adjusted for inflation and will increase to $133,000 in 2009.

A Look into the Crystal Ball: What Will Happen to the Estate, Gift and GST Tax?

Congress tried many times over the past several years to repeal the estate tax permanently, but to no avail. In addition, there have been proposals to increase the applicable exclusion amount.

During his campaign, President-elect Obama proposed an applicable exclusion amount of $3.5 million with a top tax rate of 45% (which if passed would mean, for example, that married couples with properly planned estates could pass $7 million to their children, or anyone else, without incurring estate tax).

The inclusion of a "portability provision" has also been proposed. This would allow a surviving spouse to use both his or her own applicable exclusion amount, plus the deceased spouse's exemption to double the applicable exclusion amount available for use at the surviving spouse's death. This would be a significant change from current law, where, absent proper estate planning, any unused exemption of the first spouse to die is lost.

Additional FDIC Protection for Bank Deposits

2008 was a year of unprecedented economic turbulence. In response to concerns about the safety of bank deposits, in October 2008 the federal government announced that the Federal Deposit Insurance Corporation ("FDIC") limits on bank accounts were temporarily increased from $100,000 to $250,000 for each individual's total deposits at a banking institution. The increase is effective through December 31, 2009.

Emergency Economic Stabilization Act of 2008 (the "EES Act")

In further response to economic difficulties, on October 3, 2008, President Bush signed the EES Act into law. The following is a summary of a number of the key tax provisions of the Act:

- **Mortgage Debt Relief Extended.** Generally, when a debt is cancelled, the amount cancelled must be included in gross income. Mortgage debt that is cancelled or written down was an exception to the general rule, but the exception only applied through 2009. The EES Act extended this relief through 2012.
- **Cost Basis Reporting for Brokerage Accounts.** The EES Act requires mutual funds and brokers to provide cost basis reporting with respect to sold or redeemed fund shares acquired on or after January 1, 2012. In addition, financial companies will need to specify whether gains are short-term or long-term. Financial companies will be required to provide this information to taxpayers by February 15 of each year, instead of the usual January 31 deadline.
- **AMT Patch.** The EES Act temporarily increases the AMT exemption amounts for 2008 (Married filing jointly—$69,950; single and head of household—$46,200; married filing separately—$34,975).
- **Deduction for Tuition and Fees.** The Act extends through 2009 the tuition and fees deduction (which is worth up to $4,000, depending on adjusted gross income).
- **Charitable IRA Rollover.** The EES Act extends through 2009 the IRA charitable rollover. This provision allows individuals who have attained age 70 ½ to contribute up to $100,000 directly from their IRA to a public charity (i.e., not a private foundation or a donor-advised fund), and this amount will not be included in gross income but will count toward the individual's required minimum distribution for the year. Because this amount will not be included in income, no charitable deduction will be allowed.
- **Return Preparer Penalties.** The Small Business and Work Opportunity Tax Act of 2007 altered the standards of conduct that must be met to avoid imposition of the Section 6694(a) penalty for preparing a return which reflects an understatement of liability. Prior to the 2007 Act, the standard of conduct for undisclosed positions required to avoid a penalty was a "nonfrivolous standard." The 2007 Act raised the standard of conduct for undisclosed positions to "more likely than not" (i.e., at least 51%). One of the issues with this raising of the standard of conduct is that the standard of conduct that taxpayers themselves were subject to was a "substantial authority standard" (i.e., 40% or more). Thus, there was an inherent conflict of interest between the taxpayer and the tax return preparer. The EES Act altered the return preparers' standard of conduct so that it now mirrors the taxpayers' standard of conduct for undisclosed positions (i.e., the "substantial authority standard" or 40% or more).

Planning in an Uncertain Economy

The economic challenges that faced the nation in 2008 created much stock market fluctuation, and interest rates reached historic lows. While these changes have been unsettling, they created unique estate planning opportunities which will continue into 2009. The lower interest rates fall and the more stock prices sink, the better the environment to transfer assets with little or no gift or estate tax consequences, because a number of techniques turn on assets outperforming IRS-

assumed rates of return. For example, if the IRS assumes that an asset will earn a return of 3.4% and you have assets that are significantly depressed in value, you may transfer the "spread" between the 3.4% assumed rate of return and the actual future increase in value to your children or others with minimal or no gift or estate tax cost. There are a number of estate planning techniques which become significantly more valuable as stock prices and interest rates dip further: charitable lead annuity trusts, private annuities, sales to "defective" grantor trusts and grantor retained annuity trusts ("GRATs"). Two of the most frequently used techniques are summarized below.

GRATs

A GRAT provides you with a fixed annual amount (the "annuity") from the trust for a term of years (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 gifts made in December 2008 is 3.4%).

Because you will retain the full value of the GRAT assets, according to the IRS's assumptions, assuming you survive the annuity term, at the end of the annuity term the value of the GRAT assets in excess of your retained annuity amount will pass to whomever you have named with no gift or estate tax, either outright or in further trust.

Sales to "Defective" Grantor Trusts

Another option for transferring assets without any transfer tax is an installment sale to a "defective" grantor trust (a trust of which you would be responsible for the income taxes payable on the income generated by the assets therein, but which is not included in your taxable estate upon your death).

You would sell assets likely to appreciate in value to the trust in exchange for a commercially reasonable down payment and a promissory note for the balance. From an income tax perspective, no taxable gain would be recognized on the sale of the property to the trust because the trust is a defective 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 December 2008 is as low as 1.36%) as with a GRAT, the appreciation will pass free of gift and estate tax. An additional benefit is that this type of transaction allows you to transfer assets to your grandchildren free from GST tax.

Changes That Affect Nonprofit Entities and Charitable Giving

New Form 990 and Elimination of Advance Ruling Period

The IRS has made sweeping changes to Form 990, the annual information return that must be filed by "public charities" (generally, charities with broad-based public support, as differentiated from private foundations). The new Form 990 requires far more detailed information about the charity, its directors, its receipts and expenditures. As a result of this redesign of Form 990, the IRS is streamlining the approval process for organizations seeking tax-exempt status as publicly supported charities. New regulations will be issued which will eliminate the so-called advance rulings which granted a new public charity an initial five-year period during which it could provisionally operate as a recognized public charity. Now public charities will receive a final determination of qualification as a public charity upon approval of their application. A public charity which is currently within the five-year advance ruling period will automatically be given final status as a public charity.

Sample Forms for Charitable Lead Unitrusts Provided by the IRS

The IRS provided sample forms for use in creating lifetime and testamentary charitable lead unitrusts. These forms make it easier to create charitable lead unitrusts that will meet with IRS approval.

Final Regulations on Unrelated Business Taxable Income ("UBTI") of a Charitable Remainder Trust

Final regulations provide that charitable remainder trusts with UBTI no longer lose their tax-exempt status for income tax purposes. Rather, under the final regulations, charitable remainder trusts with UBTI remain exempt from Federal income tax; however, any UBTI for a taxable year will be subject to a 100% excise tax.

Proposed Regulations Detail Ordering Rules for Charitable Distributions from a Trust or Estate

The IRS and the Treasury proposed ordering rules under §642(c) of the Internal Revenue Code ("IRC") stating that any provisions in a will or trust instrument that purport to determine whether an amount of income paid to a charitable beneficiary includes any income not included in gross income (such as tax-exempt interest), will be disregarded unless they have substantial economic effect independent of income tax consequences.

Family Limited Partnerships

Many clients have taken advantage of family limited partnerships ("FLPs") (Family Limited Liability Companies, which are substantially similar, are also used, and are referred to here also as FLPs). FLPs provide many advantages, such as protecting assets from creditors, consolidation of family held entities with centralized management, and investment advantages as a result of investing a larger pool of assets. The value of assets held in an FLP may be substantially reduced by using lack of control and/or lack of marketability discounts. This reduction in value results in lower estate and gift tax liability.

The IRS continued throughout 2008, as it has in the past, to attack the effectiveness of FLPs, but in 2008, there were a number of court cases favorable to the taxpayer. All of the cases are quite fact-specific and a number of cases with "good" facts have recently been decided in favor of the taxpayer. When there are "bad" facts, including treatment of FLP assets as personal assets and non-pro rata distributions out of FLP funds, the IRS has continued to be successful.

Of particular note is the case of Estate of Anna Mirowski T.C. Memo 2008-74 (March 26, 2008). In that case, despite the funding of a family LLC slightly before Mrs. Mirowski's unexpected death, the Tax Court upheld the formation and funding of the LLC and, contrary to the IRS's contentions, did not find the LLC assets includible in Mrs. Mirowski's estate. The IRS argued that there was no significant non-tax business reason for the creation and funding of the LLC, that Mrs. Mirowski failed to retain sufficient assets outside the LLC, and that transfer and estate taxes were paid from LLC assets.

The Tax Court found that although the LLC activities did not constitute a "business" under Federal tax laws, there was an actual business purpose for asset management, there was no commingling of personal and LLC assets, there were no express or implied agreements among LLC members to use LLC assets to pay tax liabilities, and despite the fact that Mrs. Mirowski died shortly after the LLC was funded, her death was unexpected. The case highlights the importance of proper planning and establishing non-tax reasons for creating the entity.

We believe that FLPs are a viable and important estate planning tool for use in appropriate circumstances. However, we recommend that in addition to observing business formalities, taxpayers be sure to leave enough assets outside of the FLP to provide for the taxpayer's support.

Deduction for Trust Investment Advisory Fees Subject to 2% Floor, Supreme Court Says

On January 16, 2008, the U.S. Supreme Court held that investment advisory fees paid by a trust were subject to the 2% floor pursuant to IRC §678 (*Knight v. Commissioner*, U.S., No. 06-1286, *decided* (1/16/08)).

Following the Supreme Court decision, the IRS issued Notice 2008-32, with interim guidance regarding the deductibility of fiduciary fees. The Notice states that costs paid to an investment advisor by a nongrantor trust or estate generally are subject to the 2% floor under IRC §67(a). Final regulations, which may contain safe harbors, will be issued.

Reduced Principal Residence Exclusion Where Principal Residence Not Used Exclusively as Residence

For sales of a principal residence after December 31, 2008, the home sale gain exclusion under IRC §121 (currently $500,000 for a married couple filing jointly or $250,000 for a single person) will be reduced proportionately for the period of time a home was not used as a principal residence. The gain exclusion applies to the sale of a residence used as a principal residence for at least two of the last five years prior to the sale. If a spouse dies before the date of the sale or exchange of property, the period the surviving spouse owned and used the property includes the period such deceased spouse owned and used such property before death, provided that the surviving spouse has not remarried.

IRS Reduces Extension Periods for Certain Returns

The IRS recently issued temporary and proposed regulations that will reduce from six months to five the extension of time to file tax returns for certain businesses that generate Schedules K-1 and other statements. Requiring these statements to be issued one month earlier, generally by September 15, will provide recipients time to prepare and file returns within the extended time frames.

This change will be effective for extension requests with respect to tax returns due on or after January 1, 2009, and applies to business entities that file the following returns and forms that have a tax year ending on or after September 30, 2008:

1. Form 1065, U.S. Return of Partnership Income
2. Form 1041, U.S. Income Tax Return for Estates & Trusts
3. Form 8804, Annual Return for Partnership Withholding Tax (Section 1446)

The regulation does not change the process for requesting an extension of time to file nor does it affect extensions of time to file other types of business returns, such as those used by S corporations.

IRS Confirms That 2009 IRA Contribution Limit Remains Unchanged

The amount each individual may contribute to an IRA will remain at $5,000 for 2009.

Proposed Regulations on Private Trust Companies

Families have been using private trust companies more frequently as an alternative to individual or commercial corporate trustees. The IRS issued Notice 2008-63 to solicit comments on a proposed revenue ruling setting forth requirements for favorable tax results with respect to use of a private trust company. Tax issues, including the following, are addressed and guidance is given to avoid tax problems:

- Inclusion of the value of trust assets by reason of too much control, such as a retained power or interest or because of a general power of appointment
- Whether transfer to trusts with a private trust company serving as Trustee are completed gifts
- Treatment of a grantor or beneficiary as the owner of a trust for income tax purposes

Proposed Regulations: When IRS Will Allow Late Elections to Allocate GST Tax Exemption or Opt-Out of Automatic Allocation

The IRS and Treasury have proposed regulations explaining the procedures that a taxpayer must follow in order to be permitted to make a late allocation of GST tax exemption to a transfer or to elect out of the automatic allocation of GST tax exemption to a transfer.

Retained Power Does Not Cause Section 2036 Estate Tax Inclusion

The IRS ruled in Rev. Rul. 2008-22 that a grantor's retained non-fiduciary power to reacquire trust assets in exchange for assets of equivalent value is not a retained power to receive or control the beneficial enjoyment of the trust under IRC Sections 2036 or 2038 of the IRC, as long as (1) the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by the trustee's satisfaction that the properties acquired and substituted by the grantor are in fact of equivalent value, and (2) the substitution power cannot be exercised in a manner that shifts benefits among the trust beneficiaries. This type of power is frequently used by practitioners when creating an "intentionally defective" grantor trust, so the ruling is very helpful for estate planning purposes.

International Considerations

A number of changes to the law affecting those in the international community occurred this year, including the following:

New Expatriation Legislation

On June 17, 2008, President Bush signed new expatriation legislation unanimously passed by Congress as part of the Heroes Earnings Assistance and Relief Tax Act of 2008 (H.R. 6081) (the "Heroes Act"). There are three particularly significant new aspects of the expatriation provisions of the Heroes Act, which are summarized below.

- **"Mark-to-Market" Tax**

  The Heroes Act dramatically changes the current income tax regime applicable to certain U.S. citizens who expatriate and certain long-term U.S. residents (e.g., "green card holders") who end their U.S. residency (referred to collectively as "Covered Individuals").

  Covered Individuals are taxed under new IRC Section 877A (the "mark-to-market tax") as if their worldwide assets* had been sold for their fair market value on the day before expatriation or residency termination. New IRC Section 877A allows an exclusion for only the first $600,000 of net gain (as adjusted for inflation in future years).

  In addition, any assets held by any trust or portion of a trust that the Covered Individual was treated as owning for U.S. income tax purposes (i.e., a grantor trust) are subject to the mark-to-market tax.

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* A very limited category of assets is excluded from the mark-to-market tax and subject to special rules: certain deferred compensation items, certain tax-deferred accounts and interests in non-grantor trusts.

- **Transfer Tax**

  The Heroes Act also imposes an additional new tax of potentially far-reaching scope: Gifts and bequests to U.S. persons from Covered Individuals (beyond annual exclusion gifts, which are exempt) will be subject to the U.S. transfer tax **imposed on the U.S. transferee** at the highest Federal transfer tax rates then in effect under new IRC Section 2801.

- **Withholding from Non-Grantor Trust Distributions**

  A further change to current law is that Trustees of certain "non-grantor" trusts (i.e., trusts of which Covered Individuals or others are not treated as the owners for income tax purposes) must withhold 30% of each distribution to a Covered Individual if that distribution would have been included in the gross income of the Covered Individual if he or she were still a U.S. taxpayer.

- **Covered Individuals**

  An individual falls within the scope of the Heroes Act expatriation provisions if, as of the date of expatriation or termination of U.S. residency, (i) the individual's average annual net U.S. income tax liability for the five-year period preceding that date is $139,000 or more (to be adjusted for inflation); (ii) the individual's net worth as of that date is $2 million or more; or (iii) the individual fails to certify under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years.

  The prior tax regime applicable to expatriates and those who relinquish their long-term residency, which created an alternate 10-year tax regime, will not apply to anyone who expatriates after June 17, 2008, the date of the enactment of the Heroes Act. Those individuals who already expatriated or gave up long-term residency before the date of enactment will continue to be subject to the former 10-year tax regime.

New Rules Apply to Report Foreign Accounts

Any individual who files Form 1040 is required to check a box indicating whether they have signature authority or a financial interest in any foreign account if the aggregate value of the accounts exceeds $10,000 at any time during the calendar year. Willful failure to comply with filing requirements results in criminal sanctions and severe civil penalties—up to as much as the greater of $100,000 or 50% of the balance of an undeclared account, per year. On September 30, 2008, the IRS posted a new version of the FBAR (Form 90-22.1). The new form includes a number of substantial changes, including (i) broadening the definition of a financial account to include debit card and prepaid debit cards accounts, (ii) bringing a U.S. person who has established a foreign trust or certain foreign trusts arrangements within the ambit of the FBAR filings, and (iii) requiring significant additional information. The filings are due annually on June 30.

Amended Protocol to U.S.–Canada Income Tax Treaty

The amended Protocol to the U.S.–Canada Income Tax Treaty has been ratified and is expected to enter into force by the end of 2008. The Protocol affects the provisions which correlate the Canadian income tax and U.S. estate tax regimes to offer some relief from double taxation.

UK Rules Change

In early 2008, the UK announced new rules regarding the treatment of individuals who are residents of the UK but who are not domiciled in the UK (and/or not ordinarily resident there).

Under the new rules, resident non-domiciliaries who (a) have been resident in the UK for at least seven out of the last nine years, (b) use the remittance basis of taxation from April 6, 2008, onward and (c) have £2,000 or more of non-UK income or gains in a year will (1) lose their entitlement to UK personal tax allowances, (2) lose their entitlement to the Annual Exempt Amount for capital gains and (3) have to pay a Remittance Basis Charge of £30,000 each year.

Year-End Checklist For 2008

Consider the following before 2008 is over:

Make year-end annual exclusion gifts of $12,000 ($24,000 for a married couple).

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. If 529 Plans are prefunded this year, it should be noted that small additional amounts, due to the increase in annual gift tax exclusion amounts, will be available for use in the four future years. Pay tuition and medical expenses directly to the school or medical provider.

Consider making charitable gifts before year-end to use deduction on 2008 income tax return.

Planning Ideas For 2009

Set forth below are a number of estate tax planning ideas that you might consider in 2009.

Gift Residence or Vacation Home Using Qualified Personal Residence Trusts

A discounted and leveraged gift of a residence is possible using a Qualified Personal Residence Trust ("QPRT"). After the gift to the QPRT you can continue to reside in the residence until the QPRT ends, and even thereafter, if the property is leased back at fair market value from the new owners.

This planning is most effective when the value of the residence to be given is "low" and the IRS assumed rate of return is high. However, even though the IRS assumed rate of return is now low, housing prices are dropping across the country, which makes use of a QPRT beneficial. As a result, QPRT gifting is an important alternative to consider in 2009.

Alternatives to Section 1031 Exchanges: Gifts to Charitable Remainder Trusts

Many taxpayers owning certain kinds of appreciated real estate sell that property and "rollover" the gain, using Section 1031 of the IRC, into another property—using this "like kind exchange" to defer income taxes. However, the economy is such that taxpayers desiring to sell properties now are finding it harder to find properties to purchase to accomplish this rollover.

An alternate approach to consider is a gift of the property to a charitable remainder trust, retaining for life a payment equal to 90% of the value of the gifted property. You would be allowed an income tax deduction equal to a portion of the gifted property. (In the case where 90% of the value is retained by you in the form of lifetime payments, the deduction is equal to 10% of the value of the gifted property.)

When the charitable remainder trust sells the property it recognizes no gain or loss. When you receive payments from the charitable remainder trust, part will be taxed as income, part as capital gain, and (potentially) part will be treated as a distribution from principal of the trust and not taxable at all.

At your death, the charitable remainder trust can pay over to a family foundation, allowing your family to use those funds to accomplish the family's charitable goals.

Consider Buy-Back of Appreciated Low Basis Assets from Grantor Trusts

Some clients sold or gave (through a grantor retained annuity trust) an asset that was expected to appreciate in value. The tax planning idea that motivated them was to pass that appreciation on to trusts for their children without gift or estate tax. The children's trust that ends up owning the asset typically has a very low basis, meaning that a significant capital gains tax will be due if the trust sells the appreciated asset.

Where those plans succeeded, that appreciated asset now sits in a defective grantor trust for the children. That grantor trust has a low basis in the asset. 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 equal to the value of the appreciated asset that was repurchased, leaving the same amount to escape estate tax. Alternatively, many GRAT instruments give the grantor the power to substitute the GRAT assets with other assets, which would allow the appreciated assets to be removed from the GRAT.

The advantage is that, 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. This means that the capital gains tax on sale of that asset is eliminated. The children benefit from the grantor trust's cash—and each dollar of cash has a dollar of basis—so truly the capital gain is eliminated forever.

Use of 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.

State Specific Considerations

Discussed below are a number of state law changes that you might consider along with the Federal tax planning ideas mentioned above:

California

- The California Court of Appeal has held that the graduated probate filing fee formerly imposed on estates in California, which was based on the appraised value of the estate's assets, was in violation of the California Constitution by functioning as an estate or inheritance tax (March 2008).
- California LLCs with at least some out-of-state activity will now have their fee liability reduced by apportioning their gross receipts to sources within the state and without by the sales factor rules set forth in the California Revenue and Taxation Code (August 2008).
- Senate Bill 1264 will substantially change the enforcement of no-contest clauses in California. Although not effective until January 1, 2010, the new law will be applicable to all instruments, whenever drafted, which became irrevocable on or after January 1, 2001. Among the major changes are the following: (1) declaratory relief will no longer be available; (2) no contest clauses will only be enforceable against three specific types of pleadings; and (3) the definitions of "probable cause" and "direct contest" will be modified.

Connecticut

- Connecticut is now the third state to legalize same-sex marriage. The ruling by the state Supreme Court in *Kerrigan v. Commissioner of Public Health*, which took effect on October 28, 2008, held that state law violated the constitutional guarantees of equal protection under the law. On October 28, 2008, the Connecticut Attorney General issued an opinion stating that same-sex couples should be accorded the same tax treatment as parties to other marriages and civil unions. The Attorney General recommended that the legislature revise the state tax statues to conform accordingly.

Florida

- Chapter 2008-173 of the Laws of Florida now imposes a reporting notification requirement for a change of ownership or control of Florida real property. The property appraiser must be notified of the change within 60 days, and if the property owner fails to report the change penalties may apply.

Illinois

- **Planning for Illinois Estate Taxes**

  While (effectively) there has been a separate Illinois estate tax for many years, until recently, this Illinois tax generally went unnoticed because the Illinois tax was subtracted from the actual Federal estate taxes otherwise due; that is, it was not an additional tax (above and beyond the Federal estate tax).

  Under current law, however, Illinois resident decedents must pay both a Federal estate tax, at a current maximum rate of 45%, and a separate and distinct additional Illinois estate tax, at a current maximum rate of 16%. The combined maximum effective estate tax rate for an Illinois resident decedent is about 54%, after accounting for the Federal deduction received for the Illinois estate taxes paid.

  As noted, beginning in 2009, the Federal estate tax exemption is scheduled to increase from $2 million to $3.5 million, but the Illinois estate tax exemption is scheduled to remain at its current level, which is $2 million. For certain Illinois decedents, this disconnect could result in unintended tax consequences.

  For example, married couples often structure their estate planning documents with the intent to postpone all estate taxes until the death of the surviving spouse. However, the disconnect between the Federal and Illinois estate tax exemptions that is scheduled to occur in 2009 could result in Illinois estate taxes being due upon the death of the first spouse. This could occur if the primary focus of the estate planning documents was to postpone the payment of Federal estate taxes (and not Illinois estate taxes).

  Similarly, a client may have structured his or her estate planning documents to provide that assets with a value equal to the Federal estate tax exemption will be retained in trust for his or her children, with the remaining assets being retained in a marital trust for the benefit of the client's surviving spouse. So long as the Federal and Illinois estate tax exemptions are the same, the disposition to the children would not result in any Federal or Illinois estate

taxes at the client's death, and all such taxes would be effectively postponed until the death of the surviving spouse (or eliminated with respect to that portion of the remaining assets distributed to charity). However, in this example, beginning in 2009, Illinois estate taxes would be due in connection with the disposition to the children to the extent of the difference between the Federal estate tax exemption (i.e., $3.5 million) and the Illinois estate tax exemption (i.e., $2 million).

While in these examples (which are not intended to be all-inclusive) there may be valid reasons to pay Illinois estate taxes upon the death of the first spouse, your documents should be reviewed and your estate tax minimization goals revisited in light of this recent development.

This difference, beginning in 2009, between the Federal exemption of $3.5 million and the Illinois exemption of $2 million may necessitate a revision to the estate planning for many clients. Therefore, we recommend that all clients:

1. Review their planning prior to or early in 2009 in order to confirm that their planning includes the most flexible provisions possible in view of the discrepancy in exemption amounts between the Federal exemption and the Illinois exemption.
2. Consider whether making taxable gifts is an effective tax strategy, since there is no gift tax in Illinois (unlike under federal law).
3. Consider whether it is practical to change residency to a state that does not have a separate state estate tax (e.g., Florida).

- **Organ Donations**

  Effective January 1, 2006, a new law in Illinois created the "Organ/Tissue Donor Registry", which makes a person's wishes to be an organ donor legally binding. Additional witnesses or family consent are no longer required for donation to occur.

  If you are listed in the old registry, family consent is still required for a donation to occur. To ensure that your decision to be an organ/tissue donor is honored, you must join the new registry.

  If you desire to become or continue as an organ/tissue donor, we strongly urge you to visit the website "LifeGoesOn.com", or call 1-800-210-2106, or visit your local Secretary of State facility, in order to register regardless of any prior designations and actions you have taken (including the noting of your desires in your will, on your driver's license, etc.). In addition, we recommend that you provide copies of your new first-person consent to your physician(s), family members and/or friends, and to us, so that all are aware of your desires.

- **Marriage Constraints on Trust Beneficiaries**

  In a recent Illinois appellate court case (*In Re Estate of Feinberg*, Ill. App. Ct. 1st Dist. 2008), the court found to be invalid trust provisions which stated that a grandchild and all of his/her descendants would be considered deceased, for trust purposes, if the grandchild married outside the Jewish faith (unless the grandchild's spouse converted to the Jewish faith within one year of the marriage). The appellate court found this provision to be against public policy because it seriously interfered with and limited the right of an individual to marry a person of his/her own choosing.

  While it is not known yet whether the Illinois Supreme Court will review this case, clients with similar provisions in their estate planning documents should re-examine the impact of this case on their planning.

- **Small Trust Terminations**

  Effective June 1, 2008, for trusts created prior thereto, a new law (Section 4.26 of the Trusts and Trustees Act) grants a trustee the discretion to terminate a trust whose market value is less than $100,000 (other than trusts for domestic animals or pets, and trusts where the termination would cause the trust otherwise qualifying for a federal or state benefit to not qualify).

- **New Withholding For Certain Entities**

  Effective for tax years on or after December 31, 2008, new Section 709.5 of the Illinois Income Tax Act requires trusts, partnerships (presumably including a limited liability company taxed as a partnership) and S corporations to withhold and pay to the Department of Revenue Illinois income tax for the Illinois-sourced income of its nonresident beneficiaries, partners and shareholders, based on the entity's income apportioned to the non-resident for the taxable year and the income tax rate of the beneficiary, partner or shareholder. It is unclear at this time whether the

new law requires withholding for Illinois-sourced income when the trust is taxed as a grantor trust and the grantor is a non-resident of Illinois. An exemption from the reporting requirement is provided if the non-resident beneficiary, partner or shareholder provides a certificate to the trust, partnership or S corporation (the form and manner to be provided by the Department of Revenue) that such person shall (1) file all returns the person is required to file, and (2) agree to be subject to jurisdiction in Illinois for purposes of collection of income taxes.

If you are involved with an entity that is a trust, partnership or a corporation with non-Illinois resident beneficiaries, partners or shareholders, we recommend that you contact your accountant to ensure that your entity is prepared to either (1) withhold and pay the appropriate taxes and issue the appropriate withholding statement to the grantor/beneficiary, partner, member or shareholder, or (2) obtain the appropriate certificate from the non-resident beneficiary, partner or shareholder in order to be exempted from the withholding requirement.

- **Designation of Vehicle Title Upon Death**

  Pursuant to Public Act 095-0784, effective January 1, 2009, individuals will be able to designate, either in their application for title or on their certificate of title, a beneficiary to whom a vehicle will automatically pass at the owner's death. Such a designation will greatly facilitate the transfer of a vehicle at death.

New Jersey

- Surviving partners of civil unions (dying after February 19, 2007) now boast the same inheritance rights as married couples; they are considered Class A transferees and inherit free of New Jersey inheritance tax. These new rules also apply to couples who had same-sex marriages out of New Jersey. Class A transferees now include: father, mother, grandparents, spouse, civil union partner, domestic partner, child, adopted child, stepchild and issue of any child. In addition, a decedent's non-biological child born to a partner during a civil union or domestic partnership is a Class A transferee, unless it is shown that the decedent did not intend to be the parent of such child.
- New Jersey has passed the Revised Uniform Anatomical Gift Act. This Act clarifies and updates the current law and encourages the practice of making anatomical gifts, such as by a notation on a driver's license.

New York

- The revocatory effect of divorce or annulment has been substantially broadened, so that divorce or annulment now revokes not only a disposition in favor of a former spouse in a will, but also in any revocable transfer, including transfer on death ("TOD") registration, life insurance and retirement plan beneficiary designations, and revocable trusts. Divorce and annulment now also revoke designations of the former spouse as any kind of fiduciary, including executor, trustee, agent and attorney-in-fact.
- Substantial amendments have been made to the Principal and Income Act, particularly with respect to clarifying the availability of making a unitrust election with respect to trusts in order to facilitate investing trust assets for a total portfolio return.
- TOD registration is now available to banking, as well as brokerage, institutions.
- With respect to guardianship proceedings, it has been clarified that courts do not have the ability to revoke or invalidate Wills of living, incapacitated individuals. Additionally, a guardian of a deceased person has been given the authority to pay certain estate expenses prior to the appointment of a personal representative for the estate.
- The threshold for qualifying for expedited administration of a small estate has been increased from $20,000 to $30,000.
- The New York State estate tax exemption will remain at $1 million while, as noted, the Federal estate tax exemption will increase to $3.5 million. This larger disconnect between the two amounts could result in unintended tax consequences; therefore, your estate plan should be reviewed.

North Carolina

- North Carolina repealed its gift tax in 2008, effective January 1, 2009.

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. Please do not hesitate to query any of us using the below contact information:

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