Fox Rothschild LLP
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TAX & ESTATES DEPARTMENT

ALERT

NEW YORK TAX & ESTATES ATTORNEYS

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TAX & PLANNING ALERT

In Spring 2006, we alerted our clients and friends to some significant estate tax planning opportunities and pitfalls. This year, the concerns we had expressed have become even more pronounced. For 2008, the federal estate tax exemption remains at $2 million; as of January 1, 2009, the federal exemption will increase to $3.5 million. While this is good news for estates over $10 million, estates in the $3 -$10 million range where wills were drafted to maximize the use of the federal exemption via the use of a "credit trust" could see a substantial increase in the amount of state death taxes that will be required to be paid at the first death.

In New York, for example, the state estate tax exemption is only $1 million. The difference between the federal and state exemptions is taxable at the first death. Therefore, while the federal exemption remains at $2 million and the state exemption at $1 million, upon the first death, New York estate taxes will be $99,600. When the federal exemption increases to $3.5 million in 2009 and the state exemption remains at $1 million, the estate of the first to die will pay a New York estate tax of $229,000. New Jersey and Connecticut residents will be similarly affected.

This result can be remedied in several ways. Flexible language can be utilized to give the surviving spouse the choice to elect to pay no state estate tax at the first death by not taking full advantage of the federal exemption. Alternatively, the surviving spouse can elect to pay state estate tax at the first death by taking advantage of the higher federal estate tax exemption, thereby substantially reducing estate taxes at the second death. Regardless of the method used, it is important that a conscious decision be made so that excessive first-death or second-death taxes can be controlled.

Under current law, there will be no federal estate tax for decedents dying in the year 2010. In 2011, the tax is scheduled to return with the exemption dropping down to $1 million. A number of bills currently in Congress address this situation. While it is difficult to predict the specifics of any new tax bill, there is a consensus that we will continue to have a federal estate tax after 2009. The exemption will probably not be less than $3.5 million and may be indexed to inflation or even be increased over a period of years. It is even possible that the tax rates will be decreased. As the picture becomes clearer, we will advise you.

If there have been significant changes in your family circumstances (moving to a different state, receipt of a large inheritance, significant loss of assets, sale of a business interest, retirement, divorce, marriage or death, change in health of a family member, etc.), it may be a good time to revisit your estate plan. You should make sure that the identities of and the amounts left to your beneficiaries reflect your current wishes, that your fiduciaries (Executors and Trustees) remain appropriate, and that you have taken advantage of generation skipping options that can be utilized for the benefit of grandchildren. Health care proxies, powers of attorney, and living wills that were prepared before 2004 should be updated to reflect the stringent privacy provisions of the HIPAA law amendments.

Fox Rothschild's vast resources in New York and around the country are available to you for traditional estate planning needs and beyond. Our practice areas encompass family law (e.g., divorce and pre-nuptial agreements), commercial and residential real estate, corporate matters (including structuring the sale or acquisition of a business), litigation, intellectual property, and employment matters, among many others.

NEW "EXPAT" TAX LAWS

On June 17, President Bush signed into law the Heroes Earnings Assistance and Relief Tax Act (HEART), containing legislation that significantly changes the way the U.S. taxes citizens who renounce their U.S. citizenship and permanent non-citizen residents who choose to relinquish their green cards (expatriates). The legislation is aimed primarily at those high net-worth individuals who give up their citizenship or permanent residence rights to avoid paying U.S. income, gift, or estate tax. It is effective on the date of enactment.

The former law required an expatriate to continue to pay income taxes for a 10-year period after leaving the country, but only on U.S.-sourced income. Estate and gift taxes also continued to apply during that 10-year period to certain transfers of U.S. assets. This alternate tax regime, although complicated, had the advantage of releasing the expatriate from the U.S. tax net at the end of the 10-year period. Thereafter, the expatriate would continue to be taxed in the U.S. in the same manner as other foreign non-residents. With proper planning, the alternate tax regime could be relatively tax-neutral to the expatriate.

The HEART legislation replaces the 10-year tax transition rule with a "mark to market" regime. It is essentially the "exit tax" that the government has sought to pass for many years. The expatriate to whom this law applies would be deemed to have sold all of his or her worldwide appreciated assets at fair market value on the day before expatriation. He or she would have to recognize and pay a tax on the unrealized gain (in excess of $600,000, to be adjusted for inflation) in the year of expatriation. The taxpayer could elect to defer the income taxes otherwise due until the property is actually sold and the taxpayer has the money to cover the tax. However, the expatriate would have to post a bond and pay interest on the deferred taxes at the rate set for the underpayment of taxes. This rate fluctuates quarterly. It is currently 6%; it was 7% for the first quarter of 2008, and 8% for the last quarter of 2007.

Although an exit tax has a one-time application, the legislation has an ongoing effect on various non-grantor trusts, the income of which would be payable to beneficiaries who are expatriates. To make sure that the government gets its due, the trustee would be required to withhold 30% of any distribution of ordinary income, and the expatriate would be subject to tax on such income as if he or she were still a citizen or resident of the U.S. If appreciated property were distributed to the expatriate, the trustee would be deemed to have "sold" the property to the beneficiary and the trust would recognize any gain.

In addition, the legislation applies the mark-to-market regime to grantor trusts. Grantor trusts are generally those established for the benefit of others, but the grantor or settlor remains liable for the tax on any income or capital gain generated by the trust. Expatriated grantors of such trusts would be deemed to have sold all of the assets in the trust at fair market value at the time of expatriation, requiring the recognition of taxable gain in the year of expatriation.

Finally, any gifts or testamentary transfers by an expatriate to a U.S. citizen or resident which would otherwise not be subject to U.S. gift or estate tax would be subject to such tax under HEART. The U.S. recipient, instead of the donor, would be liable for such taxes.

ENHANCED FOCUS ON FIDUCIARY DUTIES UNDER ERISA

Recently, in *LaRue v. DeWolff, Boberg & Associates, Inc.*, the U.S. Supreme Court held that a participant in a 401(k) plan can sue an employer under the federal pension law known as ERISA for failing to timely follow a participant's investment instructions. This decision has sharpened the focus on an employer's role as a fiduciary under ERISA regarding 401(k) plan investment decisions. As a fiduciary, the employer retains responsibility under ERISA - not only for following participants' investment instructions, but also for selecting and monitoring the investment choices made available to plan participants. *LaRue* will make it easier for participants to bring viable lawsuits against employers for breach of fiduciary duty. In *LaRue's* aftermath, employers will be challenged to make investment decisions that satisfy ERISA's fiduciary standards and to minimize the risk of successful participant lawsuits.

Employers should follow a participant's investment instructions. However, the employer also should review how it satisfies *all* of its fiduciary obligations under ERISA. Prudently selecting and monitoring investment funds and monitoring the fees charged by these funds are central components of this process. Best practices also dictate that an employer obtain professional assistance in managing the two-part process of selecting and monitoring investment funds and monitoring the fees charged by these funds.

First, the employer should develop a formal investment policy statement (IPS) providing investment guidelines to follow in making plan-level investment decisions. Unless the employer retains the internal capability to analyze the myriad factors that should inform any plan-level investment decision, it should hire both an expert investment advisor and knowledgeable ERISA counsel to work with the employer to develop and *implement* the IPS.

Second, it is equally important for an employer to act in accordance with the guidelines set forth in its IPS. If the IPS requires the employer to establish an "investment committee" comprised of high-level officers and human resources personnel to meet on a quarterly basis to discuss investment matters, the investment committee should be established and such meetings should be held. Committee members and advisors should evaluate fund performance, fee levels, management and any other relevant factors, and decide whether to retain or replace each investment option. ERISA counsel would advise the committee of its options from a fiduciary compliance point of view and, if necessary, renegotiate excessive fee arrangements.

Discharge of fiduciary duties is all about process. An employer that establishes and follows a formal process minimizes its risk of liability under ERISA. In the aftermath of *LaRue*, doing so is absolutely critical.