Estate Planning Developments

May 26, 2010

2010 ISSUES MAY NECESSITATE CHANGES TO ESTATE PLANNING DOCUMENTS

Less than eight months of Federal estate tax repeal remain before the estate tax is slated to automatically spring back into existence on January 1, 2011. Members of Congress continue to discuss resurrecting the estate tax retroactively to eliminate the repeal, but nothing has happened yet. It remains unclear if and when Congress will act to address the 2010 repeal, or to change the law that currently is in place for 2011 and beyond.

The 2010 repeal may cause unintended consequences in some wills and revocable trusts because of formula bequests (where the amount of the bequest is determined by using a formula) and due to references to certain tax code provisions that are inoperative in 2010.

States are attempting by legislation to help interpret wills whose terms do not operate correctly during 2010. However, only a handful of states have passed such legislation, and in some cases the legislation still does not reach the intended result. New York has proposed legislation but to date it has not been enacted. Thus for some individuals, amendments to estate planning documents will be necessary to ensure that property will pass to the intended recipients.

If you have not done so already, you may wish to contact us in order to review your estate plan to make sure that it would accomplish its intended goals during the repeal period.

PROPOSED NEW LAW WOULD REQUIRE MINIMUM GRAT TERM OF TEN YEARS; TAXABLE GIFT

Legislation passed in March by the House of Representatives (but on which the Senate has not yet voted) would require Grantor Retained Annuity Trusts ("GRATs") created after the law's enactment to have a term of at least ten years. While currently GRATS can be created with little or no taxable gift, the new law, if passed, would require a taxable gift on creation of a GRAT. It is not clear how large the gift would have to be.

CONVERSION TO ROTH IRAS

Beginning January 1, 2010, restrictions on converting a traditional IRA to a Roth IRA were eliminated; now anyone is eligible to convert a traditional IRA to a Roth IRA. For conversions done in 2010 only, the taxable income resulting from the rollover can be spread over 2011 and 2012 (in subsequent years, all income tax must be paid in the year of the conversion).

Generally speaking, a traditional IRA allows income tax deferral of compensation income (and any investment growth thereon) until the eventual distribution of such assets to the beneficiary. By contrast, assets placed in a Roth IRA have already been subject to income tax, but there is no additional tax on the eventual distribution of the assets (and any investment growth thereon) to the beneficiary.

To determine whether a conversion from a traditional IRA to a Roth IRA would make sense for you, factors such as current and future earnings, projected future income tax rates, proposed use of the IRA assets, and the balance of your estate planning should all be considered. Also relevant is your basis in the traditional IRA (i.e., your non-deductible contributions, if any).

OBAMA'S HEALTH CARE ACT INCLUDES A 3.8% SURTAX ON UNEARNED INCOME

The Federal Patient Protection and Affordable Care Act, enacted in March, will impose a new 3.8% tax on certain unearned income beginning January 1, 2013. For certain individuals, the new tax will make a Roth IRA more favorable than a traditional IRA because unlike distributions from a traditional IRA, distributions from a Roth IRA will not increase income subject to the new tax.

EXTENDED EXCLUSION OF TAX-FREE DISTRIBUTIONS FROM IRAS TO QUALIFYING CHARITABLE ORGANIZATIONS

Once again, the House and Senate have voted to extend the exclusion from gross income of up to $100,000 per year of otherwise taxable distributions (including required minimum distributions), from traditional IRAs, provided the distributions are made directly to a qualifying charitable organization through December 31, 2010, (under prior legislation, this exclusion expired December 31, 2009). The following conditions apply: (1) distributions must be to certain public charities (and, notably, cannot be to donor-advised funds); (2) the IRA owner must have attained age 70½ at the time the distributions are made; and (3) the distributions must be made before 2011. Whether it makes sense to use this exclusion will depend on a number of factors, including income level, assets available for charitable giving, and the level of an individual's charitable giving. Although the House and Senate have voted to extend the legislation, the bill still requires a House-Senate conference before going to President Obama for signing, which is expected to happen by Memorial Day.

EXPANDED DISCLOSURE REQUIREMENTS FOR FOREIGN ASSETS

The Federal Hiring Incentives to Restore Employment Act, enacted in March, includes expanded disclosure requirements relating to foreign financial assets, passive foreign investment companies ("PFICs") and foreign trusts.

Those with offshore accounts should be aware that for tax years beginning after March 18, 2010, individuals are required to report on their tax returns offshore accounts and other foreign financial assets with an aggregate value of over $50,000. Additionally beginning January 1, 2013, a 30% withholding tax will apply to certain income from US financial assets held by an offshore institution unless the foreign financial institution agrees to comply with new reporting requirements, which include verification and due diligence procedures with respect to accounts held by US persons.

As of March 18, 2010, unless otherwise provided by the IRS, each US person who is a shareholder of a PFIC must file an annual information return containing such information as the IRS may require. A person who is subject to this reporting requirement could also be subject to the new reporting rule requiring disclosure of foreign financial assets.

Foreign trusts are also subject to additional requirements. While a US person who transfers property to a foreign trust generally has been treated as the owner of the portion of the trust comprising the transferred property for any tax year in which there actually is a US beneficiary of the trust, beginning March 18, 2010, there is a rebuttable presumption that the foreign trust has a US beneficiary. Also, a taxpayer who fails to file an information return for certain transactions involving foreign trusts (*e.g.*, the creation of a foreign trust, the transfer of money or property to a foreign trust, or the death of a US owner of a foreign trust) is subject to IRS penalty.

STRICKEN—PROPOSED LEGISLATION TO ELIMINATE THE NEW YORK STATE INCOME TAX EXEMPTION FOR RESIDENT TRUSTS WITH NON-RESIDENT TRUSTEES

Earlier this year Governor Paterson introduced a budget bill that would have overhauled the taxation of trusts created by New Yorkers. The bill was drafted to tax all testamentary trusts created by New Yorkers, even after the trusts' assets, trustees and beneficiaries had left New York. Recently, this proposal was deleted from the bill, ensuring status quo for state taxation of trusts in New York for the time being. Under the current law, trusts created by New Yorkers will not be subject to tax if the trustee is not domiciled in New York, and if the trust has no assets located in New York and no New York source income.

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If you have any questions about the estate planning considerations described in this update, please contact Pamela L. Rollins (prollins@stblaw.com; 212-455-3468), Laura M. Twomey (ltwomey@stblaw.com; 212-455-3120) or any other member of our Personal Planning Department.

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