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2014 Year-End Estate Planning Advisory

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Overview

In 2014, we continued to experience a period of relative stasis in our federal transfer tax system and have been able to plan without expecting imminent significant changes to the system. Under the American Taxpayer Relief Act of 2012 (ATRA 2012), the estate, gift and the generation-skipping transfer (GST) tax exclusion amounts (the "applicable exclusion amounts") were initially set at $5 million, indexed for inflation. The current $5.34 million applicable exclusion amounts are set to increase to $5.43 million in 2015. ATRA 2012 made permanent the so-called "portability" provisions of the federal gift and estate tax laws, which, under certain circumstances, allow a surviving spouse to utilize the deceased spouse's unused applicable exclusion amount (DSUE) toward amounts gifted or transferred at death (but does not increase the surviving spouse's federal GST exemption). The historically high exclusion amounts and the portability provisions under ATRA 2012 continue to create many new estate planning opportunities.

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

Although we are enjoying the respite from annually changing transfer tax rates, the President has included a call for a reduction of the applicable exclusion amounts to the more modest 2009 levels in his 2015 budget proposal, which sets forth reduced estate and GST applicable exclusion amounts of $3.5 million and a gift tax applicable exclusion amount of only $1 million, with no inflation indexing to any of the applicable exclusion amounts. We continue to monitor these proposed changes, as well as many others that the administration has targeted, which are addressed below.

This year we also have seen some significant cases that affect planning and wealth transfer, including *Clark v. Remeker*, in which the US Supreme Court held that funds in an inherited individual retirement account (IRA) are subject to the claims of creditors and Estate of Elkins in which the Fifth Circuit substantially increased the valuation discounts allowed for a decedent's fractional interests in art.

There have been many far-reaching changes at the state law level, particularly in New York, which

made substantial revisions to its state transfer taxes and its income taxation of trusts.

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

Federal Estate, GST and Gift Tax Rates

For 2014, the estate, gift and GST applicable exclusion amounts are $5.34 million. For 2015, the estate, gift and GST applicable exclusion amounts will be $5.43 million. The maximum rate for estate, gift and GST taxes will remain at 40%.

Annual Gift Tax Exemption

Each year individuals are entitled to make gifts (the "Annual Exclusion Amount") without incurring gift tax or using any of their lifetime applicable exclusion amount against estate and gift tax. The Annual Exclusion Amount will remain at $14,000 per donee in 2015. Thus, a married couple together will be able to gift $28,000 to each donee. The limitation on annual gifts made to noncitizen spouses will increase from $145,000 to $147,000 in 2015.

Federal Income Tax Rates

- Individual ordinary income tax rates will remain the same in 2015, with a maximum rate of 39.6%.

- For taxpayers whose ordinary income is taxed at the maximum 39.6% level, long-term capital gains will continue to be taxed at 20%. Long-term capital gains for taxpayers in lower ordinary income tax brackets will continue to be taxed at 15% or 0% if the taxpayer's ordinary income is taxed at 10% or 15%. Qualified dividends are taxed at the long-term capital gains rate.

- The threshold for the imposition of the 3.8% Medicare surtax on investment income and 0.9% Medicare surtax on earned income will remain the same in 2015 for individuals ($200,000 for single filers, $250,000 for married filers filing jointly, $125,000 for married filers filing separately), but rises to $12,300 for trusts and estates.

President's Budget Proposal for Fiscal Year 2015

The President's budget proposal for Fiscal Year 2015 includes a number of transfer tax-related items, many of which have been proposed in prior years, the most relevant of which are summarized below.

Simplify and Limit Gift Tax Annual Exclusion for Present Interests

This new potentially far-reaching and significant proposal eliminates the "present interest" requirement for gifts in order to qualify for the gift tax annual exclusion. The proposal creates a new category of annual exclusion gifts that is subject to an annual limit of $50,000 per donor. This proposal is intended to address perceived abuses in the use of so-called "Crummey Powers," most frequently an issue with contributions to insurance trusts to pay insurance premiums. The ability to use essentially unlimited numbers of individuals named as Crummey Power holders to absorb the

cost of insurance premiums on trust-owned life insurance (so long as the individual has a contingent remainder interest in the trust) has long been viewed as abusive by the Internal Revenue Service (IRS). The proposal eliminates the present interest, defines a new category of transfers and imposes an annual limit of $50,000 per donor on the donor's transfers of property within this new category that will qualify for the annual gift tax exclusion. The new category includes: (1) transfers to trusts; (2) pass?through entity interest gifts; (3) transfers of interests subject to a prohibition on sale; and (4) other transfers of property that, without regard to withdrawal, put or other such rights to the donee, cannot immediately be liquidated by the donee. The $14,000 per donee per year annual exclusion will still apply to most outright gifts. There are many issues, such as allocation of gifts between the new $50,000 category and other $14,000 annual exclusion gifts, that would need to be addressed if this proposal becomes law. It could significantly affect current planning techniques, particularly as to the purchase of large insurance policies, because even if individual gifts do not exceed the $14,000 (or $28,000) limit, if gifts within the new category exceed $50,000 in the aggregate, they will constitute taxable gifts.

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

This proposal requires most non-spouse beneficiaries of traditional IRAs and Roth IRAs to take distributions over no more than five years for taxpayers after age 70 1/2. The proposal would be effective with respect to plan participants and IRA owners dying after 2014. There would be an exception for a beneficiary who is disabled, chronically ill, not more than 10 years younger than the participant or IRA owner, or a minor child.

60-Day Rollover for Inherited Retirement Benefits

A new taxpayer-friendly proposal allows a non-spouse beneficiary to roll distributions over to an inherited IRA within 60 days, effective for distributions after 2014. Currently, only a plan participant, IRA owner or spouse can receive distributions of qualified plans or IRA benefits and roll them over tax-free into another qualified plan or IRA within 60 days. A beneficiary other than a spouse may only make a trustee-to-trustee transfer from the decedent's IRA to an inherited IRA.

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

Under the proposal, the minimum distribution rules would not apply if the aggregate value of the IRA or qualified plan does not exceed $100,000 (indexed for inflation). The proposal applies to individuals reaching age 70 1/2 after 2014 or who die after 2014 before attaining age 70 1/2.

Reduce Exclusion Amounts and Tax Rate

As was the case last year as well, the budget proposal provides for a permanent return of the estate, gift and GST tax regimes to their 2009 levels, i.e., a 45% top tax rate and maximum $3.5 million applicable exclusion amounts for estate and GST tax and $1 million for gift tax, beginning in 2018. Note that the proposal makes clear that there would be no "clawback" of transfer taxes for those who took advantage of higher applicable exclusion amounts prior to 2018.

Change the Treatment of Intentionally Defective Grantor Trusts (IDGTs)

The budget proposal again contains a provision that would significantly undermine the utility of IDGTs, used frequently as a highly effective tax planning technique. The grantor of an IDGT is

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

Require Consistency of Basis Valuation

The proposal 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.

Impose New Requirements for Grantor Retained Annuity Trusts (GRATs)

The proposal adds three additional requirements that would be imposed on GRATs: (1) they must have a 10-year minimum term; (2) they must have a remainder interest greater than zero; and (3) the annuity amount cannot decrease in any year during the annuity term.

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

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

Extend Liens on Estate Tax Deferrals

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

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

Important Cases Decided in 2014

Appeals Court Grants Taxpayer Substantial Discounts on Value of Art

In Estate of Elkins v. Commissioner, the US Court of Appeals for the Fifth Circuit reversed the US Tax Court's decision and granted an increased discount for the decedent's fractional interests in art. The decision resulted in a $14 million estate tax refund.

The decedent had owned interests in 64 artworks for which the Tax Court had granted a 10% discount. On appeal, the Fifth Circuit accepted the 52% to 80% range of discounts offered at trial by the estate's expert witnesses. The overall discounts accepted were in excess of those taken by the estate.

This case is significant because it provided substantially higher discounts than have previously been granted for fractional interests in art. In addition, it provides additional support that fractional discounts for art will be accepted.

US Supreme Court Holds in *Clark v. Remeker* That Inherited IRAs Are Not Protected in Bankruptcy

In a significant, unanimous decision, the US Supreme Court held that inherited IRAs are not "retirement funds" under the federal bankruptcy law. Thus, inherited IRAs are subject to the claims of the new IRA beneficiary's creditors. The Court found a distinction between money set aside for the original owner's retirement and money inherited by a designated beneficiary. Following the Clark decision, clients should consider the possibility of designating a trust, rather than individual beneficiaries, to receive IRA assets if they wish to have the assets protected after death. There are pros and cons to this approach that should be discussed with us.

Important Planning Considerations for 2014 and 2015

Review and Revise Your Estate Plan to Ensure It Remains Appropriate

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

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

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

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

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

Same-sex couples who are married or plan to marry should review and revise their estate planning documents to take advantage of the unlimited marital deduction from federal estate and gift tax for transfers between same-sex spouses that is now available, as existing estate planning documents may have been drafted before the unlimited marital deduction was available for same-sex married couples. Accordingly, married same-sex couples may wish to modify their estate planning documents to provide that any assets included in their estates in excess of their applicable exclusion amounts will pass to their surviving spouse, either outright or in a properly structured marital trust for the spouse's benefit, thus deferring all federal estate taxes until the death of the surviving spouse. Documents that refer to a "spouse" should be sure to define that term to refer to marriages that were

valid where celebrated, so that if the couple moves to a nonrecognition jurisdiction, the claim cannot be made that the survivor is not a spouse under local law and therefore not a spouse under the documents.

Avoid the Medicare Surtax With Trust Income Tax Planning

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

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

Make Gifts to Take Advantage of the Increased Applicable Exclusion Amount

You now have a total of $5.34 million ($10.68 million for a married couple) that you can gift in the aggregate during your lifetime, subject to reduction for any gifts in excess of the Annual Exclusion Amount you have previously made. Gifts in excess of these amounts are subject to a maximum federal gift tax rate of 40%. If you are a surviving spouse and your deceased spouse left you with any DSUE, you may add such unused applicable exclusion amount to your own applicable exclusion amount from gift tax. It is less expensive to make lifetime gifts rather than making gifts at death, because you do not pay a tax on the dollars used to pay gift tax, but you do pay estate tax on the dollars used to pay estate tax. In addition, you will benefit by getting any income and appreciation on the gift out of your estate.

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

Note that your applicable exclusion amount will increase by $90,000 ($180,000 for a married couple) in 2015. Therefore, even if you use some or even all of the applicable exclusion amount available to you before the end of 2014, you may still make additional gifts in 2015 without paying any gift tax. Your applicable exclusion amount also will be adjusted for inflation in future years.

Grantor Retained Annuity Trusts (GRATs)

GRATs remain one of our most valuable planning tools, particularly in this time of continuing historically low interest rates. Because of the possibility of new legislation changing how GRATs may be structured and of rising interest rates, GRATs should be created as soon as possible. An important point to note is that GRATs may be structured without making a taxable gift, so even if you

have used all of your applicable exclusion amount, GRATs may be used without incurring any gift tax. In addition, while interest rates are projected to begin rising sometime next year, they are still relatively low, which further increases the effectiveness of GRATs.

A GRAT provides you with a fixed annual amount (the annuity) from the trust for a term of years (which may be as short as two years). The annuity you retain may be equal to 100% of the amount you use to fund the GRAT, plus the IRS-assumed rate of return applicable to GRATs (which for transfers made in December 2014 is 2%). As long as the GRAT assets outperform the applicable rate, at the end of the annuity term you will be able to achieve a transfer tax-free gift of the spread between the actual growth of the assets and the IRS assumed rate of return. Although you will retain the full value of the GRAT assets, if you survive the annuity term, the value of the GRAT assets in excess of your retained annuity amount will then pass to whomever you have named, either outright or in further trust, with no gift or estate tax.

Sales to IDGTs

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

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

If the value of the assets grows at a greater pace than the prevailing applicable federal rate (which for sales in December 2014 is as low as 0.34% for a short-term sale), as with a GRAT, the appreciation beyond the federal rate will pass free of gift and estate tax. The current near record-low interest rates make sales to IDGTs most opportune to structure now.

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

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

Consider the Use of Life Insurance

Life insurance presents significant opportunities to defer and/or avoid income taxes, as well as provide assets to pay estate tax or replace assets used to pay estate tax. Generally speaking, appreciation and/or income earned on a life insurance policy accumulates free of income taxes until the policy owner makes a withdrawal or surrenders or sells the policy. Thus, properly structured life insurance may be used as an effective tax-deferred retirement planning vehicle. Proceeds distributed upon the death of the insured are completely free of income taxes. You may want to consider paying

off any outstanding loans against existing policies in order to maximize the proceeds available tax-free at your death, although potential gift tax consequences must be examined. Note that the decision to pay off such loans requires a comparison of the alternative investments that may be available to you with the assets you would use to repay the loans and the interest rate on the loans.

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

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

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

Consider Charitable Planning

A planning tool that is very effective in a low-interest-rate environment is a Charitable Lead Annuity Trust (CLAT), which combines philanthropy with tax planning. A CLAT is an irrevocable trust that pays one or more named charities a specified annuity payment for a fixed term. At the end of the charitable term, any remaining assets in the CLAT pass to the remainder, noncharitable beneficiaries. As with a GRAT, to the extent the assets outperform the IRS assumed rate of return (2% for December 2014), those assets can pass transfer tax free to whomever you would like.

Unfortunately, there is much uncertainty as to whether you can make IRA Charitable Rollover gifts this year and in future years. There is presently no law permitting such gifts, as the Charitable Rollover provision of the Code expired on December 31, 2013. Congressional action is still required to revive the law for 2014 and beyond.

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

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

If the law is ultimately not extended for 2014, the IRA distribution would not qualify for exclusion from gross income, but the gift would qualify for an income tax charitable deduction, subject to the applicable limitations on charitable deductions. Therefore, if you need to take your required minimum distribution for 2014 and want to make a charitable gift of that amount, then arranging for it to be directly contributed to your favorite charity in accordance with the above requirements should not adversely impact you and may be beneficial if the provision is extended for 2014.

Year-End Checklist for 2014

In addition to the above planning ideas, consider the following before 2014 is over:

- Make year-end annual exclusion gifts of $14,000 ($28,000 for married couples).
- Make year-end IRA contributions.
- Create 529 Plan accounts before year-end for children and grandchildren, and consider front-loading the accounts with five years worth of annual exclusion gifts, taking into account any gifts made during the year to children and grandchildren.
- Pay tuition and medical expenses directly to the school or medical provider.
- Consider making charitable gifts before year-end to use the deduction on your 2014 income tax return.

Below is an overview of national, international and local developments that occurred in 2014.

National Developments in 2014

Charitable Legislative Development

On July 17, 2014, the United States House of Representatives approved H.R. 4719, "The America Gives More Act," which provides several provisions to increase charitable giving, including the following: (1) a retroactive and permanent extension of the "IRA Charitable Rollover," which allows individuals age 70 1/2 or older to donate up to $100,000 annually to charities directly from their IRAs without having to treat the distributions as taxable income; (2) allowing charitable contributions through April 15 to be deducted on the prior year's tax return; and (3) providing enhanced deductions for food inventory and conservation easements. The legislation has not been passed in the Senate.

International Developments in 2014

Foreign Account Tax Compliance Act (FATCA)

On July 1, 2014, FATCA withholdings began implementation.

Broadly, FATCA has at its core goal the collection of information on US beneficial owners of foreign accounts and entities. Under FATCA, certain US taxpayers holding financial assets outside the United States must report these assets to the IRS. In addition, FATCA imposes a reporting duty on foreign financial institutions, as to financial accounts held by US taxpayers, with compliance made more likely by the implementation of 30% withholding requirements of US source income and other payments to the foreign financial institutions (FFIs) that do not meet certain reporting requirements. Non?compliant FFIs generally are not entitled to a refund of taxes withheld.

The definition of FFI is very broad and was meant to include banks, securities firms, money services businesses, money exchange houses, hedge funds, private equity funds, commodity traders, derivative dealers, and any other type of financial firm that holds, invests or trades assets on behalf of itself or another person. Importantly, the final regulations illustrate that foreign trusts and holding companies owned by such trusts (often used by offshore fiduciaries as a measure of protection and

anonymity) whose income is primarily derived from investment assets are FFIs. A narrow exception from FFI status exists for foreign trusts that are not professionally managed by an entity.

Thus, in almost all cases, both foreign trusts and the holding companies owned by such trusts will have to comply with FATCA.

In the case of foreign trusts that are FFIs and have substantial US owners, there are a number of alternatives to becoming FATCA compliant. Those trusts may instead (1) become a participating FFI (by signing an FFI agreement with the IRS and obtaining a Global Intermediary Information Number [GIIN]), (2) be considered deemed compliant FFIs under an applicable intergovernmental agreement or (3) become a deemed compliant FFI by being sponsored by another financial institution. This latter alternative allows another financial institution, with management authority, to fulfill the reporting obligations of the sponsored FFI, thereby doing away with the need of each entity to become a separate reporting FFI.

The term "substantial US owner" when used with respect to a foreign trust means any specified US person who is treated as the owner of the trust for US income tax purposes and any US person who holds, directly or indirectly, a more than 10% beneficial interest in the trust. If the trust is discretionary then the determination will be based on whether the beneficiary actuallyreceived more than 10% of either (1) the distributions made in the prior year or (2) the value of the assets held by the trust at the end of the year. A de minimis exception applies if distributions to a beneficiary total less than $5,000, if the beneficiary is entitled to receive mandatory trust distributions, and if the beneficiary's total interest in the trust is valued at $50,000 or less.

With implementation of compliance procedures being an immense and complex task, the IRS has stated that it is planning a "reasonable and rational approach" to the enforcement of FATCA. While not extending any of the deadlines, the IRS has announced that an FFI that makes a "good faith effort" at compliance with FATCA and its regulations will be granted relief from IRS enforcement of (1) the 30% withholding tax liabilities or (2) penalties for failing to withhold or report during a transition period that will extend to the end of 2015.

Changes to Offshore Voluntary Disclosure Program (OVDP)

On June 18, 2014, the IRS announced significant revisions to the streamlined filing procedure and the 2012 Offshore Voluntary Disclosure Program (OVDP), both of which are applicable to US taxpayers who have unreported foreign accounts and who have failed to report income from such accounts.

Streamlined Filing Procedures

The streamlined filing procedures are available to US taxpayers whose non-reporting of foreign accounts and tax non-compliance was due to non-willful conduct.

The major modifications that were made in June include:

1. extending eligibility for the streamlined filing procedure to US taxpayers residing in the United States;
2. eliminating a requirement that the taxpayer have $1,500 or less of unpaid tax per year;

3. eliminating the required risk questionnaire; and

4. requiring that the taxpayer certify that previous failures to comply were due to non-willful conduct.

As a result, the streamlined program will be available to more taxpayers. In order to participate in the streamlined filing program, taxpayers must amend tax returns for the most recent three years for which the due date has passed, pay the previously unpaid tax and interest, certify that the previous failure to comply was due to non-willful conduct, file FBARs for the most recent six years for which the due date has passed, and pay the miscellaneous offshore penalty for participating in the streamlined filing procedure (5% of the unreported foreign assets for a US taxpayer living in the United States and no penalty for US taxpayers living abroad).

Significantly, the IRS stated on November 6, 2014, that it will not define "non-willful" conduct.

OVDP

The 2012 OVDP is a program available to US taxpayers with unreported foreign accounts and income whose non-compliance was willful. Participation in the OVDP requires amending eight years of income tax returns and FBARs. Importantly, participation in the OVDP insulates a taxpayer from criminal prosecution (which is not the case with the streamlined procedure).

The changes made to the 2012 OVDP, which are effective July 1, 2014, unless otherwise noted, include the areas below.

1. Requiring additional information from taxpayers applying to the program.

2. Eliminating the reduced penalty percentage for certain non-willful taxpayers in light of the expansion of the streamlined procedures.

3. Requiring taxpayers to submit all account statements and pay the offshore penalty at the time of the OVDP application rather than later in the process.

4. Enabling taxpayers to submit voluminous records electronically rather than on paper.

5. Beginning on August 4, 2014, increasing the offshore penalty percentage (from 27.5% to 50%) if, before the taxpayer's OVDP pre-clearance request is submitted, it becomes public that a financial institution where the taxpayer holds an account or another party facilitating the taxpayer's offshore arrangement is under investigation by the IRS or Department of Justice (for a list of such institutions, click here).

We strongly advise you to consult with one of us immediately if you have any unreported accounts.

Local Developments in 2014: State-Specific Considerations

California

In *Valli v. Valli*, the Supreme Court of California ruled that a formal express agreement is required to transmute property that is acquired from a third party with community property funds to separate

property regardless of whether the property was titled in the name of one spouse immediately upon acquisition from the third party. In doing so, the Court overturned case law from 2008 that drew a distinction between inter-spousal transfers and transfers from third parties for purposes of California's statutory transmutation agreement requirement (as is applicable to transmutations that have occurred since January 1, 1985). The facts in Valli involve the purchase of a life insurance policy with community property funds on the life of the husband. Upon purchase, the wife was designated as the owner of the policy without a formal transmutation agreement. The wife argued, in reliance on a 2008 California Appeals Court decision, that a transmutation agreement was not required where the property was acquired from a third party and thereupon was immediately titled in one spouse's name. The Court disallowed this distinction between inter-spousal and third party transfers, finding that the policy for requiring transmutation agreements—to minimize litigation over the nature of property in contentious divorce proceedings—would be undermined by such a distinction.

California enacted legislation that changes how charitable remainder trusts are taxed on certain forms of income referred to as Unrelated Business Taxable Income (UBTI). Prior to the new law, a charitable remainder trust that earns UBTI would be subject to California income tax on all of its income, as if it were a non-charitable trust. In comparison, under federal law, a charitable remainder trust would be subject to an excise tax equal to any UBTI that it earns in a given year. As a result of the new law, which is effective as of January 1, 2014, a charitable remainder trust that earns UBTI is subject to California income tax on just that portion of its income that is UBTI, which is a more favorable result to the taxpayer than both the former California law and the current federal law.

California enacted legislation requiring the disclosure of the amount of the documentary transfer tax due on an recorded transfer instrument, such as a deed. Prior to the new law, one could opt to record the deed in connection with the transfer of title on the sale of real property without disclosing the amount of documentary transfer tax due, and then file a separate document with this information. This ensured a degree of privacy with respect to the sales price amount. The new law eliminates the option to disclose the documentary transfer tax amount due on a separate instrument from the recorded deed. Beginning January 1, 2015, the amount of the documentary transfer tax due must be disclosed on the deed.

California enacted legislation effective January 1, 2015, that requires notary blocks for certificates of acknowledgment and jurats to contain specific language as set forth in the California Civil Code.

Connecticut

In 2014, Connecticut enacted double taxation relief, effective for estates of those decedents dying after January 1, 2015. The definition of "Connecticut taxable estate" is modified to exclude property that is also included in the Connecticut taxable estate as a lifetime gift. The legislation also provides a credit for any Connecticut gift taxes paid with respect to such gifts. This legislation corrects the prior law that essentially taxed twice certain types of assets, such as transfers with a retained life estate.

Florida

In 2014, Florida enacted the "Florida Family Trust Company Act", which provides a statutory framework for family-owned private trust companies in Florida, effective October 1, 2015. The act authorizes families to form and operate family trust companies, licensed family trust companies and foreign licensed family trust companies, subject to certain regulatory requirements. These private family trust companies are generally formed to manage the wealth of high net-worth families in lieu of traditional individual or institutional trustee arrangements for many reasons, including investment,

personal, regulatory and tax reasons.

Illinois

Trust Taxation

An Illinois statute provides that if the Grantor of a trust is domiciled in Illinois at the time such trust becomes irrevocable (i.e., when the trust is no longer a "grantor trust" for income tax purposes), that trust is subject to Illinois income tax in perpetuity. This statute often results in unfair outcomes, imposing Illinois income tax on trusts that, years after initially becoming irrevocable, no longer have contact with Illinois. The Illinois Fourth District Appellate Court recently agreed, holding that it is unconstitutional for Illinois to tax the income of an irrevocable inter vivos trust having insufficient contacts with Illinois (*Linn v. Department of Revenue*).

Linn involved a trust that was established in 1961 by an Illinois resident and initially administered under Illinois law. In 2002, the Trustee distributed the trust's assets to a new trust, which was subsequently modified by a Texas court to eliminate all references to Illinois law. When the Trustee filed an Illinois income tax return for the trust as a nonresident in 2006, no trust beneficiary, Trustee or other trust officeholder resided in Illinois and no trust assets were located in Illinois.

The Linn court held that it is unconstitutional for Illinois to tax such a trust's income, for several reasons. First, in the tax year in question, the trust did not have any Illinois Trustees or beneficiaries, and all trust assets were located outside of Illinois. Second, the trust was not created under Illinois law, but was instead created by a power granted to the Trustee under the original instrument. Third, the court noted that, unlike a testamentary trust, no Illinois probate court had jurisdiction over the trust, and that connections to a particular state are often "more attenuated" for inter vivos trusts. Finally, the court emphasized that a Grantor's residence within Illinois is not by itself sufficient to establish a minimum connection with the state. The Illinois Department of Revenue decided not to appeal the court's decision. Clients with irrevocable Illinois trusts that no longer have contact with Illinois should contact their attorney to determine whether these trusts may not be subject to Illinois income tax.

Asset Protection and Discretionary Trusts

Many of the trusts we create are "discretionary trusts," which grant the Trustee the sole discretion over distribution decisions (the beneficiary has no ability to compel distributions). Under the laws of most states, the assets of a discretionary trust created by a third party are protected from the beneficiary's creditors because for state law purposes the beneficiary has no "property interest" in the trust; that is, the beneficiary is not entitled to and cannot compel a Trustee to make distributions and therefore there is no interest for the creditor to attach. For example, an Illinois statute provides that no court may order the satisfaction of a judgment out of property held in trust if the trust was created in good faith and was created by someone other than the debtor. So, when a beneficiary is sued, the assets in the trust should be creditor-protected on the rationale that the beneficiary has no "property interest" in a discretionary trust. The creditor must wait until a beneficiary receives a distribution from a discretionary trust and then institute proceedings to attach the distribution to satisfy the judgment. Creditors are now seeking to garnish discretionary trusts, so that any distribution made out of the trust to the debtor beneficiary must be turned over directly to the creditor. In *Community Bank of Elmhurst v. Klein*, an Illinois appellate court ruled that a creditor may attach and place a lien on trust distributions to be made to the debtor beneficiary in the future.

Cases like this make it easier for creditors to attack discretionary trusts. For many clients, the most

significant creditor risk is a divorce creditor. Holdings like that of Klein reinforce the importance of entering into a premarital agreement with respect to inherited trust assets. A premarital agreement may protect not only the assets in the trust, but may also protect distributions from the trust (i.e., address the Klein holding) and also may provide that the trust assets cannot be considered when setting a spousal maintenance award. These issues should be raised with a matrimonial lawyer.

Statutory Health Care Power of Attorney

Illinois enacted substantial revisions to its power of attorney for health care statute. The statutory form has been revised to be more user-friendly, with a new notice section that is in a "frequently asked questions" format. The statute requires that the revised notice precede the health care form. The statute also clarifies that witnesses must be 18 years or older and may not be certain licensed medical or health care professionals providing services to the principal, such as an attending physician or mental health service provider. The effective date of the revised statute is January 1, 2015. We recommend that Illinois clients contact us to update their health care power of attorney to the new statutory form.

Virtual Representation and Non-Judicial Settlement Agreements

Illinois enacted legislation effective January 1, 2015, that amended the Illinois virtual representation statute. The existing Illinois virtual representation statute allows certain trust beneficiaries to represent other beneficiaries who may be minors, disabled or unborn, or whose whereabouts or identities may be unknown, provided the parties have a "substantially identical interest." However, the prior representation provisions of the Illinois virtual representation statute have a number of significant limitations. The new legislation also modifies Illinois law relating to non-judicial settlement agreements. Non-judicial settlement agreements are often used by Trustees and beneficiaries to modify certain trust provisions of irrevocable trusts or resolve certain matters regarding trust administration. The prior statute caused confusion as to what types of agreements can be covered by a non-judicial settlement agreement.

The revised virtual representation statute addresses a number of the shortcomings with the prior representation provisions. First, there is now a role for the parents or guardians of a minor, disabled or unborn beneficiary. Parents and guardians now may represent and bind such a beneficiary, and the right of a parent or guardian to represent such a beneficiary is superior to that of all other trust beneficiaries. Second, the standard for determining when one beneficiary may represent another has been relaxed, changing from a "substantially identical interest" requirement to the new "substantiallysimilar interest" standard.

Finally, the revised statute arguably expands and clarifies the permissible scope of nonjudicial settlement agreements. The revised statute removes the requirement that the terms and conditions of a nonjudicial settlement agreement be those that a court could approve. Now the statute provides a more straightforward list of the types of settlement agreements that do not require judicial approval, without regard as to whether the changes could have been approved by a court. Moving forward, Trustees and trust beneficiaries should be better able to resolve disputes and modify certain provisions of irrevocable trusts.

New York

There were a large number of New York state developments this year. Of particular note are the following areas.

Non-Profit Revitalization Act of 2013

On December 18, 2013, New York adopted the Non-Profit Revitalization Act of 2013, which dramatically changed and updated New York laws affecting governance, oversight, formation and administration of non-profit organizations incorporated, authorized to do business, or soliciting charitable contributions in New York. The act is intended to simplify certain archaic procedures of administering non-profits in New York, and to streamline and strengthen the oversight and governance processes of such organizations. Most of the provisions of the act came into effect as of July 1, 2014. However, the effective date of the law prohibiting employees from acting as chair of a non-profit is postponed until January 1, 2016.

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

On April 1, the New York State 2014-2015 budget became effective and made several significant changes to: (1) New York's estate tax regime; (2) the income tax treatment of trusts created by New York residents that were exempt from tax under prior legislation ("exempt trusts"); and (3) incomplete gift nongrantor trusts (INGs) created by New York residents. Perhaps most notably, the exemption from New York State estate taxes will increase by the year 2019 to match the federal exemption from estate tax (i.e., $5 million indexed for inflation), but the full benefit of this increase is available only for estates that do not exceed the federal exemption amount, with this new benefit phasing out once an estate exceeds the federal exemption amount by 5%. Additionally, (1) certain gifts made by a New York resident between April 1, 2014 and January 1, 2019, and within three years of death, will be included in the decedent's New York gross estate; (2) New York's generation-skipping transfer tax was repealed; (3) the accumulated income of exempt resident trusts now will be subjected to a so-called "throwback" tax once distributed to a New York-resident beneficiary; and (4) the current net income of an ING created by a New York resident will be included in his or her New York State income tax. \

Renunciations by Personal Representatives of Estates

It no longer will be necessary for the personal representative of an estate to secure court authorization to make a renunciation (New York's term for a "disclaimer").

Public Access to Surrogate's Court Documents

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

Qualified Domestic Trusts (QDOTs)

It is no longer necessary to create a QDOT to avoid New York State estate tax on amounts passing to a non-US citizen spouse if no federal estate tax return is required to be filed.

Decanting

Certain technical corrections were made to New York's state-of-the art decanting statute, most notably clarifying the ability to decant to a new trust that excludes all successor or remainder beneficiaries of the original trust.

Guardianships

New York adopted the Uniform Adult Guardianship and Protective Proceedings Jurisdiction Act, providing a mechanism for resolving multi-state jurisdictional disputes.

Posthumously Conceived Children

Posthumously conceived children will have inheritance rights provided that (1) the decedent authorizes the use of genetic material for posthumous conception in writing within seven years of death and appoints a person to make such decisions posthumously; (2) such person gives notice to the personal representative of the decedent's estate within seven months of the issuance of letters; (3) such person records the writing in the New York Surrogate's Court within seven months of the decedent's death; and (4) the child is in utero within 24 months or born within 33 months of the decedent's death.

Interest on Delayed Legacies

Unless overridden by the governing instrument, interest on delayed legacies is automatic and will fluctuate at market rate.

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