July 31, 2011

Estate Planning Update - July 2011

The following is a brief summary of some estate planning developments and opportunities that may be of interest to you. We hope you find this helpful and look forward to hearing from you with any questions.

CURRENT PLANNING OPPORTUNITIES TO CONSIDER As most of you know, the federal estate, gift and generation-skipping transfer ("GST") exemptions have all been increased to $5,000,000 for 2011 and 2012. However, these exemptions are temporary and sunset on December 31, 2012. Despite this period of flux in the tax laws, the increased exemption thresholds and the low-interest-rate environment offer current tax planning opportunities. The following is a brief summary of some of these opportunities.

Outright Gifts

The current federal exemption for lifetime gifting of $5,000,000 per person may be short-lived, as it is scheduled to sunset and revert to $1,000,000 in 2013 unless Congress takes further action. Many commentators believe that Congress will act to avoid the sunset and that the exemptions will either remain at the current $5,000,000 level (indexed for inflation after 2011) or be reduced to $3,500,000 (which was the estate exemption level in 2009). In any case, because of the risk that the exemption levels will be reduced, making additional lifetime gifts up to the $5,000,000 exemption (taking into account prior gifts) may present a significant opportunity for those whose financial circumstances and family dynamics allow it. In particular, those who had made gifts up to the previous $1,000,000 limit may want to consider making additional gifts to children and grandchildren at this time.

If the gift and estate tax exemptions are later lowered, this may be an ideal time to capture this ability to pass property to descendants free of federal gift tax. As part of the analysis, state gift taxes may also need to be considered. For example, the Connecticut gift tax exemption is only $2,000,000, but paying the relatively lower Connecticut gift tax on a larger gift might be prudent in some circumstances. However, most states, including Massachusetts, New Jersey and New York, do not have a separate gift tax.

Grantor Retained Annuity Trusts ("GRATs")

The current period of historically low interest rates makes certain estate planning techniques, such as grantor retained annuity trusts ("GRATs"), particularly attractive.

For clients who can afford to restrict their access to assets for a period of time, a two-year GRAT can be a very effective way to transfer appreciation on property to beneficiaries free of transfer tax. With lower interest rates, the rate of growth in the trust property needed for this technique to "work" is very low. For example, consider a two-year GRAT funded with $1,000,000 in July 2011, when the applicable federal interest rate that applies to GRATs is 2.4 percent. If the assets grow at a fairly conservative 6 percent, about $58,000 passes to the beneficiaries free of gift and estate taxes at the end of the two-year term. With a growth rate of 10 percent, beneficiaries would receive about $125,600. In both cases, about $1,037,000 is returned to the settlor by the end of the trust term, with the appreciation in excess of the July "hurdle" interest rate of 2.4 percent passing to the remainder beneficiaries.

However, please note that there is legislation pending before Congress that would require GRATs to have a term of at least 10 years and may otherwise curtail the tax-planning benefits of GRATs. This proposal was introduced into the Senate in June and would be effective for trusts created after December 31, 2010. Prior versions of this proposal have been introduced over the last year or so, effective for trusts created after the date of enactment, but none passed. Under the proposed legislation, GRATs

funded this year after the effective date are not "grandfathered," and it is not clear how these trusts would be treated for gift tax purposes. Thus, unless the legislation is clarified, there may be some risks with using short-term GRATs at this time.

Charitable Lead Annuity Trusts ("CLATs")

For clients who are presently making significant gifts to charity on an annual basis, a charitable lead annuity trust ("CLAT") may also be attractive in the current low-interest-rate environment.

A CLAT provides an annuity stream to charity (either specified at the outset or, in some circumstances, modifiable during the trust term) for a fixed period of years, after which time the remaining trust property passes to designated family members free of transfer tax. For example, consider a 10-year CLAT funded with $1,000,000 in July 2011 that pays about $113,500 to charity each year. Assuming 6 percent annual growth for the trust assets, the family member beneficiaries would receive about $290,000 free of gift and estate taxes at the end of the 10-year term. With a growth rate of 10 percent, those beneficiaries would receive about $780,000. Thus, if you are already making significant gifts to charity annually, you could establish a CLAT to make those same charitable gifts but with the added possibility of generating a gift-tax-free bonus to family members.

Please let us know you if you would like to discuss any of these ideas further to see how they might apply to you and your family.

IRS SUSPENDS GIFT TAX AUDITS OF CONTRIBUTIONS TO LOBBYING GROUPS; LONG-TERM GIFT TAX ISSUES UNCLEAR A controversy over the application of the gift tax to contributions to lobbying organizations has subsided -- for now. In May, news media reported that the IRS was auditing five donors to tax-exempt (but not charitable) 501(c)(4) lobbying organizations. The donors apparently did not treat their contributions as taxable gifts, despite a 1982 IRS ruling that donations to 501(c)(4)s are subject to gift tax. The 1982 ruling has been questioned by commentators. While the Internal Revenue Code specifically provides that contributions to 501(c)(3) charities and 527 political campaign organizations are not subject to gift tax, no Internal Revenue Code provision deals with the application of gift tax to 501(c)(4) organizations.

After news of the gift tax audits broke, Republican members of the Senate Finance Committee quickly wrote to the IRS, stating that "The applicability of gift taxes to 501(c)(4) contributions is ambiguous" and questioning whether political motives prompted audits now after a "pattern of nonenforcement over a period of nearly three decades." On July 7, the IRS announced that it was suspending gift tax audits on 501(c)(4) contributions and conceded, "This is a difficult area with significant legal, administrative, and policy implications with respect to which we have little enforcement history." The IRS also indicated, however, that it would be looking at further guidance on the issue and noted that Congress may pass legislation to clarify it.

The IRS has not withdrawn its 1982 ruling, and while the gift tax audits drew fire from Senate Republicans, the Obama administration has expressed strong concerns about the role of 501(c)(4) lobbying organizations in politics. It is therefore too soon to take the IRS retreat as a resolution of this issue. Before making large gifts to 501(c)(4) organizations, prospective donors would do well to check for the latest news in this area.

NEW YORK VACATION HOME SUBJECTS CONNECTICUT RESIDENT TO POTENTIAL DOUBLE TAX Under New York law, a person can become subject to New York income tax as a "statutory resident," even if he or she is domiciled in another state, if that person maintains a "permanent place of abode" in New York and spends more than 183 days in New York. In the *Barker* case decided in January of this year, the New York Tax Appeals Tribunal determined that the Barkers' vacation home in the Hamptons constituted such a permanent place of abode, which, when coupled with the fact that Mr. Barker spent more than 183 days in New York City with respect to his job, made Mr. Barker a tax resident of New York even though he was domiciled and lived in Connecticut.

The Barkers' vacation home, which they used sporadically, had no mail delivery, town sewer, or waste removal services; no grocery or general shopping year-round; no hospital in close proximity; and 82 percent of the surrounding properties were seasonal. However, the home was equipped with heat, electricity, phone, cable, and internet access. Despite the Barkers' sporadic use and the lack of development in the area, the Tribunal determined the house was a permanent place of abode because the Barkers could, and Mrs. Barker's parents did, use the house at various times year-round.

Several other states follow these same rules. If an individual becomes subject to tax in both the state in which he is domiciled and the state in which he is a statutory resident, he will be subject to tax in both states. While most states will allow a credit for the tax paid to the state in which your employment income is earned, which avoids double tax on that income, there usually is

no such credit for tax paid on investment income such as dividends and capital gains, which can result in double tax on such income. While this case does not create novel law in this area, it serves as a reminder of the potential trap of becoming a statutory resident in a state such as New York, if your domicile is outside the state.

DEVELOPMENTS IN REPORTING REQUIRED FOR OFFSHORE ACCOUNTS Over the last couple of years, we have monitored closely the mandatory reporting requirements by U.S. persons of offshore accounts. The reporting is required on Form TD F 90-22.1 "Report of Foreign Bank and Financial Accounts" ("FBAR"). The FBAR is required to be filed by U.S. persons to report a financial interest in, or signature authority over, a foreign financial account.

On February 24, 2011, the Treasury Department published final regulations amending the FBAR regulations. These regulations became effective on March 28, 2011, and apply to FBARs required to be filed with respect to foreign financial accounts maintained in calendar year 2010 and for FBARs required to be filed with respect to all subsequent calendar years.

The FBAR (dated March 2, 2011) form and instructions have been revised to reflect the amendments made by the final regulations. The final regulations are substantially identical to the proposed regulations that were issued on February 26, 2010, but make many clarifications, including the following:

- An account is not a foreign financial account if maintained by a financial institution in the United States, regardless of whether it holds foreign assets.
- A foreign life insurance policy or an annuity constitutes a financial account only if it has a cash surrender value.
- A foreign mutual fund whose shares are available to the general public and which has a regular net asset value and regular redemptions is a reportable account. (Importantly, the final regulations continue to reserve clarification of the treatment of investment funds other than mutual funds.)
- A discretionary beneficiary or remainderman does not have a financial interest in foreign accounts held by a trust unless he is the grantor and treated as the owner of the trust under the U.S. grantor trust rules. A beneficiary with a greater than 50 percent present beneficial interest in assets or current income has a financial interest.
- The definition of signature or other authority is revised to apply more clearly to individuals who have the authority to control the disposition of assets in the account by direct communication (whether in writing or otherwise) to the foreign financial institution. As a result, the decision to allocate assets or instruct or supervise those who do have signature or other authority is not considered signature or other authority.

In addition, certain related filing deadlines have been recently extended. On June 16, 2011, the IRS issued Notice 2011-54 extending the deadline for persons whose FBAR filing obligations for 2009 or earlier years were properly deferred to June 30, 2011 (under a prior notice affecting persons who have signature authority over, but no financial interest in, a foreign financial account). These persons now have until November 1, 2011, to comply.

If you have any questions about how these reporting requirements may affect you, please let us know.

We are required under IRS Circular 230 to include the following: Any tax advice provided herein (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed on any taxpayer.

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