PROSKAUER ROSE LLP

Personal Planning Strategies

A report for clients and friends of the Firm.

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In this issue:

Creating A "Grat": The Window of Opportunity May Be Closing

As we have previously advised many of our clients, creating a grantor retained annuity trust (commonly referred to as a "GRAT") is a relatively simple way to transfer property to your children at virtually no gift tax cost. In addition, because of the low interest rate environment and down markets, the advantages of creating a GRAT are magnified. When properly structured, a GRAT can pass to your children all of the future appreciation of the transferred property and reduce the value of the gift to virtually zero.

The most popular use of this device in sophisticated estate plans has been the short-term, "zeroed-out" GRAT, in which the term is limited to two or three years and the annuity amount is maximized in order to produce as small a taxable gift as possible. In this way, anticipated short-term growth in the trust assets can be availed of without risking longer-term uncertainty, and the risk of depreciation is virtually eliminated. Additionally, the death of the grantor of the GRAT during the two or three year GRAT term, which causes a GRAT to fail, is minimized through the use of a short-term GRAT.

When things are too good to be true, they often have a limited life. And, unfortunately, the GRAT may be no different, as the utilization of these short-term, "zeroed-out" GRATs may soon be prohibited. As part of President Obama's revenue proposals, which were proposed as a part of his 2010 budget, a new requirement would be imposed on GRATs requiring a minimum term of ten years for a GRAT. Although the revenue proposal would not prevent the use of a "zeroed-out" GRAT, it would substantially increase the risk of the grantor's death during the GRAT term and the resulting loss of any anticipated transfer tax benefit. Furthermore, with a long-term GRAT, the benefits associated with the rapid appreciation of an asset held by a GRAT could be offset by decreases in value over a longer period of time (i.e., hitting a "home run" is often less likely in a longer-term GRAT). There also has been some discussion in Washington regarding the elimination of the "zeroed-out" GRAT by requiring a minimum gift when a GRAT is created (i.e., ten percent of the value of the property transferred).

It is impossible to predict whether any of the above alternatives, or any changes to the laws regarding GRATs, will be enacted. However, if any new laws do get passed, it is likely that they would be prospective only, from the date of enactment.

If you would like to create a short term GRAT, or obtain more information on the benefits of a GRAT, please contact us immediately as the window of opportunity for this effective estate planning technique may be closing. Additionally, the June 2008 issue of *Personal Planning Strategies* contained an article entitled "Creating a GRAT: Heads You Win and Tails You Break Even" which is a detailed explanation of the operation of a GRAT. This article may be found at www.proskauer.com/news_publications/newsletters/Planning/2008_06_18.

Benefits of a Roth IRA Conversion in 2010

Introduction

Beginning in 2010, you will be eligible to take advantage of a new estate planning opportunity if you currently own a traditional individual retirement account or other qualified retirement plan ("IRA") and want to convert some or all of your IRA to a Roth IRA, but were reluctant to do so because of the immediate income tax liability that would be associated with the conversion or were prohibited from converting in the past because you earned too much income. With some advanced planning (which is why you want to start considering this opportunity now), your IRA can be converted and left for your heirs while also providing them with tax-free income for decades to come.

Traditional IRA versus Roth IRA

Traditional IRA

Under current law you can make contributions to a traditional IRA with "pre-tax" dollars. This means your investment is allowed to grow on a *tax-deferred* basis since amounts earned, including the contributions and appreciation, in a traditional IRA are not taxed until distributions are made to you. Traditional IRAs are subject to distribution requirements when you attain age 70½, also known as a "required minimum distribution" or RMD. In general, you must begin taking RMDs no later than April 1 of the year after the calendar year in which you reach age 70½, and the period for taking distributions cannot exceed the joint life expectancy of you and your beneficiary. The forced distributions from your IRA result in income tax to you each year after attaining age 70 ½ while continuously diminishing the tax-deferred amount remaining in your account.

Roth IRA

Contributions to Roth IRAs are made with “after-tax” dollars and, as a result, the appreciation inside a Roth account grows *tax-free*. Therefore, there is no income tax when you draw money from your Roth account in retirement or when distributions are made to you or your beneficiaries. In addition, the pre-death RMD rules imposed on traditional IRA owners described above do not apply to Roth IRA owners. Consequently, if you convert your traditional IRA to a Roth, you will not be required to take RMDs during your life! Although you will cease to be subject to the RMD rules after a conversion, a beneficiary receiving your Roth account after your death will be required to take RMDs over his or her life expectancy. However, unlike a traditional IRA, distributions received by your beneficiaries from an inherited Roth IRA will not be subject to income tax when received (they are income tax-free)!

How TIPRA Affects Conversions to a Roth IRA in 2010

On May 17, 2006, President George W. Bush signed the *Tax Increase Prevention and Reconciliation Act of 2005* (“TIPRA”) into law. TIPRA included a provision dealing with conversions of traditional IRAs to Roth IRAs. The current existing income limitation for converting a traditional IRA to a Roth (modified adjusted gross income under $100,000) will not apply in 2010. Thus, *all* individuals will be entitled to convert a traditional IRA to a Roth. If you decide to make a conversion, you will have to pay income taxes on the amount converted. However, if you make a timely conversion in 2010, you are eligible to have half of the converted amount taxed in 2011 and the other half taxed in 2012, effectively permitting you to “stretch out” (more on stretching later) the income taxes related to the 2010 conversion over two extra years, which will be due and payable on April 15, 2012 and 2013, respectively. *This tax deferral benefit applies in 2010 only*; thus if you make a conversion in 2011 or thereafter you must include in your gross income the conversion amount for the tax year in which the conversion is completed, in effect losing this one-time tax deferral benefit. Finally, removing the Roth IRA cap does not mean you can now fund a Roth IRA if you don’t already have one, but it does mean that you can convert your existing IRA to a Roth IRA.

Benefits of Roth IRA Conversions

Even though you are still responsible for the income taxes related to a conversion, there are significant tax benefits which can be achieved through a conversion which may be well worth the cost of paying the income tax currently rather than over time.

Let’s suppose that you have an IRA and do not need those funds for your retirement because you have plenty of other liquid assets. By converting that IRA to a Roth IRA during your lifetime, your converted Roth IRA will grow on a tax-free basis and will not be reduced by any RMDs once you attain the age of 70½. After your death, your heirs, if they wish, will be able to keep utilizing your Roth IRA as a "tax shelter" and obtain tax- free growth within the IRA during their lifetimes and not pay any income tax on the RMDs that they receive each year over their lifetimes. Thus, an inherited Roth IRA account is arguably more valuable than any of your brokerage or bank accounts because it allows your heirs an opportunity to receive tax-free growth within the Roth IRA for decades to come.

As mentioned above, after the IRA owner dies, a beneficiary will be required to withdraw money from the IRA over his or her life expectancy. In order to maximize the deferral period, many individuals name their grandchildren (or trusts for their grandchildren) as beneficiaries of their IRA because of their young age. With a Roth IRA, the benefits of naming a grandchild as a beneficiary are compounded.

The ideal candidate for a Roth conversion will have liquid non-IRA assets that can be used to pay the income tax due from the conversion. Even though converting will result in taxable income to you on the amount converted, in 2010 only, the government is giving you the opportunity to defer this liability over two extra years. We have many clients who reside in New York or other high income tax states. Some of these individuals plan to eventually move to Florida (or other states that do not have a state income tax) as a "snowbird" or a full-time resident. Such individuals who happen to have significant IRAs may want to consider changing their residency this year in anticipation of converting their IRAs in 2010. By doing so, the state (and city, if applicable) income taxes also would be avoided. For example, if a New York City resident with a $1 million IRA relocates to Florida and converts his IRA to a Roth IRA, up to $100,000 of income taxes may be avoided! If you need assistance regarding how to become a Florida resident and effectively give up another state's residence, please contact us.

Additionally, paying the income tax will lower your estate tax at the time of your death (because paying that liability will reduce the amount of your gross estate). However, like all assets you own, your Roth IRA still will be subject to estate tax at the time of your death. To achieve the desired result of not reducing the Roth IRA by the amount of estate tax due, you will need to provide that the estate taxes attributable to your Roth IRA be paid from other assets you own.

Another advantage of a Roth IRA conversion is that even though it makes sense to think of the amount converted as an account you will leave for your heirs, there is nothing precluding you from accessing the funds within the Roth IRA during your lifetime if your circumstances change and you need to withdraw some funds.

Conclusion

In sum, converting your traditional IRA into a Roth in 2010 is an excellent wealth transfer tool which you should consider taking advantage of now. If it is likely that you will not need the income from your IRA during retirement, a 2010 Roth conversion will offer you the following benefits: (1) suspends the lifetime RMD rules applicable to you allowing for continued tax-free growth in the account over your lifetime; (2) paying the income tax now, thereby effectively reducing your overall taxable estate, (3) allows you to stretch out the income tax due over a period of two extra years; and, most importantly, (4) transfers wealth to lower generations that can continue to compound free of income tax for many, many years into the future.

Double-Checking the Credit Equivalent Bequest in Your Will

The economic downturn combined with a decade's worth of increases to the amount that is excluded from estate taxation (the "credit equivalent amount") may mean that this amount currently comprises a greater percentage of your estate than you ever anticipated.

If so, a disposition of your credit equivalent amount to someone other than your spouse—which may have made sense when your estate plan was first formulated—may now render modest estates unable to provide for all of the intended beneficiaries.

Estate Tax Basics

Your credit equivalent amount effectively comprises the portion of your estate that is not subject to the Federal estate tax. Currently, this amount is $3.5 million (reduced by up to $1,000,000 for taxable gifts you may have made during your life), which means your estate will only be subject to Federal estate tax to the extent that your estate exceeds $3.5 million less the reductions above.

This exemption amount is not set in stone. For many years the exemption amount was $600,000, and as recently as 2001 the exemption amount had only risen to a modest $675,000. However, the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act") gradually increased the exemption amount over the course of the decade, peaking this year at $3.5 million.

Calendar Year	Federal Tax Exemption Amount
1987-1997	$600,000
1998	$625,000
1999	$650,000
2000-2001	$675,000
2002-2003	$1 million
2004-2005	$1.5 million
2006-2008	$2 million
2009	$3.5 million

Due to a "sunset" provision in the Act, the estate tax is set to be repealed entirely in 2010, only to reappear again in 2011 with an exemption of $1 million. However, it is likely that Congress will vote this year to prevent these sunset provisions from taking effect, possibly by maintaining the Federal estate tax at its current $3.5 million exemption amount and maximum 45% Federal estate tax rate.

The Credit Shelter Trust

The proper disposition of the credit equivalent amount is the cornerstone of estate planning for married couples. If the credit equivalent amount is set aside at the death of the first spouse in trust for the surviving spouse, significant tax savings can be achieved.

At present, a surviving spouse is not allowed to "inherit" a deceased spouse's right to exclude $3.5 million of his or her estate from the Federal estate tax. If the estate of the first spouse to die does not utilize that spouse's exemption amount (by setting it aside in trust as opposed to leaving that amount outright to the surviving spouse), that right of exclusion is lost forever.

At first glance, this may seem inconsequential, since all assets passing between spouses at death are exempt from the estate tax by virtue of an unlimited marital deduction. However, the lack of "portability" of the exemption amount of the first spouse to die can have major tax consequences at the death of the surviving spouse: his or her estate will contain the combined marital assets of both spouses, but will only be able to utilize the $3.5 million exemption of the surviving spouse at his or her death.

For instance, suppose a married couple has assets totaling $7 million—distributed equally between them—and the husband dies first and leaves his entire estate to his wife. When the wife dies, her estate will contain a total of $7 million in assets, only $3.5 million of which is exempt from taxation, since her estate may only apply her own individual exemption amount. The remaining $3.5 million is taxed at the maximum Federal rate of 45%, leading to a total Federal estate tax of $1,575,000.

Through careful estate planning, it is possible for such a couple to utilize both of their estate tax exemptions, allowing a total of $7 million in assets to pass to their descendants without Federal taxation. This is typically accomplished by employing a credit shelter trust—also known as a "bypass trust"—which allows assets to bypass the Federal estate tax that would otherwise be imposed upon the death of the second spouse.

If the husband in the above example had instead left his $3.5 million estate in trust for his wife (with full access for the wife to use the funds during her lifetime if necessary and with the remainder to his descendants at the death of his wife), the couple could have avoided the imposition of any Federal estate tax. The husband's estate could utilize his Federal estate tax exemption by funding the credit shelter trust with $3.5 million, and the wife's estate could utilize her exemption in regards to her individual assets of $3.5 million. As a result, the couple can pass $7 million to their children free of any Federal estate tax. This simple device would save the family $1,575,000 in Federal estate tax as compared to the prior example above.

Thus, by utilization of a credit shelter trust, a couple can double the amount of assets they may collectively exclude from Federal estate taxes. Additionally, any growth that occurs in the bypass trust also escapes estate taxation at the death of the surviving spouse.

Leaving Your Credit Equivalent Amount to a Nonspouse

Less often, and usually done in a second marriage, at the death of the first spouse to die, an estate plan may set aside the credit equivalent amount for beneficiaries other than a spouse, such as the Testator's descendants. If your estate plan makes such a distribution, we recommend double-checking your Will or revocable trust in light of your present net worth to determine how much will be left after your credit equivalent amount has been set aside. Calculating the actual dollar amounts that each of your beneficiaries would take today under your estate plan may be an eye-opening experience.

There is less urgency to review your credit equivalent amount if your estate plan employs a typical marital credit shelter trust. Such a trust likely allows discretionary distributions among your surviving spouse and descendants during your spouse's lifetime, then passes the remainder to your descendants. Since the trustees have discretion to distribute funds to those who need it most, such a trust avoids the worst-case scenario of unnecessarily providing for your children at the expense of your spouse. Even if your trust permits lifetime distributions only to your spouse, you can still be certain your assets will ultimately pass to your descendants.

If your credit equivalent amount is reserved solely for your descendants (or any other non-spouse beneficiary), a review of your estate plan is imperative, since you may be leaving your spouse dependent upon a portion of your estate that will be inadequate for his or her support. Although this plan may have made sense when the credit equivalent amount was lower and your net worth was greater, today you may be leaving your spouse a much lower percentage of your estate than you originally envisioned. Additionally, many states in the northeast (such as New York, New Jersey, Massachusetts and Connecticut) impose a state estate tax on a fully funded credit shelter trust. This will further reduce the amount of funds passing to your spouse.

Final Thoughts

If you have a large estate, it may make sense to leave the credit equivalent amount to your descendants at the first death. After all, why should your children have to wait until the death of both parents to receive a portion of their inheritance if there is more than enough assets to comfortably support the surviving spouse and the descendants? However, in light of the fact that neither the value of an individual's assets nor the exemption amount is set in stone, in order to avoid an unintended outcome, it is best (1) to use caution when reserving your credit equivalent amount for anyone other than your spouse and (2) to periodically review the actual dollar amounts that will pass to each of your beneficiaries given your net worth and the exemption amount then in effect.

If you have any questions as to whether your current estate plan distributes assets as you intend, please do not hesitate to contact us.

Are You a Resident of New York State for Income Tax Purposes?

If you move from New York State to another state, you may still be treated as a resident of New York State for income tax purposes. There are steps you can take to ensure that after you move you will not continue to be subject to New York State income tax.

New York State applies two separate tests to determine whether you are subject to New York State income tax. One is whether you are a "statutory resident" under New York law and the other is whether you are domiciled in New York.

Statutory Residency Test

You will be a statutory resident of New York State if you maintain a permanent place of abode in New York and spend more than 183 days of the taxable year in New York.

A "place of abode" has to be (1) suitable for human habitation during the year and (2) maintained.

If you own a vacation residence in New York that is not suitable to live in during the winter months, this is not a permanent place of abode. Similarly, if you own a cabin that is used for fishing during particular months of the year which is without electricity and heat for the remainder of the year, the cabin should not be treated as a permanent place of abode.

Whether you maintain a residence is a little bit trickier. If you contribute toward expenses of a residence you do not own but in which you reside, you may be considered to be "maintaining" a residence. You also will be treated as maintaining a residence if you own the residence and use it exclusively or have free and unlimited access to it, even if someone else pays the expenses.

The statutory residency test also calculates the amount of time you have spent in New York State. You will be considered a statutory resident of New York if you are not domiciled in New York but you maintain a permanent place of abode in New York and spend, in the aggregate, more than 183 days of the taxable year in New York. You do not have to own a home to be considered to have a "permanent place of abode" in New York; renting a home or apartment is sufficient. In addition, even a minute in New York constitutes a full day for these purposes, unless you are traveling through New York to get to another destination or you are required to stay in New York because of a medical emergency.

If you are domiciled in New York, you may still qualify as a nonresident for income tax purposes if, for a period of 548 consecutive days, you satisfy a three-part test: (1) you are out of the country for at least 450 days; (2) you are not present in New York for more than 90 days; and, (3) for tax years beginning prior to 2009, your spouse or minor children did not reside in your permanent place of abode in New York for more than 90 days. Beginning with tax year 2009, your spouse's or children's presence in New York, whether or not at a permanent place of abode, will subject you to New York tax.

Domicile Test

Domicile is defined as the combination of physical presence in a place and the intent to remain there indefinitely. Physical presence is easy to determine; your "intent to remain" somewhere, however, is harder to measure. In general, intent is a subjective determination based on your actions in a particular location.

Factors that Show Intent to Establish Domicile. The best proof of your domicile is where you say it is. However, New York State often looks to objective factors in analyzing proof of intent. New York State has developed residency audit guidelines to assist its auditors in determining domicile. The guidelines require the auditor to examine the following four primary factors, and if domicile still cannot be determined, a fifth factor will be considered:

(1) The home – The auditor will evaluate your use and maintenance of a New York "residence" compared to the nature and patterns of use of your non-New York residence. For example, the auditor will consider whether you own or rent the New York residence and where you celebrate holidays. The auditor also will consider the size and value of the residences.

(2) Active business involvement – The auditor will analyze your pattern of employment, as it relates to the derivation of your compensation. Business involvement also includes active participation in a New York trade, business, occupation or profession and/or substantial investment in, and management of, any New York closely held business such as a sole proprietorship, partnership, limited liability company or corporation. If you have New York source income, you will be subject to New York income tax on such income regardless of whether you reside in New York. New York source income consists of those items attributable to (a) the ownership of any interest in real or tangible personal property located in New York, which includes rental income, or (b) a business, trade, profession or occupation carried on in New York. Income from intangible personal property, such as dividends or interest, is considered New York source income to the extent the income is generated by property used in a business, trade, profession or occupation carried on in New York.

(3) Time – One of the more important considerations is where you spend time during the year. The time analysis is more involved than simply satisfying the "statutory residence test" by spending more than 183 days in New York State. The auditor will examine your overall living pattern to determine whether you have changed your domicile. For instance, the auditor will scrutinize (a) whether the time you spend in New York compared to another state has significantly changed, (b) your daily calendar entries and (c) your credit card bills and any other documents that provide evidence of where you spend your time.

(4) Items "near & dear" – Another factor in determining domicile is where you keep those items which you hold "near and dear" to your heart, or which have significant sentimental value, such as family heirlooms, works of art, collections of

books, stamps and coins, and those personal items which enhance your quality of lifestyle.

If the auditor is unable to make a domicile determination after reviewing these four primary factors, then the auditor looks to an additional primary factor: where do your close family members reside. As unfair as it may sound, the auditor will inquire as to where your spouse and children live. However, the location of your siblings and parents are usually not considered factors.

If the auditor still is unable to reach a conclusion based upon a review of these five factors, the auditor will then look at the following “other” factors:

(1) the address at which bank statements, bills, financial data and correspondence concerning other family business is primarily received;

(2) the physical location of the safe deposit boxes used for family records and valuables;

(3) location of auto, boat and airplane registrations, as well as your personal driver’s or operator’s license;

(4) indication as to where you are registered to vote and an analysis of the exercise of said privilege; the auditor should not limit the review to the general elections in November, but also question the taxpayer’s participation in primary or other off-season elections, including school board and budget elections;

(5) possession of a New York City Parking Tax exemption;

(6) an analysis of telephone services at each residence including the nature of the listing, the type of service features, and the activity at the location; and

(7) the citation in wills, testaments and other legal documents that a particular location is to be considered your place of domicile.

If you do not intend to be a New York domiciliary, it is important to sever all of your ties to New York and to take affirmative actions that demonstrate your intent to be domiciled in another state. It is equally important to make sure that you can demonstrate that you are not a statutory resident of New York State.

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