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Newsletters

Estate Planning Newsletter - December 2015

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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 our clients and friends aware of certain 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.

Federal Estate Tax Update

The basic applicable exclusion amount (*i.e.*, the "tax-free amount") for federal estate tax purposes will increase from $5.43 million to $5.45 million in 2016. Therefore, married couples may transfer up to $10.9 million of value during their joint lifetimes or at death after 2015—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-skipping transfer tax. Note that a deceased spouse's unused tax-free amount (*i.e.*, the deceased spouse's unused applicable exclusion amount), under some circumstances, may be able to be used by the surviving spouse, a provision known as "portability". 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. **Portability** does not apply to the federal generation-skipping transfer tax or state estate taxes. Portability, nevertheless, an be a useful tactic for married couples who have not planned efficiently to avoid federal estate taxes.

Take Advantage of Federal Annual Exclusion Gifts

"Annual exclusion" gifts are relatively small gifts that do not have to be reported. The annual exclusion limit for 2015 is $14,000 per recipient made by an individual. The limit will remain at $14,000 per recipient in 2016. **If you have the resources**

to make annual exclusion gifts, we highly recommend doing so as these gifts will pass tax-free to the recipient and will not diminish the amount of your basic applicable exclusion amount (discussed above). 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. In the case of property received, a recipient will receive a carried over basis (see discussion of carry over basis below in section on "Change in

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Emphasis to Income Tax Planning for Many Estates" below), so income tax implications will need to be evaluated too. If annual exclusion gifts are made using assets other than cash and marketable securities, or if certain discounting techniques are used to leverage the gifts, it is generally desirable to file a gift tax return to ensure the value of the gift is accepted by the IRS. Spouses can elect to treat gifts in excess of $14,000 (but less than $28,000) by one spouse as split gifts but a gift tax return is required to be filed to make such an election. Gifts to pay tuition and medical expenses may also be gift tax free if they meet certain requirements.

Act Now on Discounting Techniques Before Possible Regulatory Move to Eliminate or Reduce Valuation Discounts

One of the most significant estate planning strategies available involves the use of valuation discounts. Discounts for lack of marketability and minor interest discounts are the most common. Valuation discounts reduce the value of the taxable transfer to the beneficiaries for tax purposes without reducing the economic benefit to the beneficiaries. In the past, legislation has been proposed to eliminate discounts, but such legislation has never gained much traction in Congress. Unfortunately, the United States Secretary of the Treasury is now considering ending or reducing discounts through proposed regulations that would effectively accomplish the same thing. As of the date of this newsletter, no regulations have yet been published. **If you are a closely-held business owner** and want to take advantage of discounting techniques, now is the time to do so before valuation discounts are eliminated.

Change in Emphasis to Income Tax Planning for Many Estates

Because the "tax free" amount for federal estate tax purposes will exceed $5.45 million per taxpayer in 2016, 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 generally 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 income tax 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 $5.45 million federal applicable exclusion amount, or (b) the relevant state exclusion amount (*e.g.*, $4 million in Illinois), whichever is less, **you should re-evaluate the provisions in your revocable trust as they** 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 upon the death of the second spouse.

Trust Income Tax Planning, Including the Additional 3.8% Medicare Tax Imposed on Trust Income

Irrevocable trusts pay income taxes and capital gains taxes. Except for the last year of the trust's existence, an irrevocable trust always pays capital gains taxes out of trust assets. However, an irrevocable trust only pays income taxes out of trust assets when ordinary income items are retained by the trust. Ordinary income that is distributed to the beneficiaries can be deducted by the irrevocable trust in most instances. If the trust receives a deduction for a distribution, the beneficiary must report the income received on the beneficiary's individual income tax return. **This is often advantageous because the** beneficiary's income tax bracket is usually lower than the trust's applicable income tax bracket. With the proper election, distributions made during the first 65 days of the new tax year may 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 taxable income before having to make the distribution of such income.

Trusts and estates are also 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 most of its net investment income. **A 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.

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 additional 3.8% Medicare tax on business income, such as income passed through to the trust from S corporations and limited liability companies, can possibly be avoided by the proper selection of trustees and co-trustees. 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.

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 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.

Traditional Marital Trust Rules Do Not Apply to Foreign Spouses

Under the federal estate and gift tax laws, a taxpayer may transfer unlimited amounts of property to a U.S. spouse free of federal transfer taxes. A taxpayer may also set up one of three types of marital trusts for the benefit of a U.S. spouse and transfer assets to the marital trust free of federal transfer taxes.

If the taxpayer's spouse is a foreign national—even when he or she is lawfully residing in the U.S.— these general rules do not apply. This is particularly troublesome with regard to marital trusts. In order for a marital trust that is created for the benefit of a foreign spouse to avoid immediate taxation, a special type of marital trust, called a qualified domestic trust, or "QDOT" for short, must be used. **If you have a foreign** spouse, you should have your estate planning documents and marital trust provisions reviewed to determine whether the QDOT rules have been properly included.

Trustees Should Maintain Good Records to Avoid Litigation

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 documented the basis for key decisions made with respect to the administration of the trust. This has led the trustees to expose themselves to significant personal liability for any amounts disbursed 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 the most basic duties of serving as a trustee.

Retirement Plan Benefits and IRAs Are Important Assets That Need To Be Periodically Reviewed

Retirement benefits and IRA proceeds often constitute a large portion of an individual's assets. At death, such assets are usually transferred in accordance with the respective beneficiary form. **It is critical that** the beneficiary forms be reviewed and updated periodically. Otherwise, a transfer to an unintended beneficiary/recipient could occur. For example, if you are divorced, it is unlikely that you would want your former spouse to be listed as the primary beneficiary of all of your retirement benefits and IRA proceeds.

Rollovers are allowed to spouses and other individuals named as beneficiaries. This will help them defer income taxes on distributions by allowing the beneficiary to receive distributions over time. If a beneficiary is a trust, it may be possible to look through the trust and roll over benefits to individual beneficiaries under some circumstances. Unfortunately, it is not possible to look through an estate and roll over benefits to estate beneficiaries.

Some planners have encouraged clients to name "my then living descendants, per stirpes" as the primary or contingent beneficiary under a retirement plan or IRA. Many investment companies are now rejecting that designation and forcing the client to name actual individuals. If your investment company requires you to name an actual individual, be sure to add "per stirpes" behind that person's name (or check the box if present) so that such individual's descendants will receive his or her share should that individual fail to survive you. Congress has allowed distributions from IRAs directly to charities during the owner's lifetime. However, such provisions are only extended on a year to year basis. It is not yet clear whether Congress will allow distributions from IRAs directly to charities in 2016.

Obligation to Notify Beneficiaries of Income Tax Basis Information

Taxpayers who acquire property from a decedent must now use the value as finally determined for federal estate tax purposes as their basis for income tax purposes. A taxpayer who fails to do so may be subject to a 20% accuracy related penalty.

Executors are now required to provide the IRS and each beneficiary who receives property from the respective decedent with a notice reflecting the value of such property as finally determined. If an estate tax return is audited, this may require the executor to issue two notices. If an executor fails to provide a notice, the executor is subject to a penalty of $250 for each failure. If an executor intentionally disregards the executor's notice obligation, a penalty equal to 10% of the items that the executor failed to report may apply.

The new rules generally apply to property reported in estate tax returns filed after July 31, 2015. However, the IRS is now working on issuing guidance related to these requirements and has instructed executors to refrain from issuing any notices until after February 29, 2016.

Transferring Shares of Stock Requires That Certain Formalities Be Followed

Please be aware that shares of stock in a corporation are not considered transferred until the certificates are delivered and a power of direction is signed. The corporation's stock ledger should also be updated at the same time.

Before transferring the stock of a closely-held corporation, the relevant shareholders agreement, by-laws and articles of incorporation should be reviewed to ensure that the transfer would not violate a corporate document. The closely-held corporation's bank loan agreement should also be reviewed before the transfer is made. Loan documents often contain a covenant that prohibits stock transfers without the bank's prior written consent. You would not want to make a transfer that causes the corporation to default on its loan.

Do It Yourself Wills and Trusts May Not Accomplish Your Goals

A number of websites now offer will and trust forms which can be prepared without the assistance of an attorney. Although it may seem like a great way to save money, please be aware that some of the form language may be insufficient under your state's applicable laws. Further, we have found that individuals who use such software often fail to properly consider all the various issues which need to be addressed in a will or a trust. Such failures may be catastrophic. Do not be penny wise. **At a minimum, have a qualified** attorney review any documents that you have prepared for yourself using an online program. That is the only way that you can ensure that your estate planning documents will work the way that you intend for them to work.

Changes in the Illinois Power of Attorney for Health Care Form

The Power of Attorney for Health Care allows an "agent" to act on your behalf regarding health care matters if you are no longer able to do so yourself. Effective January 1, 2016, Illinois has made several changes to its statutory form. **These changes do** not in any way invalidate any health care power of attorney that was executed prior to January 1, 2016. The following changes have been made to the Illinois Power of Attorney for Health Care:

First, you can now nominate your agent as your guardian, should one become necessary. The definition of "decisional capacity" is now included in the form.

Second, the form now provides that a medical provider is only allowed to determine that you cannot make medical decisions for yourself when (a) you are unable to understand the nature and consequences of your medical treatment, or (b) you are unable to communicate that decision.

Third, you can now select whether your agent can have access to your medical records beginning on the date you sign the document. This change allows your agent to stay fully informed regarding your healthcare history prior to being required to act so that your agent can be better suited to make an informed healthcare decision on your behalf should the need arise.

Finally, the new form adds a provision that advanced practice nurses, dentists, podiatric physicians, optometrists, or psychologists cannot witness the signing of your health care power of attorney.

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, or significant lifetime gifts have been made, Illinois will tax the entire estate, not just the portion exceeding $4 million. Fortunately, a limitation will apply so that the Illinois estate taxes are mitgated. Illinois 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, Illinois did not adopt the federal portability provision discussed above. Therefore, **a surviving spouse cannot use a** deceased spouse's Illinois "tax-free" mount. This means that Illinois estate taxes will now be a significant planning issue. What exposure to Illinois estate taxes could you have?

Trusts Domiciled In Another State May Avoid Illinois Income Taxes Under Some Circumstance

An irrevocable trust is generally subject to Illinois income taxes whenever the grantor of the trust was an Illinois resident when the trust became irrevocable. However, as a result of *Linn v. Department of* Revenue , 2013 IL App (4th) 121055, 2 N.E.3d 1203, 377 Ill.Dec. 922, it is now clear that Illinois does not have the ability to tax a trust that no longer has a

trustee, beneficiary or assets located in Illinois—even though the trust became irrevocable when the grantor was an Illinois resident. If you are a trustee or beneficiary of an irrevocable trust and the trust is now domiciled in a state that does not have income taxes, you should reconsider the need to pay Illinois income taxes related to the trust's income in light of the Linn case.

What You Need to Know About Minnesota Estate and Gift Taxes for 2015 and 2016

The Minnesota estate tax exemption amount will increase to $1.6 million in 2016. After 2016, the exemption amount will continue to increase by $200,000 a year thereafter until 2018 as follows:

Although the Minnesota gift tax was repealed in 2014, the "3 year look back" on gifts enacted during 2013 was not repealed. Gifts made after June 30, 2013 and within three years of death will be treated as being part of the decedent's estate.

Beginning in 2015, the Minnesota estate tax rates will range from 10% to 16%.

Minnesota continues to allow a special estate tax deduction for qualifying small businesses and farms. The value of these special deductions is effectively reduced each year as the standard exemption amount increases. The total of the exemption amount and the special deduction remains at $5 million in the aggregate.

Beginning with deaths in 2014, Minnesota allows a "Minnesota only" QTIP election for qualifying property. A trust using a Minnesota QTIP election must satisfy all the federal requirements, but the election does not need to have been made on a federal estate tax return.

Do You Know What Will Happen to Your

Florida Homestead Residence Upon Death? Because of constitutional and statutory restrictions under Florida law, transferring a Florida homestead residence while alive or at death can be tricky. If an individual with a spouse and/or minor children dies owning homestead property in Florida, it may be difficult to freely devise the property by will or trust. Therefore, **it is highly recommended that you have** the title of your Florida homestead residence reviewed, along with the dispositive provisions in the will and/or revocable trust, to ensure that the homestead residence will be devised as desired without any unwelcome surprises to your surviving family members.

Transfer on Death Registrations

Transfer on Death (TOD) and Payable on Death (POD) statutes have been enacted in a number of states. The statutes provide useful tools for estate planning purposes. **TOD statutes affecting real** property allow the owner to retain ownership until the owner's death and pass by operation of law when a deed has been recorded. Property transferring under a TOD or POD statute is not subject to probate. Nor is a POD or TOD transfer subject to the requirements for a will. A TOD or POD transfer is not necessarily tax exempt for purposes of the federal or relevant state estate tax laws.

Indiana has a comprehensive Transfer on Death Property Act. The Indiana TOD Act applies to a security or a securities account and may be used to transfer an interest in tangible personal property such as a motor vehicle or a watercraft. Any type of personal property that can be adequately identified and the writing executed by the owner and acknowledged before a notary public may be transferred this way. The Act also permits the assignment of the right to receive performance under a contract. The Act generally applies to property situated in Indiana or property that was owned by an Indiana resident.

Illinois has the Residential Real Property Act, which authorizes TOD transfers for real properties with one to four units. Illinois has also adopted the Uniform TOD Security Registration Act (Illinois TOD Securities Act) and the Illinois Trust and Payable on Death (POD) Accounts Act (Illinois Trust and POD Act). Like Indiana, the Illinois statute applies to a security or a securities account and allows bank accounts to be transferred at death by the terms of the account registration.

Private Retirement Plans and Asset Protection in California

Domestic asset protection begins with the state statutory exemptions available in the client's state of residence. While California law offers few major opportunities, the statutory exemption for "private retirement plans" are an important planning opportunity. Private retirement plan funds are absolutely protected against creditor claims under California law. Distributions from these funds *after* reaching the plan's retirement age are likewise protected. Also protected (but not protected to the same degree) are individual retirement accounts ("IRAs") and self-employment plans. These assets, however, are only protected to the extent necessary for support of the participant and his or her family during retirement.

Private retirement plans include ERISA qualified plans and plans that are not qualified under ERISA. Nonqualified plans, therefore, can supplement the participant's ERISA qualified plan, which enjoys absolute creditor protection to provide a more secure retirement.

In order to be exempt, private retirement plans must be designed and used primarily for retirement purposes. A plan does not, however, need to be exclusively used for retirement purposes. Courts have applied a totality of the facts nd circumstances analysis and used many different factors to determine whether the plan was both designed and administered primarily for retirement purposes. Understanding case law is important in determining what withdrawals by and loans to the participant are allowed prior to retirement. It is also important in understanding whether the plan is designed and used primarily for legitimate retirement purposes as opposed to creditor avoidance purposes.

Private retirement plans are an opportunity for employed persons who either do not have access to an ERISA qualified plan or who wish to save more for retirement than ERISA allows them to contribute to their ERISA qualified plan.