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Estate Planning Update - July 2014

PLANNING FOR INCOME TAX BASIS "STEP-UP"

We continue to believe that passing property in trust for both a surviving spouse and descendants offers the most benefit to your family, because of estate tax savings and creditor protection opportunities. However, a limitation of trusts is that trust property is ordinarily not eligible for a "step-up" in basis at a beneficiary's death. Property owned outright, on the other hand, does get a "step-up" in basis at death, which eliminates capital gains tax on any gains to that point. In the current tax environment of lower estate and gift tax rates coupled with higher income tax rates, this would seem to present an "either/or" choice?- take advantage of the trust structure or give up the opportunity for capital gains tax relief afforded by the basis step-up rules.

By taking creative advantage of well-established tax principles, we have developed an innovative solution that avoids this "either/or" choice. Our solution is to include a new provision in trust agreements called the "contingent general power of appointment," or CGP. The CGP causes trust property to be included in a beneficiary's taxable estate at death in order to qualify for a step-up in basis, as long as that will not cause any increase in estate tax. The result?- trust property with previously unrealized capital gains can be sold with no capital gains tax liability. The CGP is tailored to cause inclusion of the least amount of trust property that will afford the most basis step-up.

For example, assume a $1,000,000 trust for a child and his descendants. By the time of the child's death, say in 30 years, the trust assets have appreciated to $2,000,000. To keep the example simple, assume the child dies with $1,000,000 of his own assets as a resident of Florida (one of the many states without a state estate tax). If properly planned, the trust will escape estate taxation at the child's death. However, capital gains tax would ordinarily be due on any sale of trust assets. If all trust assets are sold after the child's death, the gain would be $1,000,000 and the capital gains tax about $200,000. With the CGP, however, the entire trust will be included in the child's estate without causing any estate tax, since the combined value of the child's $1,000,000 estate and the trust's $2,000,000 value is below the federal estate tax exemption. The included property will receive a "step-up" in basis to the value at the child's date of death and thus escape tax on the $1,000,000 of capital gains.

We are now incorporating the CGP in new estate planning documents. Please contact us if you would like to discuss the advantages of including the CGP in your existing documents.

NEW YORK TAX LAW CHANGES

On March 31, 2014, New York state enacted several significant changes to its laws concerning estate, gift and fiduciary income taxes. The following summarizes some of the key changes:

- **Estate Tax Exemption Increased.** The New York estate tax exemption amount has been increased. This means that more New York estates will be exempt from estate tax, but because the tax rates themselves are largely unchanged, estates larger than the applicable exemption will not see a reduction in the tax due. For estates of decedents dying on or after April 1, 2014, the exemption has been increased to $2,062,500. The exemption will increase in roughly $1,000,000 increments effective April 1 of each of the next three years, until, effective for decedents dying on or after January 1, 2019, the New York exemption will be the same as the federal exemption. The phase-in of the estate tax is steep, causing New York estates that are only slightly larger than the applicable exemption amount to incur a disproportionate amount of estate tax. Clients subject to New York estate tax may wish to add a provision to their estate planning documents that will include a gift to charity if that gift will reduce the amount of estate tax due by an amount greater than the gift itself. For example, in 2018 when the New York exemption is $5,250,000, a taxable estate of $5,500,000 would owe $443,150 in estate tax, but by making a charitable gift of $250,000, there would be no estate tax due, and the amount passing to the intended beneficiaries would increase by $193,150.

- **Some Gifts Included in Taxable Estate.** Although New York does not have a gift tax, lifetime taxable gifts made by New York residents between April 1, 2014, and December 31, 2018, and within three years of death will be included in the decedent's taxable estate for purposes of calculating the New York estate tax. Accordingly, New York residents contemplating taxable gifts (that is, gifts not covered by the annual exclusion and not otherwise exempt from federal gift tax) should consult with counsel before making any additional gifts before January 1, 2019. Whether and how this will apply to gifts of non-New York property remains to be seen.

- **Incomplete Gift Non-Grantor Trusts.** So-called incomplete gift non-grantor trusts ("ING trusts") had been promoted as a way to avoid New York income tax on property without making a taxable gift of that property. That preferred treatment is no longer available. Starting with the January 1, 2014, tax year, New York will treat income earned by ING trusts as "grantor" trusts, meaning that the income earned by the trust will be taxed on the donor's individual return. An ING trust liquidated prior to June 1, 2014, is exempt from this tax treatment. Please let us know if you have an ING trust and would like to discuss your options going forward.

- **Throwback Tax on Distributions to New York Residents From New York Resident Trusts.** Previously, New York resident trusts with New York resident beneficiaries were exempt from New York income tax so long as they did not have New York resident trustees, New York source income, or New York real or personal property (so-called exempt trusts), which meant that accumulated (i.e., undistributed) income escaped New York taxation. The new "throwback" tax will now impose a tax on distributions made to a New York resident of previously accumulated, undistributed income. Although the new law is effective as of January 1, 2014, distributions made before June 1, 2014, are excluded.

DISCLOSURE OF FOREIGN ACCOUNTS AND ASSETS

U.S. persons are allowed to maintain financial accounts anywhere in the world, but they must pay tax on all income and also file special reports alerting the IRS to the existence of the accounts. In recent years the IRS has put great pressure on foreign institutions to disclose the names of U.S. clients. The IRS has also created an Offshore Voluntary Disclosure Program ("OVDP") to allow U.S. persons with undisclosed accounts to regularize their situations. (It is not an amnesty, since it calls for significant penalties.) An alternative set of Streamlined Filing Compliance Procedures ("Streamlined") was more recently introduced for less egregious fact patterns.

On June 18, the IRS introduced significant changes to both OVDP and Streamlined. These changes increase the amount of information required for OVDP and alter the penalties payable under OVDP in certain cases. The changes also broaden the availability of Streamlined and extend it for the first time to U.S.-resident taxpayers. These changes result from concerns that the penalties within OVDP were too expensive for certain taxpayers whose failures to disclose offshore accounts or assets were due to non-willful conduct. Now, such taxpayers can proceed under Streamlined and regularize their prior payment and reporting deficiencies while avoiding the large OVDP penalty. At the same time, taxpayers whose failures were not due to non-willful conduct may have their penalties substantially increased if they do not come forward promptly.

- **New Streamlined Program.** Taxpayers whose prior payment or reporting deficiencies were due to non-willful conduct may now disclose previously unreported foreign assets through Streamlined, whether or not they are U.S. residents. Non-willful conduct means conduct due to negligence, inadvertence, mistake or a good faith misunderstanding of the law. All taxpayers within Streamlined will have to file three years of original or amended tax returns and six years of original or amended Reports of Foreign Bank and Financial Accounts ("FBARs"). Taxpayers will have to pay any back tax for three years, plus interest. In addition, U.S.-resident taxpayers will have to pay a miscellaneous penalty of 5 percent of the value of all previously unreported accounts and assets, in the year within the prior three tax years that those assets had the highest value in the aggregate. Non-U.S.-resident taxpayers will not be subject to this miscellaneous penalty. No other penalties will be assessed against either U.S.-resident or non-U.S.-resident taxpayers. Finally, all taxpayers will be required to certify, under penalty of perjury, that their conduct was non-willful and to provide a brief description of the circumstances of the prior nondisclosures.

- **New OVDP.** The basic structure of OVDP remains unchanged; however, more information now must be provided, and the timeline for paying the OVDP penalty is accelerated. To request "preclearance" to apply for OVDP, taxpayers must now provide identifying information on all banks or other financial institutions where undisclosed accounts were maintained, in addition to identifying themselves. Moreover, the narrative "OVDP Letter and Attachment" now requires more detailed information. In addition, whereas the miscellaneous 27.5 percent "OVDP Penalty" previously became due upon the closing of the OVDP case, that penalty is now due with the submission of the taxpayers' amended tax returns and payment of back taxes, applicable penalties and interest. (The OVDP Penalty equals 27.5 percent of the value of all previously unreported accounts and assets, in the year within the prior eight tax years that those assets had the highest value in the aggregate.) The taxpayer will still have to file amended tax returns and FBARs for the previous eight tax years, pay all tax, accuracy, failure-to-file, and failure-to-pay penalties, as applicable, interest, and the OVDP Penalty. Finally, the OVDP Penalty is increased to 50 percent if any bank or other entity managing the taxpayer's funds or accounts has been publicly disclosed as under investigation, cooperating with U.S. authorities or the subject of a U.S. court-approved summons. Taxpayers who submit a preclearance request or the OVDP Letter and Attachment before August 4, 2014, will not pay the increased OVDP Penalty of 50 percent, even if there has been such a public disclosure.

- **"Transitional Period."** Taxpayers who are already participating in OVDP and whose prior non-disclosures resulted from non-willful conduct may request that the IRS reduce their 27.5 percent OVDP Penalty to the 5 percent Streamlined penalty (or eliminate their OVDP Penalty entirely if the taxpayer resides outside the U.S.). A taxpayer is "participating in OVDP" if he or she submitted the OVDP Letter and Attachment by July 1, 2014, and if the IRS and the taxpayer did not execute a closing agreement before that date. A taxpayer who only requested preclearance by July 1, 2014, but who had not by then submitted the OVDP Letter and Attachment would have to "opt out" of OVDP to take advantage of the Streamlined penalty structure; however, such action is irrevocable and after opting out, a taxpayer cannot later re-enter OVDP. Any taxpayer seeking this transitional period treatment must execute the non-willfulness certification required by the new Streamlined program, under penalty of perjury. Importantly, for taxpayers seeking this treatment, the other requirements of OVDP remain; the taxpayer must still file amended returns and FBARs for the prior eight tax years and pay all tax, penalties and interest otherwise required under OVDP.