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Newsletters

Estate Planning Newsletter - December 2014

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

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Federal Estate Tax Update

The basic applicable exclusion amount (i.e., the "tax-free amount") for federal estate tax purposes will increase from $5.34 million to $5.43 million in 2015. Therefore, married couples may transfer up to $10.86 million of value during their lifetimes or at death after 2014—provided that their estates are planned properly. The maximum federal estate tax rate will remain at forty percent (40%). This rate also applies to the federal gift tax and the federal generation-

Attorneys

Albert C. Angelo

Steven W. Cutler

James W. Keeling

Kevin J. Moore

Marcia L. Mueller

Service Areas

Estate Planning & Wealth Preservation

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skipping transfer tax. Note that a deceased spouse's unused "tax-free" amount (i.e., the deceased spouse's unused applicable exclusion amount) may be able to be used by the surviving spouse under some circumstances. This provision is referred to as "portability" and may help married couples who have not planned efficiently avoid federal estate taxes nevertheless. 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.

Change in Emphasis to Income Tax Planning for Many Estates

Because the "tax free" amount for federal estate tax purposes will exceed $5.43 million per taxpayer in 2015, very few families will be subject to the federal estate tax going forward. Since planning for the federal estate tax is becoming of less importance, planning for income tax savings becomes more significant for most families.

When it comes to property, a taxpayer's cost is its basis of the property for federal income tax purposes. However, when a taxpayer holds property until death, the basis of the property for federal income tax purposes steps up or down to the property's fair market value as of the taxpayer's date of death. This means that a beneficiary that sells inherited property immediately after the decedent's death should not have to recognize a gain or loss on the sale. In other words, when a taxpayer has low basis property with a high fair market value, the built in capital gain existing as of the taxpayer's death is never recognized by anyone. This "step up" rule does not apply to lifetime gifts.

When a taxpayer gifts property during his or her lifetime, the donee's tax basis in the property received will equal the taxpayer's adjusted cost basis in the property at the time of the gift (or the fair market value of the gift, if less). We call this "carry over" basis since the donee's basis for federal income tax purposes carries over from the donor. This means that a donee that sells property immediately after it is received as a gift will have to recognize a gain on the sale of the property. In other words, when a taxpayer has low basis property with a high fair market value, the built in capital gain existing as of the time of the gift is passed on to the donee.

These rules can be summarized in a couple of sentences. If a taxpayer has an estate which will not be taxed for federal estate tax purposes, there is no tax reason to make taxable gifts of appreciated assets during the taxpayer's lifetime. (However, there are still many non-tax reasons to make lifetime gifts.) If a taxpayer will have a taxable estate for federal estate tax purposes, the taxpayer should still consider making lifetime gifts in order to reduce federal estate taxes.

Here is one last idea for married couples. If you are married and your combined estates total less than (a) the $5.43 million federal applicable exclusion amount, or (b) the relevant state exclusion amount (i.e., $4.0 million in Illinois), whichever is less, you should re-evaluate the provisions in your revocable trust as it may no longer be optimal tax planning to hold assets in a credit shelter trust. If all of the property is transferred directly to a surviving spouse upon the death of the first spouse, the remaining property may be stepped up a second time for federal income tax purposes upon the death of the second spouse.

Federal Annual Exclusion Gift Amount Remains at $14,000

"Annual exclusion" gifts are relatively small gifts that do not have to be reported. The annual exclusion limit for 2014 is $14,000 per recipient and will remain at $14,000 per recipient in 2015. If you have the resources with which to make annual exclusion gifts, we highly recommend doing so as these gifts do not generally need to 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 gift recipients are your grandchildren or trusts for your 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.

Illinois Does Not Tax Estates Worth Less Than $4 Million

Illinois no longer taxes 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. The state adopted its own qualified terminable interest property ("QTIP") marital trust, which will allow a certain type of gift to your spouse that will not be subject to Illinois estate tax at your death, but will allow full use of your federal estate tax exclusion amount. However, it did not adopt the federal portability provision discussed above. Therefore, a surviving spouse cannot use a deceased spouse's Illinois "tax-free"

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amount. This means that Illinois estate taxes will now be a significant planning issue. What exposure to Illinois estate taxes could you have?

Minnesota Estate Tax and Gift Tax Changes in 2014:

Minnesota was a busy place this year. First, the Minnesota gift tax enacted during 2013 was repealed retroactively to the date of its enactment. Second, although the Minnesota gift tax was repealed, the “three-year look back” rule was not repealed. Therefore, gifts made within three years of death will still be treated as being part of the decedent’s estate in Minnesota. Third, Minnesota adopted a Minnesota QTIP election for QTIP marital trusts, which will ensure that there should be no Minnesota estate taxes due when the first spouse dies after properly planning his or her estate. Finally, the Minnesota estate tax exemption amount was increased to $1.2 million in 2014. After 2014, the Minnesota estate tax exemption amount will increase by $200,000 each year until 2018 as follows:

2015 — $1.4 million
2016 — $1.6 million
2017 — $1.8 million
2018 — $2.0 million

Large Formula Gifts Have Vitality Under the Wandry Case

If you are in a taxable position for estate tax purposes, making large gifts now is still good estate tax planning for the following reasons:

- First, all appreciation occurring and all income generated after the gift is made will avoid federal estate taxes in your estate, and possibly the estate of your beneficiaries if certain types of gifts in trust are utilized. Because of the power of compounding, this benefit can be extremely significant—particularly if trusts where the funds are held in trust for the benefit of multiple future generations are used as gifting vehicles, known as generation-skipping trusts.
- Second, if you create an intentionally defective grantor trust, all future income taxes paid on trust income by you will not count as additional gifts and, therefore, results in a very tax efficient strategy.
- Third, there is no guarantee that Congress will not change its collective mind again in the future and reduce the $5.43 million tax-free amount.
- Finally, the gift recipient can enjoy the property transferred now and the donor will be alive to observe the benefits passed on to a younger generation.

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

If you are interested in making a large gift and are concerned about not going over your remaining “tax-free” amount, consider making a “formula gift”. A formula gift means that you give the exact number of corporate stock shares or partnership units needed to equal your remaining “tax-free” amount based on a formula described in a gift letter or other transfer instrument. Such gifts are based on the Tax Court’s ruling in *Wandry v. Comm’r,* TC Memo 2012-88.

Low Interest Rates Continue to Offer Wealth Transfer Opportunities

Although interest rates may rise in the future, currently they remain at historically low levels. Therefore, this is still 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.

Additional 3.8% Medicare Tax Imposed on Trust and Estate Income

Trusts and estates are 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 rule puts an additional income tax burden on any trust or estate that does not distribute its net investment income. A

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trust or estate may mitigate this additional cost by distributing net investment 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 into the new year can be considered on the prior year's income tax return. The benefit of the 65-day rule is that a trustee can calculate a trust's net investment income before having to make the distribution of such income.

Selection of Trustee May Impact Taxation of Business Income

As noted above, a trust's net investment income is subject to an additional 3.8% Medicare tax. Net investment income does not include income from a trade or business whenever the trustee is actively participating in the business. Therefore, the proper selection of trustees and co-trustees will be important in avoiding the additional 3.8% Medicare tax on business income such as income passed through to the trust from S corporations and limited liability companies.

The IRS believes that the trustee must materially participate in the business as a trustee. However, the U.S. Tax Court in *Frank Aragona Trust v. Comm'r*, 142 T.C. No. 9 (2014), has now held that an individual trustee may materially participate in the business in another capacity and still meet the material participation requirement. Notwithstanding this new case, it is still not clear how a corporate trustee could ever meet the material participation requirement. There are some planners who believe that appointing an individual co-trustee that materially participates in the business may be enough. It may be some time before the parameters of this rule are fully known.

Now Is the Time to Plan for the Sale of a Business

If your estate plan includes selling your business, you may need to start laying the groundwork now. Because businesses are often sold based upon a multiple of earnings before interest, taxes, depreciation and amortization ("EBITDA"), it is critical to establish several years of strong EBITDA performance that trends upward. Therefore, it is important that revenues are increased and expenses are reduced for several years prior to sale in order to maximize the company's EBITDA. The company balance sheet also needs to be cleaned up by writing off worthless assets, promptly collecting receivables, paying off excess debt, and shedding unnecessary assets. Finally, the management team should be locked in using change of control agreements and/or employment agreements. Following these steps in the years leading up to the sale will help increase the marketability and the value of your business.

Planning for Business Successions Within a Family

If you intend to transition your business to family members, it would be wise to do so tax-efficiently. Because the values of businesses have generally started to improve, it is important to plan now to transition your business before the value becomes too high. Consider transitioning your business now via a gift and/or sale at fair market value. This would allow you to freeze the value of your business within your estate. By entering into this type of transaction now, future appreciation of the business itself can 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 the value of the business increases.

Eligible S Corporation Shareholders/Trusts

If S corporation shares are transferred to an ineligible S corporation shareholder, the corporation's S election will be automatically terminated. Obviously, no one wants this to happen. For estate planning purposes, we often want trusts to own S corporation shares. However, only certain types of trusts are eligible S corporation shareholders. Therefore, the possibility of transferring S corporation shares to an ineligible trust needs to be avoided with good planning. A revocable trust is an eligible S corporation shareholder during the grantor's lifetime and for two years after the grantor's death. Certain "qualified S corporation trusts" such as marital trusts are eligible S corporation shareholders, so long as the appropriate elections are timely made. Certain "electing small business trusts" are also eligible S corporation shareholders. Electing small business trusts include typical credit shelter trusts and irrevocable gift trusts provided that appropriate elections are timely filed. If S corporation shares are to be transferred to a trust under your estate plan, the S corporation shareholder rules need to be considered and the elections must be timely filed in order to avoid serious, negative tax consequences.

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New Statutory Power of Attorney Form in Illinois

The Power of Attorney for Health Care form is a significant tool in the estate plan of any individual. This document allows a chosen agent to direct decisions for your health care treatment if you are no longer able to do so yourself. Effective January 1, 2015, Illinois has changed its statutory form. However, previous statutory versions of the Power of Attorney for Health Care form remain effective. Thus, if your current form still reflects your desired directives, it is still valid. The new form actually appears to be more rigid than the old one and differs in the following ways:

- The new form offers only two options to assist your agent in making crucial end of life decisions. The previous one offered three, giving more flexibility to your agent to consider the totality of the situation.
- Regarding organ and tissue donation, the new form offers your agent general, but not specific, directives, whereas the old form offered your agent instructions regarding which organs could be donated and for what purpose.
- While still allowing you to delegate authority for disposition of remains, like the previous form, the new form lacks the additional benefit of explicitly directing that the organization disposing of your remains abides by your agent's instructions. Although your current Power of Attorney form will still be legally effective, this is a good opportunity to review the terms and language of this important estate planning tool.

Transfer on Death Instruments for Real Estate

Many states have now adopted a law that permits the owner of real estate to pass title upon his or her death without a probate proceeding and without using joint tenancy by right of survivorship. For smaller estates, this approach allows a parcel of real estate to be transferred without the need for probate and may allow the remainder of the assets to be transferred using a small estate affidavit.

The instrument is called a "Transfer on Death Instrument" in Illinois and a "Transfer on Death Deed" in other states. The transfer on death instrument must be executed with formalities similar to a will. After the death of the transferor, the transferee must record a document accepting the transfer before the transfer of real property is considered effective. If the transferee does not want the real property, it is possible for the transferee to avoid taking title by refusing to file the acceptance form. If the transferee fails to file an acceptance, the real property will transfer in accordance with the transferor's will or via intestacy, depending on whether or not the transferor was testate. A transfer on death instrument may be revoked during the transferor's lifetime should the transferor choose to do so.

Tenancy by the Entirety Asset Protection in Florida

Many states, including Illinois, allow a married couple to hold their principal residence as tenants by the entirety. Upon the death of one tenant, the other tenant becomes the sole owner of the property by operation of law much like a surviving joint tenant would do. However, during the lifetime of both spouses, the property cannot be sold to pay debts or be partitioned unless both spouses are subject to the same debt or agree to the division. This form of ownership has strong asset protection implications and is the typical form in which to hold title to a principal residence in most states.

Florida is an anomaly. In addition to allowing spouses to own real property as tenants by the entirety, Florida allows spouses to own bank accounts and investment accounts as tenants by the entirety. This makes Florida a very attractive venue for asset protection planning. If asset protection is important to you, you should consider taking advantage of this opportunity.

Inherited IRAs Are Not Protected in Bankruptcy

Qualified retirement plans and individual retirement accounts are generally protected assets for asset protection purposes. However, the U.S. Supreme Court has now held that inherited IRAs are not protected assets under the federal bankruptcy act. *Clark v. Rameker,* 134 S.Ct. 2242 (2014). This may have a significant impact on one's decision to file bankruptcy becaus inherited IRAs are now exposed to potential creditors. Note, however, that *Clark v. Rameker* did not change the status of qualified retirement plans and individual retirement accounts under the bankruptcy act.

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Litigation Against Trustees

In addition to their other fiduciary duties, trustees are required to maintain good books and records. We have seen a number of cases in the last year where trustees have been sued personally for failing to keep full and adequate records of cash receipts, cash disbursements, investments, and the basis for key decisions. This has led the trustees to expose themselves to significant personal liability for any amounts which cannot be explained. It is best to maintain good records. If good records have not been kept, it is essential to address the problem proactively before litigation ensues. Courts are not tolerant of trustees who fail to meet one of their most basic duties.

Proceeds of Life Insurance-General Rule of Includability

The Internal Revenue Code requires the inclusion in a decedent's gross estate proceeds of life insurance on the decedent's life whenever (a) it is receivable by decedent's estate, or (b) the decedent possessed an "incidents of ownership" in the policy on his or her date of death. Therefore, when you hear that life insurance proceeds are not taxed, that is an incomplete statement. Life insurance proceeds are not taxed for income tax purposes, but may be taxed for estate tax purposes. In addition, the value of life insurance proceeds remain includable in a decedent's gross estate if the decedent transferred the policy within three years of the decedent's death. Therefore, you cannot give away a life insurance policy immediately before your death as a way to avoid estate taxes on the life insurance proceeds.

Current Status of Same-Sex Marriage in the United States

The last time same-sex marriage was reported in this newsletter, 17 states and the District of Columbia recognized same-sex unions. The year 2014 witnessed challenges to same sex-marriage bans in virtually every state other than those 17. State bans on same-sex marriages have been falling around the country. The Federal Appellate Courts in the Fourth, Seventh and Ninth Circuits all affirmed lower court decisions declaring the state ban unconstitutional. With the United States Supreme Court's refusal to grant certiorari in the three circuits, the number of states recognizing same-sex marriages has increased to 32, along with the District of Columbia. Of the remaining 18 states, both federal and state judges have struck down the state's ban in Arkansas, Florida, Kansas, Missouri and Texas. A Texas Federal Judge's declaration that the Texas ban was unconstitutional is on appeal before the US Court of Appeals for the Fifth Circuit in New Orleans.

On November 6, 2014, the US Court of Appeals for the Sixth Circuit sitting in Cincinnati allowed four states to prohibit same sex unions. Those states include Ohio, Michigan, Kentucky and Tennessee. Courts in those states had previously struck down same-sex marriage bans. The Sixth Circuit's 2-1 ruling bears watching. Undoubtedly the Sixth Circuit's decision will be appealed to the United States Supreme Court, as the decision is squarely at odds with the determinations in the Fourth, Seventh and Ninth Circuits. Indeed, Supreme Court Justice Ruth Bader Ginsburg recently stated that the Supreme Court is closely watching the Sixth Circuit Court of Appeals' ruling. Justice Ginsburg said "there will be some urgency" for the Supreme Court to make a decision as to same-sex marriage rights if the Sixth Circuit upholds the ban on same-sex marriage.

Other than the four states within the Sixth Circuit, the following states currently maintain same-sex marriage bans: Alabama, Arkansas, Florida, Georgia, Kansas, Louisiana, Mississippi, Missouri, Montana, Nebraska, North Dakota, South Carolina, and South Dakota and Texas. In light of Justice Ginsburg's comments at the University of Minnesota School of Law, the pressing question is whether the Supreme Court will address the Sixth Circuit decision on an expedited basis before the 2015 term ends in June. The Supreme Court did grant an expedited review of the Fourth, Seventh and Ninth Circuit decisions.

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