December 20, 2011

Estate Planning Update - December 2011

STATUS OF FEDERAL ESTATE TAX LEGISLATION

The rumors that circulated in November that the Joint Select Committee on Deficit Reduction (the "Super Committee") would propose significant changes to the federal estate, gift and generation-skipping transfer ("GST") tax laws proved to be unfounded, as the November 23 deadline for the Super Committee passed with no action taken. The possibility of change continues to loom, however, with the introduction of a new bill that proposes a reduction in the estate, gift and GST tax exemptions to $1,000,000 and a top tax rate of 55 percent. We can only speculate as to what Congress will do, but enactment appears unlikely at this time. As with past proposals, this bill also includes other provisions that would affect tax planning, such as requiring a minimum ten-year term for grantor retained annuity trusts (or "GRATs"), imposing restrictions on certain valuation and minority interest discounts, and limiting the duration of certain long-term trusts.

When will the law change?

There is no indication to date that the current bill will progress further, but it serves as a reminder that the federal estate tax laws continue to be in a state of flux. Absent Congressional action, in 2013 the estate and gift tax exemptions will decrease from $5,000,000 (indexed for inflation) to $1,000,000, and the top tax rate will increase from 35 percent to 55 percent. In addition, the GST tax exemption will decrease from $5,000,000 to about $1,400,000, with a flat rate of 55 percent instead of 35 percent. Of course, there is also the possibility that Congress will act before then.

What should you do?

If you wish to make use of some or all of your current $5,000,000 lifetime gifting exemption, it may be prudent to make those gifts as soon as possible to ensure they occur before any federal tax law changes take effect. This includes making gifts outright to individuals, in trust for children and grandchildren, and in certain circumstances for married couples from one spouse in trust for the other spouse and descendants. We are available to discuss your options in light of your circumstances, your objectives and the continued flux in the tax laws.

INFLATION ADJUSTMENTS

Even in the absence of federal tax legislation, certain estate, gift and generation-skipping transfer ("GST") tax figures are subject to inflation adjustments. For 2012, the annual exclusion amount for gifts remains at $13,000. The estate, gift and GST tax exemption amounts for estates of decedents dying in 2012 and gifts made in 2012 are increased to $5,120,000. Finally, the annual exclusion amount for gifts made to a non-citizen spouse in 2012 is increased to $139,000.

ADVANCE PLANNING FOR CHANGE OF DOMICILE IS ESSENTIAL

Individuals change their state of domicile for a variety of reasons, such as a more favorable climate or tax structure. For such a change to be respected for state tax purposes, however, the taxpayer must prove that he or she abandoned their former state of domicile and adopted the new state as their domicile. This test is particularly challenging when the taxpayer retains the home in their former state as a seasonal residence.

The types of changes that a taxpayer must make to prove such abandonment go far beyond the typical "checklist" items, such as changing driver's license and voting registration, which one might hear about at a cocktail party or find on the Internet. Discussed below are a number of issues that we have addressed with clients in connection with a change of domicile.

First, in establishing a change in domicile, it is imperative to sever as many contacts as possible with the state in which you currently are domiciled. The tax authorities will look--both pre- and post-domicile change--at the time you spend in each state, your business contacts in each state, the size and value of your residence in each state, and your family and other social connections in each state, to see if you have both abandoned those contacts in the former state and replaced them with similar contacts in your new state. We recommend you sit down with your tax adviser in advance of any change in domicile to work out a plan to demonstrate the adoption of the new domicile.

We have seen a number of situations in which individuals simply follow the "checklist" in changing domicile, but do not examine or modify their "pattern of life," which, of course, is unique to them. Simply changing your driver's license, car registration, voting registration and completing a declaration of domicile in the new state are unlikely to be sufficient. For instance, if you regularly "winter" in Florida, and later decide to change your domicile to Florida, you will need to show that you truly changed, rather than just continued or extended, your existing pattern of life.

Timing of the change also can be important. It is much easier to demonstrate the requisite intent to change domicile if the change is made over a fairly short period of time in a number of focused steps. Alternatively, if you gradually take the steps to change domicile over an extended period of time, it is difficult to show the date on which the "change" was completed.

Finally, the maintenance of detailed records of your location each and every day, as well as of the change to your other lifestyle factors, is critical to sustaining the change. Again, with advance planning, and identification of the type of records that are necessary, the information can be gathered on a day-by-day basis and stored for use in the case of an audit. Alternatively, if the records have to be reconstructed two, three or four years after the fact, it can be very difficult.

Please let us know if you are contemplating a change of domicile and wish to discuss these items further.

ANNUAL RETURN FILINGS FOR CHARITIES--THREE STRIKES AND YOU'RE IN TROUBLE

If you have a charitable family foundation, or if you are on a charity's board, it is more important than ever to make sure that the charity is filing annual returns.

Even though they are tax-exempt, virtually all charities except certain religious organizations have to file some form of return with the IRS. Under a 2006 law change, charities that don't file for three consecutive years have their exemption revoked automatically.

2011 saw the first wave of automatic notices revoking over 250,000 exemptions. Revocation eliminates the income tax deductibility of contributions to the charity and subjects the charity to tax as well. The charity can reapply for tax-exempt status, but exemption generally will not be granted retroactively to the date of revocation, leaving the charity with some stretch of time when it is taxable. Requests for complete retroactivity require an extensive case to be made demonstrating why the organization is "innocent"--and ignorance of the filing requirement is not being accepted as an excuse.

If your charity has received one of these revocation notices, you should know that it has a lot of company, and we can help. However, the easiest way to deal with the problem is to head it off. At the next meeting of your charity, make a check of return filing an agenda item.

ADDITIONAL FOREIGN ASSET REPORTING REQUIRED

U.S. citizens and residents (including individuals who hold a green card or otherwise meet the physical presence requirements under the tax laws) are already required to file returns and pay tax on their worldwide income. They are also required to file the Report of Foreign Bank and Financial Accounts (FBAR) to report their financial interest in, or signature authority over, foreign financial accounts. In addition, they have other reporting requirements if they have an interest in foreign entities, including foreign trusts and corporations.

U.S. persons must also now comply with an additional filing requirement for foreign assets. The Foreign Account Tax Compliance Act (FATCA), enacted in 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act, created a new filing requirement for U.S. taxpayers who hold foreign financial assets with an aggregate value exceeding $50,000. These U.S. taxpayers must report certain information about those assets on new Form 8938 which must be attached to their annual income tax return. Reporting applies for assets held during the 2011 taxable year. However, under Notice 2011-55, the reporting is temporarily suspended pending the release of the final Form 8938 and instructions.

Failure to report foreign financial assets on Form 8938 will result in a penalty of $10,000 (and a penalty of up to $50,000 for continued failure after IRS notification). In addition, underpayments of tax attributable to undisclosed foreign financial assets will be subject to an additional substantial understatement penalty of 40 percent. If you may be affected by this new filing requirement and have questions about complying with it, please let us know.