Trusts & Estates

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Planning for **Tax Reform** in 2017

BY CHRISTEN DOUGLAS AND CARLYN McCAFFREY

Tax reform was a central component of President-elect Donald Trump's campaign. In many respects his goals for tax reform closely aligned with those described in the House Republicans Tax Reform Task Force report issued last summer (the House Plan).

Trump and his newly designated Treasury Secretary, Steven Mnuchin, have indicated that there will be ongoing negotiations and refinements of the plan. Although we cannot predict which parts of either plan will be enacted, the continued Republican control of the House and Senate make it likely that some combination of both plans will become part of our tax law as early as next year. Because the Republicans lack the 60 Senate votes required to pass permanent tax legislation that is not revenue neutral, it is possible that any changes that are enacted will be temporary.

With this uncertainty, it is important to prepare for significant tax changes while maintaining flexibility. This article discusses the proposed changes that are likely to have the greatest effect on high net worth individuals and suggests some planning strategies to consider.

Changes to Expect

Income Tax. The income of individuals is now subject to a federal tax rate as high as 43.4 percent (or 23.8 percent in the case of long-term capital gains and qualified dividends) including the 3.8 percent tax on net investment income. Both the Trump Plan and the House Plan would decrease the top tax rate to 33 percent, eliminate the alternative minimum tax, and eliminate the 3.8 percent tax. Additionally, the House Plan would lower the effective top tax rate applicable to capital gains, interest, and dividends to 16.5 percent, and the top rate applicable to the business income of individuals (net of reasonable compensation for working owners) who earn this income as sole proprietors of a business or receive it from pass-through entities to 25 percent.

The advantage of the rate decrease would be offset to some extent by substantial decreases in the itemized deductions now available to individuals. The Trump Plan proposes to cap deductions at $100,000 for each single filer and $200,000 for each married couple filing jointly. The House Plan eliminates all itemized deductions except for charitable gifts and the already limited deduction available for home mortgage interest.

> It is important to **prepare for significant tax changes** while maintaining flexibility.

Under either plan, residents of high tax states such as New York will be hard hit by the elimination or significant curtailment of their ability to deduct state and local income taxes.

Estate, Gift and Generation-Skipping Transfer Taxes. President-elect Trump has unequivocally promised to repeal the estate tax. Less clear is how he would treat unrealized appreciation (or built-in gains) at a decedent's death. On his website, Trump states: "The Trump Plan will repeal the death tax, but capital gains held until death and valued over $10 million will be subject to tax to exempt small businesses and family farms." This statement does not tell us whether the tax will be imposed on the death of a decedent or at a later time when the decedent's beneficiaries sell the appreciated property. A literal reading suggests a tax on gains at death with an exemption of gain up to $10 million, and perhaps an additional exemption for owners of small businesses and farms. Without the exemption, beneficiaries of small estates would actually be worse off with repeal than under current law. Trump's proposal says nothing about the repeal of the gift and generation-skipping transfer (GST) taxes.

The House Plan eliminates the estate and GST taxes but leaves the basis adjustment at death (the basis "step-up") and the gift tax in place. This combination would be of substantial benefit to beneficiaries of wealthy decedents.

The repeal of the federal estate tax will make dying in states with their own estate tax systems, such as New York, more costly than it is under the current system. New York's estate tax is imposed at a 16 percent rate on taxable estates above $10,100,000. Under current law, the impact of the New York estate tax is softened by its deductibility from the federal taxable estate. The deduction reduces the net cost of dying as a New Yorker from 16 percent to 10.6 percent. Without a federal estate tax, the cost will be 16 percent. If the estate tax repeal is accompanied by a capital gains tax at death or carry over basis, the estates of many New Yorkers will pay more taxes than under the current system.

Planning Strategies

Because it is difficult to predict what changes will be enacted and how long they will last, maintaining flexibility in estate plans is important. The list below contains what we believe to be the most important steps for high net worth individuals and their advisors to consider while waiting to learn how the federal tax law will be changed over the next several years.

• Avoid making gifts that will create gift tax liability. The gift tax could be repealed. Even if the gift tax survives, it will seldom be tax efficient for an individual to pay a gift tax if property can pass tax-free to his or her beneficiaries at death. Because the tax on gifts is higher than the New York estate tax, New Yorkers should avoid paying gift tax despite the likely continuation of the New York estate tax.

• Continue to make gifts that can be made without incurring gift tax, such as annual exclusion gifts, gifts protected by a donor's exemption, and transfers structured to shift income and growth gift-tax free to beneficiaries. Use grantor trusts as donees so that the donor can continue to pay income taxes on income earned by the recipient trusts. If tax reform leaves us with a gift tax but no estate tax, lifetime estate planning will continue to be important to individuals who want their children to enjoy some of the family wealth before they die. Continuing to take steps to shift property to the next generation will also achieve some protection against capital gains at death and against the possible future restoration of the estate tax.

• Consider postponing plans to sell appreciated property held in irrevocable grantor trusts to the donor. Under » Page 12

CARLYN McCAFFREY *is a partner and co-head of the private client practice at McDermott Will & Emery in New York.* CHRISTEN DOUGLAS *is a partner in that practice.*

Letting Go: Common **Gift** and **Estate** Tax Triggers

BY HENRY E. KLOSOWSKI AND MOIRA A. JABIR

It is the season of giving which ultimately fuels the season of estate and gift tax audits.

Many of the questions raised in an audit can be anticipated by prior cases, such as: review of the decedent's background, lifestyle, gifts and assets (*Estate of Harper*, TC Memo 2002-121); information about the donor's heath, intent and entity operation (*Estate of Rosen*, TC Memo 2006-115); the order in which transactions occurred (*Estate of Shepard*, 115 TC 376 (2000), aff'd 283 F3d 1258 (11th Cir. 2002)); and information about meetings with the client(s) and the reason for the entity, the manner in which business responsibilities were assumed, and the documentation of legitimate non-tax reasons (*Estate of Rosen*, TC Memo 2006-115). One of the common gift or estate tax audit triggers occurs when a family limited partnership (FLP) or a limited liability company (LLC) is involved. This is because these entities are utilized by donors who may not completely understand the risks associated with planning with these entities or who demand continued control. The result is that the Internal Revenue Service may claim the estate retained certain enumerated rights over the entity, and pursuant to §2036 of the Internal Revenue Code, the full value of the transferred asset should be included in the estate at the date of death value, not at a discounted value.

> Many of the questions raised in an audit can be **anticipated by prior cases.**

That is why *Estate of Purdue v. Commissioner*, TC Memo 2015-249, stood out—because it bucked the typical scenario. In this case, the decedent and her husband in August 2000 formed a family limited liability partnership (PFLLC) to hold their marketable securities and their interests in a commercial building to centralize management and take advantage of valuation discounts. As set forth in the memorandum prepared by their attorney, the purposes of the FLP was (1) to consolidate their assets, (2) avoid fractionalization of their interests, (3) keep the ownership in the family, (4) protect assets, (5) provide flexibility and (6) promote education of and communication among the family with respect to financial matters.

The day after the FLP was formed, the family, including all five children received a draft Purdue Family Limited Liability Company operating agreement from this same attorney noting the tax savings the FLP could provide as well as four non-tax business reasons for the formation of the FLP. In November 2000 the FLP was funded. In the same month, the decedent and her husband also formed a family trust, the beneficiaries of which were their descendants and the spouses of their descendants. The trust provided for Crummey » Page 11

HENRY E. KLOSOWSKI *is the managing partner of Moritt Hock & Hamroff's trusts and estates department.* MOIRA A. JABIR *is an associate in the department.*

Top 10 Developments, Lessons and Reminders Of 2016

BY SHARON L. KLEIN

From new legislation, to important regulatory guidance to instructive case law, 2016 saw some significant New York developments, lessons and reminders.

10. Disregarded Entities Owned by Nonresidents Will Not Shield Real Property From New York Estate Tax.

Under New York Tax Law §960, a nondomiciliary's real and personal New York situs property is subject to New York estate tax, but intangible personal property owned by a non-New York domiciliary is not subject to New York estate tax.

In a 2015 Advisory Opinion,[1] a New York resident who planned to move to another state inquired whether contributing his New York condominium to a single member LLC (SMLLC) would recharacterize it as intangible property, exempt from New York estate tax. The New York State Department of Taxation and Finance (the Department) determined that, since a SMLLC is a disregarded entity for federal income tax purposes (deemed not separate from its owner), the condominium owned by the LLC would be treated as real property held by the taxpayer.[2]

In an Advisory Opinion issued on Aug. 26, 2016,[3] the Department considered whether a different result would ensue if a SMLLC had a post-mortem retroactive election in place to be treated as corporation for income tax purposes. Such elections can be effective up to 75 days prior to the date on which the election is filed.[4] The taxpayer planned to direct his executor to elect that the SMLLC be taxed as an S-Corporation, retroactive to at least one day prior to his death. The Department concluded that there is no provision in New York state law applicable to the estate tax that provides for retroactively changing an election to be treated as an S-Corporation post-mortem. The election that is in place at the date of death will be determinative. The Department reiterated that a membership interest in a SMLLC owning New York real property, which is disregarded for federal income tax purposes, will be treated as real property for New York estate tax purposes. However, where a SMLLC elects to be treated as a corporation, that ownership interest would be considered intangible property, not subject to estate tax in a nonresident's estate.

Accordingly, advisors should consider whether a more complex entity structure for real property (or an election to be treated as a corporation) would be appropriate given income, estate and other non-tax considerations, or whether the issue can be bypassed altogether if the nonresident opts instead to own shares in a cooperative apartment, which are considered intangible property.

9. Property Discovered After New York Estate Tax Return Filed Didn't Require Filing of Amended Return or Payment of Additional Taxes, Penalties or Interest.

An Advisory Opinion[5] issued on June 8, 2016 involved a decedent for whom an estate tax return was timely filed in Aug. 2010. The New York and federal gross estate was $3,186,590, the federal taxable estate was $2,946,751 and the New York tax due was $177,314, which was paid and a closing letter issued in March 2012. In 2015, the executor discovered $61,886.77 was in the possession of the New York State Comptroller's Office of Unclaimed Property, the funds not having been surrendered to the Comptroller's Office until sometime in 2012.

The Department pointed out that a tax generally must be assessed within three years after a return is filed. It concluded that, because the omitted asset was discovered after the three-year limitation period, and the date of death value was less than 25 percent of the federal gross estate, the federal taxable estate and the New York gross estate (an extended six-year statute of limitations period applies if the omitted property exceeds 25 percent), the executor was not required to file an amended return or pay any additional taxes, penalties or interest related to the newly discovered asset. A tax may be assessed at any time if a false or fraudulent return is filed with intent to evade tax, but the Department found no indication that was the case.

> The Department of Taxation and Finance concluded that there is **no provision in New York state law** applicable to the estate tax that provides for retroactively changing an election to be treated as an S-Corporation post-mortem.

8. Guardians Required to Inform Designated Individuals of Certain Events to Protect Rights of Relatives.

A law signed by Gov. Andrew M. Cuomo on July 21, 20166 is designed to protect the rights of relatives of those under a guardianship. Known as "Peter Falk's law," the new obligations were introduced after the wife of the late "Columbo" actor prohibited his children of a prior marriage from visiting their terminally ill father. The new law makes changes to the order of appointment for a guardianship to prevent a guardian from improperly isolating the incapacitated person, or limiting visitation rights. It requires the order to identify those entitled to notice of the incapacitated person's death, funeral and burial arrangements. It also allows the order to identify anyone entitled to visit the incapacitated person, or receive notice if the person is transferred to a medical facility.

7. Amendments Clarify and Improve Non-Profit Revitalization Act.

On Dec. 18, 2013, Gov. Cuomo signed the Non-Profit Revitalization Act of 2013, bringing sweeping changes to the governance of the nonprofit sector. Revisions enacted on Nov. 28, 2016 make amendments to clarify and improve that Act.[7] These include revising the definition of a "related party transaction" (any transaction in which a » Page 12

SHARON L. KLEIN *is the New York Metropolitan Region President at Wilmington Trust, N.A. and chair of the Tax Committee of the NYSBA Trusts & Estates Law Section.* REBECCA LOMAZOW, *a wealth strategist at Wilmington Trust, assisted in the preparation of this article.*

Drafting **Irrevocable Trusts** for the **Modern Family**

BY MARJORIE HORNADAY AND STEPHANIE E. HEILBORN

In an era of co-habitation, co-parenting, and good old-fashioned divorce, the identity of a client's intended beneficiaries can be a moving target. Defining the class of beneficiaries to provide flexibility is especially important in irrevocable trusts. Trust decanting pursuant to §106.6 of the New York Estates, Powers and Trusts Law (EPTL) is not always desirable or possible.

This article suggests two alternatives for adapting an irrevocable trust to the client's future needs: first, revising the definitions of "spouse" and "descendants," and second, granting a "Selector" the power to add or remove beneficiaries. Sample language is provided.

Defining 'Spouse' and 'Descendants' in Irrevocable Inter Vivos Trusts. Consider a common scenario: John Doe, as grantor, creates an irrevocable life insurance trust (ILIT) to be administered initially "for the benefit of the grantor's wife, JANE DOE, and such of the grantor's descendants as shall be living from time to time" during John's lifetime. During the initial trust term, Jane and each of John's children have Crummey rights of withdrawal with respect to each transfer made to the trust.

Upon John's death, the life insurance proceeds will be held in a trust for the benefit of Jane and their children during Jane's lifetime, if Jane survives John, or if not, the proceeds will be held in separate trusts for their children. The trust agreement provides that "all references in this instrument to the grantor's 'wife' shall mean JANE DOE." John and Jane have two children and subsequently divorce. Assume that their divorce agreement does not address the ILIT.

John later remarries and wants his new wife, Anne, to take Jane's place as a beneficiary of the ILIT. A trust decanting will not achieve this objective, because the EPTL decanting statute permits a trustee to appoint trust assets to a new trust *only* for the benefit of one or more current beneficiaries of the existing trust. John could request the trustee of the original ILIT to sell the insurance policy to a new ILIT for the benefit of Anne and his descendants, but this solution involves additional legal expense, and if Jane is a trustee of the ILIT, she is unlikely to agree. The issue could be avoided by changing the definition of "spouse" in the trust agreement. For example:

SAMPLE ONE

(A) (1) During the grantor's life, references in this instrument to the grantor's "spouse" shall mean JANE DOE, if the grantor is then living with and married to JANE DOE.

(2) After the grantor's death, references in this instrument to the grantor's "spouse" shall mean JANE DOE, if she is the individual whom the grantor is married to and living with at the time of his death.

(3) Anything in this paragraph (A) to the contrary notwithstanding, if at any time during the grantor's life or upon the grantor's death the grantor is not then living with and married to JANE DOE, JANE DOE shall be deemed to have predeceased the grantor [and all references in this instrument to the grantor's "spouse," other than with respect to the power to remove and replace trustees, shall instead mean the individual, if any, whom the grantor is married to and living with at the time in question during his life or upon his death, as applicable].

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The attorney can omit the bracketed wording if the client does not wish a future spouse to become a permissible beneficiary of the trust. This sample language ensures that in the event of a divorce, Jane will no longer be a beneficiary of the trust, and, if desired, the individual to whom the grantor is married at any given time will automatically be included as a beneficiary of the ILIT.[1] By using the gender-neutral term "spouse," rather than "husband" or "wife," the provision accommodates a scenario in which the grantor has a same-sex second marriage.

If the trust agreement does not specify that the grantor's original spouse will continue to hold a Crummey power only if she is (or at the time of the grantor's death, was) married to the grantor, additional complications may arise. A typical Crummey withdrawal power in John Doe's trust might provide: "With respect to the initial and each subsequent actual or deemed transfer of property to the trust during the grantor's lifetime, the grantor's wife, JANE DOE, if living on the date of the transfer, shall have the right to withdraw …"

If Jane is living but no longer married to John, she is still entitled to exercise her Crummey power. By specifying that, in the event of a divorce, Jane will not only no longer be treated as the grantor's spouse, but also will be treated as having predeceased the grantor, Jane's Crummey power will be eliminated.

> A **Selector** is an **independent individual** (i.e., not the grantor, his spouse, a trustee or a beneficiary) who has the power to add and/or remove beneficiaries of the trust at any time during the grantor's life.

If the trust agreement gives the grantor's spouse the power to remove and replace trustees after the grantor's death, this definition also will eliminate Jane's ability to change the trustees of the ILIT after the divorce. However, it may not necessarily be a good idea for a future spouse to have the power to remove and replace trustees, especially where the grantor's children from a prior marriage also are beneficiaries. In that case, the drafter should either ensure that a *future* spouse does not succeed to the removal and replacement power, or specify that the power to remove and replace trustees only applies to Jane, and only if she and the grantor are not divorced.

If a friend or relative of the original spouse is named as a trustee and the trust provides that a future spouse will become a beneficiary but does not have the power to remove and replace trustees, there could be tension between the trustee and the future spouse. To avoid this, the trust agreement could provide that the original trustee will cease to act if the grantor and the grantor's original spouse divorce. For example:

SAMPLE TWO

Anything in this Article to the contrary notwithstanding, if at any time JANE DOE is not the grantor's "spouse" as hereinafter defined, then [JANE DOE'S RELATIVE/FRIEND] shall cease to act as Trustee of all trusts under this instrument.

It is also possible that after his divorce, John chooses to co-habitate with, but not marry, his new partner. The definition of "spouse" can be expanded to include a domestic partner to whom he is not legally married:

SAMPLE THREE

Anything in this instrument to the contrary notwithstanding, if at any time during the grantor's life or upon the grantor's death the grantor is not then living with and married to JANE DOE, JANE DOE shall be deemed to have predeceased the grantor and all references in this instrument to the grantor's "spouse" shall instead mean the individual, if any, (a) whom the grantor is married to and living with, or (b) with whom the grantor is living in the same manner as husband and wife in a committed domestic partnership at the time in question during the grantor's life or upon his death, as applicable.

Another scenario is that John remarries an individual who has children from a prior marriage, and John wishes them to become beneficiaries of the trust along with his own children. One option would be to include stepchildren in the definition of descendants, but the grantor may not want to automatically include stepchildren unless he views them as his own children, for example by having helped raise them from a young age. In such cases, the client may wish to employ a trust "Selector."

Using a Trust 'Selector'. The flush language of Internal Revenue Code (IRC) §674(c) provides that "if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus" of a trust, then the trust will be treated as a "grantor trust," meaning that the income, deductions, and credits of the trust will be attributed to the grantor for Federal income tax purposes.

A Selector is an independent individual (i.e., not the grantor, his spouse, a trustee or a beneficiary) who has the power to add and/or remove beneficiaries of the trust at any time during the grantor's life. If John determines that he does not want a future spouse, domestic partner or stepchild to be included by definition as a beneficiary of the trust, but wants the flexibility to include such individuals later in life, he can give the Selector the power to add one or more of them as beneficiaries. For example:

SAMPLE FOUR

(A) At any time and from time to time during the grantor's life, the Selector, as hereinafter defined, shall have the power to add to or remove from the class of beneficiaries entitled to receive distributions from the trust under Article [ ] hereof, subject to the following restrictions:

(1) The Selector may add one or more of the following individuals to the class of beneficiaries: any current or future spouse [or domestic partner] of the grantor and any descendant of a current or future spouse [or domestic partner] of the grantor.

(2) The Selector may remove one or more of the following individuals from the class of beneficiaries: any current or future spouse [or domestic partner] of the grantor and any descendant of a current or future spouse [or domestic partner] of the grantor.

The grantor may retain the power to remove and replace the Selector at any time; provided, however, that the grantor may not appoint (a) himself, (b) his spouse, (c) any beneficiary of the trust, or (d) any "non-adverse" party[2] in the place of a removed Selector.

These techniques provide flexibility in defining the class of beneficiaries according to possible future changes in circumstances and may save the client a great deal of time, money, and administrative hassle in the future. Either or both options can be incorporated in a trust agreement depending on the client's preferences, though the drafter should carefully consider and explain to the clients the implications (both practically and with respect to the income tax treatment of the trust) of these provisions before including them.

MARJORIE HORNADAY *is an associate and* STEPHANIE E. HEILBORN *is a partner in the New York office of Norton Rose Fulbright US.*

1. If the attorney represents both spouses in their estate planning, the authors strongly recommend that the attorney discuss the implications of this option with both spouses and memorialize their agreement to and understanding of this definition.

2. IRC §672(a) provides that an adverse party is "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust."

Foreign Parents With **U.S. Children:** Trusts Play an Important Role

BY GARY A. PHILLIPS AND STEVEN M. SARAISKY

Anyone who has seen the current Broadway hit Hamilton knows that we are a nation of immigrants. Moreover, many U.S. persons who moved here from elsewhere have parents back in their home country.

When those "foreign" parents pass away and leave assets to their U.S. children, those assets become subject to the U.S. estate tax system in the children's estates, where ultimately they can be taxed at a 40 percent federal tax rate (plus state estate taxes) when a child dies.

The adverse tax result that follows from foreign parents leaving their assets outright to U.S. children can be avoided with advance planning. Often, foreign parents can incorporate trust planning into their own estate planning documents. If assets pass to a properly structured trust for the benefit of a child rather than outright to the child, the assets in the trust may not be subject to estate tax in the child's estate.

New York estate tax practitioners often consult with foreign advisors to effectuate this kind of planning, and it is becoming more important given the amount of immigration and investment in the New York area in recent years.

A parent can incorporate this type of trust planning—often called "dynasty trust" planning—in a Will that is valid in his or her home jurisdiction. The Will would include provisions to create the dynasty trust upon the parent's death. To accomplish this, the U.S. trusts and estates lawyer can work with foreign counsel to (1) confirm that the "home country" law allows such a structure and (2) provide the dynasty trust language that will reflect the client's goals and satisfy U.S. tax law requirements. For example, the trust can allow the child to be sole trustee of the trust created for his or her benefit, and permit distributions to the child and his or her descendants subject to ascertainable standards (i.e., health, education, maintenance and support) so that the trust assets are not included in the child's estate. The trust can include powers of appointment and several other tools that allow for greater flexibility in the trust.

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As an alternative to including the dynasty trust plan in a foreign parent's Will, the parent could establish and fund a trust during lifetime to carry out his or her objectives. The U.S. tax practitioner can assist with the U.S. tax advice relating to such a trust.

If established outside the United States, such a trust usually will be structured to be a "foreign grantor trust." This is a trust that, under the U.S. grantor trust rules (Internal Revenue Code §§671-679), is not treated as a separate taxpayer from the grantor. The trust is disregarded for U.S. income tax purposes, and the foreign grantor reports all items of income, deduction, gain, loss, credit, etc. on his or her own tax return, if any.

It is often simpler to structure this type of trust as a foreign grantor trust, rather than a foreign *non-grantor* trust that is treated as a separate taxpayer. A foreign non-grantor trust with U.S. beneficiaries has a number of tax reporting requirements, and also can be subject to punitive income tax rules (known as the throwback rules) when funds are distributed to U.S. beneficiaries. Thus, the parent's trust is often best structured as a foreign grantor trust while the parent is alive. When the parent dies, the trust becomes a non-grantor trust, and the U.S. children generally will move the trust to the United States at that time (pursuant to a "change of situs" provision in the trust) so that it becomes a domestic, U.S.-situs trust.

In order to qualify as a foreign grantor trust, the trust must be fully revocable by the grantor. Internal Revenue Code §§672(f)(1) and (2). (Note that foreign trusts do not qualify as grantor trusts under the same rules as domestic trusts). This is often a desirable structure for U.S. children and their foreign parents. The foreign parent is committing to a structure that he or she can revoke or change at any time, while the U.S. child has the benefit of the parent's proactive tax planning.

The foreign trust generally will have a bank or trust company acting as trustee in the jurisdiction of choice (e.g., BVI or Cayman Islands). The trust may have a family member named as a "trust protector" who has the right to remove and replace the trustee and make other changes to the trust. The trust may own the stock of an investment company that holds the assets transferred into this structure, and a family member can act as director of the company to manage the investments.

The substantive provisions of the trust permit distributions to children and grandchildren in the discretion of the trustee (which provides an asset protection benefit to the beneficiaries). The trust can continue in this fashion for many generations, and should not be subject to U.S. estate or generation-skipping tax.

As the parent/grantor of the trust is also included as a trust beneficiary, distributions from the trust can be made to the parent during his or her lifetime. In practice, if the parent wants funds in the trust to be distributed to a child, it is often best for the parent to withdraw funds from the trust and distribute them directly to the child. Among other things, this makes the U.S. tax reporting of the gift on a Form 3520 simpler.

Under certain circumstances, the foreign parent may wish to establish a U.S.-situs grantor trust rather than a foreign trust. This may make sense, for example, if the foreign parent has U.S. assets that will be transferred to the trust.

This article provides just a brief treatment of this issue and of course there are many additional complexities. The trusts and estates practitioner must consider, among other things, (1) whether home country law allows foreign parents to leave assets in this manner, (2) various reporting requirements for foreign trusts with U.S. beneficiaries, (3) trustee selection and fees, (4) numerous drafting issues to build maximum flexibility into long-term trusts, and (5) compliance with U.S. income and estate tax laws. Yet the tax saving opportunity for clients in this situation is substantial, and should be considered by all foreign parents leaving significant assets to U.S. children.

GARY A. PHILLIPS *and* STEVEN M. SARAISKY *are members of the tax, trusts and estates department at Cole Schotz.*

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withdrawal rights and on Dec. 28, 2000, the decedent and her husband funded the trust with cash from two separate bank accounts, which was partially distributed to their children on Dec. 29, 2000 and completely distributed during 2001.

From 2001 until the death of the decedent, the children held annual meetings in their capacities as trustees and beneficiaries of the trusts, personal representatives and beneficiaries of their parents' estates, attorneys-in-fact for the parents and as members of the FLP. They discussed accounts and assets, heard presentations and received estate tax planning updates and advice. In addition, beginning in 2001, in order to address their concerns about the fractionalization of the investment structure, the family hired an investment firm who provided guidance regarding the FLP and their investments.

Also, prior to forming the FLP and the family trust, the decedent and her husband made annual gifts to their children and grandchildren. This pattern of gifting continued where from 2002 to 2007 the decedent made annual exclusion gifts of her FLP interests to the beneficiaries of the family trust with additional gifts at the end of the year if there were additional births or marriages. The value of the gifts was based on valuation summaries prepared by their attorney and each year waivers of their withdrawal rights were distributed and signed by the beneficiaries of the family trust.

During this period of planning, the decedent was in excellent health until her death in 2007, other than an injury sustained in 1984 from which she never fully recovered her ability to walk safely. Her husband, who died unexpectedly in 2001, was also considered to be in good health although later it was determined that he had Alzheimer's disease. Finally, because of family disputes and the structuring of the ownership of assets, one of the decedent's children was able to block the liquidation of assets/distributions so that the estate tax liability could be paid. Therefore, some of the beneficiaries loaned money to the estate to pay the estate tax liability and the estate in turn took any interest paid on the loan as a deduction on the estate tax return.

The issues highlighted in this case—§2036(a), annual exclusions and the deductibility of loan interest to pay estate tax—frequently arise in estate and gift tax audits although not usually in one single case. The first issue refuted was the IRS claim that the contributions of assets to the LLC was a transfer with a retained interest includible in the decedent's estate under §2036.

Section 2036(a) generally provides that if there is an inter vivos transfer made for something other than a bona fide sale for adequate and full consideration and the decedent retains certain enumerated rights or interests in the property which are not relinquished until death, the full value of the transferred property is included in the value of the decedent's gross estate.[1] A bona fide sale requires a legitimate and significant non-tax reason for creating the entity. The estate, who had the burden of proof and never argued that the burden shifted to the government, stressed the seven non-tax motives for the transfer outlined in the decedent's attorney's memorandum the day after the formation of the FLP (TC Memo 2015-249 at p. 15-17). The court in *Purdue*, however, focused on the change in management of the assets after the FLP was formed, specifically that there was a single advisor involved in the management, that the children made the decisions jointly and that the decedent and her husband were not involved once the transfer occurred. To the court, this was a legitimate non-tax motive for the transfer of property. And although, as the IRS argued, the decedent and her husband stood on both sides of the transaction, the court reasoned that "an arm's length transaction occurs when mutual legitimate and significant non-tax reasons exist for the transaction and the transaction is carried out in a way in which unrelated parties to a business transaction would deal with each other." (Id. at 20 (citing *Estate of Bongard v. Commissioner*, 124 TC 95 at 123)). The court was clear that this was not a mere change in form, as argued by the IRS, because if "a decedent employ[s] his capital to achieve a legitimate non-tax purpose, the court cannot conclude that he merely recycled his shareholdings." (Id. at 22 (citing *Estate of Schutt v. Commissioner*, TC Memo. 2005-126). The remaining factors (the financial independence of the transferors, the lack of commingling, timely transfers, the entity maintained annual records and the transferors were in good health) all were decided in favor of the Estate.

'Purdue' provides a clear roadmap of how to **successfully divest oneself of the risks** associated with key audit triggers.

The next issue refuted was the IRS claim that the annual gifts were not present interest gifts that qualified for the annual exclusion. To qualify as a present interest gift, a gift must give the donee "[a]n unrestricted right to the immediate use, possession or enjoyment of property or of income from the property." When the gift is of LLC or limited partnership interests, as in *Purdue*, the donees must "obtain use, possession or enjoyment (1) of the limited partnership interests or (2) of the income from those interests within the meaning of Section 2503(b)." The difficulty that the estate had in *Purdue* was that the donees membership interests in the LLC were limited because no one interest could be transferred without unanimous consent of the other members and so there was not the receipt of "unrestricted and noncontingent rights to the immediate use, possession or enjoyment of the PFLLC interests themselves." However, utilizing the three prong test set out in *Calder v. Commissioner*, 85 TC 713, 727-28 (1985), the court reasoned that the present interest requirement was met (TC Memo 2015-249 at pg. 26-27) since the LLC held income-producing real estate and dividend-paying marketable securities, the LLC made distributions to the trust and the trust made distributions to the beneficiaries over eight years of approximately $2 million, and the rent was readily ascertainable.

The third issue refuted was the claim by the IRS that the interest expense deducted as an administration expense under §2053 was not actually and necessarily incurred in the administration of the estate. For interest to be deductible, "the loan obligation must be bona fide and actually and necessarily incurred in the administration of the decedent's estate and essential to the proper settlement of the estate." Since one of the decedent's daughters created a deadlock by not voting for the liquidation of assets/distributions so that the estate tax liability could be paid, the loan was necessary. Therefore, the deduction of the interest expense on the loan was permitted.

Purdue provides a clear roadmap of how to successfully divest oneself of the risks associated with key audit triggers. Careful planning, working with trusted advisors whose advice is followed, and having the ability to cede control to the successor generation ensured that the issues raised by the auditors were resolved in favor of the Estate. The Purdue family began their estate plan almost 12 years prior to the audit and five years prior to the actual creation of the family LLC or family trust. Yet it was not the facts alone that made their plan a success but rather the years of administration that followed. Succession planning is difficult for myriad reasons but those difficulties can be minimized when a plan is instituted based on a knowledge of known audit triggers and an ability to let go.

1. Section 2036(a) is applicable when (1) an inter vivos transfer was made, (2) that was not a bone fide sale for full and adequate consideration, (3) decedent retained an interested or right enumerated under Section 2036(a)(1) or (2) or (b) in the transferred property that was not relinquished prior to death.

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related party has a financial interest and in which the corporation or an affiliate is a participant) to except certain transactions, and to provide statutory defenses in any legal action involving a related party transaction. In an action by anyone other than the Attorney General, it will be a defense that the transaction was fair, reasonable and in the best interests of the corporation at the time the corporation approved the transaction. In an action by the Attorney General, additional actions are required, including board ratification of the transaction.

Under previous statutory language, no employee could serve as chair of the board. This prohibition created many practical difficulties. Under the newly enacted law, an employee can serve as chair, provided the board approves the employee by a two-thirds vote of the entire board and contemporaneously documents in writing the basis for board approval.

6. Computer May Be Deemed Discoverable Evidence in Court Proceeding, If Information Is Material and Necessary.

In re Estate of Nunz[8] provides a lesson to law firms to be mindful of the data that is potentially discoverable from deleted electronic data.

The decedent signed a will a month before his death, naming his second spouse as executrix and sole beneficiary, leaving nothing to his six children from a prior marriage. When five of the six children contested the will, the attorney draftsman testified that any computer files relating to the preparation of the will "have been destroyed or no longer exist." Decedent's children sought production of the computer and forensic analysis of electronically stored information. The Surrogate noted that Civil Practice Law Rules §3101(a) requires disclosure of "all matter material and necessary in the … action." She found that forensic analysis of the computer's hard drive was clearly discoverable, but a strict protocol had to be followed because of the undisputed potential for finding significant nonrelevant confidential information and non-relevant information falling within the attorney-client privilege. The court directed as follows:

- The computer should be delivered by the attorney draftsman himself or the estate attorney, with no involvement by the objectants in the turnover process;
- Once the hard drive had been cloned, the forensic expert should ensure immediate return of the computer to whomever delivered it;
- After receiving the computer, the expert would be barred from speaking with anyone involved in the case;
- Employees of the expert must swear to abide by the same directions;
- Once the court reviewed the expert's report and findings, it would issue whatever further order was appropriate and necessary regarding disclosure of any contents.

5. New Procedures for Discharge of Estate Tax Lien on Real Estate.

Although a federal development, the new Internal Revenue Service (IRS) Release of Lien procedure will affect many New York estates. An IRS lien attaches to estate property on death.[9] Prior to June 2016, the IRS issued discharges of liens on real estate included in an estate quickly on a simple application (Form 4422), so the sale of estate property could proceed during the estate administration process.

As of June 1, 2016, for estates above the federal filing threshold, a new policy applies for real estate, including cooperative apartments. After filing Form 4422, the executor can either: (1) enter into an escrow agreement with the IRS and appoint an escrow agent to hold the entire net proceeds of sale or (2) deposit the entire net proceeds with the IRS to be held as payment on account of the federal estate tax. Only when the estate receives a final closing letter, which could be years after death, will the IRS release the net proceeds, even if the sale proceeds far exceed the estimated tax liability. Executors may wish to consider the possibility of establishing an escrow account at an institution that can also offer a line of credit, in order to provide them with the liquidity necessary during the estate administration period.

4. Fiduciary Access to Digital Assets Act Enacted.

The ownership, transfer and disposition of digital assets present unprecedented challenges. From establishing rights to access information, to retrieving confidential user IDs and passwords, to Terms of Service (TOS) Agreements that can provide that an account is not transferable and all rights to the account cease on death, to federal and state laws that criminalize unauthorized access to computers and prohibit the release of electronic account information, fiduciary access to digital assets can be riddled with obstacles.

The Uniform Law Commission approved a Revised Uniform Fiduciary Access to Digital Assets Act (RUFADAA)[10] on July 15, 2015. The Act extends to four types of fiduciaries: personal representatives, guardians, agents acting under a power of attorney and trustees.

Among the more significant provisions are the following:

- For personal representatives the default rules are: (1) They cannot access the content of electronic communications, unless the decedent consented to disclosure and (2) They can access a catalogue of electronic information (like the "to" and "from" lines of an email, without content, so accounts could be identified, for example), unless the decedent prohibited disclosure.
- For trustees, the default rules are: (1) They can access content when the trustee is the original user, or if access is permitted by the trust agreement and (2) They can access a catalogue of electronic information, unless prohibited by the user, trust or court.
- RUFADAA specifically provides that users can utilize an online tool provided by a custodian to allow or prohibit custodians from disclosing information, including content.
- RUFADAA takes a three-tiered approach:

(1) Directions given via an online tool that can be modified or deleted at all times prevail over any other direction in a will, trust, power of attorney or other record;

(2) If the user has not utilized an online tool, or if the custodian has not provided one, a user's direction in a will, trust, power of attorney or other record prevails; and

(3) In the absence of any direction, the TOS Agreement controls.

Accordingly, in order to avoid a provider's generic TOS Agreement potentially controlling, it is important to use a provider's online tool, if one is provided, and to address these issues in estate planning documents.

RUFADAA has been introduced or enacted in at least 35 jurisdictions.[11] Governor Cuomo signed digital asset legislation that is substantially identical to RUFADAA into law in New York on September 29, 2016.[12]

3. A Well Drafted Release can be Critical in Cutting off Fiduciary Liability.

In *Matter of Mercer*,[13] a decedent was survived by his wife and three children from a prior marriage. The decedent's will provided his wife with lifetime enjoyment of the bulk of his $8 million estate, and appointed her as co-executor. After the decedent's two sons objected to probate, the parties reached a settlement to admit the pounded instruments to probate in exchange for a $1.5 million payment to objectants and settlement of another pending action. By its terms, the settlement sought to resolve "any and all claims and disputes raised or which could have been *raised by any party to date* …" including claims relating to the administration of the decedent's estate. The settlement also provided for the mutual release of obligations "including but not limited to any claims and causes of action that … [the parties] have asserted against each other *or claims they could have asserted* …" (emphasis added).

The co-executors filed a petition for judicial settlement of their account. The sons and the guardian ad litem, appointed to represent infant, unborn and contingent beneficiaries, objected to the account. The Surrogate dismissed several of the sons' objections on the ground they were based on information available at the time they executed the agreement. However, the court found that the sons did not intend to release claims of which they had no knowledge at the time they entered into the settlement. The court also determined that the guardian ad litem's wards were not bound by the settlement. The Second Department disagreed. Reversing the Surrogate's decision, the Appellate Division found the guardian ad litem's wards were bound by the settlement because the agreement stated that the rights and obligations set forth were binding upon the parties and "their respective heirs, executors, administrators, successors, assigns, trustees and legal representatives." With respect to the sons, the appellate court found that the language of the settlement unambiguously reflected a desire to resolve any and all claims, with no indication that the parties intended to limit the release to claims known at the time the settlement was signed.

2. Lesson and Reminder of the Importance of Selecting the Right Fiduciary.

In *Matter of LaForgia*[14] and *Matter of Billmyer*[15] serve as powerful lessons of the importance of selecting a fiduciary who can be trusted to act in the best interests of the beneficiaries. In *LaForgia*, the decedent's daughters, co-executors of the estate, had their letters testamentary suspended when they failed to fund trusts set up by decedent's will, one of which was for the benefit of decedent's disabled grandson; they liquidated a brokerage account in order to purchase a $2 million real property; expended over $1 million in attorney fees and other unidentified administrative expenses; and "in a further display of inability to comprehend one's fiduciary duties and obligations," violated a temporary restraining order prohibiting them from removing assets from the estate. In *Billmyer*, the executor hired his friend to sell a building included in the estate. The building was sold to an entity of the executor's "personal acquaintance" for $670,000. Three days later, the entity sold the building for $1.3 million. Testimony at trial made clear that the contract for the latter sale had been in existence before the original sale took place. The court surcharged the executor $630,000, the difference between the sale price and the fair market value, plus 6 percent interest. These cases are stark reminders of the advantages of including an independent professional trustee that is cognizant of the responsibilities imposed on fiduciaries, and can provide guidance in complying with the law.

> If one spouse simply leaves everything to the other, the **exclusion of the first to die is wasted,** and that may also push the survivor's estate over the cliff, resulting in hundreds of thousands of estate tax that could easily have been avoided.

1. Estate Tax Cliff, Disparity between New York and Federal Exclusion Amounts and Lack of Portability Make Planning Critical.

The New York estate tax exclusion increased to $4,187,500 for individuals dying after April 1, 2016 and will further increase to $5,250,000 for individuals dying after April 1, 2017 and before Jan. 1, 2019, after which the exclusion amount will be linked to federal exclusion amount.[16] However, because the New York exclusion amount is not portable between spouses and the computation contains an estate tax "cliff,"[17] it becomes critical to take advantage of the exclusion amounts of both spouses. If one spouse simply leaves everything to the other, the exclusion of the first to die is wasted, and that may also push the survivor's estate over the cliff, resulting in hundreds of thousands of estate tax that could easily have been avoided.[18]

Care must also be taken in pegging a credit shelter bequest to take advantage of the full federal exclusion because the combination of the disparity between state and federal exclusion amounts and the cliff effect might trigger substantial estate taxes. For example, when the New York exclusion amount increases to $5.25 million, a credit shelter disposition of the state exclusion amount wouldn't generate any New York tax. However, if the credit shelter disposition was just $240,000 more because it was tied to the 2017 federal exclusion amount of $5.49 million, that extra $240,000 would generate a state estate tax of over $435,000, which can be further compounded with an interrelated tax computation if the tax is payable from a marital or charitable residuary. One solution to avoid this result is to define a formula credit shelter bequest to mean the maximum amount that can pass free of both federal and state taxes. However, many practitioners now prefer to avoid formulaic dispositions[19] and rely instead on techniques that maximize flexibility after death, enabling family and fiduciaries to make a post-mortem determination regarding trust funding amounts. These techniques include disclaimer planning, allowing the fiduciary to make a partial qualified terminable interest (QTIP) election or using a Clayton Trust, whereby the estate can pass into a QTIP trust if the executor makes a QTIP election.

1. Advisory Opinion TSB-A-15(1)M (May 29, 2015).
2. A memorandum submitted by the New York City Bar Association (http://www2.nycbar.org/pdf/report/uploads/20073013SMLLCTaxAdvisoryEstateGiftReportFINAL121015.pdf) asserts that, in looking to federal income tax law to determine state estate tax liability, the Department reversed the proper order of analysis: State law should first determine the character of property rights, and tax law should then be applied based on the state law characterization.
3. Advisory Opinion TSB-A-16(3)M (Aug. 26, 2016).
4. See https://www.irs.gov/pub/irs-pdf/f8832.pdf.
5. Advisory Opinion TSB-A-16(2)M (June 8, 2016).
6. New York A.3461/S.5154 (2015).
7. Amendments to Estates, Powers and Trusts Law §8-1.9 make the relevant revisions applicable in the trust context.
8. 52 Misc.3d 1216(A), 2016 N.Y. Slip Op. 51185(U) (Surr. Ct. Erie County, Aug. 9 2016).
9. Internal Revenue Code §6324.
10. Available at http://www.uniformlaws.org/shared/docs/Fiduciary%20Access%20to%20Digital%20Assets/2015_RUFADAA_Final%20Act_2016mar8.pdf.
11. States in which RUFADAA has been enacted include: Arizona, California, Colorado, Connecticut, Florida, Hawaii, Idaho, Illinois, Indiana, Maryland, Michigan, Minnesota, Nebraska, New York, North Carolina, Oregon, South Carolina, Tennessee, Washington, Wisconsin and Wyoming. States in which RUFADAA has been introduced include: Alabama, Iowa, Louisiana, Massachusetts, Mississippi, Missouri, New Jersey, Ohio, Oklahoma, Pennsylvania, Rhode Island, Utah, Virginia and West Virginia.
12. New York A.9910 (2016).
13. 141 A.D.3d 594, 35 N.Y.S.3d 692, 2016 N.Y. Slip Op. 05502 (Sup. Ct. App. Div. 2d Dept, July 13, 2016).
14. 2013-331/P, NYLJ 1202766601209 (Surr., RI, Decided Aug. 4, 2016).
15. 142 A.D.3d 1000 (2016), 37 N.Y.S.3d 330, 2016 N.Y. Slip Op. 05994 (2nd Dept., Sept. 14, 2016).
16. N.Y. Tax Law §952(c)(2).
17. Estates that are less than or equal to the New York estate tax exclusion amount will pay no tax, but the credit for New York taxable estates that are between 100 percent and 105 percent of the exclusion amount is rapidly phased out and eliminated entirely if the New York taxable estate exceeds 105 percent of the exclusion amount.
18. N.Y. Tax Law §952(c)(1).
19. Note that if the federal estate tax is eliminated, as proposed by President-Elect Donald Trump, formula provisions can become particularly distorted (as they were in 2010), if their conceptual underpinnings are removed from the law.

Tax Reform

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current law, these transfers make good sense. They provide a means of securing a basis step-up at the donor's death. But, if reform brings capital gains taxes at death, the transfers will trigger a tax that could otherwise have been postponed.

- Avoid outright lifetime gifts except gifts to donees who have immediate need of the gifted funds. Unspent gifts could be subject to estate tax or capital gains tax at the death of the donee, if the estate tax is restored after repeal. Property held in trust may not be.
- Consider including provisions in Wills that would produce tax efficient results if the individual dies during a year when there is no estate tax. Some provisions to consider include:

Eliminate direct gifts to charity. If there is no estate tax, there will be no tax advantage to charitable gifts at death. Instead, provide a bequest of the amount intended for charity to a trust to be held for the benefit of family members and charity. The terms of the trust could require the payment of all trust income to charity until charity receives the intended amount. This approach should provide a significant tax benefit to the non-charitable beneficiaries through the income tax deduction allowed under §642(c) of the Code for payments to charity from trusts. Include §501(c)(4) organizations as additional beneficiaries to protect against the possible repeal of the §642(c) deduction. Alternatively, the individual could provide a bequest to a trusted family member with the request that he or she make a gift to charity.

Do not use formula bequests that would cause too much to pass to children at the expense of a surviving spouse if death occurs when there is no estate tax. For example, a bequest to children of the maximum amount that can pass free of federal estate tax could result in the entire estate passing to the children. Instead, provide an alternate pattern of bequests that would be effective if there is no estate tax.

All bequests should pass in trust rather than outright. An outright gift might be subject to estate tax or capital gains tax at the death of the recipient. A gift in trust is not likely to be caught if the estate tax is restored.

- Because it is impossible to anticipate all of the changes that will occur in the tax law, consider giving another person an expanded power of attorney that can be exercised to make certain changes to the principal's estate plan in response to changes in the tax law. For example, a power of attorney could authorize the holder of the power to make transfers of property to revocable trusts and to change the terms of revocable trusts in a manner that would maximize tax efficiency without changing the basic dispositive plan.