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Newsletters

Estate Planning Newsletter - December 2016

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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-Free Amount Increases in 2017

The basic applicable exclusion amount *(i.e.*, the "tax-free amount") for federal estate tax purposes will increase from $5.45 million in 2016 to **$5.49 million in 2017**. Therefore, married couples may transfer **up to $10.98 million** of value during their joint lifetimes or at death after 2016— 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 may be a useful tactic for married couples who have not planned efficiently to avoid federal estate taxes. However, portability does not apply to the federal generationskipping transfer tax or to certain state 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 2016 is $14,000 per recipient. The limit will remain at $14,000 per recipient in 2017. If you have a taxable estate and the resources to **make annual exclusion gifts,** strongly consider doing so **because the gifts will pass tax-free to the recipient and will not diminish your basic applicable exclusion amount** (i.e., your "tax-free 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, so income tax implications

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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will need to be evaluated too. (We have included a discussion of the carry over basis rules below in “Change in Emphasis to Income Tax Planning for Many Estates”.) Spouses may elect to “split” the gifts made by only one spouse and treat the gifts as if one-half (1/2) were made by each spouse. The election will allow up to $28,000 to be transferred to an individual recipient free of federal gift taxes. However, the election to split gifts must be made on a timely filed gift tax return—even though no gift taxes will be due.

Make Good Use of Tuition Gifts and Medical Gifts

Tuition gifts paid directly to an accredited education institution and medical expense gifts paid directly to a medical care provider are not subject to federal gift taxes. Tuition gifts and medical expenses gifts are excluded from federal gift tax treatment regardless of the amount paid. However, the gifts must be paid directly to the school or the medical service provider. You cannot give the money to the donee and let the donee pay the school or the medical service provider and achieve the same result. Note that tuition gifts do not include room and board, fees, books, or equipment. Medical expenses include, but are not limited to, medical insurance premiums, co-pays, out-of-pocket charges and deductibles. Like annual exclusion gifts, tuition and medical gifts are a good tax-minimizing strategy because they are tax-free and do not count against your exclusion amount.

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

One of the most significant estate planning strategies available to business owners and real estate owners 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 gift and estate tax purposes without reducing the economic benefit to the beneficiaries. Proposed regulations were issued on August 2, 2016, which may limit or possibly eliminate the use of such valuation discounts as of the effective date of the proposed regulations. The effective date of the proposed regulations is not yet known. The proposed regulations may be put into final form immediately after the 90-day comment period expires. Some of the proposed regulations would become effective upon finalization and the remainder would become effective 30 days later. It is possible that these changes could become effective in early 2017. **If you are a business owner or a real estate owner and want to take advantage of discounting techniques, you should seriously consider making significant gifts of business or real estate interests before December 31, 2016.**

Change in Emphasis to Income Tax Planning for Many Estates

Because the "tax-free" amount (i.e., the applicable exclusion amount) for federal estate tax purposes will equal $5.49 million per taxpayer (*i.e.*, up to $10.98 million for married couples with properly planned estates) in 2017, 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.

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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 $5.49 million federal applicable exclusion amount, or (b) the relevant state exclusion amount (*i.e.*, $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.

Review Your Retirement Plan and IRA Beneficiaries

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.

If you are charitably inclined, note that distributions made directly from an IRA to a qualified charity will not have to reported as income on the IRA owner's income tax return so long as the total distributions total no more than $100,000 per calendar year. The charitable distributions will also count against the IRA owner's obligation to take minimum required distributions ("RMDs") from an IRA.

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.

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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.

If a federal estate tax must be filed, the executor is 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.

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.**

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.**

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

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.

Illinois Only Taxes Estates Worth More 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.

Note that 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.** This means that Illinois estate taxes will now be a significant planning issue for individuals or married couples owning assets worth more than $4 million, including life insurance proceeds. What exposure to Illinois estate taxes might you have?

What You Need to Know About Minnesota Estate and Gift Taxes

The Minnesota estate tax exemption amount will increase to $1.8 million in 2017. In 2018, it will increase to $2 million, butremain at that level thereafter.

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.

The Minnesota estate tax rates 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.

No Gift or Estate Taxes in Certain Other States Where Hinshaw Has Offices

Hinshaw maintains offices in 23 locations throughout the United States. If you are fortunate to live in Florida, California, Indiana, or Wisconsin, you will not be subject to state estate taxes or state inheritance taxes upon your demise.

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

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to your surviving family members.

One Size Fits All Estate Plans May Not Account For Community Property Considerations

Property that is acquired at any time during a marriage between current or former residents of a community or marital property state, such as Wisconsin, is likely to be treated as co-owned by both spouses. Estate plans for couples who live or have ever lived in a community/marital property state must take this into consideration or their estate plan may be susceptible to challenges later. Correctly classifying assets as owned jointly between spouses protects a surviving spouse's interest and facilitates ease of transfer upon death. Furthermore, certain gifts and bequests require that the spouses act together in making the gift. For example, a spouse who desires to leave a specific asset, such as a piece of real estate or an interest in a business to one child, while leaving the other assets to another child, may not be able to accomplish these goals unless the individual's estate plan accounts for community/marital property considerations. If you are married and reside in (or have resided in) a community/marital property state, **you should strongly consider having your estate plan reviewed to ensure it complies with community/marital property rules.**

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. In determining whether a plan is set up primarily for retirement purposes, the California courts have looked at all the facts and circumstances and used a variety of factors to determine whether the plan was both designed and administered primarily for retirement purposes. An understanding of this case law is important in determining what type of withdrawals by and/or loans to the participant are allowed prior to retirement in order for the private plan to be considered to be set up primarily for retirement purposes. It is also important in understanding whether the plan is designed and used primarily for legitimate retirement purposes as opposed to creditor avoidance purposes.

Think about a private retirement plan if you are employed, living in California, and either do not have access to an ERISA qualified plan or wish to save more for retirement than ERISA allows you to contributeto your ERISA qualified plan. An added benefit is that **the funds are protected from creditor claims.**

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.

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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.

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 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, 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.

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