HINSHAW

Newsletters

Estate Planning Newsletter - November 2012

November 27, 2012

Federal Gift Tax — The Window of Opportunity

On January 1, 2013, the present $5.12 million federal gifting and estate tax exemption drops to $1 million and the federal estate tax rate — now at 35 percent — increases to 55 percent. These factors combine to create a tax savings opportunity that may never exist again in our lifetime.

A political compromise between now and year-end is possible. However, many experts think that these issues will not be sorted out until some time in 2013, with the compromise to be retroactive to January 1, 2013.

The Republican-controlled U.S. House of Representatives may be able to resist having some of the new restrictive estate tax provisions enacted. However, because many wealthy individuals have used some or all of their $5.12 million gifting exemption in 2011 and 2012, or are finalizing their plans to do so by December 31, 2012, we may not see significant resistance to allowing the gift tax exemption to fall to $1 million. It is therefore imperative to review options and act in the next four weeks for gifting strategies of $1 million or more in 2012.

Individuals who have the financial means should consider making gifts exceeding $1 million in value to take advantage of all or part of the $5.12 million tax-free temporary gifting allowance. Donors hesitant to gift significant amounts because they fear the depletion of their assets should consider listing a spouse as a beneficiary. Structuring a trust in this way enables the donor to derive indirect benefit by being supported by the spouse while the spouse is being supported by the trust, for as long as the spouse is alive.

If you are interested in discussing the possibility of implementing this strategy, you can contact a member of Hinshaw's Estate Planning Practice Group or your regular Hinshaw attorney. This is a substantial opportunity that should be seized upon. We look forward to assisting you in determining the best options for capturing these potential tax savings.

What Will the Federal Estate Tax Look Like in 2013?

Unless Congress takes additional action, the federal estate tax provisions in 2013 will automatically revert to the provisions as they existed in 2001, which could negatively affect taxpayers. Beginning in 2013, the federal applicable exclusion amount (the tax-free amount) will be $1 million per taxpayer. Married couples can transfer up to $2 million of combined value, tax-free, if they plan properly. This may sound like a lot of money. However, taxpayers should realize that all of the equity in their homes, and the value of all of their investments —

Attorneys

Albert C. Angelo

Steven W. Cutler

James W. Keeling

Marcia L. Mueller

Service Areas

Estate Planning & Wealth Preservation

including retirement benefits, and life insurance proceeds — are included in the applicable exclusion amount. Therefore, even middle-class families may end up with taxable estates if they do not plan properly.

Beginning in 2013, the federal estate tax rate will be as high as 55 percent, with a five percent surtax on large estates. A tax credit (i.e., not a deduction) for state death taxes and a deduction for small businesses will be allowed. Regardless, if a taxpayer has a taxable estate, the estate tax bill may increase if he or she dies after 2012.

Congress knows that the 2013 estate tax provisions remain generally unpopular among those who may pay the tax, particularly among business owners. Therefore, it may change the provisions of the federal estate tax after 2012. Tax-free amounts of $3.5 million and $5 million per taxpayer have been discussed. Yet, only time will tell if Congress will timely address this issue.

Those concerned about this issue should contact their representatives in Congress. Hinshaw will continue to follow the issue closely.

Illinois Estate Tax Becomes Permanent

As of 2012, the Illinois estate tax only applies to estates worth more than $3.5 million. However, if an estate is worth more than $3.5 million in 2012 or later, Illinois will tax the entire estate, not just the portion exceeding $3.5 million.

The Illinois exemption amount will increase to $4 million in 2013 and remain at that level permanently. However, if an estate is worth more than $4 million in 2013 or later, Illinois will tax the entire estate, not just the portion exceeding $4 million.

Marital Trust Allocation Formulas in Illinois Wills or Trusts May Need to Be Updated Now

In 2012, the federal estate tax tax-free amount exceeds the Illinois estate tax exemption amount. In 2013, unless Congress acts, the Illinois exemption amount will significantly exceed the federal tax-free amount. The decoupling of the Illinois estate tax from the federal estate tax has created significant complexities in the estate plans of married couples residing in Illinois.

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 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.

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 be mitigated. 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.

Marital Trust Allocation Formulas in Minnesota Wills or Trusts May Need to Be Updated

The Minnesota estate tax applies to estates worth more than $1 million. Because the state has decoupled from the federal estate tax tax-free amount, married couples residing in Minnesota face significant complexities in their estate plans.

As in Illinois (as discussed above), 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 Minnesota estate taxes whenever the combined family assets (including life insurance) exceed $1 million. Further, Minnesota does not allow a “Minnesota-only” marital deduction for QTIP (qualified terminable interest property) marital trusts or any other type of marital trust. Wills and trusts that still use the traditional approaches to funding marital trusts may therefore need to be updated because there may be unintended Minnesota estate tax consequences.

Indiana’s Inheritance Tax to Be Phased Out and Estate Tax May Become Effective Again

Indiana’s inheritance tax will be phased out between 2013 and 2022. A 10 percent credit will be subtracted from the bottom-line inheritance tax computed on at-death taxable transfers of decedents dying in 2013. For decedents dying during calendar year 2014, the credit will be 20 percent. The credit will increase by 10 percent per year through 2021, when it will be equal to 90 percent of the computed bottom-line inheritance tax. Effective for decedents dying after December 31, 2021, the Indiana inheritance tax will no longer exist.

Effective January 1, 2012, the definition of Class A transferees under the Indiana inheritance tax was broadened to include a spouse, a widow, or a widower of a child or step-child of a transferor. Additionally, the Class A transferee exemption (for lineal descendants and lineal ancestors such as children, grandchildren, step-children, parents and grandparents) was increased from $100,000 to $250,000 per person.

Note that in addition to its inheritance tax, Indiana’s currently dormant estate tax and generation-skipping tax will become active again beginning in 2013 unless Congress acts to make the state death tax credit ineffective for federal estate tax purposes. Because the Indiana estate tax is a “pick-up tax,” the federal estate tax will be reduced by the estate tax amount payable to Indiana.

Florida’s Dormant Estate Tax May Become Effective Again

Florida’s estate tax is currently dormant but will become active again beginning in 2013 unless Congress acts to make the state death tax credit ineffective for federal estate tax purposes. Because the Florida estate tax is a “pick-up tax,” the federal estate tax will be reduced by the estate tax amount payable to Florida beginning in 2013.

Asset Protection Trusts Can Be Used to Protect Property From Creditors

The economic downturn that began several years ago has spurred increased interest in asset protection strategies. Because fraudulent conveyance statutes restrict transfers in excess of current debts (including contingent liabilities), individuals often wait too long to consult an attorney regarding asset protection.

Individuals who have assets exceeding their debts can invest the excess in “protected assets” (e.g., qualified retirement plans and assets held as tenants by the entirety). The excess can also be transferred to a domestic asset protection trust. Special irrevocable trusts formed under the laws of Alaska, Delaware, South Dakota and several other states are increasingly being used for asset protection purposes. Individuals with assets exceeding their liabilities, including contingent liabilities, can use a domestic asset protection trust to guard their excess assets from creditors if all of the rules are followed and the transfer is not deemed to be for the primary purpose of hindering or defrauding known or reasonably foreseeable creditors. Individuals who are exposed to professional liability or own rental real estate may also consider creating a domestic asset protection trust.

2013 Limit for Annual Exclusion Gifts Increases to $14,000

“Annual exclusion” gifts are relatively small gifts that may be made tax-free to a donee. The annual exclusion limit for 2012 is $13,000 per donee; it will increase to $14,000 per donee in 2013. 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 donee. Note that the annual exclusion limit includes all gifts to the donee during the year; special rules apply for gifts to trusts. If the donees are grandchildren or trusts for grandchildren, generation-skipping implications will also need to be considered. Note also that a donee will receive a carried over basis in any property received, so income tax implications will need to be evaluated too.

Breach of Trustees' Duties May Result in Personal Liability

Trustees owe several duties to each trust beneficiary. The most important are the duties of loyalty, to keep books and records, and to use reasonable care. A breach of any such duty may expose the trustee to personal liability.

Pursuant to the duty of loyalty, the trustee must administer the trust solely in the beneficiaries' interests, may not sell property to himself or herself — even when the price is fair — and may not use trust property for his or her own purposes. Under the duty to keep good books and records, receipts and records of all transactions should be kept. A trustee may be held personally responsible whenever a loss results from the trustee's failure to keep good books records. The duty of reasonable care requires the trustee to invest and manage trust assets as a prudent investor would do.

Trustees must be scrupulous about their duties if they intend to avoid litigation and, potentially, personal liability.

Word to the Wise — Keep Lists of Digital Assets

The law often moves slower than technology. Those who have not done so already should maintain a list all of their digital assets (including passwords) and digital accounts. This list should be available to the asset owner's agent, executor and/or successor trustee. The ability to transfer and utilize one's digital devices (e.g., computers, smart phones, etc.); digital assets (e.g., email accounts, licenses and registrations); and digital accounts (e.g., financial accounts, social media accounts, online stores) should be specifically added to the owner's powers of attorney, wills and trusts. All relevant software licenses should also be considered in the owner's estate plan.

"Fixing" Irrevocable Trusts

Irrevocable trusts are inherently difficult to change once they are created and funded. Because irrevocable trusts tend to survive for long periods of time and circumstances often change, the ability to "fix" an irrevocable trust can be problematic.

Fortunately, there are several ways to address the need for flexibility. With regard to irrevocable trusts that have not yet been created, the trust agreement should include a provision for a "trust amender" or "trust protector" who can amend the trust in the future. The trust amender and/or trust protector must be an independent third-party. With regard to existing irrevocable trusts, a trust agreement may be amended or reformed by a court of competent authority. In some states, a virtual representation agreement statute may allow the beneficiaries and trustee to agree to such changes by contract without court involvement. In a few states, the trustee may "decant" the trust assets into a new trust created by the trustee. However, this is only allowed when the relevant state (e.g., Illinois) has adopted a "decanting statute."

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, 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.