Client Advisory

Katten
Katten Muchin Rosenman LLP

Trusts and Estates

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2010 Year-End Estate Planning Advisory

This year has been notable particularly for its absence of federal estate and generation-skipping transfer (GST) taxes, as well as uncertainty as to what will happen with the federal transfer tax regime in 2011. Further confusion is caused by the one-year lack of a step-up in basis for assets held by individuals who die in 2010. Numerous questions have arisen as to how to address estate planning and estate administration this year. However, the apparent one-year "hiatus" has also created significant planning advantages.

Against this backdrop of uncertainty as to the federal transfer tax system, there have been certain important changes affecting estate planning and related areas on the local, national and international levels. The Trusts and Estates Practice at Katten Muchin Rosenman LLP is pleased to provide you with a summary of some of the most significant developments that have occurred over the past 12 months, along with important time-sensitive recommendations for you to consider for planning before year-end.

We urge you to consider carefully the planning opportunities presented in this Advisory and to contact one of us as soon as possible if any are of interest, as time is of the essence to take advantage of these opportunities before year-end.

Where Will the Federal Estate, Gift and GST Taxes End Up in 2011?

Speculation and rumors have been flying all year as to what will happen to the federal transfer tax system in 2011. Possibilities discussed and introduced as potential legislation include a return of the system in place in 2009 (i.e., a $3.5 million applicable exclusion amount for each taxpayer, along with a return to the regime of step-up in the basis of assets held at death), possibly retroactive to January 1, 2010. Recently, rumors have been circulating out of Washington that the federal estate and GST taxes will not be reinstated until 2012 or 2013. At this point, only one month before the end of 2010, it is impossible to predict where things will stand next year.

If Congress does not act before year-end, in 2011 the federal estate and GST taxes are scheduled to return, with only a $1 million applicable exclusion amount for each taxpayer ($1 million, in the case of GST exemption, indexed for inflation). The gift tax will remain as it has been throughout this period, at a $1 million lifetime applicable exclusion amount. Top rates for the estate, gift and GST tax will increase to 55% and the step-up in basis will return.

As soon as Congress acts, we will provide you with a separate update.

Federal Estate, GST and Gift Tax Rates

As stated above, in 2011 the estate tax and GST tax are scheduled to return, with a top rate for each of 55%, as well as for the gift tax.

An important point to note is that for the remainder of 2010 the federal gift tax rate is imposed at the top individual income tax rate, which is 35%. Under current law, in 2011 the top gift tax rate will return to 55%.

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 remain at $13,000 per donee in 2011. Thus, a husband and wife together will be able to gift $26,000 to each donee.

The amount of the annual gift tax exclusion with respect to gifts made to non-citizen spouses will increase from $134,000 to $136,000 in 2010.

Retroactive Reinstatement of 2009 Law?

One of the issues discussed extensively this year is whether the federal estate and GST taxes, the higher gift tax rate and the step-up in basis (i.e., the "2009 estate and gift tax system") will be restored retroactive to the start of 2010. There is still no certainty as to this issue. At an October meeting of the American College of Trust and Estate Counsel, a spokesperson for the Treasury Department stated, to our surprise, that it is still a possibility that there will be retroactive reinstatement of the 2009 estate and gift tax system to 2010 gifts and estates, and that such retroactive reinstatement could even occur sometime next year, as opposed to before year-end.

YEAR-END PLANNING OPPORTUNITIES TO CONSIDER IMMEDIATELY

Make Outright Gifts to Take Advantage of Reduced Gift Tax Rate

The federal gift tax rate is now 35%, scheduled to increase to 55% as of January 1, 2011. Therefore, making gifts before the end of 2010 may provide significant transfer tax savings. In addition to the reduced rate, it is always cheaper to make lifetime gifts rather than 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. For example, if you want to get $5 million to your child, you can make a $5 million gift and, assuming a 50% gift tax rate, pay $2.5 million of gift tax. The total cost is thus $7.5 million. In order to have your child receive $5 million under your Will, you must leave the child $10 million, as $5 million will go to pay estate tax (assuming a 50% estate tax rate). The lifetime gift to your child will therefore cost $2.5 million less in transfer tax than will the gift under your Will. The benefit is compounded further by the lower gift tax in 2010.

Make Gifts to Take Advantage of the Absence of GST Tax

Particularly in conjunction with the reduced gift tax rate, the remaining days of 2010 present a unique opportunity to make outright gifts to grandchildren. The GST tax was repealed for 2010 and so an outright gift to a grandchild this year will not be subject to GST tax and will only be subject to a 35% federal gift tax.

However, the mechanics of the gift need to be considered, particularly where the gifts are to minor grandchildren, as gifts to trusts and uniform transfers to minors' accounts may be subject to the GST tax in subsequent years. We advise you to speak to one of us to discuss the mechanics of any such gifting.

Caveats

When considering gifting in 2010, one must take into account the uncertainty as to whether the federal estate tax will return in 2011 (and if so, in what form), as well as the possibility of retroactive reinstatement of the GST tax and a higher gift tax rate. One must also consider the time value of the use of money when prepaying taxes that might not otherwise be due for a long time, even at a lower rate. Finally, it is possible that the lifetime applicable exclusion amount for giving will increase next year, in which case a gift beyond the current $1 million lifetime application exclusion amount made next year could escape gift tax. Even in this time of uncertainty, however, the uniquely advantageous possibilities for gifting discussed herein should be carefully considered.

A Gifting Technique to Protect Against Retroactive Transfer Tax Changes

If you wish to make gifts this year to take advantage of the 35% gift tax rate but would like to hedge against a possible retroactive reinstatement of the GST tax and a higher federal gift tax rate, you should consider making a gift to a "disclaimer trust" for your spouse. Before the end of this year you would create a lifetime trust for your spouse. The gift would not be subject to gift tax as long as your spouse is a U.S. citizen and the trust is created to qualify as what is known as a QTIP trust, which requires your spouse to receive all of the trust income currently.

The trust would contain language allowing your spouse to disclaim (give up) his or her interest in the trust within nine months of its creation. During that time period, you can wait to see what legislation Congress passes.

If the federal gift tax rate is retroactively raised or the GST tax reinstated, retroactively, your spouse would not disclaim the trust assets and the property could continue to be held in trust for your spouse, or some or all of the trust assets could be distributed outright to your spouse.

If Congress allows the 35% federal gift tax rate and the lack of the GST tax to stand for 2010, your spouse could disclaim his or her interest and the trust property could pass outright or in further trust to your children or grandchildren.

Please contact one of us if you would like to discuss further details about this hedging strategy. Note that this technique would not serve a hedging function if Congress acted after the expiration of the disclaimer period.

Distributions from Trusts That Are Subject to the GST Tax

Certain trusts which were created to benefit generations of family members are not protected from the GST tax when distributions are made to beneficiaries at the grandchild or lower generation level from the settlor of the trust ("skip" beneficiaries). Until the end of this year, distributions from such trusts to skip beneficiaries should be free from any GST tax consequences. Trustees of such trusts should consult with one of us as to making such distributions before year-end, as it is likely that next year such distributions will be subject to a 55% GST tax. Again, there is the possibility of retroactive reinstatement of the GST tax, and so you would need to consider strategies that could be used to hedge against such possibility.

Repeal of the Pease Limitation

The "Pease limitation" reduces most itemized deductions by 3% of the amount by which adjusted gross income (AGI) exceeds a certain threshold. This limitation effectively adds 3% to marginal tax rates of high-bracket taxpayers. The 2001 Tax Act phased out the Pease limitation, culminating with its repeal in 2010. Unless extended, the Pease limitation will reemerge in 2011. Repeal of the Pease limitation in 2010 creates a significant income tax planning opportunity.

Assume that taxpayer (over age 59½) has AGI of $1,000,000, withdraws $250,000 from his or her IRA and immediately gifts that amount to Charity X. Assume further that the AGI threshold is $166,800. The Pease limitation in this example would cause a reduction of $24,996 of itemized deductions ($1,000,000 - $166,800, or $833,200, x 3%). The result is that a portion of the amount withdrawn from the IRA ($24,996 in this example) is subject to income tax even though the taxpayer made a contribution of a like amount to charity. In 2010, the taxpayer in this example would be entitled to a full $250,000 charitable deduction and no portion of the amount withdrawn from the IRA would be subject to income tax. While the $100,000 charitable rollover opportunity was not extended to 2010, repeal of the Pease limitation effectively provides taxpayers with a "back door" charitable rollover opportunity in 2010.

Grantor Retained Annuity Trusts (GRATs)

Despite the fact that there were numerous bills introduced this year containing provisions which would have limited the current advantageous use of GRATs, none of the legislation became law, and so GRATs currently 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.

A GRAT provides you with a fixed annual amount (the "annuity") from the trust for a term of years (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 2010 is 1.8%). As long as the GRAT assets outperform 1.8%, 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 1.8%. 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 as to 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 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 2010 is as low as .32%), 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.

Family Limited Partnerships

Many clients 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, consolidation of family held entities with centralized management, and investment advantages as a result of investing a larger pool of assets. The value of assets 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 with respect to non-operating assets 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 past years, 2010 saw numerous IRS attacks on the use of FLPs, in various contexts and with mixed success. The Federal District Court for the Southern District of Indiana held in *Fisher v. Commissioner* that the transfer of interests in an LLC did not qualify for the annual exclusion from gift tax because the interests were not "present" interests, as required to qualify for the annual exclusion. The court held that restrictions in the LLC's operating agreement were sufficient to render the donee's interests merely future interests.

The Tax Court in *Price v. Commissioner* reached a similar holding, finding that gifts of partnership interests did not qualify for the annual exclusion, as there was not a steady dependable flow of partnership income to donees.

The Eighth Circuit reduced lack of marketability and minority interest discounts claimed by the donees in *Holman v. Commissioner*. The court found that the transfer restrictions in the limited partnership agreement did not constitute a bona fide business arrangement and therefore would be disregarded.

All was not bad for the taxpayer in the FLP arena, though, as the Tax Court provided a significant taxpayer victory in *Shurtz v. Commissioner*. The Tax Court held in that case that assets transferred were not included in the decedent's taxable estate because the transfer of the FLP interests was held to be a bona fide sale for full and adequate consideration. In a particularly useful approach for the taxpayer, the Tax Court found non-tax reasons for forming the FLP despite certain bad facts.

PLANNING IDEAS FOR 2011 REGARDLESS OF OUTCOME OF ESTATE AND GIFT TAX REGIME

Set forth below are a number of estate tax planning ideas that you might consider in 2011, in addition to those set forth above.

Gift Residence or Vacation Home Using Qualified Personal Residence 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 live in the residence until the QPRT ends, and even thereafter, if the property is leased back at fair market value 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 are dropping across the country, which makes use of a QPRT beneficial. Additionally, unlike with GRATs, the value of the gift may be further reduced for gift tax purposes by retaining a contingent reversionary interest in the event you die during the term of the QPRT (the value of which is higher the older you are). As a result, QPRT gifting is an important alternative to consider in 2011.

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 IRC, 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 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 or Substitution of Appreciated Low Basis Assets from Grantor Trusts

Some clients have sold or given (through a GRAT) 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 GRAT instruments give the grantor the power to substitute the GRAT assets with other assets, which would allow the appreciated assets to be removed from the GRAT.

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, provided that you die in a year with a federal estate tax and a basis step-up at death. This means that the capital gains tax on the 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 (assuming the reinstatement of the estate tax and of a step-up in basis at death).

Use of Intra-Family Loans

Because interest rates are so low, many techniques involving the 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.

YEAR-END CHECKLIST FOR 2010

In addition to the above planning ideas, consider the following before 2010 is over:

- Make year-end annual exclusion gifts of $13,000 ($26,000 for a married couple).
- Consider Roth conversions.
- Accelerate income and deferral of recognition of loss if you think rates are going up.
- 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 2010 income tax return. However, if income tax rates increase in 2011, as slated, deductions will be more valuable in 2011.

The following is a discussion of national, international and local developments that occurred in 2010.

International Developments in 2010

The HIRE Act

On March 18, 2010, President Obama signed the Hiring Incentives to Restore Employment (HIRE) Act, which contained a version of the previously proposed Foreign Account Tax Compliance Act of 2009. These provisions are intended to combat offshore tax evasion by U.S. taxpayers by requiring increased information reporting.

The HIRE Act requires significant additional reporting requirements with respect to U.S. "owners" of "specified foreign financial assets," defined as foreign accounts, and, to the extent not held in an account at a financial institution, foreign issued stock or securities, interests in a financial instrument or contract held for investment with a foreign issuer or counterparty, and interests in other foreign entities (most likely including foreign trusts). Under the HIRE Act, any individual who during any taxable year holds any interest in a specified foreign financial asset must attach to his or her income tax return for that year information, including the name and address of the financial institution in which such

account is maintained and the number of such account, and in the case of any stock or security, the name and address of the issuer and such information as is necessary to identify the class or issue of which such stock or security is a part.

For any other specified foreign financial asset, such as an instrument, contract or other interest, the taxpayer will have to provide such information as is necessary to identify such asset, the maximum value of such asset during the taxable year and the names and addresses of all issuers and counterparties with respect to such instrument, contract or interest. The filing is required if the aggregate amount of the individual's specified foreign financial assets exceeds $50,000. The penalty for failure to file is $10,000, with additional penalties for non-compliance after notification. The filing is required for taxable years after 2010.

Also, for payments made after December 31, 2012, HIRE provides for withholding taxes to enforce reporting requirements on certain foreign accounts owned by specified U.S. persons or U.S.-owned foreign entities. Generally, a tax equal to 30% must be withheld by a U.S. withholding agent on any withholdable payment made to a foreign financial institution if the institution does not have an agreement with the IRS under which the institution agrees to obtain certain information on each U.S. account holder and comply with various reporting and withholding requirements. The withholding of 30% is also on a broader category of U.S. source income than is captured under the current withholding rules. This provision will almost certainly result in increased disclosure of U.S. account holders by foreign financial institutions.

An additional significant provision of the HIRE Act is that it imputes a distribution of the fair market rental value of any residential and other tangible property held by a foreign trust and used rent-free by a U.S. beneficiary. This new rule will have no effect on a U.S. beneficiary of a foreign grantor trust, as a distribution from such a trust has no U.S. income tax consequence to such beneficiary, although it could trigger a 3520 filing requirement for such beneficiary. The deemed distribution is not triggered if the U.S. beneficiary pays fair market rent for the use of the trust property to the trust. This deemed distribution rule is effective as of March 19, 2010.

The HIRE Act also increases the penalty for a beneficiary of a foreign trust failing to file a 3520 to the greater of $10,000 and 35% of the reportable amount for taxable years 2010 and beyond.

Finally, there will be enhanced reporting for U.S. shareholders of passive foreign investment companies (PFICs). PFICs generally are foreign non-operating companies, such as a foreign fund. The enhanced PFIC reporting is effective as of March 18, 2010.

IRS Voluntary Disclosure Program

Although the ability of U.S. taxpayers to enter into the IRS's voluntary disclosure program for unreported offshore accounts ended October 15, 2009, many of these cases are still open and being processed by the IRS. Even though the official program of voluntary disclosure has ended, taxpayers may still voluntarily disclose heretofore unreported foreign accounts. Taxpayers who are considering voluntary disclosure of unreported foreign accounts should contact their attorney before making such a voluntary disclosure.

Expatriation

As you may know, U.S. citizens or certain long-term residents who expatriate are subject to a mark-to-market exit tax and certain other punitive taxes if they are treated as a "covered expatriate." A covered expatriate is someone who (i) meets either a net worth test on the date of expatriation of $2,000,000 or (ii) a tax liability test if his or her average annual net income tax liability for the five taxable years ending before the expatriation date exceeds a certain threshold, indexed for inflation ($147,000 in 2011).

Upon the expatriation of a covered expatriate, his or her worldwide assets are treated as sold for fair market value the day before expatriation and the covered expatriate must pay U.S. income tax on the deemed gain. The amount of gain which would be includible in the covered expatriate's gross income is reduced by a certain dollar amount which is also indexed for inflation. For 2011, this amount is $636,000.

If you are thinking of expatriating, you should contact one of us for strategic planning and tax advice before doing so.

Tax Treaties

On December 16, 2009, the United States and Italy ratified a new U.S.-Italy income tax treaty. The treaty became effective January 1, 2010, except for provisions relating to withholding at source, which became effective February 1, 2010.

On December 23, 2009, a Protocol to the 1994 U.S.-France income tax treaty came into effect. This Protocol generally became effective January 1, 2010.

A new Protocol to the U.S.-New Zealand income tax treaty entered into force on November 12, 2010. The Protocol generally will be effective in the United States beginning January 1, 2011.

A new income tax treaty with Malta officially entered into force November 23, 2010.

For more information, contact one of us.

Important Development in Effectiveness of LLCs in Protection from Creditors

The Florida Supreme Court's decision in *Olmstead v. Fed. Trade Comm'n*, No. SC08-1009 (Fla. June 24, 2010), significantly eroded, at least in Florida, the use of LLCs to protect members from liability. The Court held that a court may order an owner of a single-member Florida limited liability company (LLC) to give up his or her LLC interest in satisfaction of an outstanding judgment. The decision holds that charging orders are not the exclusive remedy to enforce a judgment against the member of a single-member Florida LLC. The holding results in considerable uncertainty regarding the benefits provided by multi-member LLCs formed in Florida and calls into question how much asset protection is provided by such LLCs.

This opinion is of general importance even outside Florida, since it signals that business owners may not be able to rely on LLCs to provide asset protection.

New Definition of Family Offices

The Dodd-Frank Wall Street Reform and Consumer Protection Act contains provisions which may require certain family offices to register with the SEC by removing existing exemptions from registration. The registration creates privacy concerns, as family offices exist largely to keep family assets protected and private. The new law requires the SEC to define "family office" by next year, by which time we should be provided some clarity as to which offices must register.

State-Specific Considerations

California

Federal Tax Treatment of California Registered Domestic Partners

In May, the IRS issued a Private Letter Ruling and Chief Counsel Advice Memorandum which harmonized the treatment of California registered domestic partners for state and federal income tax purposes. Although federal tax law generally respects state property law characterizations and definitions, the IRS previously did not recognize community property treatment of California registered domestic partners, despite California's extension of full community property treatment to registered domestic partners since 2007. Now, consistent with California law, each registered domestic partner in the partnership must report on his or her individual federal income tax return: (a) one-half of the combined income earned by the two registered domestic partners, and (b) one-half of the combined income derived from their community assets. Each partner is also entitled to one-half of the credits for income tax withholding from the wages of both partners. For tax years after December 31, 2006, but prior to June 1, 2010, the domestic partners may (but are not required to) file amended returns.

Net Operating Losses and Carrybacks

As part of the California budget passed on October 7, 2010, tax provisions were enacted that extend the suspension of the net operating loss (NOL) deduction for taxpayers whose modified adjusted gross income or pre-apportioned income exceeds $300,000 for tax years 2010 and 2011. The NOL deduction has been suspended since the 2008 tax year, but previously applied only to taxpayers with taxable income of greater than $500,000. Implementation of the two-year NOL carryback provision was delayed to begin with the 2013 tax year rather than the 2011 tax year. The NOL carryback will be phased in over a three-year period, allowing a 50% NOL carryback for NOLs incurred in the 2013 taxable year and a 75% NOL carryback for NOLs incurred in the 2014 taxable year; 100% of the NOL may be carried back for NOLs incurred after the 2014 taxable year.

Electronic Tax Payment

Beginning in 2009, individuals were required to remit all future tax payments electronically once they: (a) made an estimated tax or extension payment (by check or electronic method) over $20,000, or (b) filed an original return with a tax liability over $80,000. Once the mandatory e-pay threshold is met, taxpayers are required to make all subsequent payments electronically, regardless of the amount, type or taxable year. Fiduciaries, estates and trusts are not required to make payments electronically, regardless of the amount owed.

Although a 1% mandatory e-pay penalty for failure to make payments electronically was not imposed in 2009 and 2010, starting January 1, 2011, the Franchise Tax Board (FTB) will impose a 1% penalty on the amount paid via non-electronic payment, unless failure to pay was for reasonable cause and not willful neglect.

Electronic payments may be made by the following methods: (a) Web Pay on the FTB's website at ftb.ca.gov; (b) electronic funds withdrawal (EFW) when e-filing a tax return; (c) credit card, online at www.officialpayments.com, or by calling toll free (800) 272-9829; or (d) pay-by-phone by completing and submitting Form FTB 4073, Mandatory e-pay Pay-by-Phone Authorization Agreement for Individuals, available on the FTB's website at ftb.ca.gov.

Illinois

State Estate Taxes

Beginning on January 1, 2010, Illinois "re-coupled" with the federal estate tax system and imposes a state estate tax only equal to the maximum state death tax credit that is allowed for federal estate tax purposes.

Since there is no federal estate tax for decedents dying in 2010, there is no applicable state death tax credit for federal estate tax purposes for 2010. Therefore, there is no Illinois state estate tax for Illinois residents who die in 2010.

As discussed above, if Congress does not act, beginning on January 1, 2011, the federal estate tax is reinstated with a $1 million federal estate tax applicable exclusion amount, along with the state death tax credit. If that happens, Illinois residents who die in 2011 with taxable estates in excess of $1 million will be subject to an Illinois state estate tax equal to the state death tax credit. Under that scenario, no additional estate taxes will be due or owing by the Illinois decedent's estate since the amount paid to Illinois will reduce the amount due to the federal government.

It is unclear at this point what our federal estate tax system will be next year. There has been discussion that if the federal estate tax applicable exclusions increase beyond $1 million, then the state death tax credit will be changed to a deduction (which was the case in 2009) or eliminated altogether.

If the state death tax credit is eliminated and there is no subsequent change in Illinois law, then once again there will not be any Illinois state estate tax. However, based upon the current fiscal crisis that Illinois is experiencing, it appears likely that Illinois will subsequently change its law and "de-couple" from the federal estate tax system if the state death tax credit is eliminated.

We continue to monitor the federal and Illinois legislative efforts regarding these issues and will keep you apprised as things develop.

Substantial Changes to Illinois Power of Attorney Act

Illinois recently enacted new legislation which becomes effective on July 1, 2011, that makes substantial changes to both Illinois Powers of Attorney for Property and Illinois Powers of Attorney for Health Care. The legislation creates new statutory forms that make many changes, including the addition of provisions for “co-agents” for Property Powers of Attorney and provisions which grant agents under Health Care Powers of Attorney the power to use and disclose identifiable health information and confidential medical records covered by HIPAA.

Tenancy by the Entirety Maintained in Revocable Trusts

Effective January 1, 2011, Illinois married couples will be entitled to have their primary residences owned in the names of their revocable trusts as tenants by the entirety. Previously, in order to achieve the creditor protection that tenancy by the entirety provides, title needed to be in the names of the husband and wife, individually, which would subject the residence to probate following the death of the first to die. Accordingly, the new legislation is designed to provide Illinois married couples with the tenancy by the entirety creditor protection as well as probate avoidance.

However, there is some uncertainty as to how this legislation will work as a practical matter. For example, if the residence is titled one-half in the name of the husband’s revocable trust and one-half in the name of the wife’s revocable trust, as tenants by the entirety, the legislation does not make it clear what would happen upon the death of the first to die. In order to avoid that situation, title to the residence would need to be solely in the name of one spouse’s revocable trust, as tenants by the entirety, which raises additional questions and concerns.

Based upon the foregoing, clients may wish to hold off trying to take advantage of this new legislation until these issues have been resolved.

New York

New York Adopts No-Fault Divorce

New York finally adopted no-fault divorce, meaning that couples no longer need to assert “grounds” for divorce. In addition, New York made divorce available to same-sex couples resident in New York who were validly married in another state.

New York Savings Statute

A savings statute was enacted to make sure that formula bequests of the unified credit or unused GST exemption amounts work in the case of decedents dying when there is no federal estate, by treating the decedent as having died on December 31, 2009.

Changes to New York Power of Attorney Forms

Substantial technical corrections were made to the sweeping changes that were previously made to New York’s power of attorney legislation in 2009. In particular, the execution of a power of attorney no longer automatically revokes prior powers of attorney, and most business, governmental and bank powers of attorney have been exempted from the application of the law. It was clarified that gifts in excess of $500 in the aggregate annually must still be made pursuant to a statutory gift rider, one of the witnesses to which may be a notary, but that trusts may once again be created, modified or revoked by power of attorney and/or statutory gifts rider. It has also been clarified that the principal may provide succession rules with respect to the agent. All changes are retroactive, unless a notice of revocation of a prior power of attorney was in fact delivered.

Important Changes to New York Not-For-Profit Law

A new article 5-A has been added to the Not-for-Profit Corporation Law, incorporating, with changes, the Uniform Prudent Management of Institutional Funds Act, called the "New York Prudent Management of Institutional Funds Act." It sets forth the relevant standards of conduct in managing and investing an institutional fund by a not-for-profit, which is generally the good faith care of an ordinarily prudent person (except to the extent that someone has special skills), and sets forth the factors that should be considered (except as otherwise provided by a gift instrument). It also requires not-for-profits to adopt a written investment policy. It further sets forth the applicable considerations for an appropriation for expenditure or accumulation of endowment funds, subject to the intent of a donor expressed in the gift instrument (limitations with respect to which must be specific). In the case of gift instruments executed prior to enactment, notice must be given to the donor, if available. While prospective expenditures may be made without regard to historic dollar value, an expenditure in excess of 7% of the fair market value of the endowment creates a rebuttable presumption of imprudence (though a smaller expenditure does not create the opposite presumption). The ability to delegate management and investment functions is established, along with a concomitant duty to monitor such delegations. A new mechanism has been enacted to release or modify restrictions on management, investment or purpose, either by donor consent, by application to court, or upon 90 days notice to the attorney general and to the donor, if available (in the case of funds of less than $100,000 established more than 20 years ago). Finally, it has been clarified that in reviewing compliance, the prevailing circumstances at the time shall apply, as opposed to hindsight.

Family Care Decisions Act and Do Not Resuscitate Orders

New York has enacted the Family Care Decisions Act, which supplements existing provisions of law, and is intended to operate when health care agents have not been appointed or guardians or other fiduciaries authorized to make health care decisions are not in place. The Act creates procedures for health care providers to follow and provides a prioritized list of surrogates to make decisions for the patient, specifically, a court-appointed guardian, a spouse (if not legally separated), a domestic partner, an adult child, a parent, an adult sibling and a close friend.

New York has also enacted a new law creating the ability to enter Do Not Resuscitate orders that are applicable after patients leave the hospital or to patients who are not in the hospital at all.

New York Applicable Exclusion Amount and QTIP Election

The state estate tax law has been amended to clarify that the applicable exclusion amount for New York purposes shall be $1 million, regardless of the amount of the federal applicable exclusion amount in effect on the date of death, and that a New York State QTIP election may be made when no federal estate tax return is required.

North Carolina

Repeal of Rule Against Perpetuities

NCGS §41-23 was enacted in 2007 to repeal the Rule Against Perpetuities as it applies to trusts administered in North Carolina and to allow for the creation of dynasty trusts. In February 2010, the North Carolina Court of Appeals upheld the constitutionality of this statute in *Brown Brothers Harriman Trust Co. v. Benson*.

Savings Clause

North Carolina enacted §31-46.1 and §36C-1-113, under which formula clauses contained in wills and trusts previously executed by a decedent dying in 2010 will be interpreted in accordance with the 2009 federal estate and generation-skipping transfer tax laws. This construction applies unless the will or trust contains a contrary intent.

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.

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