November 2013

2013 Year-End Estate Planning Advisory

Last year's looming fiscal cliff crisis and the 13th hour passage of the American Taxpayer Relief Act of 2012 (ATRA 2012), have resulted in a period of relative calm in the estate planning world. For the first time in over 11 years, we may not have to plan with imminent change on the horizon. Under ATRA 2012, the estate and gift applicable exclusion amounts and the generation skipping transfer (GST) exemption amount (the "applicable exclusion amounts") were initially set at $5 million, and are indexed for inflation in 2013 and future years, resulting in the current $5.25 million applicable exclusion amounts. Although the applicable exclusion amounts and the tax rates are said to be permanent, the Obama Administration's latest budget proposal already seeks to make changes to them. ATRA 2012 made permanent the so-called "portability" provisions of the federal gift and estate tax laws, whereby a surviving spouse is entitled to use any portion of the deceased spouse's unused applicable exclusion amount (DSUE), allowing the surviving spouse to make tax-free gifts and/or reduce the amount of estate taxes owed upon the surviving spouse's death by adding the DSUE to the surviving spouse's own applicable exclusion amounts (note, however, that the DSUE does not increase the surviving spouse's federal GST exemption). The historically high exclusion amounts and the portability provisions under ATRA 2012 create many new estate planning opportunities.

At the same time, income tax rates were significantly increased by ATRA 2012, thus placing a new emphasis on achieving basis step-ups wherever possible as well as other techniques that decrease income tax liability. There is a certain tension now between income tax and estate tax planning. In fact, some commentators say that, conceptually speaking, income tax is becoming the new estate tax in terms of effective tax planning.

Though ATRA 2012 was a tough political act to follow, the US Supreme Court (Supreme Court) did its best to upstage Congress and grant a major victory to the marriage equality movement by striking down Section 3 of the federal Defense of Marriage Act (DOMA) as unconstitutional in the case of *United States v. Windsor* (*Windsor*). Relatedly, the Supreme Court dismissed an appeal from the federal district court ruling that struck down California's Proposition 8 (which prohibited marriages of same-sex couples in California) as unconstitutional in the case of *Hollingsworth v. Perry* (*Perry*), thus judicially adding California to the list of states that permit marriage for same-sex couples. In addition to California, seven other states, including Delaware, Hawaii, Illinois, Maryland, Minnesota, New Jersey and Rhode Island, decided to permit marriages between same-sex couples in 2013. The federal and state recognition of marriages between same-sex couples has significant tax consequences (positive and negative) for married same-sex couples, among them the ability to take advantage of the marital deduction from federal estate, gift and GST taxes. Note that, pursuant to federal guidance implementing the *Windsor* decision, the federal government will recognize as "married" only those couples that were lawfully married in any jurisdiction. Same-sex couples that are in so-called "marriage equivalent" legal relationships, e.g., civil unions, registered domestic partnerships and domestic partnerships, will not be treated as married.

These are just a few of the significant developments at the federal, state and international levels this year, and the Trusts and Estates practice at Katten Muchin Rosenman LLP is pleased to provide you with a summary of those 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 2013, the exclusion amount is $5.25 million. For 2014, the exclusion amount will be $5.34 million. The maximum rate for estate, gift and GST taxes will remain at 40%.

Annual Gift Tax Exclusion

Each year individuals are entitled to make gifts of a certain amount (the "Annual Gift Tax Exemption Amount") without incurring gift tax or using any of their lifetime applicable exclusion amount against estate and gift tax. The Annual Gift Tax Exemption Amount will remain at $14,000 per donee in 2014. Thus, a married couple together will be able to gift $28,000 to each donee. However, gifts made to noncitizen spouses are limited to a different Annual Gift Tax Exemption Amount, which will increase from $143,000 to $145,000 in 2014.

Federal Income Tax Rates

- Individual ordinary income tax rates will remain the same in 2014. The threshold amount for the maximum tax rate of 39.6% for 2014 will rise to $457,600 for married couples filing jointly, $228,800 for married couples filing separately, $432,200 for heads of households, and $406,750 for single filers.
- For taxpayers whose ordinary income is taxed at the maximum 39.6% level, long-term capital gains will be taxed at 20%. Long-term capital gains for taxpayers in lower ordinary income tax brackets will 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 so-called "Pease Limitation," whereby certain itemized deductions, including deductions for mortgage interest, property taxes, state and local taxes and charitable contributions, are reduced by an amount equal to 3% of the excess of the adjusted gross income (AGI) over a threshold amount, indexed for inflation, but not by more than 80% of the itemized deductions, is expected to impact taxpayers with AGI above $305,050 (married filing jointly) or $254,200 (unmarried) for 2014. Taxpayers with AGI above the same thresholds will also be subject to the so-called "PEP Limitation," whereby their personal and dependency exemptions will be reduced by 2% for every $2,500 or part thereof that the taxpayer's AGI exceeds the threshold.
- Certain itemized deductions, including the deduction for state and local sales taxes, were extended through 2013 under ATRA 2012, but will expire on December 31, 2013.
- The thresholds for the imposition of the 3.8% Medicare surtax on investment income and 0.9% Medicare surtax on earned income will remain the same as they were in 2013 ($200,000 for single filers, $250,000 for married filers filing jointly, $125,000 for married filers filing separately, and $11,950 for trusts and estates).
- The exemption amount from the alternative minimum tax (AMT) is projected to rise to $82,100 for married couples filing jointly and surviving spouses, $52,800 for unmarried single filers and heads of household and $41,050 for married couples filing separately in 2014.

President's Budget Proposal for Fiscal Year 2014

The President's budget proposal for Fiscal Year 2014 includes a number of transfer tax-related items, some of which have been proposed in prior years. In contrast to the President's budget proposals in prior years, the 2014 proposal does not include a proposal to limit the availability of valuation discounts on family limited partnerships, limited liability companies, and other family entities—a very favorable development for taxpayers.

Subject Payments From Health and Education Exclusion Trusts (HEETs) to GST Tax

Payments made by a donor directly to a medical provider for medical expenses and/or directly to an educational institution for tuition are exempt from gift tax. When such payments are made on behalf of the donor's grandchildren and subsequent generations, they are exempt from both gift tax and GST tax. A HEET, which is a trust designed to provide for the medical expenses and tuition of multiple generations of descendants, has historically been used to bypass the need to make direct payments from the donor to the provider in any particular year. Under the proposal, however, only qualifying payments for tuition and medical expenses by a living individual directly to the medical provider and/or school will be exempt from GST tax. Distributions from trusts, such as HEETs, for such purposes would not be GST exempt. This proposal would apply to trusts created after the introduction of the bill and to transfers after that date that were made from preexisting trusts.

Reset Exclusion Amounts and Tax Rate

Just when we thought we could breathe a sigh of relief as to the new "permanent" applicable exclusion amounts and tax rates, 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 $3.5 million exemption 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 contains a provision that would significantly undermine the utility of a highly effective planning technique. IDGTs are currently used as a central part of much tax planning, as they allow a grantor the ability to be taxed on all of the trust's income, thus allowing the trust assets to grow undiminished by tax payments. Under the proposal, the assets in IDGTs would be included in the grantor's estate and subject to estate tax. 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.

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 Grantor Retained Annuity Trusts (GRATs): (i) they must have a 10-year minimum term; (ii) they must have a remainder interest greater than zero; and (iii) the annuity amount cannot decrease in any year during the annuity term.

Limit the Duration of the GST Exemption

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 under the trust instrument and/or state law.

Extend Liens on Estate Tax Deferrals

Currently, the law allows a deferral for estate tax on closely held business interests for up to 15 years and three 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.

Disallow Deductions for Contributions of Certain Conservation Easements

The Proposal would prohibit a deduction for any contribution of a partial interest in property that is used as a golf course, and would also prohibit a charitable deduction for the contribution of a historic preservation easement associated with forgone upward development above a historic building.

It is impossible to say which if any of these proposals may ever be enacted, but it is important, in reviewing one's planning options, to note which devices are on the President's radar screen for change.

Important Planning Considerations for 2013 and 2014

Review and Revise Your Estate Plan to Ensure It Remains Appropriate

If you made large gifts before the end of 2012 you should review your estate planning documents to make sure that those documents still make sense in light of your recent gifting. 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 having your documents revised to a "disclaimer plan", which provides the greatest level of flexibility to take into account the possibility of future changes to the applicable exclusion amount. Under a disclaimer plan, your assets pass to your surviving spouse (thus qualifying for the unlimited marital deduction from estate tax if the surviving spouse is a US citizen), subject to your spouse's option to disclaim, i.e., refuse to accept, some or all of such assets, causing the disclaimed assets to pass to a trust for the benefit of your spouse and descendants. The amount of any such disclaimer can be based on your remaining applicable exclusion amounts at the time of your death, as well as your spouse's comfort level with ceding control of the assets to a trustee.

For some individuals, it may be advisable to distribute property previously transferred into a trust in order to obtain a step up in basis for such property upon the death of the beneficiary. 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 all of your planning, as it is unclear that the portability provisions under existing laws will remain in place. In addition, the DSUE may not be available upon remarriage.

You should also review any provisions in your Wills 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 to reflect your desires and take full advantage of your applicable exclusion amounts, as appropriate under the circumstances.

Other provisions which should be reviewed include the allocation of the GST applicable exclusion amount. If you are married, you should carefully review the provisions regarding your applicable exclusion amount from GST tax because the portability provisions discussed above do not apply to the GST tax. In addition, whether single or married, if you did not have sufficient GST applicable exclusion amount to exempt all of your prior gifts to a trust from GST tax, that trust will only be partially exempt from GST tax. In order to avoid the expense and administrative difficulty of a trust that is only partially exempt from GST tax, you could consider making a "qualified severance" of the trust into two trusts, one of which is entirely exempt from GST tax, and the other of which is nonexempt from GST tax.

If you were the beneficiary of lifetime gifts made by someone else, you should review your estate planning documents to ensure that they take such gifts into account and take full advantage of your applicable exclusion amounts.

Same-sex couples who are married or plan to marry should immediately review and revise their estate planning documents to take advantage of the unlimited marital deduction from federal estate tax and gift tax for transfers between same-sex spouses that is now available after the *Windsor* decision. Existing estate planning documents may have been drafted with the assumption that any gift or bequest to a spouse of the same sex over and above the individual's applicable exclusion amount would be subject to federal estate tax. However, that assumption is no longer true. Indeed, such gifts and bequests, if properly structured, are now entitled to the unlimited marital deduction. In addition, under the portability provisions of federal gift and estate tax laws, a surviving spouse of the same sex will also be entitled to use any portion of the deceased spouse's DSUE, allowing the surviving spouse to make additional tax-free gifts and/or reduce the amount of estate taxes owed upon the surviving spouse's death (note, however, that the DSUE does not increase the surviving spouse's federal GST exemption). 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. Further, documents that refer to a "spouse" should be sure to define that term to marriages that are 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 $11,950 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 couples filing separately).

Note that trusts created under Section 2503(c) of the Internal Revenue Code and so-called "Crummey trusts," unlike uniform transfers to minors act (UTMA) accounts, are treated as separate taxpayers for federal income tax purposes, provided that the beneficiary is under the age of 14, and are not subject to the so-called "kiddie tax." Accordingly, such trusts can be used to avoid the Medicare surtax on the first $11,950 of trust income in situations where the beneficiary would be subject to the surtax based on the beneficiary's individual income.

Careful evaluation and tax calculations should thus 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 $5.25 million ($10.5 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 gift tax 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 unused applicable exclusion amount from estate tax, you may add such unused applicable exclusion amount to your own applicable exclusion amount from gift tax, thus permitting you to make larger lifetime gifts without paying gift tax. It is less expensive to make lifetime gifts rather than making 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. In addition, you will benefit by getting any income and appreciation on the gift out of your estate.

The downside of lifetime gifting is that the assets given away will not get a step up in basis upon 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 basis of your various assets, their projected income and appreciation, the total amount of your assets, and your 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. We are available to discuss this analysis with you in more detail.

Note that your applicable exclusion amount will increase by $94,000 ($188,000 for a married couple) in 2014. Therefore, even if you use some or even all of the applicable exclusion amount available to you before the end of 2013, you may still make additional gifts in 2014 without paying any gift tax. Your applicable exclusion amount will also be adjusted for inflation in future years. Thus, you may "max out" your applicable exclusion in 2013 and still make additional gifts in 2014 and subsequent years to take advantage of the increased applicable exclusion amount available in each year.

Grantor Retained Annuity Trusts (GRATs)

GRATs remain one of our most valuable planning tools, particularly in this time of historically low interest rates and depressed asset values. Because of the continuing 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. An important point to note is that GRATs may currently 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 (currently 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 2013 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 applicable rate. 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

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

You would sell assets likely to appreciate in value to the trust in exchange for a commercially reasonable down payment 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 defective 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 2013 is as low as 1.65%), 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.

Consider Making Qualified Payments From HEETs for the Benefit of Grandchildren

Because the President's budget proposal would subject distributions from HEETs for the benefit of the grandchildren and/or more remote descendants of the transferor, for GST purposes, of the trust property to GST tax, we recommend making payments for covered medical and tuition expenses from HEETs for the benefit of such beneficiaries as soon as possible.

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

Some of you sold or gave (through a GRAT or other grantor trust) an asset with a low basis. If the asset is sold at a gain, 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 equal to the value of the asset that was repurchased, leaving the same amount to escape estate tax. 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.

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. This means that the capital gains tax on sale of that asset is eliminated and the beneficiaries still benefit from the grantor trust's cash.

Consider the Use of Life Insurance

Though the higher annual exclusion amounts available after ATRA 2012 may have reduced the role of life insurance as a means to minimize estate taxes and/or provide liquidity to pay estate taxes, life insurance still presents significant opportunities to defer and/or avoid income taxes altogether. Generally speaking, appreciation and/or income earned on a life insurance policy accumulate 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. If the gain is distributed upon the death of the insured, such gain is completely free of income taxes. You may also want to consider paying off any outstanding loans against existing policies in order to maximize the income tax savings. Note that the decision to pay off such loans requires a comparison of the rate of return available under the policy versus alternative investments that may be available to you and the applicable interest rate on the loans. In addition, paying off loans held in an Irrevocable Life Insurance Trust (ILIT) may use part of your applicable exclusion amount from gift tax.

Many same-sex spouses previously purchased individual life insurance policies of which the other spouse is the beneficiary (either directly via beneficiary designation or indirectly through a life insurance trust) in order to provide the surviving spouse with sufficient liquid assets that may be used to pay federal estate taxes due upon the death of the first to die. With the unlimited marital deduction and DSUE now available to married same-sex couples, as explained above, there may be little or no need for such liquidity upon the death of the first spouse to die. Thus, married same-sex couples should consider replacing such individual policies with so-called "survivor" or "second-to-die" policies that pay benefits only upon the death of the surviving spouse. Such policies will still provide liquidity to children or other beneficiaries of the married same-sex couple and are generally less expensive than individual policies having the same death benefits.

Use Intra-Family Loans

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

- 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. Note that forgiveness of debt that is a gift is not treated as taxable income of the borrower.
- 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.

Consider Charitable Planning

A variety of planning tools are available for the charitably inclined. One 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, non-charitable beneficiaries. As with a GRAT, to the extent the assets outperform the IRS assumed rate of return (2% for December 2013), those assets can pass transfer tax free to whomever you would like. Like GRATs, CLATs can be "zeroed out" so that there is no taxable gift.

Taxpayers over the age of 70½ should consider making up to $100,000 of qualified charitable distributions from IRAs on or before December 31, 2013. Note that taxpayers will not have the ability to make such distributions in 2014 unless Congress acts to extend the underlying statutory provisions.

Further, giving appreciated assets directly to charity has always been an effective means to avoid capital gains tax on the donated assets. Now it is also an effective way to avoid the 3.8% Medicare surtax. The income tax deduction for charitable gifts may also be worth more as a result of the higher tax rates. Note that the Pease Limitation described above, if applicable, may reduce the amount of the deduction for charitable gifts.

Consider Utilizing a Nevada Incomplete Gift Nongrantor Trust (NING Trust)

If you live in a state with a high state income tax that does not tax trusts created by state residents but sitused out of the state (such as New York and New Jersey), you should consider utilizing a properly-structured NING Trust as a state income tax planning tool. These trusts are self-settled irrevocable trusts designed to avoid state income taxes by transferring income-producing assets to trusts sitused in Nevada, which does not have a state income tax, while simultaneously providing the asset protection benefits available for self-settled trusts under Nevada law.

To create a NING Trust, you would transfer income-producing assets to a trust and would retain enough control over trust assets so that you do not make a completed gift, such as by retaining a lifetime power of appointment, but give up enough control so that the trust does not achieve grantor trust status for federal income tax purposes, such as by specifying that distributions must be authorized by a "distribution committee." As a nongrantor trust, the trust is treated as a separate taxpayer and pays no state income tax on its earnings (but does pay federal income tax).

Because the transfer to the trust is an incomplete gift, subsequent distributions made to you will not be subject to federal gift tax because such distributions are treated as a return of your own assets. Distributions made to other beneficiaries will be treated as gifts, however. At your death, the assets remaining in the trust will be included in your estate and will get a step up in basis, thus avoiding capital gains tax. Note that a NING Trust must be carefully structured in order to achieve the above results and the potential tax savings will depend on your particular facts and circumstances.

Year-End Checklist for 2013

In addition to the above planning ideas, consider the following before 2013 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 2013 income tax return.

Below is a discussion of national, international and local developments that occurred in 2013.

National Developments in 2013

The Supreme Court Struck Down DOMA as Unconstitutional

As mentioned above, the Supreme Court struck down Section 3 of the DOMA statute in the *Windsor* decision. In *Windsor*, Edith Windsor and Thea Spyer, a same-sex couple, married in Canada in 2007 after having been together in New York for over 40 years. New York law did not permit marriages between same-sex couples at the time but recognized marriages of same-sex couples performed in other jurisdictions. Spyer died in 2009, and Windsor inherited all of Spyer's estate as Spyer's surviving spouse. However, because of DOMA, which defined "marriage" as "a legal union between one man and one woman as husband and wife" and "spouse" as "a person of the opposite sex who is a husband or a wife," the federal government refused to recognize the couple's marriage for federal estate tax purposes. As a result, Windsor's inheritance from Spyer was not entitled to the unlimited marital deduction from federal estate tax that would have been available had Windsor and Spyer's marriage been recognized by the federal government. After paying the estate taxes owed on her inheritance as a result of DOMA, Windsor sued for a refund of the estate taxes on the grounds that DOMA unconstitutionally discriminated against same-sex married couples. Windsor prevailed in the US District Court for the Southern District of New York and also in the Second Circuit Court of Appeals. The Supreme Court agreed with Windsor, holding that "DOMA seeks to injure the very class [of married same-sex couples] New York seeks to protect. By doing so it violates basic due process and equal protection principles applicable to the Federal Government." The Supreme Court further explained that DOMA's "demonstrated purpose is to ensure that if any State decides to recognize same-sex marriages, those unions will be treated as second-class marriages for purposes of federal law."

Federal Agencies Have Begun to Implement the Windsor Decision

Following the *Windsor* decision, on August 29, 2013, the US Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued Revenue Ruling 2013-17 (the "Ruling") holding that, for purposes of administering all federal tax laws, including those pertaining to income, gift and estate taxes, married same-sex couples who were lawfully married in any jurisdiction (domestic or international) will be treated as married regardless of whether the jurisdictions in which such couples are resident and/or domiciled recognize the marriage. However, neither Treasury nor the IRS will recognize as married those unmarried same-sex couples that are in so-called "marriage equivalent" legal relationships, e.g., civil unions, registered domestic partnerships and domestic partnerships.

The Ruling "applies to all federal tax provisions where marriage is a factor, including filing status, claiming personal and dependency exemptions, taking the standard deduction, employee benefits, contributing to an IRA, and claiming the earned income tax credit or child tax credit." As a result of the Ruling, married same-sex couples generally will be required to file their 2013 federal income tax returns with a "married filing jointly" or "married filing separately" filing status. In addition, same-sex couples who were married in prior years may, but are not required to, file original or amended tax returns within the statutory limitations period, which is ordinarily three years from the date the tax return was originally due or filed (if on extension) or two years from the date the tax was paid, whichever is later. Accordingly, married same-sex couples ordinarily

may amend their returns for the years 2010, 2011 and 2012 and obtain a refund of any overpayment of taxes, if applicable. Taxpayers with special situations (e.g., those who filed protective claims for a refund or that signed tolling agreements with the IRS) may be able to amend their returns for 2009 and/or prior years as well.

A handful of other federal agencies have issued their own guidance on various nontax issues in the wake of *Windsor*, but have taken contrasting positions on whether they will follow the "place of celebration" rule, i.e., by referring to the law of the jurisdiction where the marriage took place, as the Treasury and IRS have done, or the "place of domicile" rule, i.e., by referring to the law of the jurisdiction in which the couple is resident and/or domiciled, in determining whether married same-sex couples should be treated as "married" under federal law. Some agencies have indicated that they will follow the "place of celebration" rule, including: the Office of Personnel and Management (spousal benefits for federal employees); the US Department of Labor (ERISA-covered plan benefits) the US Department of Health and Human Services (Medicare eligibility for certain services), and the US Department of Homeland Security (immigration visas). Other agencies have indicated that they will follow the "place of domicile" rule, including the Social Security Administration (spousal social security benefits). In accord with the Treasury and IRS, none of the above agencies have indicated that they will recognize marriage equivalent relationships. Still more federal agencies are expected to issue their own guidance implementing *Windsor* in the future. However, it is too soon to predict which of such agencies will follow the "place of celebration" rule or the "place of domicile" rule or whether any such agencies will recognize marriage equivalent relationships for purposes of determining which same-sex couples will be entitled to the more than 1,000 benefits, responsibilities and protections applicable to married opposite-sex couples under federal law.

International Developments in 2013

US International Developments

In August 2013, the US Department of Justice (DOJ) announced a new voluntary disclosure program for Swiss financial institutions whereby eligible Swiss banks that are not already under investigation by the DOJ may avoid criminal prosecution in the US by disclosing detailed information on US-held accounts and, in some cases, paying significant penalties.

On January 18, 2013, Treasury issued the long-awaited final regulations (the "FATCA Regulations") promulgated under the Foreign Account Tax Compliance Act (FATCA). FATCA imposes a new withholding tax on foreign entities, unless such entities comply with new information reporting requirements. The FATCA Regulations provide detailed guidance on complying with FATCA.

Relatedly, Treasury continues to negotiate so-called "inter-governmental agreements" or "IGAs" with other countries pursuant to FATCA. Under such IGAs, foreign financial institutions report tax-related information about accounts held by US customers to the foreign government, which relays that information to the IRS. In exchange, the IRS provides similar information to the foreign government with assistance from US financial institutions. To date, Treasury has entered into IGAs with 10 countries, including: Denmark, France, Germany, Ireland, Japan, Mexico, Norway, Spain, Switzerland, and the United Kingdom. Treasury is very close to entering into final IGAs with Bermuda, the Cayman Islands, Italy, and Malta. In addition, final negotiations are underway with the following jurisdictions: Australia, Belgium, British Virgin Islands, Canada, Czech Republic, Finland, Guernsey, Isle of Man, Israel, Jersey, Luxembourg, Netherlands, New Zealand, Singapore, and Sweden.

Germany

In September 2012, the German Federal Tax Court issued a decision that clarified the tax treatment of foreign trusts and held that all distributions from foreign trusts to beneficiaries resident in Germany are subject to German gift tax. Though the decision did not expressly state whether such distributions would also be subject to German income tax, there is a significant risk that that such distributions will indeed be subject to German income tax in addition to German gift tax.

Israel

As a result of recent legislation, beginning on January 1, 2014, a trust will be classified as a "Foreign Settlor Trust" only where the settlor and the beneficiaries are relatives, and the trust will cease to be a Foreign Settlor Trust upon the death of its settlor. A Foreign Settlor Trust is a trust funded by a non-Israeli resident and which is not subject to the direct or indirect control of an Israeli resident, and which yields important tax benefits to Israeli resident beneficiaries. As a result of the recent legislation, the trustee of a Foreign Settlor Trust will need to elect for either the Trust's current income, allocable to its Israeli beneficiaries, or the income distributions to Israeli beneficiaries to be taxed in Israel. Israeli beneficiaries who receive any distribution from any trust will now be required to report such distribution.

Italy

Under new Italian reporting regulations that came into effect on September 4, 2013, trust beneficiaries who are "beneficial owners," defined broadly by reference to anti-money laundering rules, of offshore structures are subject to the existing Italian taxpayer reporting obligations. If applicable, such beneficiaries may be required to disclose the existence of the trust in their tax return.

Additionally, the Italian Securities and Exchange Commission has issued new rules that now subject trusts that hold 2% or more of the ordinary shares in a listed Italian company, or are a party to a shareholders' agreement in relation to such a company, to disclosure requirements. In these cases, trustees must disclose the identity of the settlor, beneficiaries, protectors as well as the nature and duration of such trusts. Failure to comply will result in a fine.

Local Developments in 2013: State-Specific Considerations

California

Contemporaneous with the *Windsor* decision, the Supreme Court also dismissed an appeal from the federal district court ruling that struck down California's Proposition 8 (which prohibited marriages of same-sex couples in California following a brief six-month period in which such marriages were permitted as a result of a prior California Supreme Court decision) as unconstitutional in the *Perry* decision. In *Perry*, two same-sex couples wished to marry in California. Though the California Supreme Court held in 2008 that the California Constitution required the State to recognize marriages of same-sex couples, California voters passed Proposition 8 later the same year, amending the California Constitution to provide that only "marriage between a man and a woman is valid and recognized in California." As a result of Proposition 8's passage, the two couples were unable to marry. They sued the California Governor, attorney general and various other state and local officials responsible for enforcing California's marriage laws (the "California officials"), claiming that Proposition 8 violated their rights to due process and equal protection under the United States Constitution. In the US District Court for the Northern District of California (district court), the California officials refused to defend Proposition 8, but the private parties who were the proponents of Proposition 8 (the "Proposition 8 proponents") successfully intervened to defend the measure. After the district court held that Proposition 8 was unconstitutional, the California officials declined to appeal the decision and the Proposition 8 proponents appealed. The Ninth Circuit Court of Appeals (Ninth Circuit) upheld the district court's ruling that Proposition 8 was unconstitutional. The Supreme Court dismissed the appeal from the district court on the grounds that the Proposition 8 proponents lacked standing to appeal because they were merely private parties and were not properly authorized under state law to defend the constitutionality of Proposition 8. As a result of the Supreme Court's ruling, the district court's ruling that Proposition 8 is unconstitutional remains in place and marriages between same-sex couples are once again permitted in the State of California beginning June 28, 2013.

The California Revised Uniform Limited Liability Company Act (RULLCA) will take effect on January 1, 2014 and replaces the Beverly-Killea Limited Liability Company Act (Beverly-Killea), the current California law governing limited liability companies (LLCs). RULLCA will apply automatically to all existing California LLCs and all foreign LLCs previously registered with the California Secretary of State as well as to LLCs formed after January 1, 2014. There is no option to opt out. Existing LLCs will not be required to file any new documents with the California Secretary of State or any other governmental agency as a result of RULLCA coming into effect.

RULLCA made some important changes to Beverly-Killea, including the following:

- Adding provisions under which a member may be dissociated from a LLC and the effects of dissociation on the member;
- Distinguishing between a manager-managed LLC and a member-managed LLC for purposes of defining the scope of a member's agency and imposing fiduciary duties only on persons in control of a LLC;
- Authorizing the establishment of classes of members;
- Allowing a LLC to be subject to the nonexclusive jurisdiction of courts in another state or the exclusive jurisdiction of California courts; and
- Allowing a member to consent to arbitration.

Florida

In 2013, Florida updated the Florida Principal and Income Act (FPIA). The amendment clarified its use of the terms "trustees" and "fiduciaries," making clear that certain sections apply only to trusts while other sections apply to both trusts and estates. The amendment additionally defines "carrying value" to mean the "fair market value at the time the assets are received by the fiduciary." Accounting income allocated to beneficiaries should be based upon carrying values, except where disproportionate distributions are made. The amendment also incorporates a "smoothing rule" to compute the fair market value of a unitrust.

Illinois

A 2013 change to the Illinois Administrative Code affects how Illinois residency is determined for state income tax purposes. In general, Illinois defines a resident for state income tax purposes as someone who is in the state for other than a temporary or transitory purpose during the year or who is domiciled in the state but absent from the state for a temporary or transitory purpose during the year. The amendments revised the factors that may be used to prove or disprove Illinois residency. One of our Chicago attorneys would be happy to discuss whether and how you may be affected by the amendments based on your individual facts and circumstances.

Illinois Governor Pat Quinn signed the Religious Freedom and Marriage Fairness Act into law on November 20, 2013, making Illinois the 16th state to allow same-sex marriage. As a result, beginning on June 1, 2014, same-sex couples will be able to marry in Illinois.

Illinois' new directed trustee statute went into effect on January 1, 2013. The new law, which applies to all Illinois trusts in existence or established after the effective date, specifically authorizes a trust to bifurcate management duties between a trustee and an investment trust advisor, trust protector, distribution advisor, or other person or entity acting as a fiduciary. The new statute insulates the trustee from liability for following the direction of the advisor.

Illinois' new trust decanting statute went into effect on January 1, 2013. Trust decanting may be used to update the terms of an otherwise irrevocable trust by distributing trust assets from one trust to another trust that contains the desired terms. The extent to which a trustee may modify the terms of an irrevocable trust through decanting depends on how much discretion is granted to the trustee under the original trust. If the trustee is granted "absolute discretion" to distribute trust assets to beneficiaries under the original trust, then the trustee may eliminate the interests of one or more beneficiaries and may also modify any powers of appointment granted under the original trust. If a trustee does not have absolute discretion to distribute trust assets, then the trustee is not permitted to change beneficiaries, but may make other changes to the original trust. The new statute applies to all Illinois trusts in existence or established after January 1, 2013.

The Illinois state estate tax threshold amount will increase to $4 million for all decedents dying on or after January 1, 2013.

New Jersey

Effective October 21, 2013, New Jersey permits marriages between same-sex couples. In *Garden State Equality v. Dow*, a New Jersey Superior Court held that New Jersey's civil union statute violates equal protection under the New Jersey constitution after the Supreme Court's *Windsor* decision by virtue of the fact that same-sex couples in New Jersey civil unions will be denied

many federal benefits because they will not be deemed "married" under federal law. Though Governor Chris Christie initially appealed the decision to the New Jersey Supreme Court, his administration ultimately dropped the appeal.

New York

Section 467-a of the Real Property Tax Law has been amended to provide that a property tax abatement that is afforded to an individual will not be lost if a dwelling unit held in the form of a cooperative or condominium is transferred to a trust if such trust is for the sole benefit of such individual. This act was effective on its enactment on July 3, 2013 and is retroactive to June 1, 2012.

Various sections of New York's so-called "decanting statute" under the Estates, Powers and Trusts Law (EPTL) were amended to make certain technical and clarifying amendments to the statute. The new law clarifies that where a trustee has unlimited discretion to invade principal, the trustee may decant a portion or all of the trust principal in favor of one or all of the current beneficiaries and that in such circumstances, the trustee may exclude any of the remainder beneficiaries of the invaded trust. The new law also addresses how the six-year statute of limitations governing a proceeding to compel a fiduciary to account is affected by decanting. Present law merely states that the failure of a beneficiary to object to the exercise of the decanting power does not foreclose an interested party from objecting to an account or compelling a trustee to account. The new law would require that the instrument by which the decanting power, in an *inter vivos* trust, is exercised contain a statement that in certain circumstances the appointment, i.e., the exercise of the decanting power, will begin the running of the statute of limitations that will preclude persons interested in the invaded trust from compelling an accounting by the trustees after the expiration of a given time. Whether the exercise of the decanting power actually triggers the running of the statute of limitations on an action to compel a trustee to account will be based on all relevant facts and circumstances. The new law also clarifies that unless otherwise specified in the governing instrument, decanting may be done by a majority of the trustees authorized to invade trust principal. Last, if a nongrantor trust is decanted to a grantor trust, the new law makes clear that a provision in the new trust allowing for tax reimbursements does not in and of itself cause the creator of the trust to be considered a beneficiary of the decanted trust. These amendments became effective on November 13, 2013. The decanting statute was previously amended on August 17, 2011, and those amendments (the "2011 amendments") made sweeping changes to the decanting statute. However, there was some confusion as to whether the 2011 amendments were effective to trusts created on the date of the 2011 amendments, in addition to trusts created before or after the effective date. Thus, on October 23, 2013, the decanting statute was amended to make clear that the 2011 amendments were effective to trusts created on the effective date, as well as to trusts created before or after that date.

Section 3-3.3 of the EPTL, New York's anti-lapse statute, was amended to clarify that it applies, absent a condition precedent of survival, to a testamentary disposition, including a disposition to a future estate, for a beneficiary who is one of the testator's issue or a sibling. If the anti-lapse statute is applied to a disposition, the disposition is by representation, i.e., all beneficiaries at a generational level will receive equal shares, regardless how the shares were distributed at the preceding generational level (a so-called "per capita" distribution), and applies regardless of when the testamentary instrument was executed. The law was enacted on September 27, 2013, and is effective immediately, but applies only to estates of decedents dying on or after September 27, 2013.

Sections 715 and 716 of the Surrogate's Court Procedure Act (SCPA) were amended to permit a resigning fiduciary to settle his/her account judicially or informally, provided that no person interested in the estate or trust is under a disability. Current law requires a judicial settlement of a resigning fiduciary's account. This amendment took effect on November 13, 2013 and will apply to estates of decedents dying on or after that date.

A new Section 991 has been added to the Tax Law that precludes the Tax Department from charging interest on any additional estate tax liability owed by an estate due to late-discovered assets in the possession of the State Comptroller as abandoned property and for which the State Comptroller did not pay interest. This relief is available only if the information pertaining to the asset did not appear in the public records of abandoned property at the time the estate tax return was due, including extensions. This law was enacted on July 31, 2013, is effective immediately and applies to estates of decedents dying or on or after June 1, 1944, provided, however, that no refunds or credits are to be granted as a result of this act.

Two other significant bills were passed by the New York legislature this year. Though they have yet to be signed by the Governor, he is expected to sign both bills.

The Nonprofit Revitalization Act of 2013 would make significant changes to the Not for Profit Corporation Law (N-PCL) and will also result in changes to other statutes such as the EPTL, SCPA and the Executive Law. The objective is to reduce unnecessary and outdated burdens on nonprofits and to enhance nonprofit governance and oversight to prevent fraud and improve public trust. The changes are considerable, but some of the highlights that would affect the N-PCL include the following: a) eliminating distinctions in the types of nonprofits and instead categorizing entities as either charitable corporations or noncharitable corporations (existing entity types will be grandfathered to eliminate the need to file a certificate of amendment); b) permitting facsimiles, emails, video conferencing, Skype and other more modern technological means for meeting notifications and meetings themselves; c) requiring that nonprofits adopt written conflict of interest policies; d) prohibiting any employee from also serving as chairperson of the board in order to have clear lines of accountability; e) simplifying the process and reducing costs where an organization wants to sell, lease or dispose of substantially all of its assets by eliminating the need for court approval and instead relying on the review and approval of the Attorney General as a control mechanism; f) similarly simplifying the steps for a proposed merger; and g) requiring organizations with 20 or more employees and annual revenues in excess of $1 million to adopt whistleblower policies. Generally, the changes would be effective as of July 1, 2014.

Section 951 of the Tax Law would be amended to add a new Subsection (c) that would provide, in the case of an estate where no federal estate tax return is required to be filed, that a disposition to a surviving spouse who is not a US citizen does not need to pass to a qualified domestic trust (QDOT) in order to qualify for the marital deduction under state law. The act is to be effective immediately upon enactment, is to apply to estates of decedents dying on or after January 1, 2010 and is to expire and be deemed repealed on July 1, 2016.

North Carolina

In July 2013, North Carolina repealed its estate tax. The repeal will be retroactive to January 1, 2013 and will be effective for estates of decedents dying on or after that date.

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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