December 30, 2013

Estate Planning Update - December 2013

PLANNING AFTER ATRA

After years of flux, the federal estate, gift and generation-skipping transfer (GST) tax laws have finally settled into a "permanent" state. With the enactment of the American Taxpayer Relief Act of 2012 (ATRA) as of January 2013, for the first time in over a decade, the federal estate tax statutes do not have built-in expiration dates and the uncertainty that came with the scheduled changes.

Now that the $5,250,000 federal estate, gift and GST tax exemptions are permanent and will continue to increase based on automatic annual inflation adjustments, the decision-making process for making significant gifts has changed for many individuals. The "use it or lose it" atmosphere that influenced planning decisions to capture larger exemptions (and thus accelerated the gifting process for many individuals) is gone.

The stability in the transfer tax laws, however, does not change the opportunities for making gift transfers. For example, maximizing the use of annual exclusion gifts, now permitting gifts of $14,000 per donee, will always be a strategic way to benefit family members. In addition, we continue to be in a period of historically low interest rates, which make transactions permitting the transfer of wealth using little or no gift tax exemption very appealing. A brief summary of some planning techniques that take advantage of the low interest rate environment follows.

- **Grantor Retained Annuity Trusts (GRATs).** GRATs are designed to transfer future appreciation without any gift or estate tax charged on that growth. The trustee of the GRAT annually pays to the person setting up the trust (the grantor) a designated percentage of the initial fair market value of the trust for the term of the trust, say two years. That percentage is based on the prevailing federal interest rate for the month that the GRAT is funded. The assets originally transferred to the trust, plus interest, are thus returned to the grantor. Any growth in excess of the applicable annual interest rate is accumulated in the trust and, so long as the grantor is living at the end of the trust term, passes to children(or other beneficiaries) free of tax. GRATs offer the potential for transfers to the next generation without tax cost because they can be "zeroed out" for gift tax purposes. More important, they offer that potential with no significant tax risk, because they have been specifically approved by the IRS.
- **Sales or Loans to Grantor Trusts.** Similar to a GRAT, a sale or loan to a grantor trust (a trust, the grantor of which is treated as the owner for tax purposes, i.e., all items of trust income and deduction will be reported on the grantor's personal income tax returns) allows the future appreciation of an asset to escape estate tax. The transaction is not subject to gift tax, because the trust is paying fair market value for the asset or repaying a loan from the grantor. In addition, because the trust is a grantor trust for income tax purposes, any income tax payments the grantor makes on

behalf of the trust are essentially tax-free gifts that serve to reduce the grantor's estate. In the sale scenario, the grantor sells an asset to a trust for a specified price in a commercially reasonable way, generally taking back an installment note. The trust repays the grantor in whole or in part out of the earnings of the purchased asset. If the asset sold to the trust appreciates in value at a rate in excess of the combined interest rate and purchase price, the appreciation is removed from the grantor's estate. Similarly, cash can be the subject of an installment sale in the form of a loan. If the borrower-trust invests the cash in an asset that produces income in excess of the interest charged on the loan, the income and appreciation accrue in the trust tax-free and not in the seller's estate.

- **Intrafamily Loans.** An intrafamily loan can provide a significant benefit to a junior generation family member with relatively modest tax implications to the senior generation family member. These intrafamily loans may be made without gift tax implications as long as the lender charges interest at a rate no less than the "applicable federal rate." The applicable federal rates are determined and published by the IRS on a monthly basis and are based on the average market yield on outstanding marketable U.S. government obligations of varying lengths. The applicable federal rates for December 2013 are 0.25% for a loan term less than three years, 1.65% for a loan term between three and nine years, and 3.32% for a loan term longer than nine years. In addition, the payment terms can be designed to fit the specific needs and resources of the borrower. Balloon notes that require only the payment of interest at the outset provide an attractive way to provide liquidity for a child or grandchild without the immediate burden of substantial loan payments.

Please let us know if you would like to discuss any of these ideas to see whether they might be beneficial to you and your family.

INFLATION ADJUSTMENTS

Each year, certain estate, gift and generation-skipping transfer (GST) tax figures are subject to inflation adjustments. For 2014, the annual exclusion amount for gifts remains at $14,000. The estate, gift and GST tax exemption amounts for estates of decedents dying in 2014 and gifts made in 2014 are increased to $5,340,000. Finally, the annual exclusion amount for gifts made to a noncitizen spouse in 2014 is increased to $145,000.

IRS RESPONSE TO WINDSOR DECISION

Earlier this year, in *United States v. Windsor*, the United States Supreme Court struck down Section 3 of the Defense of Marriage Act, which defined "marriage" as exclusively a union between a man and a woman under federal law. Since the Supreme Court's decision, the Internal Revenue Service (IRS) has clarified that a same-sex couple will now be recognized as legally married for federal tax purposes if the marriage was valid in the state or country where the marriage was performed,

even if the couple lives in a state that does not recognize same-sex marriages. Thus, taxpayers in a same-sex marriage must be sure to file their 2013 federal income tax return using the "married filing jointly" or "married filing separately" status. Couples may (but are not required to) amend prior returns within the applicable statute of limitations (generally three years) to reflect a same-sex marriage, using the IRS's new form 1040-X. The IRS has also announced, however, that "marriage" does not include other forms of unions for federal tax purposes, such as registered domestic partnerships, civil unions or other similar relationships that are not termed "marriage" under the laws of the state.

The IRS has declared that post-*Windsor* guidance is a top priority. Nevertheless, many issues remain unresolved, such as whether a legally married same-sex couple who lives in a state that does not recognize same-sex marriage can jointly file their state income tax return or claim a marital deduction with respect to a separate state estate tax. As this area of the law continues to develop, it is important for those affected to consult with their advisors about their particular circumstances.

REPORTING FOREIGN BANK ACCOUNTS

U.S. taxpayers with a financial interest in or signature authority over foreign financial accounts are required to report them if the aggregate value of those accounts exceeds $10,000 at any time during the calendar year.

This foreign bank account reporting is separate from the filing of the federal tax return, Form 1040, and also should not be confused with the new Form 8938, Statement of Specified Foreign Financial Assets, which is required to be filed with Form 1040.

The required foreign bank account reporting, or "FBAR" for short, was previously accomplished by completing the informational return, Form TD F90-22.1, Report of Foreign Bank and Financial Accounts, and mailing that form to the Department of the Treasury in Detroit by June 30, following the calendar year in respect of which it was required. As of July 1, 2013, however, changes went into effect, and going forward all filing (including late filings and amended filings) must be done electronically. The Financial Crimes Enforcement Network (aka FinCE N), a division of the Department of the Treasury, has established the BSA E-Filing System for the electronic filing.

FinCEN has also updated and revised Form TD F90-22.1, changing its designation to Form 114. It also developed Form 114a, Record of Authorization to Electronically File FBARs, which is to be used to obtain permission from clients to file an FBAR on their behalf.

Day Pitney is now a registered BSA e-filer and can accomplish the filing of an FBAR (Form 114) for you. Please let us know if we can help you meet the current filing requirements for a foreign bank account.

DIGITAL ASSETS

There has been increasing discussion in the mainstream media and the planning community about how to account for so-called "digital assets." The term "digital assets" comprises several different categories of data that most of us already possess and continue to acquire at an accelerating pace. For example, "digital assets" may refer to digital photos or e-mails. It encompasses downloaded music files, e-books, online subscriptions, airline miles and credit card reward points, any of which may have significant monetary value. Finally, "digital assets" can describe traditional assets that we access through digital means, such as automatic bill-pay accounts or brokerage accounts.

You may have strong preferences for how you would want those assets handled in the event of your incapacity or death. You may feel strongly that some photos or e-mails should be saved, others deleted. And you may want family members to have access to your online accounts. Planning for digital assets, however, poses unique challenges. For example:

- the class of "digital assets" evolves continuously;
- digital assets may exist in any number of locations and formats, including off-site (cloud) storage, making them difficult to locate;
- digital assets are often password-protected, making them difficult to access; and
- state and federal legislators have been slow to address these issues, leading to a tangle of inconsistent user agreements governing your online accounts.

Careful planning and organization increase the likelihood that your digital assets are not lost forever (assuming you would like them to be found) and are handled in a manner consistent with your wishes. As the law continues to catch up with the reality of our lives, it is worth reflecting on your digital assets and how those assets can (or should) be accessed in the event you are unable to access them yourself. If you would like to discuss this topic further, or would like practical thoughts on how to organize your digital assets, please do not hesitate to contact us.