Katten
Katten Muchin Rosenman LLP

November 2012

2012 Year-End Estate Planning Advisory

Now that the election is over, we anticipate having some guidance soon with respect to the numerous tax and planning issues that have been mired in uncertainty for the past two years. Many tax benefits are scheduled to “sunset” as of December 31, 2012. These benefits include the $5.12 million estate and gift applicable exclusion amounts and the generation skipping transfer (GST) exemption amount (the “applicable exclusion amounts”); the maximum 35% rate for estate, gift and GST taxes; and the 15% capital gains tax and dividend rates. Absent congressional action, as of January 1, 2013, the estate and gift tax applicable exclusion amounts will each be reduced to $1 million, and the GST tax applicable exclusion amount, which will be indexed for inflation, will be reduced to approximately $1.4 million. The maximum tax rate for estate, gift and GST taxes will increase to 55%. The capital gains tax rate will increase to 20% and dividends will be taxed as ordinary income.

There is much speculation as to whether these provisions will be allowed to sunset with no adjustment. It is widely believed that there will be legislation that will either extend the current $5.12 million applicable exclusion amounts for a limited period, or that, for a limited time, there will be a retroactive increase of the applicable exclusion amounts. President Obama has stated his view that the applicable exclusion amount for transfers at death should be $3.5 million and that the applicable exclusion amount for gifts should revert to $1 million, with a maximum transfer tax rate of 45%.

Regardless of where the applicable exclusion amounts and rates are ultimately set, it is clear that planning before year-end to take advantage of the current exclusion amounts and rates can provide significant tax savings.

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.

Federal Estate, GST and Gift Tax Rates

In 2010, gift and estate tax applicable exclusion amounts were reunified for the first time in several years. The applicable exclusion amount for each of the gift, estate and GST taxes was set at $5 million with a top tax rate for each of 35%. For 2012, the $5 million was indexed for inflation and increased to $5.12 million.

In addition, in 2010 the law changed to allow “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 can be used by the surviving spouse. If there is no congressional action, as of January 1, 2013, the estate and gift tax applicable exclusion amounts will decrease to $1 million; the GST tax applicable exclusion amount will decrease to approximately $1.4 million; and the maximum rate for each of these taxes will jump from 35% to 55%. In addition, there will be no portability of unused estate tax exclusion for surviving spouses.

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 increase from $13,000 per donee in 2012 to $14,000 per donee in 2013. Thus, a husband and wife together will be able to gift $28,000 to each donee.

The amount of the annual gift tax exclusion with respect to gifts made to non-citizen spouses will increase from $139,000 to $143,000 in 2013.

Income Tax Rates

Absent congressional action, capital gains and dividend tax rates will increase significantly. Currently, long-term capital gains are taxed at the rate of 15% (or 0% if the taxpayer's total income places the taxpayer in the 10% or 15% tax bracket). Qualified dividends are taxed at the long-term capital gains rate. In 2013, long-term capital gains will be taxed at the rate of 20% (or 10% if the taxpayer's total income places the taxpayer in the 15% tax bracket), and all dividends will be taxed as ordinary income.

Individual income tax rates will also increase. At present, there are six individual ordinary income tax brackets taxed at rates of 10%, 15%, 25%, 28%, 33% and 35%. In 2013, there will be five brackets taxed at rates of 15%, 28%, 31%, 36% and 39.6%.

In addition, a new 3.8% Medicare surtax will be imposed on investment income for taxpayers with income exceeding the minimum threshold ($200,000 for single filers, $250,000 for married filers filing jointly, $125,000 for married filers filing separately, and $12,000 for trusts and estates). An additional 0.9% tax will be imposed on earned income above the same threshold.

President's Budget Proposal for Fiscal Year 2013

The president's budget proposal for fiscal year 2013 includes a number of transfer tax-related items, some of which were proposed in prior years.

Resetting of Exclusion Amounts and Rate

The budget proposal provides for a permanent return of the estate, gift and GST tax regimes to a 45% top tax rate, a $3.5 million applicable exclusion amount for estate and GST tax and a $1 million applicable exclusion amont for gift tax, starting in 2013.

Change to Treatment of Intentionally Defective Grantor Trusts (IDGTs)

The budget proposal contains a provision that would significantly change a highly effective planning technique. IDGTs are currently used as a central part of much tax planning, as they allow a grantor the ability to be taxed on all of the trust's income, thus allowing more assets to remain for the trust beneficiaries. Under the proposal, the assets in IDGTs would be included in the grantor's estate and subject to estate tax. In addition, distributions from an IDGT would be subject to gift tax and if the trust ceases to be a grantor trust, the remaining assets would be subject to gift tax.

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

The proposal adds three additional requirements that 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 permanent the portability of unused applicable exclusion amounts between spouses starting in 2013.

Limiting the Duration of the GST Exemption

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

Extend the Time to Pay Estate Tax Under Certain Circumstances

The proposal would also allow tax deferrals under Section 6166 of the Internal Revenue Code to be extended for up to 15 years and three months from date of death.

Planning Opportunities to Consider Immediately

NOTE: While there are a number of highly effective techniques discussed below, because of the limited time available before year-end, at this point the focus should be primarily on making direct gifts of cash and marketable securities. Some of the techniques discussed below are not as time sensitive and they do not involve making taxable gifts. Those techniques should be considered without regard to completion before year-end.

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

You now have a total of $5.12 million ($10.24 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 $5.12 million ($10.24 million for a married couple) are subject to a maximum federal gift tax rate of only 35%. The federal $5.12 million applicable exclusion amount is substantially in excess of the $1 million applicable exclusion amount for gifting that is slated to be the new exclusion rate as of January 1, 2013. Thus, making gifts before the end of 2012 may provide significant transfer tax savings. In addition to the reduced rate, it is always cheaper to make lifetime gifts rather than making 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 2012. 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. And even if the applicable exclusion amount remains at $5 million indexed for inflation, it always makes sense to use it sooner rather than later, as you get the income on and appreciation to the gifted assets out of your estate as well.

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 need access to the transferred funds in the future. 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, among others) 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 that interest rates may rise, GRATs should be created as soon as possible. An important point to note is that GRATs may currently be structured without making a taxable gift, so even if you have used all of your applicable exclusion amount, GRATs may be used without incurring any gift tax. Thus, this technique does not have to be used before year-end.

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 transfers made in November 2012 is 1% and for transfers made in December 2012 is 1.2%). As long as the GRAT assets outperform the applicable rate, at the end of the annuity term you will be able to achieve a transfer tax-free gift of the spread between the actual growth of the assets and the 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 for 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 2012 is as low as 0.89% and in December 2012 is as low as 0.95%), 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% for November 2012 and 1.2% for December 2012), those assets can pass transfer tax free to whomever you would like. Like GRATs, CLATs can be "zeroed out" so that there is no taxable gift.

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 have dropped 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. Note that the donor must survive for the entire QPRT term in order to remove the residence from the donor's estate. However, 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—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 will be taxed 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 individuals 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:

- Forgiving loans previously made to family members. The amount that is forgiven in excess of the annual gift tax exclusion amount will be a gift, and thus will use a portion of your applicable gift tax and/or GST tax exclusion amount.

Note that forgiveness of debt that is a gift is not treated as taxable income of the borrower.

- 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 individuals 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, 2012 saw numerous IRS attacks on the use of FLPs, in various contexts, with mixed success.

The *Wandry* Case

One particularly significant case, *Wandry v. Commissioner*, T.C. Memo 2012-88 (March 26, 2012), resulted in an important taxpayer victory. In *Wandry*, gifts of a family limited partnership were transferred to family members according to a formula designed to fix the value of each gift according to a specific dollar amount rather than a percentage interest. This type of "valuation clause" is an important estate planning tool, and is often used to ensure that the value of the gift falls within the gift tax applicable exclusion amount, thus avoiding the imposition of unanticipated gift tax in the event that the IRS audits the transfer and increases the value of the gift from the amount claimed by the taxpayer. The IRS argued in *Wandry* that such defined value formula clauses violate public policy because they undo previously completed transfers by reducing the percentage interests actually transferred to the donee. Moreover, although courts had previously upheld defined value formula gifts, they had only done so when the terms of the gift contained an adjustment clause providing that any excess value resulting from an audit of the gift would go to a charity. The Tax Court disagreed with the IRS, finding that such clauses do not violate public policy even where a charity is not involved. Though the IRS recently withdrew its appeal of the Tax Court's decision, it subsequently announced that it would not acquiesce in the court's decision and so will not follow the court's decision when dealing with other taxpayers. Accordingly, while *Wandry* is an important decision that approves the use of defined value formula clauses without the use of a charity, it will not necessarily prevent the IRS from challenging gifts based on such clauses in future cases.

The *Wimmer* Case

In *Wimmer v. Commissioner*, T.C. Memo 2012-157 (June 4, 2012), the Tax Court held that gifts of interests in a family partnership that was funded with publicly traded and dividend paying stock qualified for the annual exclusion from gift tax because the beneficiaries had a present right to income. The Tax Court stated that the gifts must convey a substantial economic benefit by allowing the use, possession or enjoyment of either property or income in order to qualify as a present interest. Based on the many restrictions on transfer of partnership interests, the court found that the beneficiaries did not have the right to use the property. In determining whether the beneficiaries had a right to income, the court applied a three-part test: 1) whether the partnership would generate income; 2) whether some portion of the income would flow steadily to the donees; and 3) whether that portion of income could be readily ascertained. All three elements were satisfied. First, the partnership assets produced income through dividends. Second, the income would flow steadily to the donees because one of the donees was a trust that required income distributions in order to pay its taxes, and the partnership agreement required pro-rata distributions to all of the limited partners. Third, the amount of income could be ascertained based on historical dividends paid on the stocks owed by the partnership.

The *Kelly* Case

In *Kelly v. Commissioner*, T.C. Memo 2012-73 (March 19, 2012), the Tax Court held that interests in a family limited partnership that were gifted to the decedent's children would not be included in the decedent's estate even though the decedent was the sole owner of the corporate general partner, which in turn received a management fee that theoretically could have been used to pay the decedent's living expenses. The IRS argued that the gifted partnership interests should be included in the decedent's estate because the management fee constituted an agreement for the decedent to retain income from the partnership. The Tax Court disagreed, noting that the decedent and her family consistently observed the formalities of the partnership structure and that the decedent had sufficient assets to meet her needs. The court also noted that the management fees were never actually used to pay for the decedent's living expenses. Indeed, the general partner would have breached its fiduciary duties to the limited partners had it used the management fees for that purpose.

Year-End Checklist for 2012

In addition to the above planning ideas, consider the following before 2012 is over:

- Sell appreciated long-term gain capital assets to take advantage of the 15% rate before it increases.
- Accelerate dividends, if possible.
- 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 the deduction on 2012 income tax return, although since rates are likely to increase in 2013 it may be more advantageous to wait and make charitable gifts in 2013.

Below is a discussion of national, international and local developments that occurred in 2012.

National Developments in 2012

Defense of Marriage Act Ruled Unconstitutional by Two Federal Appellate Courts

The First and Second Circuit Court of Appeals struck down as unconstitutional the Defense of Marriage Act of 1996 (DOMA), which prohibits the federal government from recognizing marriage or marriage equivalents (such as civil unions and domestic partnerships) between people of the same sex. In 2011, the Obama administration announced that it would no longer defend DOMA's constitutionality. In response, House leaders intervened and retained outside counsel to defend DOMA's constitutionality in *Windsor v. United States*, 2012 U.S. App. LEXIS 21785, No. 12-2335-cv(L) (2d Cir. Oct. 18, 2012) and *Gill v. Office of Personnel Management*, 682 F.3d 1 (1st Cir. 2012).

In *Windsor*, the Second Circuit held that a widow who was in a same-sex marriage with the decedent was entitled to the unlimited marital deduction under federal estate tax law.

In *Gill*, the First Circuit held that a group of plaintiffs who were in same-sex marriages were entitled to various federal protections and benefits available to opposite-sex married couples under the approximately 1,138 federal laws in which marriage is a factor.

Both decisions have been stayed while on appeal to the United States Supreme Court. Appeals to the Supreme Court are discretionary, however, and the Court is not likely to announce whether it will review either case until late November 2012. If the Court elects to hear either case, a decision will likely be issued during the summer of 2013. In the meantime, DOMA is still in effect.

A Testamentary Power of Appointment over an Irrevocable Trust May Not Prevent a Transfer to the Trust from Being Subject to Gift Tax

On February 24, 2012, the IRS Office of Chief Counsel issued an internal legal memorandum, No. 201208026, which takes the position that a grantor's retention of a testamentary limited power of appointment under an irrevocable trust for the benefit of the grantor's descendants will not prevent a transfer to the trust from constituting a "completed gift." Thus, any transfer to such a trust could be subject to immediate gift tax. According to the memorandum, a testamentary power of appointment relates only to the remainder of the trust and not to the interest held by the current beneficiaries. Thus, each transfer to the trust should be viewed as consisting of two segments: a current interest (which is a completed gift, and therefore subject to gift tax), and a remainder interest (which is incomplete, and therefore not subject to gift tax). Applying that framework, the entire fair market value of the transferred property may be subject to gift tax, depending on the particular provisions of the trust. Therefore, any planned transfer to a trust that gives the grantor a testamentary power of appointment should be carefully reviewed for gift tax consequences before the transfer is made.

International Developments in 2012

UK Law Changes

Though there are a number of UK tax reform initiatives and consultations in various stages of implementation, the following are likely to be the most significant to those with a connection to the UK.

The UK government has imposed new tax charges on high-value residential property (valued at more than £2 million), which are designed to curb the perceived abuse of the tax system arising from a UK or non-UK entity that is a "non-natural person," i.e., a company, a partnership whose partners include a company, or a collective investment scheme, owning residential property. The charges apply during ownership and at the purchase and sale of covered properties. Some charges have already taken effect, while others will take effect in April 2013.

A UK Statutory Residence Test (SRT) will be effective beginning April 6, 2013. This new test is designed to minimize uncertainty regarding what constitutes UK resident status.

The government has introduced a General Anti-Avoidance Rule (GAAR), designed to deter abusive tax arrangements, also scheduled take effect in April 2013. Though the proposed legislation currently lacks a clearance procedure, there will be an advisory panel that will issue non-binding, unpublished opinions to taxpayers on particular tax arrangements. Many provisions of the GAAR are still being reviewed, and additional legislation and guidance will be forthcoming later this year and in early 2013.

Beginning in 2013, the inheritance tax exemption for assets passing upon the death of a UK domiciled individual to a non-domiciliary surviving spouse will increase from £55,000 to £325,000 (the current amount of the nil rate band (NRB)), and will be pegged to the NRB thereafter. The government is also considering a measure that would permit non-domiciled spouses to elect to be treated as domiciliaries for inheritance tax purposes in order to obtain the full spousal exemption, in exchange for bringing the spouse's individual assets within the scope of the inheritance tax.

Effective April 2012, UK resident non-domiciliaries are permitted a tax exemption for remittances used for qualified investments in UK companies.

For questions regarding whether any of these developments apply to your facts and circumstances, please contact one of us.

French Law Changes

The French government recently released a decree clarifying the tax reporting obligations imposed on trustees of any trust established by a French resident, having a French resident beneficiary or holding a French asset. Under a 2011 law, trustees are obligated to declare the creation, modification and revocation of such trusts, and must also file an annual market value declaration of the trust assets. There is an annual wealth tax of 0.5% of the trust assets under certain circumstances. The penalty for failing to file the required declarations is high, including a fine of the greater of 5% of the trust assets or €10,000,

in addition to the annual wealth tax. 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.

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

2012 Offshore Voluntary Disclosure Initiative

The IRS once again extended the Offshore Voluntary Disclosure Initiative (OVDI) in 2012. In contrast to the 2009 and 2011 programs, the 2012 program will remain open indefinitely, and the penalty rate for disclosed assets greater than $75,000 has increased from 25% to 27.5% of the highest aggregate balance of the foreign assets during the eight tax years prior to the disclosure. The IRS could end the 2012 program or change the terms of the program (such as by increasing penalties or adding eligibility requirements) at any time. Taxpayers who did not enter the 2009 or 2011 OVDI but who want to disclose unreported offshore income should contact one of us to enter into the 2012 OVDI.

The Required Records Doctrine

Foreign bank account records may be subject to the "Required Records Doctrine" and thus may be discoverable in a criminal proceeding.

In the case of *In re Grand Jury Subpoena*, 696 F.3d 428 (5th Cir. 2012), the Fifth Circuit Court of Appeals ordered the production of foreign bank account records required to be kept under Treasury Department regulations by a witness who was the target of a grand jury investigation based on allegations that he was using Swiss bank accounts to avoid US income tax. The witness refused to produce the records, relying on his Fifth Amendment privilege against self-incrimination. The court held that the privilege against self-incrimination did not apply because the records fell within the "Required Records Doctrine," which applies when three conditions are met. First, the purpose of the recordkeeping requirement must be essentially regulatory and serve purposes other than criminal law enforcement. Second, the records sought must be of a kind customarily kept by the regulated party. Third, the records must have "public aspects" to them, which would render them analogous to public documents.

The court found that all three conditions were met based on the facts of the case. Because there is nothing inherently illegal about having a foreign bank account (as opposed to a completely illegal activity such as selling street drugs), the requirement to maintain and produce foreign bank account records is regulatory in nature. The witness did not dispute that he customarily kept bank account records. Though the court acknowledged that bank account records are usually viewed as private, it nonetheless found them to be analogous to medical records, which have been found to have sufficient "public aspects" to satisfy the Required Records Doctrine. The Seventh Circuit and the Ninth Circuit have reached the same result in cases arising in those jurisdictions.

Foreign Account Tax Compliance Act of 2009

Under the Foreign Account Tax Compliance Act of 2009 (FATCA), a tax equal to 30% must be withheld by a US 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 US account holder and comply with various reporting and withholding requirements. The withholding of 30% is on a broader category of US source income than is captured under the current withholding rules.

Although this regime was scheduled to go into effect on January 1, 2013, the IRS issued Announcement 2012-42, which extends this deadline and phases in FATCA over 2014 and 2015.

In September, the United States concluded a bilateral treaty with the UK designed to facilitate compliance with FATCA. The treaty provides a mechanism for UK financial institutions to comply with FATCA and avoid the withholding requirement by providing the required information to the UK government, which in turn will relay the information to the IRS. In exchange, US institutions will be required to report more limited information regarding their UK account holders to the IRS, which will

forward the information to the UK. Treasury recently announced that negotiations for similar treaties are underway with more than 50 countries, including France, Germany, Italy, Spain, Japan, Switzerland, Canada, Denmark, Finland, Guernsey, Ireland, Isle of Man, Jersey, Mexico, the Netherlands and Norway. Treasury expects that many of those agreements will be concluded by the end of 2012.

In addition to the withholding regime described above, FATCA also requires new reporting for individuals who are US owners of specified foreign financial assets and enhanced reporting for US shareholders of passive foreign investment companies. Those reporting obligations became effective in tax year 2011, and the IRS has issued final forms, instructions and additional guidance.

Please contact us if you would like more detailed information.

FBAR Forms

In February 2011, the Financial Crimes Enforcement Network (or 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 US person who creates a foreign trust and appoints a trust protector subject to the US 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 US person who has an ownership interest in a trust for US 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 US person that files an FBAR disclosing the trust's foreign financial accounts.

Form 3520

Any US person who receives gifts or bequests from foreign individuals or estates in excess of $100,000 is also required to file a Form 3520 with the IRS. The penalty for failing to file the return is 5% of the amount of the foreign gift for each month for which the failure to report continues, up to a maximum of 25% of the gift.

Local Developments in 2012: State-Specific Considerations

California

In 2012, California voters passed Proposition 30, which temporarily increases the personal income tax rates for upper-income California taxpayers. Proposition 30 is retroactive to January 1, 2012, and expires at the end of 2018. Proposition 30 creates three new tax brackets for income exceeding a minimum threshold ($250,000 for single filers, $340,000 for heads of household and $500,000 for married couples) with the highest marginal personal income tax rate being 13.3% (taking into account the mental health tax rate of 1% for taxable income in excess of $1 million).

Connecticut

Individuals who are domiciled in Connecticut or who intend to make gifts of real estate or tangible personal property located in Connecticut are subject to a separate Connecticut gift tax in addition to the federal gift tax. Such individuals have a total of $2 million ($4 million for a married couple) that they may gift in the aggregate during their lifetimes, reduced by the amount of any prior gifts in excess of the annual gift tax exclusion amount that they made in 2005 or any following year. The maximum Connecticut gift tax rate is 12% for gifts in excess of the Connecticut applicable exclusion amount. Accordingly, any gift of Connecticut real estate or tangible personal property or a gift made by a Connecticut domiciliary should be carefully reviewed for potential Connecticut gift tax consequences before the gift is made.

Florida

In *Astrue v. Capato ex rel. B.N.C.*, 132 S. Ct. 2021 (2012), the United States Supreme Court held that children conceived after the death of their father would only be eligible for Social Security survivor benefits if they could inherit from their deceased father's estate under state intestacy law, i.e., if their father had not left a valid will, or if they could meet one or more statutory alternatives to the intestacy requirement (e.g., by being the subject of an affirmation or acknowledgment of paternity, a paternity judgment or order to pay child support). Under the law of Florida, where the case originated, children conceived after their father's death could not inherit in the absence of a will. The court found that the intestacy requirement was not met because the children in that case were conceived with their father's frozen sperm approximately 9 months after their father died, and born approximately 18 months after his death. Moreover, none of the statutory alternatives to the intestacy requirement were met. Accordingly, the court held that the children were not entitled to Social Security survivor benefits.

Illinois

Directed Trusts

Illinois joined more than 30 other states in enacting a directed trustee statute. Under prior Illinois law, trustees were potentially liable for the decisions of other advisors designated in the trust instrument. Illinois' new directed trustee statute specifically authorizes a trust to bifurcate management duties between a trustee and an investment advisor, trust protector, distribution advisor or other person or entity acting as a fiduciary. The new statute insulates the trustee from liability for following the direction of the advisor. The directed trustee statute applies to all Illinois trusts in existence or established after January 1, 2013.

Trust Decanting

Illinois became one of approximately 15 states to enact trust decanting legislation. Trust decanting is used to update the terms of an otherwise irrevocable trust by distributing trust assets from one trust to another trust with the desired terms. For example, decanting may be used to update the administrative terms of a trust, such as changing successor trustees. In addition, trust decanting may be used to change the beneficiaries of a trust. The extent to which a trustee may modify the terms of an irrevocable trust depends on how much discretion is granted to the trustee under the first trust. If the trustee is granted "absolute discretion" to distribute trust assets to beneficiaries under the first trust, then the trustee may eliminate the interests of one or more beneficiaries and may also modify powers of appointment. If a trustee does not have absolute discretion to distribute trust assets, then the trustee may not change beneficiaries, but may make other changes to the trust. The trust decanting statute applies to all Illinois trusts in existence or established after January 1, 2013.

Civil Unions Qualify for State Estate Tax Marital Deduction

On August 9, 2012, the Illinois Attorney General issued an administrative ruling providing that parties to a civil union will be allowed a marital deduction for Illinois estate tax purposes even though same-sex couples are not allowed the marital deduction for federal estate tax purposes because of the federal Defense of Marriage Act.

Estate Tax Threshold

Illinois increased the state estate tax exclusion amount from $3.5 million in 2012 to $4 million in 2013 and each year thereafter.

New York

Although the 2012 New York legislative session did not produce as much law affecting estate and trust planning, administration and litigation as the 2011 session, there were still a number of changes in the field.

Hurricane Sandy

Following the widespread disruption caused by Hurricane Sandy, Governor Cuomo issued Executive Order 52, which, until further notice, effectively suspends the statute of limitations for any civil claim where the time to file such claim expired on or after October 26, 2012. The order also suspends the time to take an appeal or cross-appeal, and gives the courts discretion to extend the time for filing or service of any legal action, notice or other process or proceeding not otherwise covered by the order. Relatedly, the Commissioner of the New York Department of Taxation and Finance issued Notices N-12-11 and N-12-16, which extended the deadlines for taxpayers to file certain tax returns and pay taxes due on or after October 26, 2012, until November 26, 2012.

New York Estates

Section 5-3.1 of the Estates, Powers and Trusts Law (EPTL) was amended to include "marketable securities" in the list of liquid assets (not exceeding $25,000 in value) that are deemed excluded from the estate of a decedent who is survived by a spouse or a child under the age of 21.

Sections 1123, 1213 and 1301 of the Surrogate's Court Procedure Act (SCPA) were amended to raise the cap for the size of a "small estate" from $5,000 to $30,000 for purposes of filing an "informatory" account, thus avoiding the expense of a judicial accounting, and to clarify which assets will be included in determining the size of a small estate.

Standby Guardians of Developmentally Disabled Persons

The legislature amended Section 1757 of the SCPA to provide that a standby guardian of a developmentally disabled person will be deemed to have renounced his or her guardianship if the standby guardian fails to act within 60 days of written notice that the prior guardian is unable to serve.

Life Insurance Guarantees

In the wake of the restructuring of Executive Life Insurance Company of New York, the legislature amended Article 77 of the Insurance Law to raise the cap for state guarantees of life insurance policies from $550 million to $558 million.

North Carolina

In 2012, North Carolina enacted a directed trust statute NCGS 36C-8A-801, et seq. Directed trusts are trusts that do not grant the trustee full managerial authority, and instead assign some of the trustee's powers to other individuals. The North Carolina statute provides that trust instruments may confer various investment, distribution and other administrative powers on persons other than the trustee. The individuals holding such powers ("power holders") are generally fiduciaries who are required to act in good faith and are liable for any losses resulting from a breach of their fiduciary duty. The statute absolves the directed trustee from liability except in cases of intentional misconduct. Similarly, the directed trustee is absolved of liability for failure to take any action that requires a power holder's consent if the directed trustee requests the power holder's consent but the power holder withholds such consent. The directed trustee does not have a duty to monitor, advise or consult with the power holder. The statute also addresses related matters, such as compensation and expense reimbursement, jurisdiction, and the appointment, resignation and removal of power holders.

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 B. Burks, Associate	704.344.3153	diane.burks@kattenlaw.com
William E. Underwood, Jr., Of Counsel	704.444.2010	bill.underwood@kattenlaw.com

CHICAGO

Charles Harris, Chicago Co-Head	312.902.5213	charles.harris@kattenlaw.com
Michael O. Hartz, Chicago Co-Head	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
Anthony L. Engel, Associate	312.902.5316	anthony.engel@kattenlaw.com
Jonathan Graber, Partner	312.902.5317	jonathan.graber@kattenlaw.com
Stuart E. Grass, Partner	312.902.5276	stuart.grass@kattenlaw.com
Anna G. Kardaras, Associate	312.902.5314	anna.kardaras@kattenlaw.com
Royelle M. Kashiwahara, Associate	312.902.5335	royelle.kashiwahara@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
Andrew L. McKay, Associate	312.902.5315	andrew.mckay@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 Head	310.788.4722	abby.feinman@kattenlaw.com
Steven L. Guise, P.C., Of Counsel	310.788.4695	steven.guise@kattenlaw.com
Jesse R. Jacobsen, Associate	310.788.4457	jesse.jacobsen@kattenlaw.com
Carol A. Johnston, Partner	310.788.4505	carol.johnston@kattenlaw.com
Heather J. Turk, Associate	310.788.4531	heather.turk@kattenlaw.com

NEW YORK

Joshua S. Rubenstein, National Head	212.940.7150	joshua.rubenstein@kattenlaw.com
Ronni G. Davidowitz, New York Head	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
David S. Goldstein, Associate	212.940.6740	david.goldstein@kattenlaw.com
Lauren M. Goodman, Associate	212.940.6344	lauren.goodman@kattenlaw.com
Jasmine M. Campirides Hanif, Partner	212.940.6491	jasmine.hanif@kattenlaw.com
Milton J. Kain, Of 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
Jason J. Smith, Associate	212.940.6392	jason.smith@kattenlaw.com
Beth D. Tractenberg, Partner	212.940.8538	beth.tractenberg@kattenlaw.com

Katten

Katten Muchin Rosenman LLP   www.kattenlaw.com

CENTURY CITY   CHARLOTTE   CHICAGO   IRVING   LONDON   LOS ANGELES   NEW YORK   OAKLAND   ORANGE COUNTY   SHANGHAI   WASHINGTON, DC

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

©2012 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.

11/20/12