Client Advisory

Katten
Katten Muchin Rosenman LLP

Trusts and Estates

November 2011

2011 Year-End Estate Planning Advisory

Once again, we have had a year of changes and planning possibilities as to federal estate, gift and generation-skipping transfer (GST) taxes. On December 17, 2010, President Obama signed into law The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Act) that temporarily extended the Bush tax cuts for 2011 and 2012, and increased the gift, estate and GST tax applicable exclusion amounts for that period to an historic high level of $5 million. This temporary increase provides significant tax saving opportunities. Because of the uncertainty that these opportunities will remain available until the end of 2012, given the current, ever-changing economic and political landscape, we strongly recommend that you contact us as soon as possible if you have any interest in taking advantage of gifting opportunities. In addition to the increased applicable exclusion amounts, the 2010 Act retroactively reinstated the federal estate tax for decedents dying in 2010, with an option to opt out of the estate tax and receive only a limited basis step-up.

The Trusts and Estates Practice at Katten Muchin Rosenman LLP is pleased to provide you with a summary of some of the most significant state and federal developments from the past year, along with important, time-sensitive recommendations for you to consider for planning before year-end.

The "Super-Committee" and Other Proposed Legislation

Rumors have been flying that the Super Committee may follow its mandate to trim the deficit by reducing the applicable exclusion amounts, to as low as $1 million, possibly by the end of this year. While we have been unable to substantiate any of these rumors, and believe it is highly unlikely this turn of events will happen, the rumors illustrate the current uncertainty and the possibility that you need to "use it or lose it." To add to the uncertainty, on November 17, 2011, a senior Democrat tax writer in the House introduced legislation called the "Sensible Estate Tax Act of 2011" to push the estate tax applicable exclusion rate back to $1 million with a 55% marginal rate (with adjustments for inflation). The proposed legislation would go into effect on January 1, 2012. Gifting now rather than waiting can only be to your advantage.

Federal Estate, GST and Gift Tax Rates

The 2010 Act reunifies the gift and estate tax for the first time in years. The applicable exclusion amount for each of the gift, estate and GST taxes is $5 million with a top tax rate for each of 35%. For 2012, the $5 million is indexed for inflation and will increase to $5.12 million.

In addition, the 2010 Act creates "portability" between spouses for 2011 and 2012, meaning that when the first spouse dies any unused portion of his or her estate tax applicable exclusion amount may be used by the surviving spouse. However, the portability provision is of limited utility, as, under current law, the surviving spouse must also die by the end of 2012 in order to use the predeceased spouse's applicable exclusion amount.

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 will remain at $13,000 per donee in 2012. 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 will increase from $136,000 to $139,000 in 2012.

Retroactive Reinstatement of Estate Tax for 2010 Decedents

The estate tax was reinstated retroactively for estates of decedents dying in 2010, with an estate tax applicable exclusion amount of $5 million and a rate of 35%. However, there is an option to "opt out" of the estate tax and instead elect to have limited carryover basis rules (with certain adjustments) apply to property passing from the decedent.

In general, 2010 decedents with estates of less than $5 million or which pass to a surviving spouse would not opt out of the estate tax, as the estate would not owe federal estate tax and would receive a step-up in basis of the estate assets to their fair market value at the date of the decedent's death. Executors of estates of 2010 decedents with more than $5 million may want to opt out of the estate tax so that the estate does not pay estate tax, but advisers have to calculate whether paying capital gains tax on the appreciation over the decedent's basis upon sale of property yields a better tax result than paying the estate tax.

Basis Increase Allocations

If an executor opts out of the estate tax for a 2010 decedent, assets will have a limited carryover basis (but not in excess of date of death fair market value), but that basis can be adjusted to a certain extent. The executor can allocate several adjustments to increase the basis of assets received by recipients that are both "property acquired from the decedent" and "property owned by the decedent." The amount of increased basis from these allocations is referred to as the "Basis Increase."

There is $3 million of Spousal Basis Increase that may be allocated to "qualified spousal property" acquired from the decedent by a surviving spouse. Qualified spousal property includes outright transfers of property and qualified terminable interest property.

The General Basis Increase, which can be allocated to property going to anyone, is $1.3 million. However, for a decedent who was neither a resident nor a citizen of the United States, the General Basis Increase is only $60,000.

The Carryover Basis Election Is Made by Filing Form 8939

The election to opt out of the federal estate tax and elect the carryover basis regime may be made up until January 17, 2012. The election in effect on the due date is irrevocable (except as provided in Notice 2011-66).

Filing Due Dates for 2010 Decedents

For estates of decedents who died before December 17, 2010, the due date for filing a Form 706 was September 19, 2011. However, IRS Notice 2011-76 acknowledges that because of the length of time that has been required to implement the carryover basis legislative changes and to issue Form 8939 and the related instructions, 2010 estates may not have had sufficient time by September 19, 2011, to decide how to proceed. The Notice makes clear that an automatic six-month extension of the time to file is available by filing Form 4768 (Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes). There is no need to substantiate the reason an estate is requesting an extension. The automatic six-month extension makes the Form 706 due on March 19, 2012. For estates of decedents dying on or after December 17, 2011, the automatic six-month extension period will end 15 months after the decedent's date of death.

President's Budget Proposal for Fiscal Year 2012

The President's budget proposal for Fiscal Year 2012 includes three transfer tax-related items that were proposed in each of the past two years and two new items dealing with estate and gift taxes.

Consistency of Basis Valuation

The proposal to require consistency in value for transfer and income tax purposes requires that the basis for income tax purposes be the same as that determined for estate and gift tax purposes.

Eliminating Certain Valuation Discounts

The budget proposal adds a new category of "disregarded restrictions" that would be ignored for transfer tax valuation purposes in valuing an interest in a family-controlled entity transferred to a member of the family.

Grantor Retained Annuity Trusts (GRATs) to Be Subject to New Rules

Three additional requirements would be imposed on Grantor Retained Annuity Trusts (GRATs): (i) they must have a 10-year minimum term; (ii) they must have a remainder interest greater than zero; and (iii) the annuity amount cannot decrease in any year during the annuity term.

Make Portability Permanent

The budget proposal seeks to make portability permanent by extending the provisions of the 2010 Act regarding the portability of unused exclusion between spouses.

Limiting the Duration of the GST Exemption

The exclusion from the imposition of GST tax would last only 90 years, regardless of whether a trust has a longer duration.

Planning Opportunities to Consider Immediately

Make Outright Gifts to Take Advantage of Reduced Gift Tax Rate and Increased Applicable Exclusion Amount

You now have a total of $5 million ($10 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 Gift Tax Exclusion Amount you have previously made. Gifts in excess of that amount are subject to a federal gift tax rate of only 35%. The $5 million applicable exclusion amount is substantially in excess of the $1 million applicable exclusion amount for gifting that was previously available. Thus, making gifts before the end of 2011 may provide significant transfer tax savings. In addition to the reduced rate, it is always cheaper to make lifetime gifts rather than gifts at death. This result occurs 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. The benefit is compounded further by the lower gift tax in 2011. We should note that under current law, there is a possibility that if the applicable exclusion amount is reduced in the future, there may be a "clawback" if amounts gifted during life exceed the applicable exclusion amount in place at the time of death. In that event, estate tax could be imposed on the amount gifted in excess of the applicable exclusion amount at the time of death. We believe this unintended "glitch" will be fixed. However, even if it is not, you will be no worse off than if you had not gifted and you will benefit by getting any appreciation on the gift out of your estate.

Gifts with Retained Interests

Many individuals are faced with a dilemma as to the temporarily increased gifting amounts. They want to take advantage of the estate planning opportunities but are concerned that they may in the future need access to the transferred funds. There are two options that you can consider to "have your cake and eat it too."

Domestic Asset Protection Trusts of Which You and/or Your Spouse Are Discretionary Beneficiaries.
If an individual creates a trust in one of the states that has asset protection legislation (Delaware, Nevada, New Hampshire, South Dakota and Alaska) with a trustee resident in the jurisdiction, the trust may be safe from estate taxation even if the settlor and/or the settlor's spouse is a discretionary beneficiary. In order to avoid estate tax, the settlor must not receive regular distributions, but the funds would be available in the event of an emergency. It should be noted that there have not yet been any cases addressing the effectiveness of this planning technique.

Husband and Wife Create Trusts for Each Other.
A husband and wife can create trusts of which the other and their descendants are beneficiaries. As long as each trust differs in some fairly significant way from the other, the trust assets should be safe from estate tax inclusion and each spouse will have access to trust assets.

Grantor Retained Annuity Trusts (GRATs)

GRATs remain one of our most valuable planning tools, particularly in this time of historically low interest rates. Because of the possibility that legislation may soon pass changing how GRATs may be structured and interest rates may rise, GRATs should be created as soon as possible.

A GRAT provides you with a fixed annual amount (the annuity) from the trust for a term of years (currently 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 November 2011 is 1.4% and for gifts made in December 2011 will be 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 applicable rate. Because you will retain the full value of the GRAT assets—as calculated using the IRS's assumptions for growth—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 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 as to which you would be treated as the owner for income tax purposes and would pay the income taxes on the income generated by the assets therefrom, 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 downpayment 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 November 2011 is as low as .19% and for sales made in December 2011 will be .20%**), as with a GRAT, the appreciation will pass free of gift and estate tax. The current record-low interest rates make sales to defective grantor trusts most opportune to structure now.

Charitable Lead Annuity Trust (CLAT)

Another very effective planning tool in a low interest rate environment is a 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, non-charitable beneficiaries. As with a GRAT, to the extent the assets outperform the IRS assumed rate of return (1.4% for November and 1.6% for December), those assets can pass transfer-tax free to whomever you would like.

Gift Residence or Vacation Home Using Qualified Personal Residence Trusts and Other 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 rent 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, particularly in light of the increased gifting applicable exclusion amount. In addition, one can retain a contingent reversionary interest in case the donor dies during the QPRT term, further discounting the taxable value of the transferred interest—sometimes by a substantial amount in the case of older donors.

Another possibility, given the depressed real estate prices and the increased applicable exclusion amount, is to make a gift of real estate outright or to a trust that is not a QPRT. You may rent the house back from the trust for its fair market rental value and thus continue to use the house. If the trust is drafted as a defective grantor trust, the rent will not be subject to income tax, as for tax purposes it will be treated as though you are renting from yourself. The rent proceeds may be used to pay maintenance and taxes (which you will still be able to deduct). To the extent rent payments exceed expenses, you will have made additional transfer tax-free gifts to the trust.

Alternatives to Section 1031 Exchanges: Gifts to Charitable Remainder Trusts

Many taxpayers owning certain kinds of appreciated real estate sell that property and "roll over" the gain—using Section 1031 of the Internal Revenue Code (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 up 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 GRAT or other grantor 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 grantor trust instruments give the grantor the power to substitute the trust's assets with other assets, which would allow the appreciated assets to be removed from the trust.

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.

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 and consolidation of family held entities with centralized management, as well as other investment advantages as a result of investing a larger pool of assets. The value of partial interests 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. As it did with GRATs, the Obama Administration signaled that valuation discounts are targets to be eliminated or minimized. However, that has not yet happened. The fact that valuation discounts are on the Administration's radar screen suggests that FLP planning should be done sooner rather than later.

As in recent years, 2011 saw numerous IRS attacks on the use of FLPs, in various contexts, with mixed success.

In *Turner*, gifts of a limited partnership interests were transferred to family members. The decedent and his wife paid themselves management fees although they provided few services. No distributions were made to family members prior to the decedent's death but payments were made to the decedent and his wife and treated as repayment of advances made by the decedent. The Court concluded that one-half of the partnership assets were included in the decedent's estate. The Court found there was an express and implied agreement for retained enjoyment under 2036(a)(1) of the IRC. The Court also viewed the decedent as effectively being the sole general partner so that 2036(a)(2) of the IRC would apply.

In *Jorgensen*, the Ninth Circuit Court of Appeals rejected the taxpayer appeal of a Tax Court opinion, which held that Section 2036 of the IRC applied to all assets in two limited family partnerships that were attributable to capital contributions by the decedent. Although the decedent had assets outside of the partnerships for her day-to-day expenses, there was no evidence why one FLP was created, and, as to the other FLP, there was contemporaneous attorney correspondence referring to estate tax savings as the reason for creating it. The decedent had control of the FLP's checkbook even though she was not the general partner and she wrote checks out of the FLP accounts for her personal purposes.

In *Levy*, the Fifth Circuit affirmed a jury finding at the district court setting the value of a partnership at $25 million without allowing discounts for lack of control or marketability. In *Levy*, the estate owned an interest in a limited partnership that owned undeveloped land near Dallas, Texas, which the partnership had apparently sold about two years after the estate valuation date. The estate received $25 million from the sale. The jury concluded that the estate's interest was valued at $25 million and allowed no discounts for lack of control or marketability. The estate's arguments for setting aside the verdict were rejected by the court, which found that absent a change in economic conditions, actual subsequent sales of assets are highly persuasive in determining the value of an asset and whether any discounts should have been applied.

There was one taxpayer-favorable aspect of *Levy*. The court ruled against the IRS with respect to Section 2036, finding that there was a legitimate non-tax purpose of the partnership.

Year-End Checklist for 2011

In addition to the above planning ideas, consider the following before 2011 is over:

- Make year-end annual exclusion gifts of $13,000 ($26,000 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. Pay tuition and medical expenses directly to the school or medical provider.
- Consider making charitable gifts before year-end to use deduction on 2011 income tax return.

Below is a discussion of national, international and local developments that occurred in 2011.

National Developments in 2011

Decision Regarding Asset Protection Trusts as Protection from Creditors and Estate Tax

A recent unreported Alaska Bankruptcy Court case, *In re Mortensen*, allowed creditors to reach the assets of an Alaska asset protection trust, despite its finding that Mr. Mortensen was solvent when he created the trust. Mr. Mortensen filed for bankruptcy in 2009, four years after creating the trust. Alaska's creditor statute precluded the bankruptcy trustee from recovering the trust property, but the Bankruptcy Court judge held that creditors could pierce the trust and reach the assets. The opinion focused on a new provision of the Bankruptcy Code which allows a 10-year "clawback" period and contains some troubling language suggesting that the trust's purpose to protect assets from creditors and from the estate tax was one of the reasons the court reached its conclusion. However, the debtor's facts were particularly egregious. We will have to watch and see if there are any further developments along these lines.

IRA Distributions to Charity

Qualified charitable donations of up to $100,000 may be made from an individual's IRA directly to charity and excluded from that individual's gross income if the individual is at least 70 ½ years old and certain other requirements are met. This provision was temporary, has been extended twice and is due to expire on December 31, 2011.

Respect for Marriage Act Approved by Senate Judiciary Committee

On November 10, 2011, federal legislation was introduced to repeal the Defense of Marriage Act (DOMA). DOMA precludes the recognition of same-sex marriages.

The bill now moves to the full Senate, but it remains to be seen whether Senate Majority Leader Harry Reid will bring the bill to the full Senate for a vote.

International Developments in 2011

UK Law Changes

The UK government has proposed a UK Statutory Residence Test (SRT), with the goal of implementing the SRT by April 6, 2012. This new test is designed to minimize uncertainty regarding what constitutes UK resident status. For questions regarding whether or not your status as a prospective UK resident has changed, please contact one of us.

In August 2011, IRS Revenue Ruling 2011-19 was released which allows for the GBP 30,000 Remittance Basis Charge to be credited against U.S. income tax for U.S. taxpayers.

Beginning April 6, 2012, the Remittance Basis Charge will be increased to GBP 50,000 for taxpayers resident at least 12 of 14 tax years.

French Law Changes

France enacted sweeping tax changes in 2011, with most changes to take effect as of January 1, 2012. The French wealth tax threshold was raised to net wealth exceeding EUR 1.3 million and its gift and inheritance tax rates changed. In addition, the so-called tax shield that guaranteed that a taxpayer would not pay taxes representing more than 50% of his or her income in a year was repealed. France also enacted an "exit tax" on certain residents effective March 3, 2011.

Under new French law, trustees are now obligated to declare the creation, modification and revocation of any trust if there is a French resident beneficiary or a French asset held in the trust. The trustee of such a trust must file an annual market value declaration of the trust assets and there is an annual wealth tax on such trusts under certain circumstances. Assets of a trust may also be included in the estate of a French resident settlor and there is other wide-reaching legislation to tax trusts, some of which are effective in 2011.

For further information concerning these extensive French tax changes, please contact one of us.

2011 Offshore Voluntary Disclosure Initiative

Admittance to the IRS's 2011 Offshore Voluntary Disclosure Initiative (OVDI) was extended through September 9, 2011, due to Hurricane Irene. Taxpayers who did not enter the 2011 OVDI but who want to disclose unreported offshore income should contact one of us to enter into the IRS Voluntary Disclosure Program.

Foreign Account Tax Compliance Act of 2009

On March 18, 2010, President Obama signed the Hiring Incentives to Restore Employment Act (HIRE), which contained a version of the previously proposed Foreign Account Tax Compliance Act of 2009 (FATCA). These provisions are intended to combat offshore tax evasion by U.S. taxpayers by requiring increased information reporting.

HIRE provides for withholding taxes to enforce reporting requirements on certain foreign accounts owned by specified U.S. persons or U.S.-owned foreign entities. Generally, a tax equal to 30% must be withheld by a U.S. withholding agent on any withholdable payment made to a foreign financial institution (FFI) if the institution is not a "participating FFI." An FFI is a participating FFI if it has an agreement (an FFI Agreement) with the IRS under which the institution agrees to obtain certain information on each U.S. account holder and comply with various reporting and withholding requirements. The withholding of 30% is on a broader category of U.S. source income than is captured under the current withholding rules.

Although this regime was scheduled to go into effect on January 1, 2013, tax practitioners, foreign governments and FFIs expressed concerns about the ability of FFIs to become compliant so quickly. As a result, the IRS issued Notice 2011-53, which extends this deadline and phases in FATCA over time. Please contact us if you would like more detailed information.

In addition to the withholding regime described above, FATCA also requires new reporting for U.S. owners of specified foreign financial assets and enhanced reporting for U.S. shareholders of passive foreign investment companies. These reporting obligations have been suspended until the forms for reporting have been released in final. The Treasury Department has announced that it expects to issue further FATCA guidance by the end of this year. We hope that the withholding and reporting obligations of trusts will be clarified in the Treasury's guidance.

FBAR Forms

In February 2011, the Financial Crimes Enforcement Network (the FinCen) issued final regulations regarding the filing of Form TD 4 90-22.1 Foreign Bank Account Report (FBAR). Although the final regulations are very similar to the proposed regulations, there are several important differences with respect to trusts:

The final regulations clarify that a trust beneficiary will not be deemed to have a financial interest in the trust's foreign account merely by reason of being a discretionary beneficiary or a remainderman of such trust. However, if the beneficiary receives more than 50% of the trust's current income, he will be deemed to have a financial interest in the trust's foreign account.

A beneficiary of a trust with a present beneficial interest in more than 50% of the trust's assets or who receives more than 50% of the trust's current income will be deemed to have a financial interest in the foreign accounts of such trust.

The final regulations no longer provide, as did the proposed regulations, that a U.S. person who creates a foreign trust and appoints a trust Protector subject to the U.S. person's direct or indirect instruction will be considered to have a financial interest in the trust's foreign accounts.

Like the proposed regulations, the final regulations provide that a U.S. person who has an ownership interest in a trust for U.S. income tax purposes will be deemed to have a financial interest in the trust's foreign accounts. Similarly, the final regulations also contain the proposed rule that a trust beneficiary, who would otherwise be required to file, will not have to do so if the trust, a trustee of the trust or an agent of the trust is a U.S. person that files an FBAR disclosing the trust's foreign financial accounts.

Local Developments in 2011: State-Specific Considerations

California

Transfers Without Probate: Estate of Giraldin (Court of Appeal of California, Fourth Appellate District, Division Three, September 26, 2011).

In *Estate of Giraldin*, the settlor executed a revocable trust and appointed his son as trustee. Pursuant to the terms of the trust, the settlor was the sole beneficiary under the trust and the trustee was to distribute as much income and principal as the settlor directed. In making such determinations, the trustee was not to consider the rights of the remainder beneficiaries, who were the settlor's wife and other children. One month prior to executing this trust, the settlor invested $4 million—the majority of his estate—in his two sons' business, one of whom was the trustee. The funds to pay for the investment were taken from the settlor's separate account and the stock was issued in the settlor's name. After the investment was fully funded, the stock was transferred into the name of the trust.

The remainder beneficiaries filed a petition, seeking to remove the trustee, to compel an accounting and, in effect, to undo the investment. They claimed, amongst other arguments, that the trustee violated his fiduciary duties to diversify the investments of trust assets, to avoid conflicts of interests and to deal impartially with the beneficiaries. The petitioners further argued that the trustee had a legal obligation to dissuade the settlor from making unwise investments.

The court held in favor of the trustee. It explained that the trustee's duty is solely to the settlor, who possessed the power to revoke. Moreover, the remainder beneficiaries have no right to determine how the trust assets are managed and have no rights to any trust property until the settlor dies, when the trust becomes irrevocable. The court went on to say that the settlor is entitled to do what he wants with trust assets, unless he is adjudicated legally incompetent, and the trustee has no duty or obligation to determine whether the settlor is competent and possesses capacity.

Change of Ownership Statement.

Effective January 1, 2012, S.B. 507 will take effect, under which the deadline to file a change of ownership statement with the local assessor will be extended from 45 days to 90 days. This bill applies to transferees of real property or manufactured homes; corporations, partnerships and other legal entitles that own real property; and legal entities that own real property for which ownership or control has been changed by more than 50%.

Additionally, this bill will increase the penalty cap for late filings from $2,500 to $5,000 for properties eligible for the homeowners' exemption, and increase the penalty cap to $20,000 for properties that are ineligible for the homeowners' exemption.

Effective January 1, 2012, the value of estate assets that can be transferred without probate administration will increase due to the passage of Chapter 117, Statues of 2011 (AB 1305-Huber).

The size of estate trust assets—excluding joint tenancy assets, which pass under beneficiary designation, such as life insurance or retirement accounts—that can be collected by affidavit will increase from $100,000 to $150,000 (Probate Code Section 13100). Additionally, the value of the decedent's salary or other compensation that is excluded from the value of the decedent's property in California will increase from $5,000 to $15,000 (Probate Code Section 13050). These statutory increases will assist in the collection of small value accounts, investments or automobiles that were inadvertently not transferred to a decedent's revocable living trust. In California, we recommend the use of such trusts for probate avoidance purposes.

Connecticut

In May 2011, the estate and gift tax applicable exclusion amounts were lowered to $2 million retroactive to January 1, 2011.

Florida

In June 2011, Florida adopted its version of the Uniform Power of Attorney Act (the Act) that was effective on October 1, 2011. The highlights are as follows:

- Existing powers of attorney executed prior to the effective date of the Act remain valid under the Act provided its execution complied with the law of Florida at the time of its execution. Existing durable or springing powers of attorney remain durable or springing under the new Act.
- Contingent or "springing" powers of attorney are no longer authorized unless they were in existence prior to the effective date.
- The Act permits the appointment of successor agents and co-agents and unless the power of attorney provides otherwise, each co-agent may act independently. This is a significant change from the prior law, which required a majority of named agents to concur unless otherwise provided in the document.
- New powers of attorney must be signed by the principal and two witnesses and be notarized.
- The principal may revoke a power of attorney by expressing that revocation in a subsequently executed power of attorney in any other writing signed by the principal. However, the mere execution of a new power of attorney does not revoke an existing power of attorney.
- An agent may only exercise authority that is specifically granted to the agent and any authority necessary to give effect to that express grant of specific authority.
- The Act allows a principal to grant authority to the agent to take significant actions that can impact the principal's estate plan or gifting program, but such power may be granted with additional formalities and is subject to restrictions.

Illinois

State Income Taxes.

Illinois lawmakers passed a significant income tax increase in 2011 to close a $13 billion budget deficit. Personal income tax rates were increased from 3% to 5%, a 67% increase. Trust income tax rates were subject to an identical increase, and trusts also pay a 1.5% "replacement tax." Corporate income tax rates were increased from 4.8% to 7%, a 46% increase. Corporations also pay a 2.5% replacement tax in Illinois. The income tax increases are supposedly temporary in nature, expiring after 2014, but many expect the increases to be extended indefinitely given Illinois' significant budget deficit. The new law does include a trigger that would cause a reversion to the old rates if spending increases at greater than 2% from year to year through 2014.

State Estate Taxes—Generally.

Illinois has again "decoupled" from the federal estate tax system. Effective for decedents dying after December 31, 2010, Illinois imposes an estate tax equal to the state death tax credit amount that used to be in effect under Section 2011 of the IRC assuming an applicable exclusion amount of $2 million. While the federal applicable exclusion amount was increased for 2011 and 2012 to $5 million, Illinois' applicable exclusion amount remains relatively low. Illinois, however, does not impose a gift tax. Therefore, significant planning opportunities exist under current law to reduce state estate taxes by making lifetime gifts.

It was recently reported that Illinois legislators have agreed in principle to increase the Illinois applicable exclusion amount to $3.5 million in 2012 and $5 million in 2013. These changes are to be included as part of the tax bills being considered to keep the CME Group, Inc. and Sears Holdings Corp. in the state. These proposed changes are interesting given that legislators needed to significantly increase income taxes, yet are finding room in the budget to decrease estate taxes. Also, under current federal law, the $5 million applicable exclusion amount is to revert to $1 million in 2013, but the proposed Illinois law would apparently provide a $5 million applicable exclusion amount in 2013.

It is also unclear whether any of the proposed changes to Illinois law would include making the Illinois estate tax applicable exclusion amount portable, like the federal applicable exclusion amount in 2011 and 2012. Also unclear is whether the proposed legislation would clarify the applicability of the Illinois estate tax marital deduction to partners of a civil union.

Illinois lawmakers failed to pass the proposed legislation prior to the end of its scheduled veto session on November 10. However, lawmakers are set to return to Springfield on November 21 to deal with these issues.

Deduction for State Estate Taxes.

Section 2058 of the IRC provides a deduction on the federal estate tax return for state estate taxes paid with respect to property included in the federal gross estate. Given the differing federal and state estate tax applicable exclusion amounts, one planning tool Illinois estate planners have been making use of involves establishing a state-only QTIP marital trust upon the death of the first spouse and funding the trust with an amount equal to the difference between the remaining federal and state applicable exclusion amounts. In short, this planning allows full use of both the federal and state applicable exclusion amounts without incurring a state estate tax upon the first spouse's death.

One technical issue that has arisen with this planning concerns payment of state estate taxes on the state-only QTIP marital trust upon the surviving spouse's death. If the state estate tax due is apportioned to the state-only QTIP marital trust, the Section 2058 deduction on the federal estate tax return may not be available because the tax would have been paid from assets not included in the federal gross estate. Accordingly, consideration should be given to revising estate tax apportionment clauses in estate planning documents to apportion the state estate tax due on a state-only QTIP marital trust to assets that are included in the federal gross estate.

Illinois Powers of Attorney.

New statutory property and health care powers of attorney became effective on July 1, 2011. The new power of attorney forms made a number of substantial improvements to the prior forms. While prior statutory forms remain valid, consideration should be given to executing the updated forms.

Following the enactment of the new statutory property and health powers of attorney, various technical changes have been made or proposed to the new power of attorney forms. For example, a bill was signed into law this summer amending the new health care power of attorney form to address issues relating to HIPAA. In addition, concerns have been raised regarding what existing property powers of attorney are revoked by the new property power of attorney form (e.g., powers of attorneys executed with investment firms may be revoked by the new property power of attorney form). The legislature passed a bill defining "excluded powers of attorney" which would not be revoked by execution of the new property power of attorney form. The governor, however, exercised his amendatory veto power to substantially change the bill. The Illinois House recently overrode the governor's veto and the expectation is that the Illinois Senate will take up the measure when it returns to Springfield on November 21.

New York

Although the 2011 New York legislative session did not produce as much law affecting estate and trust planning, administration and litigation as the 2010 session, there were still a number of significant changes in this field. Perhaps the most notable piece of legislation from the 2011 session came in the area of domestic relations, as New York enacted a law recognizing same-sex marriage. Other relevant pieces of legislation from this session concern formula clause constructions related to the reinstatement of the federal estate tax, changes to the laws authorizing a trustee to decant trusts, examination of individuals in connection with wills containing in *terrorem* clauses, and making of health care decisions related to hospice care.

Domestic Relations Law.

A new Section 10 has been added to the Domestic Relations Law (DRL) to recognize the validity of same-sex marriages, and to provide same-sex married couples with the same public marital rights and benefits as opposite-sex couples. Benevolent organizations and charitable corporations, however, shall not be required to provide accommodations, advantages, facilities or privileges related to the solemnization or celebration of marriage. This change was effective on July 24, 2011.

Section 13 of the DRL has been amended to provide that no application for a New York marriage license shall be denied on the grounds that the parties are of the same or a different sex. This change was effective on July 24, 2011.

Formula Clauses.

Section 2-1.13 of the Estates, Powers and Trusts Law (EPTL) has been amended, in light of the reenactment of the federal estate tax, to clarify certain formula clauses in wills and trusts as they relate to the federal estate tax and tax applicable to estates of decedents dying in 2010. On August 13, 2010, the New York Legislature added Section 2-1.13 to address the repeal of the federal estate tax and GST tax for 2010. In light of the federal opt-out regime, Section 2-1.13 has been amended to provide that, where a beneficiary designation, will or trust of a decedent who dies after December 31, 2009 and before January 1, 2011 is made with reference to applicable exclusion amounts available under the federal estate tax or federal GST tax, such dispositions shall be deemed to refer to the federal estate tax or federal GST tax in effect in 2010, regardless of whether an election is made not to have the federal estate tax apply to the estate. The above construction shall not apply where the will or trust manifests an intention that it be otherwise construed.

New Decanting Statute.

Substantial changes have been made to Section 10-6.6 of the EPTL relating to the exercise of a power of appointment and an authorized trustee's authority to invade trust principal (i.e. decanting). The new statute permits an authorized trustee with unlimited discretion to appoint principal to another trust for the benefit of one or more of the current beneficiaries, and to grant a power of appointment to trust beneficiaries if such beneficiaries would have received principal outright under the invaded trust.

The new trust may have a term longer than the term of the invaded trust, as long as it does not violate the applicable rule against perpetuities.

The exercise of the power of appointment shall be evidenced by a written instrument effective 30 days after service upon persons entitled to notice (unless they consent to a shorter period). The authorized trustee may exercise the power without consent of the creator or the persons interested in the invaded trust and without court approval, though the authorized trustee may seek court approval. A person interested in the trust may object by serving notice prior to the effective date.

Public Health Law.

On March 16, 2010, Chapter 8 of the Laws of 2010 amended the Public Health Law (PHL) by creating new Article 29-CC (Family Health Care Decision Act) and 29-CCC (Nonhospital Orders Not to Resuscitate) to establish procedures for making medical treatment decisions on behalf of persons who lack the capacity to decide about treatment for themselves and who have not designated a health care agent. The PHL has now been amended to add decisions related to hospice care to the Family Health Care Decisions Act. This change was effective on September 18, 2011.

Surrogate's Court Procedure Act.

Section 1404(4) of the Surrogate's Court Procedure Act (SCPA) has been amended to allow—in probate proceedings where the will contains an in *terrorem* clause—the examination, in addition to the nominated executors and the proponents, of persons who, after application to the surrogate court based on "special circumstances," the Surrogate determines may provide information related to the validity of the will that would be of substantial importance or relevance in informing a party's decision to object to the will. This change is effective immediately and applies only to estates of decedents dying on or after August 3, 2011. These changes are intended to address the Court of Appeal's decision in *Matter of Singer*, 13 NY3d 447 (2009). Similarly, EPTL Section 3-3.5 was amended to make it clear that none of those examinations will trigger the in *terrorem* clause.

North Carolina

North Carolina Estate Tax.

North Carolina estate tax will apply to decedents dying in 2011 and 2012 with an applicable exclusion amount tied to federal law. (Session Law 2011-5 (House Bill 124) redefined “Code” as the Internal Revenue Code as enacted as of January 1, 2011, for North Carolina tax purposes.) The North Carolina Department of Revenue has confirmed that North Carolina law conforms to the federal law for those decedents who died in 2010, and estates that elected to pay federal estate tax and receive a stepped-up basis will also receive a stepped-up basis for North Carolina purposes.

529 Plans.

S.L. 2011-106 cancelled scheduled adjusted gross income limitations for state income tax deductions for contributions to a North Carolina 529 Plan. The income tax deductions for 529 Plan contributions were to become available only to individuals whose adjusted gross income was not greater than $60,000, or $100,000 for married couples filing jointly. This law cancelled the income limitations, which were scheduled to begin in 2012.

We Can Help

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

CHARLOTTE

A. Victor Wray, Charlotte Chair	704.444.2020	victor.wray@kattenlaw.com
Diane Blackburn Burks, Associate	704.344.3153	diane.burks@kattenlaw.com
William E. Underwood, Jr., Of Counsel	704.444.2010	bill.underwood@kattenlaw.com

CHICAGO

Michael O. Hartz, Chicago Chair	312.902.5279	michael.hartz@kattenlaw.com
David M. Allen, Associate	312.902.5260	david.allen@kattenlaw.com
Alan M. Berry, Partner	312.902.5202	alan.berry@kattenlaw.com
Victor H. Bezman, Partner	312.902.5204	victor.bezman@kattenlaw.com
Hadar R. Danieli, Special Counsel	312.902. 5581	hadar.danieli@kattenlaw.com
Samuel M. Dotzler, Associate	312.902.5249	samuel.dotzler@kattenlaw.com
Anthony L. Engel, Associate	312.902.5316	anthony.engel@kattenlaw.com
Juli D. Gilliam, Associate	312.902.5328	juli.gilliam@kattenlaw.com
Jonathan Graber, Partner	312.902.5317	jonathan.graber@kattenlaw.com
Stuart E. Grass, Partner	312.902.5276	stuart.grass@kattenlaw.com
Charles Harris, Partner	312.902.5213	charles.harris@kattenlaw.com
Melvin L. Katten, Senior Counsel	312.902.5226	melvin.katten@kattenlaw.com
Tye J. Klooster, Partner	312.902.5449	tye.klooster@kattenlaw.com
Allan B. Muchin, Of Counsel	312.902.5238	allan.muchin@kattenlaw.com
Kelli Chase Plotz, Associate	312.902.5347	kelli.plotz@kattenlaw.com
Philip J. Tortorich, Partner	312.902.5643	philip.tortorich@kattenlaw.com
Neil H. Weinberg, Partner	312.902.5646	neil.weinberg@kattenlaw.com

LOS ANGELES

Abby L. T. Feinman, West Coast Chair	310.788.4722	abby.feinman@kattenlaw.com
Steven L. Guise, P.C., Of Counsel	310.788.4695	steven.guise@kattenlaw.com
Carol A. Johnston, Partner	310.788.4505	carol.johnston@kattenlaw.com
Judy Portnoy, Associate	310.788.4554	judith.portnoy@kattenlaw.com
Heather J. Turk, Associate	310.788.4531	heather.turk@kattenlaw.com

NEW YORK

Joshua S. Rubenstein, National Chair	212.940.7150	joshua.rubenstein@kattenlaw.com
Ronni G. Davidowitz, New York Chair	212.940.7197	ronni.davidowitz@kattenlaw.com
Mal L. Barasch, Counsel	212.940.8801	mal.barasch@kattenlaw.com
Lawrence B. Buttenwieser, Counsel	212.940.8560	lawrence.buttenwieser@kattenlaw.com
Neil V. Carbone, Partner	212.940.6786	neil.carbone@kattenlaw.com
Allison S. Clayton, Associate	212.940.6533	allison.clayton@kattenlaw.com
Alexandra B. Copell, Associate	212.940.8588	alexandra.copell@kattenlaw.com
Marla G. Franzese, Counsel	212.940.8865	marla.franzese@kattenlaw.com
Robert E. Friedman, Counsel	212.940.8744	robert.friedman@kattenlaw.com
Jacqueline Garrod, Special Counsel	212.940.6661	jacqueline.garrod@kattenlaw.com
David S. Goldstein, Associate	212.940.6740	david.goldstein@kattenlaw.com
Lauren M. Goodman, Associate	212.940.6344	lauren.goodman@kattenlaw.com
Jasmine M. Hanif, Partner	212.940.6491	jasmine.hanif@kattenlaw.com
Milton J. Kain, Counsel	212.940.8750	milton.kain@kattenlaw.com
Theresa A. Kraker, Associate	212.940.6678	theresa.kraker@kattenlaw.com
Dana B. Levine, Special Counsel	212.940.6668	dana.levine@kattenlaw.com
Marianna Schwartsman, Associate	212.940.8581	marianna.schwartsman@kattenlaw.com
Beth D. Tractenberg, Partner	212.940.8538	beth.tractenberg@kattenlaw.com
Kathryn von Matthiessen, Partner	212.940.6631	kathryn.vonmatthiessen@kattenlaw.com

Katten

Katten Muchin Rosenman LLP

www.kattenlaw.com

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK OAKLAND WASHINGTON, DC

Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion.

©2011 Katten Muchin Rosenman LLP. All rights reserved.

Circular 230 Disclosure: Pursuant to regulations governing practice before the Internal Revenue Service, any tax advice contained herein is not intended or written to be used and cannot be used by a taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. Katten Muchin Rosenman LLP is an Illinois limited liability partnership including professional corporations that has elected to be governed by the Illinois Uniform Partnership Act (1997). London affiliate: Katten Muchin Rosenman UK LLP.