SHERMAN WELLS SYLVESTER & STAMELMAN LLP

TAX AND TRUSTS & ESTATES UPDATE

September 2014

Welcome to Sherman Wells Sylvester & Stamelman LLP

We would like to extend our thanks to clients and friends for your overwhelming support of the launch of our new firm. We are off to a great start and excited to have successfully opened offices in Florham Park, New Jersey, and Manhattan, with our tax and trusts & estates teams, along with corporate, mergers and acquisitions, finance, and commercial litigation practice groups. We have taken advantage of this fresh start to launch with new, state of the art document management technology, and with a tremendous commitment from all involved. We appreciate your support and look forward to continuing to work with you. For more information on our practice groups and personnel, please see our website at www.shermanwells.com. We hope that you enjoy our inaugural newsletter. We intend to provide regular updates on tax and trusts & estates matters that are particularly relevant to our clients and friends.

Estate Planning Opportunities You May Be Missing

As we have reconvened with a number of clients who had not reviewed their estate plans in several years, we are seeing that many of these plans require updating. Significant federal and state gift, estate and generation-skipping tax ("GST") law changes have been enacted over the past few years. That means estate plans that date from before those changes took effect need a fresh look to make sure that the planning that was done – and the documentation put into effect – is consistent with the current state of the tax laws. In addition, increased gift and GST exemptions and continued low interest rates offer unprecedented opportunities to transfer significant wealth to future generations where appropriate.

Simplification of Planning in Light of Increased Estate Tax Exemptions and Portability

In 2014, each of us has a lifetime gift, estate and GST tax federal exemption of $5,340,000. Those exemptions continue to be indexed for inflation, so they should increase significantly over the coming years. Further, beginning in 2011, the lifetime gift and estate (but not generation-skipping) tax exemptions are "portable" between surviving

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Office Locations:

Florham Park
210 Park Avenue
2nd Floor
Florham Park, NJ 07932
973.302.9700

New York
805 Third Avenue
10th Floor
New York, NY 10022
212.763.6464

spouses. With portability, a surviving spouse will generally inherit the unused lifetime gift and estate tax exemptions of the deceased spouse. For example, if a husband dies in 2014 without having used any of his lifetime gift tax exemption (and uses none at death), his surviving spouse will inherit through "portability" his unused $5,340,000 exemption. That surviving spouse will then have $10,680,000 of combined lifetime gift and estate tax exemptions (with the surviving spouse's own exemption amount – but not the portability exemption – subject to CPI adjustments in 2015 and beyond).

Credit-Shelter/By-Pass Trust or Disclaimer Trust Planning: Earlier plans required that clients create a "by-pass trust" or "credit-shelter trust" at the first death to ensure that both spouses' federal estate tax exemptions were utilized. Use of such a trust also required that each spouse have enough assets in his/her name to fully fund the "credit-shelter trust". With portability, a by-pass or credit shelter trust plan is not required to get the benefit of both spouses' transfer tax exemptions.

Unless there are non-tax reasons for these trusts, a simplified plan that passes an estate outright to a surviving spouse (with disclaimer trust provisions for post-death tax planning) may be more appropriate for certain clients to consider. This is particularly true where paying state estate tax at the first death may not make sense. With New Jersey's estate tax exemption being limited to $675,000, fully funding a $5,340,000 "credit-shelter trust" at the first death in 2014 would trigger a New Jersey estate tax of approximately $432,000. And even with New York's larger estate tax exemption of $2,062,500, a fully funded $5,340,000 "credit-shelter trust" in 2014 would trigger a New York estate tax of the same approximately $432,000. (Note that the New York exemption is scheduled to increase over time, until it is in sync with the federal exemption in 2019.)

"Credit shelter" or "by-pass" trust plans still offer benefits and should be considered in certain cases. Although "portability" allows a surviving spouse to inherit a deceased spouse's unused lifetime gift and estate tax exemption, portability does <u>not</u> apply to pass on a decedent's unused GST tax exemption ($5,340,000 in 2014 subject to annual CPI increases beginning 2015). Therefore, where multi-generational tax considerations call for employing both spouses' generation-skipping tax exemptions, use of an outright spousal bequest and portability may not make sense. "Credit-shelter" or "by-pass" trust plans that use GST tax exemptions to fund trusts designed for children, grandchildren and beyond may be more appropriate. Also, note that, although "disclaimer trusts" provide great flexibility to do post-death tax planning, trusts into which assets are disclaimed cannot include a testamentary power of appointment that would otherwise allow for flexibility to alter dispositions, including trust terms, at the second death.

Consider Whether Generation-Skipping Tax Planning Is Still Applicable: Many estate plans were put in place when available estate and generation-skipping exemptions were as low as $600,000 or $1,000,000. At that time, clients and advisors could reasonably expect that, in most cases, estate taxes at marginal rates of 50% or more would be imposed at each generational level. Faced with such taxes, many clients put in place plans with GST-tax-exempt trusts that may have been designed to permit transfer-tax savings at multiple generational levels. Where husbands and wives can now leave in excess of $10 million to the next generation without triggering a federal transfer tax, certain older generation-skipping tax plans might be reconsidered and simplified.

<u>Unprecedented Planning Opportunities with Increased Gift, Estate, and Generation-Skipping Tax Exemptions</u>

Where large gifts <u>are</u> applicable and generation-skipping tax planning appropriate, very significant wealth can be moved down the generations in flexible generation-skipping trusts free of transfer tax. As noted earlier, lifetime gift, estate, and generation-skipping tax exemptions are at an unprecedented level ($5,340,000) and are scheduled to increase by annual CPI adjustments. Married couples can make current gifts up to $10,680,000 (in addition to annual exclusion gifts) in trust for spouse and children and extend the benefits of such a trust to even more remote descendants. For example, if a 50-year-old married couple gifts $10,680,000 into a “dynasty trust” and uses their available gift and GST tax exemptions to shelter the gift and its appreciation from transfer tax, then, assuming an after-tax growth rate of 5% annually, in 40 years that gift will have appreciated to over $75 million. If the next generation has no need for those gifted funds and the dynasty trust continues to grow at a 5% annual growth rate, then, in another 30 years, the trust will have a value in excess of almost $325 million. Families with the ability to make these large gifts will be in a position to grow their GST-tax-exempt trusts while spending down other gifted and inherited assets that do not have the same transfer tax protections.

Clients with significant estates can benefit greatly by creating large GST-tax-exempt dynasty trusts. Once funded, the tax benefits might be magnified in the following ways:

- The dynasty trust could be structured as “intentionally defective grantor trust”, which would allow the trust to grow income-tax free (like an IRA) because the grantor would pay the income tax on the trust’s income and gain. Under current law, the grantor’s tax payments should not result in additional gifts to the trust.
- The dynasty trust generally has a long-term investment horizon. Within the parameters of appropriate trust investments, the trustees of the dynasty trust might invest for growth and greater yield than a trust with a shorter investment horizon. Clients’ dynasty trusts often invest in growth opportunities that are available to the family.
- Assets could be structured so gift tax values are discounted, leveraging a larger benefit from the transfer. Gifts of minority and non-marketable interests in S corporations, limited liability companies or partnerships may allow for larger transfers than if cash gifts are made.
- Low-interest loans can be made to adequately capitalized intentionally defective grantor dynasty trusts to leverage the investment opportunities and yield of the tax-advantaged trusts. In September 2014, the applicable federal rate for a short term loan (3 years or less) is 0.36%, and the applicable federal rate for a mid-term loan (between 3 and 9 years) is 1.86%.

<u>GRAT Planning Continues to Offer Significant Wealth Transfer Opportunities</u>

Significant benefits can be realized using grantor retained annuity trust (“GRAT”) planning. In particular, those clients who have fully used their lifetime gift exemptions benefit from “zero-out GRAT” planning. In a “zero-out GRAT”, the grantor creates a trust and retains an annuity interest in that trust for a stated number of years. The trustee would be required to pay the grantor a set annuity amount each year, but then, at the end of the retained-interest period, the assets remaining in the trust would pass to the intended beneficiaries (e.g., the children) or in trust for their benefit. The annuity amount would be determined so that, pursuant to the IRS actuarial tables, the value of the remainder interest to the children for gift tax purposes is zero. In September 2014, the applicable rate (i.e., the Section 7520 rate) is 2.2%. Therefore, to the extent that the trust investments perform better than the 7520 rate during the GRAT retained-interest period (so that only the value of the investment gains are being paid in annuity amounts to the grantor), then the value of the trust assets at the end of the retained-interest period will be equal to or larger than the value of the initial contribution to the GRAT. That value thus passes free of gift tax to or for the benefit of children, without utilizing any of the grantor’s gift exemption to make the transfer. Rolling short-term (e.g., 2-year) GRATs, along with planning to lock in gains while assets are in a GRAT, may allow for significant wealth transfers.

Offshore Voluntary Disclosure Program Gets Streamlined

The IRS recently added a streamlined option to its offshore voluntary disclosure program. If you have a foreign account and would like to discuss whether you qualify for the new program or would like more information about the disclosure program, please contact your tax attorney or other tax advisor. In all events, if you have a foreign account (or access to a foreign account of or on the behalf of another person – for example, under a power of attorney – or a business, trust, or estate) and you have not yet reported the existence of that account to the IRS, you should contact a tax attorney or other tax advisor as soon as possible to avoid potential criminal and civil liabilities.

Problematic Assets to Have in Your Estate

Late in life, it can be particularly useful to assemble detailed information that would be required to administer an estate, as well as pursuing any further steps that might be taken to save estate taxes. It may also be beneficial to transfer ownership of certain assets with a goal of getting a stepped-up tax basis, if those an assets may likely be sold after death, and to determine steps that can be taken to simplify administration (e.g., transfer or disposition of "problematic assets").

In particular, certain assets have a reputation for being "bad pennies" that complicate the administration of a deceased person's estate often well beyond their value or significance. In certain instances, you might consider divesting yourself of these types of assets later in life. Some of the particularly problematic assets we see are:

- Leased vehicles. Most leases will require the estate to continue to pay all of the remaining lease payments, unless someone can be found to take over the lease.
- Time shares. These are often hard to value for estate tax purposes, and the market for their sale is often very limited.
- Illiquid investments that have negligible value, but will require costly appraisals at death (e.g., small partnership or limited liability company interests).
- Private equity investments (especially if you own only a very small piece of the venture). It is often very difficult to determine accurate date-of-death values for these assets. This problem exists for any interest in a non-publicly traded enterprise, especially if you have no "say-so" in the enterprise.
- Assets in foreign countries. These usually require additional legal and tax advisors, expensive translations and certifications with respect to documentation, as well as giving rise to sometimes unresolvable issues of what country's law applies to their disposition.
- Residences with underground oil storage tanks. These can necessitate environmental cleanup expense in even the simplest of estates.
- Abandoned or neglected assets. It's always best to confront these while you live, since they will likely have to be dealt with at your death, and generally with much more significant cost and aggravation.
- Tangible personal property (e.g., cars, boats, planes, even coins and other currency) located in a state that imposes non-resident estate or inheritance taxes.

Information That Can Help Your Family at the End of Your Life

Losing a loved one is never easy. However, you can help make the necessary aspects of dealing with that loss just a bit easier if you prepare some guidance in advance to help those you leave behind find their way as they work through the details of preparing for a funeral, dealing with your estate, etc. This sort of guidance can be similarly helpful if a loved one has become disabled.

We've found that it's very helpful for an executor, next of kin, and others, to be advised in advance of the location of, or wishes regarding, the following:

- Last Will (and signed and dated list of disposition of personal articles, if any)
- Power of Attorney
- Living Will/Health Care Proxy
- Organ donation preference
- Funeral arrangements/wishes
- Memorial fund preferences
- Pallbearer preferences
- Address book or other list of people to be notified of death

And the following can be necessary, or at least useful (and save time and legal fees), to effectively administer an estate:

- Prior three years of income tax returns and related work files
- Any gift tax returns filed by you
- Bank and brokerage statements
- Bank books
- Original stocks and bonds
- Records of loan receivables
- Records of outstanding loans payable and/or guarantees of indebtedness
- Credit card statements and records regarding any other debts
- Attorney, accountant, financial planner, private banker, insurance agent and investment advisor names, addresses, phone numbers and email addresses
- IRA or pension statements, and summary plan descriptions for pensions
- Information regarding any pending lawsuits filed by you or against you
- Estate tax records of any estate benefitting you (predeceased spouse, parent, etc.)
- All insurance policies and coverage, including life, auto, and homeowner (including homeowner riders)
- Deeds to all residential, commercial and investment real property
- Partnership agreements, limited liability operating agreements and shareholder agreements
- Three years of financial statements for your businesses
- Employment or consulting agreements
- Trust agreements (created by you, or for your benefit, or of which you are a trustee)
- Birth certificates or immigration papers
- Military service records
- Children's adoption papers
- Divorce settlement agreements or judgments
- Safe combinations
- Safe deposit box key
- Any relatively current appraisals of any property

- Information concerning cost basis (including capital improvements and other after-tax additions to value) of capital assets
- Passwords necessary to allow electronic access to all electronic accounts, social media, email, etc.

Note, in particular, that if your original Last Will and Testament cannot be located, there will be a presumption that it's been revoked, and that presumption can only be rebutted with an action in court, which may or may not be successful.

We urge all of our clients to consider sharing this information, or at least the location of this information, with those close to them. It can be a tremendous help during an otherwise difficult time.

New York Tax Law Changes: The Good News and (for the Wealthy) the Bad News

On March 31, 2014, New York State and New York City enacted substantial changes to their tax laws, including changes that impact estate planning for New York residents.

Estate Tax: Before April 1, 2014, each New York resident had a $1 million exclusion from New York estate tax. As of April 1, the new law increases the exclusion by approximately $1 million each year, up to $5.25 million by 2019. Thereafter, the exclusion will be indexed for inflation and will be brought in line with the federal exemption beginning on January 1, 2019. The increased exclusion amounts are as follows:

$2,062,500 for decedents dying on or after April 1, 2014, and before April 1, 2015
$3,125,000 for decedents dying on or after April 1, 2015, and before April 1, 2016
$4,187,500 for decedents dying on or after April 1, 2016, and before April 1, 2017
$5,250,000 for decedents dying on or after April 1, 2017, and before January 1, 2019

For decedents dying on or after January 1, 2019, the exemption amount will be equal to the federal estate tax exemption then in effect.

However, the exclusion is **not** available for taxable estates that exceed the exclusion amount by more than 5%. For example, if a New York resident dies on April 2, 2014, with a taxable estate in excess of $2,165,625 (105% of the $2,062,500 exclusion amount), the New York exemption is zero, and the entire taxable estate will be subject to New York estate tax. Moreover, the exclusion amounts phase out for taxable estates between 100% and 105% of the New York exclusion amount in the year of death.

In addition, unlike the federal estate tax exemption, the New York exemption will not be "portable", so that any unused portion of a decedent's New York estate tax exemption will be lost rather than added to the surviving spouse's available New York exemption.

Inclusion of Gifts within Three Years of Death: The new law adds a three-year "lookback" period for taxable gifts made on or after April 1, 2014, and before January 1, 2019. If a New York resident dies within three years of making a taxable gift (as defined under federal law) during this period, the value of the gift will be included in the decedent's estate for New York estate tax purposes. Similar rules apply to a non-resident decedent who, while living in New York, made gifts of property located in New York or used in a business carried on in New York.

Certain Trusts No Longer Avoid Income Tax: Under prior law, if a trust had no trustees domiciled in New York, did not own any property in New York, and had no New York source income (e.g., income from an LLC or S corporation doing business in New York), the trust was not subject to tax on its income by New York State or New York City, even if the grantor or beneficiaries of the trust were New York residents. This meant that such a trust could accumulate income free of New York tax and then distribute that income to its beneficiaries in later years. Because the beneficiaries were not subject to federal income tax on distributions of accumulated income already taxed at the trust level, those beneficiaries were able to avoid New York State and City income tax on these distributions. Many New York residents took advantage of this situation by establishing trusts in states that do not impose state income tax on certain trusts, such as Delaware.

Under the new law, if a trust is not a grantor trust for federal income tax purposes (and therefore pays its own income taxes), and the grantor's transfer of assets to the trust was an incomplete gift for federal gift tax purposes (and therefore not subject to gift tax), the grantor will be taxed on trust income for New York State and City purposes. That trust will – in effect – be a grantor trust for New York State and City tax purposes, even though the trust is not a grantor trust for federal purposes. If the grantor's transfer of assets to the trust was a completed gift for federal gift tax purposes, the grantor will not be taxed on the trust's income, but any New York resident beneficiaries will be taxed on distributions of accumulated trust income, even if these distributions are not taxable to them for federal purposes.

Taxes Repealed: New York's generation-skipping transfer (GST) tax has been repealed in its entirety; and the New York State and City alternative minimum taxes are repealed for tax years beginning on or after January 1, 2014.

Given this new set of ground rules, if you are a New York resident with a taxable estate likely to exceed the increased New York exclusion amount, consider revisiting your current estate plan to review your planning options.

New IRS Form EZ-1023 Makes It a Bit "EZ-er"
for Very Small Charities to Get Tax-Exempt Status Recognized

On July 1, 2014, the IRS released the much anticipated Form 1023-EZ, which simplifies the internal IRS process of reviewing applications for federal 501(c)(3) tax-exempt status. Now, organizations with less than $50,000 in gross annual receipts, and assets less than $250,000 are eligible to file the three page Form 1023-EZ, submit the application on line, and pay a reduced fee of $400. The purpose of this new form is to speed up the IRS approval process for very small charities, and free up the IRS's resources to be allocated instead to reviewing large, more complex organizations.

It is important to note that the 1023-EZ application still requires a significant amount of research and preparation. Before filing, an organization must have a clearly articulated purpose, financial statements or projections, knowledge of planned events, a list of directors (or trustees) and must have successfully complete the IRS Eligibility Checklist, which is five pages long. If your organization answers "yes" to any question on this checklist, the Form 1023-EZ is no longer a filing option for your organization and the full Form 1023 needs to be used.

As always, we encourage you to seek the assistance of your tax advisor in preparing and filing this application.

Attorney Contact Information

Sandra Brown Sherman
Partner
973.302.9716
ssherman@shermanwells.com

Andrew J. Stamelman
Partner
973.302.9714
astamelman@shermanwells.com

Charles R. Berman
Partner
973.302.9692
cberman@shermanwells.com

James A. Mohoney
Counsel
973.302.9702
jmohoney@shermanwells.com

Heidi I. Hansen
Counsel
973.302.9706
hhansen@shermanwells.com

Tracy McSweeney Child
Counsel
212.763.6465
tchild@shermanwells.com

Fiduciary Accountant & Paralegal Contact Information

Monika Hilliard
Fiduciary Accountant
973.302.9701
mhilliard@shermanwells.com

Judith Kaplan Malamed
Fiduciary Accountant
973.302.9703
jmalamed@shermanwells.com

Marci Racaniello
Fiduciary Accountant
973.302.9699
mracaniello@shermanwells.com

Betty Kleiman
Paralegal
973.302.9705
bkleiman@shermanwells.com

Beatrice Kwok
Paralegal
973.302.9704
bkwok@shermanwells.com

Farhayal Zubair
Paralegal
973.302.9678
fzubair@shermanwells.com