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Trusts & Estates Department Alert

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UPDATES AND PLANNING OPPORTUNITIES

Possible Elimination of Increased Gift and Estate Exemptions and Gifting Opportunity for 2011

As previously reported, through December 31, 2012, the gift and estate tax exclusion amount and generation-skipping transfer (“GST”) tax exemption has been increased to \$5 million per individual or \$10 million for a federally recognized married couple splitting gifts (reduced by the amount of any lifetime taxable gifts made), indexed for inflation in 2012. This provides a window of opportunity to transfer up to \$10 million of wealth gift and GST tax-free. After December 31, 2012, the gift tax exclusion amount is scheduled to revert to a level of \$1 million per individual, the GST tax exemption is reduced to \$1 million (indexed for inflation since 1997) and the gift and GST tax rates are scheduled to increase from 35% to 55%.

New proposals by the House Ways and Means Committee Democratic staff propose decreasing the exemption amount to 2009 levels beginning January 1, 2012, instead of January 1, 2013. In 2009, the gift tax exclusion amount was \$1 million and the GST tax exemption was \$3.5 million. Furthermore, there is chatter from Capitol Hill that the Joint Select Committee on Deficit Reduction (known as the “Super Committee”) may propose a decrease of the gift tax exemption amount to \$1 million in the report it is tasked to issue by November 23, 2011. If such a proposal is included in the Super Committee’s report, it is possible that a decrease in the gift tax exemption amount would have an effective date as early as November 23, 2011, though it is more likely to have an effective date of December 31, 2011. In light of these developments, if you wish to use the current increased gift tax exclusion amount and/or GST tax exemption amount, we encourage you to do so as soon as possible. We would be pleased to discuss with you the various ways in which you can make optimum use of these exemptions.¹

¹ Please note that, if the gift and estate tax applicable exclusion amount is lower than \$5 million at a donor’s death, then the IRS could potentially recapture the gift tax that was not imposed on a 2011 or 2012 gift utilizing the \$5 million exemption by collecting additional estate taxes. Even if recapture occurs, the potential estate tax liability would likely leave the donor in the same position as if the increased \$5 million exemption never existed, and it is still beneficial for a donor to move \$5 million out of his or her estate now by making a lifetime gift as any appreciation on the gift will pass to the donee gift and estate tax-free and, in certain states such as New York, the gifted assets will not be subject to state estate taxes.

Please feel free to discuss any aspect of this alert with your regular Milbank contacts or with any of the members of our Trusts and Estates Group, whose names and contact information are provided herein.

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Historically Low Interest Rates for November 2011 Beneficial for GRATs, Charitable Lead Trusts and Intra-Family Loans

The IRS has announced that the 7520 rate applicable to GRATs and charitable lead trusts will be 1.4% for November 2011 – the lowest it has been since the inception of the 7520 rate in 1989. If you have investments that are likely to outperform the 7520 rate, now is an excellent time to create a GRAT or charitable lead trust in order to transfer the appreciation in excess of the 7520 rate gift tax-free.

Similarly, the applicable federal rates (“AFRs”) for intra-family loans for November 2011 are at or near historic lows – 0.19% for a loan with a term of 3 years or less, 1.20% for a loan with a term of 9 years or less and 2.65% for a loan with a term of more than 9 years, in each case compounding semi-annually. It would be appropriate now to consider making intra-family loans or refinancing existing loans at these low rates.

IRS Announces Inflation Adjustments for 2012 Exclusion Amounts

As noted above, unless Congress changes the current estate, gift and GST tax provisions, the estate/gift tax applicable exclusion amount and GST tax exemption are subject to inflationary adjustments. The IRS has recently released updated exclusion/exemption amounts for 2012 to reflect inflation adjustments. The estate tax applicable exclusion amount, which is the amount of an individual’s estate that can pass free of estate tax at death, is increased to \$5,120,000 (reduced by the amount of any lifetime taxable gifts) for an individual dying during calendar year 2012, up from \$5,000,000 in 2011. The gift tax applicable exclusion amount and GST tax exemption are similarly increased to \$5,120,000 for 2012. If Congress does not act, each of these exclusion amounts will decrease to \$1,000,000 in 2013.

The gift tax annual exclusion amount, which is the amount that an individual can give gift-tax free to one or more individuals during the calendar year, remains the same at \$13,000 per year per recipient (or \$26,000 per year if spouses elect to “split” gifts). The gift tax annual exclusion amount for gifts to non-citizen spouses is increased to \$139,000 for 2012, up from \$136,000 in 2011. Finally, the amount above which individuals may be required to report aggregate gifts received from foreign corporations and partnerships has increased to \$14,723 for 2012, up from \$14,375 in 2011. The threshold for reporting gifts from foreign individuals remains the same at \$100,000.

New Filing Requirements for Tax Returns of New York Resident Trusts

On July 27, 2011, the New York Commissioner of Taxation and Finance issued an Advisory Opinion regarding filing requirements for New York resident trusts. By way of background, a trust (or portion of a trust) is considered a New York “resident trust” if it consists of (i) property transferred by the will of a person who was domiciled in New York at his or her death, (ii) property of a person who was domiciled in New York when the property was transferred to an irrevocable trust or to a revocable trust that has not become irrevocable or (iii) property of a person who was domiciled in New York at the time the trust became irrevocable, if the trust was revocable when the property was transferred to it. (Section 605(b)(3)(A) through (C) of the New York State Tax Law.)

New York resident trusts are subject to New York State personal income tax *unless* three conditions are satisfied: (i) there are no New York domiciled trustees, (ii) no trust property is located in the State of New York and (iii) all income and gains of the trust are derived from sources outside of New York. (Section 605(b)(3)(D).) For tax years beginning prior to 2010, New York resident trusts that were exempt from New York State personal income tax because they met the foregoing conditions (“exempt resident trusts”) were not required to file an income tax return with New York State. For tax years beginning in 2010 and beyond, however, exempt resident trusts are now required to file a New York State fiduciary income tax return even though no tax is due to New York State.

In a recent Advisory Opinion, the New York State Department of Taxation and Finance found that certain trusts created by two New York residents in 2000 were New York resident trusts (with respect to portions of the trusts funded while the grantors lived in New York) which were *not* exempt from New York State personal income tax because a Trustee was a New York resident. However, when the New York resident Trustee later resigned in 2005, the trusts then met all of the requirements to be exempt resident trusts, exempt from New York State personal income tax. From 2010 on, the trusts, although exempt from New York State personal income tax, are required to file New York fiduciary income tax returns (Form IT-205) and certifications that the trusts meet all the conditions for exemption under section 605(b)(3)(D) (Form IT-205-C).

In general, if a trust is a grantor trust, these filing requirements are not applicable because the income, gains, deductions and credits are required to be reported directly by the grantor of the trust on his or her federal and state income tax returns. For example, if a father living in New York City establishes a grantor trust for the benefit of his children, the father would be required to pay the federal, state and city income taxes of the trust and report all trust income, gains, deductions and credits on his federal and state income tax returns. When the father dies, the trust becomes a non-grantor trust and must pay its own income taxes. For non-grantor trusts, even if no New York State income tax is due because all of the requirements of section 605(b)(3)(D) are met, the trust is now required to file a New York fiduciary income tax return. If you have funded a non-grantor trust, your accountant should already be aware of this relatively new filing requirement.

New York’s New Decanting Statute

On August 17, 2011, Governor Cuomo signed into law an amendment to New York’s decanting statute (section 10-6.6 of the Estates, Powers and Trusts Law), which clarifies and expands upon a trustee’s ability to decant (*i.e.*, invade the principal of a trust and pay it over to another trust) when the power is not specifically provided for in the trust instrument. In some cases, trust instruments explicitly provide authority for a trustee to decant. In cases where such a power is not provided in the trust, however, trustees may rely on New York’s decanting statute to invade the principal of a trust (the “invaded trust”) and pay it over to the trustee of another trust (the “appointed trust”).

Under New York’s prior decanting statute, only a trustee with “absolute discretion” to invade the principal of a trust could rely on the statute for authority to pay over the principal of the invaded trust to the appointed trust. The new statute now provides that a trustee may invade principal even in the absence of unlimited discretion in the trust instrument.

The new statute also clarifies to whom trust property may be appointed. In the prior decanting statute, decanting was permitted in favor of a trust for the benefit of “one or more proper objects of the exercise of the power,” which was not defined. The new statute provides that, when a trustee has unlimited discretion to invade trust principal, the appointed trust may be for the benefit of any one or more of the beneficiaries of the invaded trust. In cases where the trustee has a limited power to invade trust principal, however, the beneficiaries of the invaded trust and the appointed trust must be identical.

Additionally, while the old decanting statute was silent on the term of an appointed trust, the new decanting statute allows the appointed trust to have a term that is longer than the term in the invaded trust.

Finally, the new decanting statute describes the fiduciary duties and standard of care by which a trustee must exercise the power. The trustee has a fiduciary duty to exercise the power in the best interests of one or more proper objects of the exercise of the power and as a prudent person would exercise the power under prevailing circumstances.

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Statement About Circular 230

Recent amendments to a Treasury Department regulation, known as Circular 230, require lawyers and accountants to follow strict rules in issuing a written statement about a Federal tax issue. The most onerous rules of compliance under §10.35 of the Circular involve written advice about so-called Listed Transactions, arrangements that have tax avoidance as their principal purpose and what are called Marketed Opinions. We do not believe any issue discussed in this memorandum relates to a Listed Transaction. We believe the tax benefit sought is consistent with the Internal Revenue Code of 1986 as amended (Code) and Congressional purpose. That means the principal purpose is not tax avoidance. We also believe no issue discussed herein is a significant Federal tax issue – meaning that we believe the IRS does not have a reasonable basis for a successful challenge on the overall Federal tax treatment of the issues discussed in this memorandum. That means we do not think this memorandum must comply with §10.35 of the Circular. Nevertheless, we add the following statements to ensure compliance with said §10.35. Notwithstanding these statements, we believe the conclusions reached herein are correct.

1. The written advice contained in this memorandum is not intended or written by us to be used, and it cannot be used, by any taxpayer for the purpose of avoiding penalties.
2. No one may use any part of this memorandum in promoting, marketing or recommending an arrangement relating to any Federal tax issue to any taxpayer.
3. Nothing herein shall be construed to impose a limitation on disclosure by any person of the tax treatment or tax structure of any transaction that is addressed herein.

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