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Newsletters

Estate Planning Newsletter - December 2013

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***Hinshaw's Estate Planning Newsletter** includes reports on opportunities and challenges that may impact individuals' estate plans. This publication is designed to keep readers aware of such opportunities and challenges so that they may determine whether changes to their estate plans are necessary or desirable. Our goal is to provide the information necessary to ensure that readers are effectively providing for their loved ones, planning for the transition of their businesses, protecting their assets, and paying as little tax as possible.*

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Federal Estate Tax Provisions Became Permanent in 2013

The American Taxpayer Relief Act of 2012 made the following federal estate tax provisions permanent as of January 1, 2013:

1. The basic applicable exclusion amount (i.e., the "tax-free amount") is now $ 5 million plus adjustments for inflation. This means that each taxpayer may transfer up to $5 million (plus the inflation adjustment) of value tax-free during his or her lifetime or at death. Married couples may transfer up to

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$10 million (plus the inflation adjustment) of value during their joint lifetimes. The inflation adjustment is $250,000 in 2013 and will be $340,000 in 2014.

2. A spouse's unused applicable exclusion amount may be able to be used by a surviving spouse under some circumstances. This provision is referred to as "portability" and may help married couples who have not planned efficiently still avoid federal estate taxes. A federal estate tax return must be filed upon the death of the first spouse if portability is intended to be used by the surviving spouse.
3. The maximum federal estate tax rate will be 40 percent. This rate also applies to the federal gift tax and generation-skipping transfer tax.
4. State death taxes will continue to be allowed as deductions rather than as credits. Therefore, state estate tax laws based on the federal state death tax credit formula will not be effective. For example, the estate tax law in Florida will not apply until the Florida statute is changed by its legislature.
5. The general rules for valuations did not change. Therefore, grantor retained annuity trusts and family limited partnerships remain viable opportunities.

Because we now seem to have a stable planning environment, all taxpayers should consider taking the following actions:

1. If you are married, the marital trust allocation formula in your will or trust declaration should be reviewed as soon as possible. It is quite possible that it will not work the way that it was intended. Because the federal tax laws now seem permanent, amending your trust may be a good idea.
2. If you are married, you should review the balance of assets between spouses so that both spouses can use their full tax-free amounts. Portability does not apply to the Federal generation-skipping tax or many state estate taxes.
3. If you have not yet planned for your business transition, you should do so now. It takes a long time to plan for a successful business transition. The tax law change allows us to plan efficiently for the needed ownership transfers.

Additional 3.8% Medicare Tax Imposed on Trust and Estate Income

Beginning in 2013, trusts and estates will be subject to an additional 3.8% Medicare tax on "net investment income" in excess of $11,950. Net investment income includes interest, dividends, rents (unless the trustee is actively participating in a real estate business), royalties, capital gains and income from a trade or business (unless the trustee is actively participating in the business). This new rule will put an additional income tax burden on any trust or estate that does not distribute most of its net investment income.

A trust or estate may mitigate this additional cost by distributing income to beneficiaries who are in lower income tax brackets and who are not subject to the 3.8% Medicare tax. With the proper election, distributions made within 65 days after a year end can be considered on the prior year's income tax return. By using the 65-day rule, a trustee can calculate a trust's net investment income before having to make the distribution of such income.

Proper selection of trustees and co-trustees will be important in avoiding additional income taxes on passive income from real estate activities and passive income from trades or businesses.

Large Gifts Remain Good Estate Tax Planning Tools

The applicable exclusion amount (i.e., the "tax-free amount") related to federal gift tax is now $ 5 million plus adjustments for inflation. This means that each taxpayer may transfer up to $5 million (plus the inflation adjustment) of value tax-free during his or her lifetime or at death. Married couples may transfer up to $10 million (plus the inflation adjustment) of value during their joint lifetimes. The inflation adjustment is $250,000 in 2013 and will be $340,000 in 2014.

If you are lucky enough to be in a taxable position, making large gifts is still good estate tax planning. First, all appreciation occurring and all income generated after the gift is made will avoid federal estate taxes. Because of the power of compounding, this benefit can be extremely significant—particularly if generation-skipping transfer trusts are used as gifting vehicles. Second, if the donor creates an intentionally defective grantor trust, all future income taxes paid on trust income by the donor will not count as additional gifts. This is very tax efficient. Third, there is no guarantee that Congress will not change its collective mind again in the future and reduce the $5 million tax-free amount. Finally, the recipient can enjoy the property transferred now and the donor will be alive to observe the benefits passed on to a younger generation.

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If you will have a taxable estate, and have not yet made a large gift, you should consider making such gifts now. Gifting to newly created generation-skipping trusts, intentionally defective grantor trusts and grantor annuity trusts are particularly efficient.

Federal Annual Exclusion Gift Amount Remains at $14,000

“Annual exclusion” gifts are relatively small gifts that may be made tax-free to a recipient. The annual exclusion limit for 2013 is $14,000 per recipient and will remain at $14,000 per recipient in 2014. Individuals who have the resources with which to make annual exclusion gifts should seriously consider doing so as these gifts generally need not be reported for gift or estate tax purposes and will pass tax-free to the recipient. Note that the annual exclusion limit includes all gifts made to an individual recipient during the year; special rules apply for gifts to trusts. If the recipients are grandchildren or trusts for grandchildren, generation-skipping implications will also need to be considered. Note also that a recipient will receive a carried over basis in any property received, so income tax implications will need to be evaluated too. Annual exclusion gifts may be made in cash or other property and can be leveraged with certain discounting techniques.

Low Interest Rates Still Offer Opportunities

Interest rates remain at historically low levels. Therefore, this is an excellent time to sell assets to a family member on an installment basis or loan money to a family member at extraordinarily low rates of interest. This is particularly true when planning for business transitions. Gifting to newly created generation-skipping trusts, intentionally defective grantor trusts and grantor annuity trusts are especially efficient.

Now Is the Time to Plan for Business Successions

Although the economy is not great, the values of businesses appear to be improving. Before values become too high, it would be a good time to consider transitioning a business via a gift and/or sale at fair market value. This would allow you to freeze the value of your estate and allow all of the future appreciation to be transferred to family members. Sales to intentionally defective grantor trusts are particularly useful with proper planning. Many families have recapitalized their businesses to allow for voting and non-voting shares in anticipation of gifting the non-voting shares. The opportunity to transfer a business tax efficiently will diminish as soon as business values increase. This is an opportunity which should not be wasted.

If it is your intention to retain your business interests until your demise, it will be critical to plan for liquidity in your estate. Estate taxes are based on value. Quite often, the assets held by the business are illiquid and the ability to pay estate taxes becomes problematic. In such a case, a number of alternatives need to be considered. For example, it may be possible to pay estate taxes related to the business interest in installments under some circumstances. It may also be possible to use special redemption rules to redeem the business interest and thereby provide cash with which to pay estate taxes and administration expenses tax efficiently. When planning to address estate taxes, serious consideration must also be given to the use of life insurance to provide liquidity and the use of valuation techniques to avoid over valuing the ownership interest in a business.

Selling to an ESOP May be a Possible Exit Strategy for a Closely-Held Business Owner

Transitioning a closely-held company is not easy. An owner of a closely-held company often wants to convert a portion of his or her shares into cash to reduce investment risk. An owner who is evaluating complete exit strategies should consider selling his or her shares to an ESOP among the possible choices.

An ESOP, or an “employee stock ownership plan,” is a type of employee benefit plan that invests primarily in employer stock. An ESOP provides certain tax advantages that are not generally available to other potential buyers. Sales to ESOPs are typically used as a succession tool for owners of closely-held companies. ESOPs who buy closely-held stock can borrow the purchase price at an attractive after-tax cost and also provide additional employee benefits to the company’s employees.

Selling some or all of a closely-held company to an ESOP offers significant tax incentives that are not available in traditional sales transactions. One key advantage is that an owner who sells a portion of the company to the ESOP can still retain control over the company.

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When considering whether an ESOP is a viable and sustainable option for a company, the owner should consider the following: (1) value of the company; (2) company's history of profitability; (3) company's debt capacity; (4) strength of the current management team (and/or a management team succession plan); (5) number of employees at the company; (6) amount of the company's payroll; and (7) company's employee turnover statistics.

Contact your current Hinshaw lawyer to discuss the uses and benefits of an ESOP, including how it can be used to create a liquidity event or entirely exit a closely-held company.

The IRS Will Treat Lawfully Married Same-Sex Couples as Married For All Federal Tax Purposes

The IRS issued IR 2013-72 and Revenue Ruling 2013-17 on August 29, 2013. By doing so, the IRS has resolved one of the key issues which was left open by the Supreme Court's decision in *U.S v. Windsor*. It is now clear that the IRS will treat lawfully married same-sex couples as married for all federal tax purposes regardless of where the couple might reside. This means that lawfully married same-sex couples will be treated as married for all federal tax purposes, including filing jointly, alimony deductions, innocent spouse relief, favorable IRA and qualified retirement plan beneficiary payment periods, and tax-free employee benefits (especially tax-free employer health coverage for spouses). Beginning in 2013, lawfully married same-sex couples must file federal income tax returns jointly or as married filing separately.

With regard to federal gift taxes, same-sex couples will be allowed to transfer unlimited amounts of property between one another without subjecting themselves to gift taxes. They will also be allowed to split gifts and thereby maximize the combined gifting capacities.

With regard to federal estate taxes, same-sex couples will be allowed to transfer unlimited amounts of property between one another at death. Marital trusts can now be used to protect same-sex spouses while maximizing each spouse's federal taxfree amount. Portability of a deceased spouse's unused federal tax-free amount is now possible.

All lawfully married same-sex couples should file all 2013 federal income tax returns and gift tax returns as married taxpayers. All other federal income tax returns and gift tax returns due, but not yet filed, should also be filed as married taxpayers. If a lawfully married same-sex partner died in 2013 and the federal estate tax return has not yet been filed, the Form 706 should be filed as a married taxpayer and transfers to the surviving spouse may be eligible for the marital deduction.

As a general rule, refund claims for federal income, gift and estate taxes must be filed within three (3) years of the extended due date or within two (2) years after the tax was paid, whichever is later. Because the U.S. Supreme Court struck down Section 3 of Defense of Marriage Act, refund claims are now possible unless the respective statutes of limitation have expired. All lawfully married same-sex couples should consider filing refund claims for all federal taxes paid (including income, gift and estate taxes) within the respective unexpired statute of limitations. Note, however, that all lawfully married couples will not benefit from filing joint income tax returns.

Certain estate planning techniques, particularly the use of marital trusts and the portability of the decedent's unused tax-free amount, should now be considered. Balancing assets between the spouses tax-free should also be considered for tax planning purposes. Therefore, all lawfully married same-sex couples should consider having their respective estate plans reviewed and updated.

There are a number of property and other statutory rights which remain dependent upon state law. Only spouses have homestead rights, intestacy rights, preference on being executors, the right to elect against a will, and the ability to hold real estate as tenants by the entirety. Only spouses have a right to community property, possible liability for family medical expenses and a statutory preference as a health surrogate. Divorce laws only apply to spouses. If the state of residence does not recognize a same-sex marriage, none of these rights will be conferred upon same-sex spouses for state law purposes—including for state income tax and state estate tax purposes.

Revenue Ruling 2013-17 does not extend to partners in domestic partnerships or parties in civil unions. Because the Windsor case was limited to lawful marriages, domestic partnerships and civil unions are not treated as marriages for federal law purposes. Therefore, if federal law benefits are important to the parties, such same-sex couples may now wish to become lawfully married in a state which allows same-sex marriages.

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Illinois Will No Longer Tax Estates Worth Less Than $4 Million

Illinois will no longer tax estates worth less than $4 million. However, if an estate is worth more than $4 million, Illinois will tax the entire estate, not just the portion exceeding $4 million. Therefore, planning for the Illinois estate tax will become significant in many estates in Illinois.

Minnesota Adopts a Gift Tax With a $1 Million Tax Exempt Limit

Beginning in 2013, Minnesota imposed a state gift tax on its taxpayers. Taxpayers who make lifetime aggregate gifts in excess of $1 million will be subject to tax in Minnesota.

Marital Trust Allocation Formulas Should Be Updated Now in Illinois and Minnesota

Because the federal estate tax tax-free amount exceeds the Illinois and Minnesota estate tax exemption amounts, the decoupling of Illinois and Minnesota estate taxes from the federal estate tax has created significant complexities in the estate plans of married couples residing in those states.

Historically, married couples in Illinois used A/B trust provisions to ensure that no estate taxes would be due on the death of the first spouse. A credit shelter trust (i.e., the “B” trust) would receive the federal tax-free amount (i.e., the basic exclusion amount in today’s nomenclature) and a marital trust (i.e., the “A” trust) would receive the balance. Power of appointment marital trusts were often used in first marriage situations. Wills or trusts that still use these traditional approaches may need to be updated because there may be unintended Illinois and Minnesota estate tax consequences upon the death of the first spouse and/or the second spouse.

Beginning in 2013, the historical approach to allocating value between a credit shelter trust and a marital trust based solely on the federal estate tax tax-free amount may cause unnecessary Illinois estate taxes upon the death of a second spouse whenever the combined family assets (including life insurance) exceed $4 million. The same is true in Minnesota whenever the combined family assets (including life insurance) exceed $1 million.

Because Illinois allows an “Illinois-only” marital deduction for QTIP (qualified terminable interest property) marital trusts, the discord caused by the difference between the federal estate tax tax-free amount and the Illinois exemption amount can emitigated. However, the executor or trustee must timely make the necessary special election on the Illinois estate tax return. Note that Illinois only allows a marital deduction for QTIP marital trusts, not power of appointment marital trusts. Therefore, no “Illinois-only” QTIP election is available for a power of appointment marital trust. This may result in the unnecessary imposition of Illinois estate taxes in some circumstances unless the operative will or trust instrument is updated to address the Illinois tax law changes.

Minnesota does not have a “Minnesota-only” QTIP deduction, so planning for state estate taxes in Minnesota is particularly difficult. Fortunately, the federal estate tax portability provisions will help mitigate this issue significantly in most estates.

Indiana’s Inheritance Tax Repealed

Indiana’s inheritance tax was repealed in 2013. Further, estate tax and generation-skipping tax will remain dormant for the foreseeable future.

Estate Planning Developments in Florida

Because Florida’s estate tax is tied to the federal state death tax credit, Florida’s estate tax will remain dormant for the foreseeable future.

Florida amended its statutory health surrogate and durable power statutes in 2013. This would be a good time to update both documents if you are a Florida resident.

Finally, a number of taxpayers are considering changing their domiciles to Florida in order to reap significant tax planning benefits. This should not be attempted without the advice of counsel.

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Asset Protection for the Middle Class

Asset protection features are available to the middle class as well as to the wealthy. Insurance is always the first line of defense. Be sure that you have adequate homeowner's insurance, car insurance, disability insurance and a liability umbrella. Consider investing in "protected assets" such as qualified retirement plans and assets held as tenants by the entirety. (Note that Florida does not limit assets which can be held as tenants by the entirety to principal residences.) For the wealthy, domestic asset protection trusts formed under the laws of Alaska, Delaware, South Dakota and several other states are increasingly being used for asset protection purposes. Offshore trusts are also available, but remain costly to create and administer.

Trustees of Irrevocable Life Insurance Trusts Need to Beware

Being the trustee of an irrevocable life insurance may come with personal liability if the trustee is unaware of his or her duties and breaches such duties as a result. Unless liability is limited in the respective trust agreement and such restrictions are enforceable under state law, a trustee can be held personally liable for failing to act as a prudent investor would act or failing to follow the terms of the trust.

Each trustee must become familiar with the controlling trust agreement. Next, each trustee must fully understand his or her duties and responsibilities under the trust agreement and state law. Third, each trustee must keep advised of his or her fiduciary duties to the beneficiaries and his or her personal liability exposure for breaching such duties. Finally, each trustee is allowed to seek legal advice and pay for such costs from trust assets.

Each trustee must manage all trust assets proactively in accordance with the trust agreement and the prudent investor rule. Each trustee should periodically review the trust's portfolio with an insurance advisor to insure that the life policy held remains a suitable investment for the respective trust and immediately take action if it is no longer suitable. There are many existing life insurance policies which no longer make economic sense. Without the proper review of policies owned by a trust a trustee could be caught in a whipsaw if the beneficiaries assert that the trustee has not been doing his or her job properly.

Health Care Documents for College Students

When a child attains the age of majority, his or her parents are no longer entitled to access to the child's medical records, to talk to the child's medical care providers about the child, or to communicate with the child's medical insurance provider about the child, unless the child consents. This can be problematic because the parents often provide for the medical insurance and drug benefits for such child. Should the child request help from the parents, neither the health care provider, nor the medical insurance carrier nor the drug company is permitted talk to the parents about the child. Further, university health care clinics and hospitals will not generally communicate or share confidential medical information with the student's parents unless they have the appropriate health care documents on file. Before a child heads off for college, he or she should seriously consider executing a health care directive. The directive should grant the child's parents access to his or her medical records and give the parents authority to act for the child with regard to medical matters.

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