ESTATE PLANNING: COUPLES WITH LARGER ESTATES

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Introduction

Effective estate planning requires a basic understanding of many issues. This is especially important for larger estates where estate taxes are of concern. In Illinois, a larger estate is an estate in excess of the Illinois exclusion amount – currently $4 Million – and in estates such a Missouri that do not have an estate tax, the federal estate tax exclusion amount – roughly $5 Million.

The estate tax has been in a state of flux for literally decades. As recently as 2011, the estate tax was scheduled to apply to estates of over $1,000,000. The uncertainty – for now – ended in 2013. The federal estate tax law became permanent at the time, at least as permanent as anything Congress does. The estate tax was not abolished but applies to far fewer couples. Still, for larger estate its impact needs to be considered. By being informed, you will be able to assure that your attorney and estate planning team may achieve your personal goals with the least impact of estate taxes. It is also important to be alert to changes that necessitate updating your estate plan.

Some Questions You Should Ask …

- ✓ What would be our ideal disposition of our estates?
- ✓ How important is saving estate taxes?
- ✓ Are our intended beneficiaries able to manage their likely inheritances?
- ✓ Do we want to restrict a spouse's interest in assets to assure that children by a prior marriage ultimately receive those assets?
- ✓ Do we want certain assets to go to specific beneficiaries?
- ✓ Do we need to include special provisions for beneficiaries who are young, disabled, incompetent, or not U.S. citizens?
- ✓ Should we provide special provisions to protect particular beneficiaries, such as a right to acquire a home, family farm, or business asset?
- ✓ Are we concerned about our creditors or the creditors of a beneficiary? What about ex-spouses? Or in-laws?
- ✓ Are there other things we consider important?

This information provides an overview of some important estate planning issues that you should understand. The focus is on couples where there is a potential for estate taxes – state or federal. Please realize that everyone's circumstances differ. Therefore, this material is intended only as general information and not specific legal advice.

The Schmiedeskamp Estate Planning and Administration Group

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Determine Your Estate Planning Objectives

Estate planning should begin with a review of your objectives. Sometimes they are obvious. Other times they are not.

Where larger estates are involved, taxes often are considered an important – even most important – issue. Taxes are clearly a critical consideration, but other goals may be important as well. Don't overlook them. Estate planning involves choices. Each choice may have advantages and disadvantages. One might say, for example, that the most important goal is to avoid estate taxes. Actually, this is but one goal and may have to give way in order to achieve still other goals. Giving one's wealth to charity would certainly avoid estate taxes, for example, but few couples will do so simply to avoid estate taxes. It is important to consider each of your goals. Your goals must be blended and take into consideration both advantages and disadvantages to achieve a balanced estate plan.

Involve Your Estate Planning Team

Attorneys serve a central role in estate planning. But don't overlook the important role other professionals may plan as well. Your accountant, financial advisor, broker, insurance agent, banker, trust officer, and others should be involved as may be appropriate. This is particularly important when you have substantial retirement assets or insurance.

However important it is to seek advice – which is encouraged – keep in mind that the most important aim is achieving *your* goals. Be certain that your goals are clear to your estate planning professionals. The estate plan must reflect your wishes.

The Schmiedeskamp Firm Assists Couples With Larger Estates

The Schmiedeskamp, Robertson, Neu & Mitchell LLP Estate Planning and Administration Group works with couples in estate planning. Our clients are families and individuals from all walks of life, along with individual and corporate executors, trustees, and fiduciaries, as well as public and private charities. The Group provides estate planning and administration services from the simple to the complex. Services relate to wills, trusts, beneficiary arrangements, and other estate planning techniques and approaches. We advise our clients regarding the effective and efficient transfer of wealth and succession planning. For more information about the Estate Planning and Administration Group and all our lawyers, please visit www.srnm.com.

Gather Your Financial Information

To properly plan your estate, you should gather your financial information. A financial advisor, life insurance agent, or accountant may be helpful in organizing this information.

When gathering your financial information, prepare a listing that at least includes this information:

- Description of each asset.
- How the asset is owned (*e.g.*, individually or joint).
- Beneficiary designations, if any (*e.g.*, for insurance, annuity, IRA, retirement plans).
- Value of the asset.
- Debt on the asset.

The form of ownership affects how an asset passes on death. Some assets are known as "probate assets." This means they pass as you provide in your will. Other assets are "non-probate assets." These assets pass outside of a will. This means that your will has no effect on those assets. Examples of non-probate assets are property held in joint tenancy, a home held as tenants

Common Ways to Own Property:

- ✓ **Individual**: Property may be owned in one's own name. This property will pass as you provide by will.
- ✓ **Tenants in Common**: Where property is owned as tenants in common, an undivided share is owned that passes just like property individually owned. It does not pass to a co-owner.
- ✓ **Joint Tenants**: If property is held jointly, it will pass to the co-owner automatically on death.
- ✓ **Tenants by the Entirety**: Tenants by the entirety is very much like joint tenancy, but is available only to married couples. Upon death, the property passes to the surviving spouse. What is important is that creditors of only one spouse may not claim the property; the creditors must have a claim against both spouses. Also, neither spouse can deal with the property separately. In Illinois, only a couple's home may be held as tenants by the entirety; in some other states, including Missouri, most all property may be held in this way.
- ✓ **Beneficiary Forms**: Property may designate beneficiaries. The beneficiary will then receive the property on death. Payable on death (POD) or transfer on death (TOD) designations, insurance beneficiaries, and IRA, 401k or other retirement beneficiaries, are common examples. Under some circumstances, beneficiaries to be designated by deed or other instruments.

by the entirety, or assets, such as insurance or a retirement plan, with a designated beneficiary. These assets pass by operation of law or contract to the joint tenant or designated beneficiary. Assets held in a trust also pass outside of a will and, instead, in accordance with the trust. Assets, which are individually owned, or a person's individual undivided ownership in property, however, are governed by a will.

The distinction between probate and non-probate assets is very significant. A will or trust does not trump or override non-probate forms of ownership or beneficiary designations. Where an individual desires to fund a trust in a will or make special gifts, it will only be funded with probate assets. Similarly, joint tenancy and beneficiary designations may defeat the directions in a will. Therefore, it is very important to make certain that non-probate forms are used only where clearly intended and coordinated with your estate plan. There are many common ways to own property. It is important to understand how things are held because this may affect your estate plan.

Be Careful of the Unintended Consequences Of Joint Tenancies and Beneficiary Designations

The distinction between probate and non-probate assets may be very significant. Despite the simplicity and popularity of non-probate methods of ownership, they may have unintended consequences. Use of these forms of ownership may actually prevent or conflict with an estate plan. Joint tenancies and beneficiary designations require special attention, often as much as wills and trusts. Don’t assume that they should be used.

Here are some of the problems that might result:

- **May Interfere with Estate Tax Planning:** Estate tax planning may require that property be “sheltered.” To shelter property, it is best for the property to be in a spouse’s individual name. Use of joint tenancies may interfere with or complicate sheltering property from estate taxes. For most couples where estate taxes are of concerned, holding property or at least some property individually or as tenants in common is preferred.

- **Access to Property May be Allowed:** It is usually assumed that the intended beneficiary would not touch property. A joint tenant, however, has legal access to the property. For accounts, this may well be access to the entire account. In other situations, access may be limited to the joint tenant’s relative interest.

- **Creditors May Claim Property:** Where property is held jointly with a child, creditors of the child or a child’s spouse may attempt to claim an interest in the property. In some circumstances, they might well be successful.

- **Intended Beneficiaries May be Disinherited:** Most parents want their assets to pass to all of their children and, if one is deceased, then to the descendants of a deceased child. Where an account is held jointly with a child or children, the property will pass to the surviving children should a child predecease you. If a child dies before the account is closed, that child's share does not go to the child's children and, so, the child's children are disinherited. This same problem often arises where beneficiary designations are made. Unless made clear, where a child dies, the account or benefit will usually go to the surviving children and not a deceased child's children as would usually be intended. This is an all too frequent mistake encouraged by ill-informed people helping to set up accounts or beneficiary designations.

- **Planned Division May Change:** Where joint tenancies or beneficiary designations are used, the planned division of one's property might be inadvertently changed. As already mentioned, wills and trusts do not trump or override joint tenancies or beneficiary designations.

These are only a few examples of consequences that may result from the use of joint tenancies or beneficiary designations. When a bank teller or broker asks, "Don't you want to put someone else's name of this account or make someone a beneficiary?," or an insurance agent urges, "Be certain to name your children as alternate beneficiaries!," consider carefully whether this will carry out your plans. Very often it does not.

Joint tenancies or beneficiary designations may well be appropriate in some circumstances. Couples who are not concerned with estate taxes often hold property in joint tenancy or name each other beneficiary. A surviving spouse might do the same where there is a sole child. These estate-planning tools may be useful where a special gift is intended for a specific beneficiary. Beneficiaries may be appropriately named on insurance and retirement plans as well, provided the impact of a beneficiary's death is contemplated and carefully addressed.

What is important is that you clearly understand all the consequences of joint tenancies and beneficiary designations. Very often, these consequences are not known. They must be used thoughtfully and established appropriately to achieve your wishes.

Should We Have Wills or Trusts?

There are many tools that may be used to carry out your estate plan. The most common are wills and trusts.

A will is a legal document by which a person directs how property is to be distributed upon death. Wills still are the most frequently used method to dispose of assets on death.

A person who makes a will is called the testator. That's why a person's will is called a "Last Will and Testament." The formalities are few. A person making a will must be at least 18 years old and of sound mind and memory. The will must be in writing and, in most states including Illinois and Missouri, witnessed by two persons.

After a person's death, the will is submitted to a court for official recognition as the person's will. This process is called probate. A legal representative, usually called the executor, is appointed. The executor collects the person's assets, pays any debts, taxes or other obligations, and ultimately distributes the assets as directed by the will.

What Happens If We Don't Have Wills?

A person without a will dies intestate. When this happens, the person's property goes to his or her heirs or next of kin.

A married person's heirs are the surviving spouse and any children. Where there is no surviving spouse, parents and siblings or their descendants are heirs. If there are no persons in these groups, more remote relatives are heirs.

Contrary to popular belief, the state does not take the property of a person who dies without a will. Property can go to quite distant relatives.

Wills are not always presented for probate (even if filed with the court clerk). Where estate taxes are not a concern and a couple holds all property in joint tenancy or with a spouse as beneficiary, it would not be necessary to probate the will. In this situation, the will is a backup. It is only important on the death of the surviving spouse. Keep in mind, again, that this convenience can then run counter to tax planning.

Although wills remain the most frequently used method to dispose of property on death, trusts are growing in use. Indeed, there is a decided trend toward the use of the trusts for wealthier couples.

A trust is a legal relationship between a trustee (often also the creator of the trust) and the trust beneficiaries (which, again, may include the creator of the trust). The trustee holds the trust assets for the benefit of the beneficiaries under the terms of the trust.

The most common type of trust is a living or inter-vivos trust. This is a trust a person creates during the person's lifetime. These trusts are usually revocable; they may be changed. For this reason they are often titled by "revocable" living trusts although they actually become irrevocable on death. Other types of trusts may be used. Some are irrevocable and are not subject to change. Others are created in wills; these are testamentary trusts. Trusts also may be prepared for specific purposes, such as a special needs trust to care for a disabled child or a spendthrift trust which protects assets from one's creditors.

Some advantages of living trusts:

- ✓ A trust is private and doesn't have to be made public.
- ✓ Probate and court involvement may be avoided.
- ✓ Costs of settling things may be reduced.
- ✓ Trusts may provide for asset management where the trust creator is incompetent.
- ✓ Assets are often better organized.
- ✓ After death some creditor protection may result from use of a trust; protection usually is not available during one's life.

There are advantages and disadvantages to trusts. Perhaps the most cited reason for a trust is to avoid probate. This alone has accounted for the expanding popularity of living trusts. In those states without a streamlined probate process, this is a very significant advantage.

Some disadvantages of living trusts:

- ✓ Setting up a trust is more time-consuming because it requires that property be transferred into the trust and titles changed.
- ✓ Costs are greater to prepare a trust because more documentation is involved.
- ✓ While trusts are private, financial institutions and others often want copies.
- ✓ Trusts may be amended, but because of the greater documentation, may be more cumbersome.
- ✓ Because the authority of the probate court is not involved, there is a greater risk of dishonesty by a successor trustee.
- ✓ Whereas claims are barred during the probate process, they may hang on longer where a trust is used.
- ✓ Some federal, state, or other programs may not allow participation by trusts. When allowed, greater paperwork may be required to participate.
- ✓ Powers of attorney usually will not have the authority to modify a trust and changes will be difficult if a person becomes incompetent.

There is often a misunderstanding that a living trust will eliminate taxes. In reality, estate and tax planning objectives may be accomplished through the use of either a will or a trust. The decision whether to use a will or a trust is an estate-tax neutral choice. The critical factor is what is contained in the will or the trust. Either can achieve estate tax planning.

Even where a living trust is not used, a trust will still be a part of most estate plans where estates taxes are of concern. Rather than a trust being created during one's lifetime, it is created by will upon death.

There is no doubt that living trusts are becoming more and more popular. Although they are not for everyone, most couples should consider their use.

What About Joint Wills and Trusts?

Estate planning documents may be jointly prepared. Whether joint documents should be used requires careful consideration.

A joint will is almost never appropriate. A joint will is a single will that both couples execute as their respective wills. The reason that joint wills are not used very often is that upon the death a spouse, a contract arises preventing the surviving spouse from altering the will even where it might be appropriate to do so. Most spouses execute reciprocal wills. These are wills that contain essentially the same provisions but are separate and may be changed.

Where there is consideration of a joint estate plan, the underlying reasons should be openly discussed. Some spouses are very fearful about a surviving spouse remarrying and then leaving assets to another spouse, perhaps even disinheriting the couple's children. Others have inherited wealth or separately acquired assets that they want to be certain will go to their children. These sorts of issues may be addressed in various ways. A joint will is not the way to do so.

A joint trust may or may not be appropriate. Unlike a joint will, a joint trust is a single document. However, each spouse ordinarily retains the right to control whatever assets are held in the trust belonging to that spouse. Usually, the assets are held equally, but this is not always the case. Where a couple has separate assets rather than equal shares in common assets, separate trusts are most often used. For larger estates, separate trusts are more frequently used than joint trusts. The reasons for this is that after the death of a spouse, it is usually easier to keep track of what assets are or are not sheltered from further estate taxes. With care, however, a joint trust may be used.

An important consideration in determining whether assets should be held separately is where they were derived. Assets acquired before one's marriage or through gifts and inheritance are non-marital in the event of the dissolution of one's marriage. Assets may be held separately to protect them in the event of divorce.

Estate Tax History in Brief

The federal estate tax dates to 1916. The law provided a $50,000 exemption with marginal rates ranging from 1% to 10%. The exemption was subsequently raised to $60,000, but rates increased to a maximum of 77%. The marital deduction was limited to one-half of an estate, resulting in a maximum tax-free gift to a spouse of a mere $120,000.

The estate tax remained largely unchanged until 1976. At that time, important changes were made including establishing an exclusion amount of $600,000 (and provided for increases), reducing the maximum tax rate to 55%, and allowing an unlimited marital deduction. Special breaks for family farms and, subsequently, family-owned businesses were also adopted.

Legislation enacted in 2001 resulted in the further changes, among other things, increasing the amount of estates to which taxes did not apply. Although the estate tax was abolished for one year – 2010 – the current law because permanent in 2013.

What is the Potential Impact of Estate Taxes to Your Family?

Under the current law, there is no estate tax between couples. If spouses leave their estates outright to each other, then, no federal estate tax is imposed. Even Melinda Gates will pay no estate taxes on what she might receive outright from Bill. The estate tax becomes significant only upon the death of the surviving spouse. It is that eventuality that couples must plan for.

Where assets are not left to a surviving spouse, the estate tax is not imposed unless the estate exceeds a prescribed amount. This amount applies regardless of the number of beneficiaries or their relationships to the decedent. By contrast, the gift tax does have a per person annual exemption ($14,000 in 2016). For estate tax purposes, one's entire estate is considered. Too, gifts over the annual exemption are further considered and reduce the amount that may then be given to beneficiaries on death. In other words, except for annual gifting, the estate and gift tax laws are unified and usually it doesn't matter whether one's estate is given during one's lifetime or on death.

The amount that may be given on death is known as the exclusion amount. Where the net estate exceeds this amount, federal estate taxes will apply. If the estate does not exceed this amount, there will not be any federal estate taxes. Keep in mind, again, gifts during one's lifetime may affect and reduce the exclusion amount on death. As discussed later, state estate taxes may or may not apply.

What is the exclusion amount? It varies depending on when a person dies but has grown significantly since 2002. At that time, the exclusion amount was $1 Million. In 2010 (after the abolished estate tax was readopted), the exclusion amount was fixed at $5 Million and, importantly, indexed for inflation. The rate was fixed at 40% on amounts in excess of the exclusion amount.

For Persons Dying in …	The Exclusion Amount is …	And Highest Tax Rate is …
2002	$1,000,000	50%
2003	$1,000,000	49%
2004	$1,500,000	48%
2005	$1,500,000	47%
2006	$2,000,000	46%
2007	$2,000,000	45%
2008	$2,000,000	45%
2009	$3,500,000	45%
2010	$5,000,000	35%
2011	$5,000,000	35%
2012	$5,120,000	35%
2013	$5,250,000	40%
2014	$5,340,000	40%
2015	$5,430,000	40%
2016	$5,450,000	40%

"Portability" Introduced

The single most important estate planning technique that has been used for couples with estates that exceed the exclusion amount was to take advantage of each spouse's exclusion amount. This typically required the use of separate trusts. The deceased spouse would allocate an amount up to the exclusion amount to a trust. From this trust, the surviving spouse would receive income and, if needed for health and maintenance, principal. In this way the trust established by the deceased spouse was not added to the estate of the surviving spouse. The surviving spouse's estate was then separately and alone exposed to the possibility of taxation. Both exemptions were utilized and taxes to that extent avoided.

Federal estate tax law now allows "portability" of the exclusion amounts by couples. This means that a spouse, on death, may leave his or her entire estate to the survivor. The surviving spouse pays no tax at that time because anything left to a spouse is exempted from estate taxes. Portability allows the survivor to also receive the deceased spouse's unused exemption amount. The surviving spouse then has a double exemption – currently $10,900,000 for 2016. It's no longer "use it, or lose it" for federal estate tax purposes!

Because of this change, federal estate taxes are an issue for fewer couples. It remains an issue for some. When the federal estate tax applies, the rate is 40%.

Is There Also a State Estate Tax?

For many years, most states, including Illinois and Missouri, did not impose a separate state estate tax. Using a formula, the federal estate tax allowed a maximum credit or deduction against federal estate taxes for state taxes. This didn't increase the overall tax, just allocated some estate tax to the states and the balance to the federal government. This was known as the "pick up" tax. The states "picked up" some of the federal taxes.

Changes to the federal tax law abolished the "pick up" taxes. Many states, as a result, ended the collection of state estate taxes. Missouri (and the majority of states) no longer have an estate tax.

Illinois and a dozen or so other states responded by "decoupling" the state estate tax from the federal tax. Without "decoupling," the state death tax was eliminated. In these states there still is a state estate tax. This has resulted in many couples becoming residents of other states and changing the taxable "situs" or location of assets to outside the state. For some, this will eliminate the Illinois estate tax.

The Illinois estate tax applies to estates over $4 Million. This is significant. For an estate of $5.45 Million, for example, there is no federal estate tax. The Illinois estate tax, however, would be $397,482.00 (which is over 27% of the taxable amount). Where there is a federal tax the state estate tax is allowed as a deduction from the federal gross estate for estate tax purposes. This cuts the state estate tax rate to roughly 16%. Keep in mind, though, that this would be in addition to federal estate tax meaning that over half of one's estate is paid in taxes. Significantly, the Illinois exemption is not indexed to inflation and the state does not recognize portability. This complicates estate planning in states such as Illinois.

Family Farm and Business Tax Relief

Where estate taxes are an issue, two important estate tax relief measures were enacted to assist farm and business owners:

- ***Section 2032A Special Valuation*** allows certain farmland to be specially valued. Briefly, the average cash rent less real estate taxes per acre is divided by the average Farm Credit Services interest rate and this gives the special valuation of the farmland per acre. This valuation method may be used to reduce an estate (not taxes) by as much as $1,110,000 in 2016.

- ***Section 2057 Family-Owned Business Deduction*** allowed certain business interests to be excluded from an estate for tax purposes. The value that was allowed was $675,000. Because of changes in the federal estate law, this deduction was repealed beginning in 2004.

Section 2032A is subject to complicated rules and, in general, at least 50 percent of one's estate must consist of farm or business assets. Family members must retain the farm or business for at least ten years and be involved in the operation.

How Can We Reduce Estate Taxes?

At one time the hope was that the estate tax would be abolished. This is now highly unlikely and the federal estate tax now in place will remain for some time. Thus, some couples must deal with the tax.

The ways to reduce estate taxes have been significantly curtailed in recent years. Although there is much written about estate taxes, there are actually very few basic methods to reduce or deal with estate taxes. Most “hyped” techniques are variations of these methods.

The key methods are these:

- ✓ Taking full advantage of the available exclusion amounts.
- ✓ Gifting assets to reduce the value of an estate, especially the annual exclusion.
- ✓ Gifting assets to freeze the value of selected assets rather than allow one’s estate to increase through appreciation.
- ✓ Using insurance for wealth replacement, to pay estate taxes, or leverage gifts.
- ✓ Holding property in less-marketable forms, such as limited partnerships or partial interests, to reduce or discount valuation of the property.
- ✓ Planning for estate tax relief measures applicable to family farms and businesses.

In addition to these, some couples are in a position to consider generation skipping. This aims at avoiding taxes when children or even more remote descendants die. This is accomplished by limiting a child’s (or even subsequent beneficiary’s interest to income and, except under restrictive circumstances, principal) so that assets are not included in the child (or beneficiary’s) estate. To limit this, the estate tax imposes a special generation skipping tax for skips beyond the federal exclusion amount. Although generation skipping is much talked about, few couples are inclined to utilize the technique. Still, this may be of interest to some couples.

Charitable giving is a means to avoid estate taxes and, for some, a key part of their estate planning. Charitable gifts may be made in a manner whether family members still receive income, delaying the charitable gift.

There are more seldom-used techniques. Again, however, most estate planning involves use of some variation of these methods.

How Do We Take Full Advantage of Our Exclusion Amounts?

The most common way for a couple to reduce or even eliminate estate taxes is to take advantage of each spouse’s exclusion amount. By doing so, the amount that may be given tax-free to family is doubled. With federal estate tax portability, this has greater import where there is a potential Illinois tax.

Absent a state estate tax or special family circumstances (*e.g.*, subsequent marriage), there often would be little reason to do anything other than an outright transfer to the surviving spouse. This is the estate plan most couples have. Because anything given a spouse passes tax free, no taxes are due at the death of the first spouse to die. The problem occurs, if at all, at the death of the surviving spouse. The surviving spouse's estate will be the couple's combined estates. Where portability doesn't apply, there is only a single exclusion amount available at the death of the surviving spouse. The deceased spouse's exclusion amount is lost. Taking advantage of the exclusion amounts of both spouses is therefore important and may result in estate tax savings.

With portability, the double exemption is available without special tax planning. Moreover, if estate taxes are not of concern an important benefit of leaving assets outright to one's surviving spouse is that the tax basis of the assets would be "stepped up" on the death of the survivor. On death, the tax basis of most assets changes to the date of death fair market value. If, for example, a person has an asset costing $100 and at death it is worth $1,000, the person would have had to pay tax on a $900 gain if sold the day before death but because the basis would move to $1,000 on death there would be no taxes if sold the day after death. By giving assets outright to the surviving spouse the assets would be valued at the date of the death of the survivor. Where an exclusion tax planning trust is used, the basis of retained assets would be fixed at the death of first spouse. Accordingly, the estate tax and income tax consequences need to be weighed.

Where an exclusion trust is used, this is the usual process:

- Divide property so that each spouse has sufficient property in his or her name to take advantage of the exclusion amount to the extent necessary.

- Execute wills or trusts sheltering property from future estate taxes to the extent necessary.

Just how much should be in a spouse's name depends on the exclusion amount that applies. It is often best to simply divide all assets equally between a couple other than retirement plans and certain other selected assets. This is not always required, however. A lesser amount might well be sufficient. Using the Illinois exclusion amount of $4 Million and assuming a couple, together, has $5 Million in assets, it would really only be necessary to shelter $1 Million for Illinois estate tax purposes. Accordingly, under that precise scenario and assuming no increase in value, a greater amount would not be required to be sheltered because the survivor's estate would not exceed the $4 Million available exclusion amount of the survivor.

The Exclusion Amount Trust

A common and traditional way property is sheltered from estate taxes on the death of a surviving spouse is an exclusion trust. There are many names for this sort of trust. They are also called credit shelter, bypass, non-marital, “B,” or family trusts. The purpose is always the same – shelter the trust principal from estate taxes on the death of the surviving spouse.

The exclusion trust provides that an amount up to the exclusion amount is set aside in a trust. This amount would then be sheltered from estate taxes on the death of the surviving spouse. Any excess is given outright or in a more generally worded trust for the surviving spouse.

The reason that a trust is used is because it allows great flexibility. A spouse may have quite a number of rights in the trust and the property will still be sheltered from estate taxes on the surviving spouse’s death.

Some rights or interests a spouse may have in an exclusion trust:

- ✓ Serving as trustee.
- ✓ Receiving of all income.
- ✓ Invading principal where needed for the spouse’s health and maintenance according to the spouse’s usual standard of living.
- ✓ Deciding which family members who will receive the trust upon the spouse’s death.

It’s worth recognizing that it is not actually necessary to use a trust or give a spouse any interest in the property to take advantage of the exclusion amount. What is critical is that the property not be given outright to one’s spouse or in a manner that it would be included in the surviving spouse’s estate. You could decide to give property directly to other family members. This would also permit taking advantage of the exclusion amount. However, most couples want the surviving spouse to benefit from the property. Therefore, use of a trust is most common.

Exclusion trusts may take a variety of forms. Each form has various advantages and disadvantages. No particular method is ideal in all circumstances. The selection of which approach to take has become more difficult because of changes in the estate tax law.

As a broad statement, there are two approaches frequently taken:

- ✓ **Use the Maximum Exclusion Amount Available:** One approach – most common under the old federal estate tax scheme – is to assume that the entire exclusion amount will need to be used. This has usually made sense because the exclusion amount was only $675,000. It was necessary to shelter as much as possible. This may still be appropriate where larger estates are involved.

- ✓ **Use the Exclusion Amount Only to the Extent Needed:** Another approach – one that now is used more frequently – is to take advantage of the exclusion amount only to the extent needed to escape estate taxes. Where estates are large, but are likely to eventually be less than a single exclusion amount, this approach makes more sense.

Writing documents to achieve the rather direct goal of taking advantage of the exclusion amount has been quite complicated. This is because of the scheduled changes to the estate tax law. The tax law is a moving target. This still remains so to some extent, but the law is more stable.

The QTIP Trust

Although the exclusion trust remains commonly used, the federal estate tax law allows a flexible technique known as the QTIP trust. Importantly, Illinois law allows this as well. It is not necessary in Missouri for state estate tax purposes because, as mentioned, that state does not have an estate tax.

The letters “QTIP” refer to “qualified terminable interest property.” What happens with a QTIP trust most often is that a surviving spouse is given a life estate or income interest for life in property. A special election is then made for estate tax purposes – a QTIP election – whereby a part of the property is qualified for the marital deduction (just as an outright gift to a spouse would be) for estate tax purposes even though the interest is not outright. Because of the election, there would be no tax on the gift at the death of the first spouse but the gift (or what’s left of it) would be included in the survivor’s estate for estate tax purposes.

A QTIP election, at least for estate tax purposes, may be used to divide a trust into two shares (somewhat like the exclusion amount trust mentioned earlier). The QTIP election is made only to the extent necessary for the estate plan. Again, for estate tax purposes, no tax would apply as to the portion for which the election is made because it is treated as being given to one’s spouse and the exclusion amount avoids taxes on the balance. Where the election is made, the portion to which the election applies is treated as the survivor’s property on death. Thus, the effect is to delay taxes just as an outright gift would. Whether the assets are then taxable would depend on the size of the survivor’s estate and the estate tax law then in effect.

QTIP trusts are often used where there are children by a prior marriage. In most situations, a couple will want to give the surviving spouse as much discretion as possible over one’s entire estate. However, if there are children by a prior marriage or strong concern over possible remarriage, there may be interest in limiting a spouse’s interest in either share. With a QTIP, a person may limit a spouse’s interest in property and assure that the principal will eventually pass to specific beneficiaries. This may be done and still achieve estate tax savings.

The QTIP election is especially useful to coordinate the federal and Illinois estate taxes. Through the election a spouse may shelter the full federal estate tax exclusion amount and defer the Illinois estate tax on the difference between the federal and state estate tax exemptions until the death of the surviving spouse. For 2016, this would be the difference between $5.45 Million and $4 Million. If the election were not possible or made, there could either be a wasting of some of the federal exclusion amount or being required to pay Illinois tax at the death of the first spouse. Moreover, by delaying the tax, if there is a federal tax on the death of the surviving spouse, the Illinois tax would be deductible for federal estate tax purposes.

The Disclaimer Trust

There are many situations where the need for estate tax planning is uncertain. A couple’s estate may be on a borderline. If estate tax planning is not needed, there’s simply no desire to utilize it.

If there is a need, a couple wants it available. In these situations, use of a disclaimer trust is helpful.

A disclaimer is a giving up or relinquishing of a gift. Where property is disclaimed, it passes as if the person disclaiming it died before the gift was made. This would usually be the death of one's spouse.

A couple's estate plan could involve establishing a disclaimer trust on a standby basis. The couple would leave all assets to each other. On the death of the first spouse the die, the survivor would determine whether estate tax planning (or sheltering) is needed. If it is not, the surviving spouse would accept the gift outright. If it is, then a portion of the estate given outright is disclaimed by the surviving spouse. Rather than pass directly to one's children or other beneficiaries, however, it would pass to the disclaimer trust. The survivor could still enjoy all income and, if needed for health and maintenance, principal. What the survivor could not do is to change the ultimate disposition of the property.

Where a disclaimer trust is not in place, the survivor may still give up property. The surviving spouse could not selectively retain income or access to principal. It would pass however would have been planned had the spouse not survived.

Other Variations of Tax Planning Trusts and Making Choices

There are many variations of tax planning trusts and approaches. Outlined are only some basic concepts. Whatever approach is taken needs to be customized to your needs.

In estate planning, choices need to be made. Every choice has advantages and disadvantages. As it is sometimes framed: "Pick your devil!" Basis adjustment (*i.e.*, step up in basis) has already been mentioned. However, there are other implications of any decision that is made.

Retirement Plans and Annuities May Require Special Considerations

Retirement plans or annuities may be a significant part of an estate. These require careful planning. The reason for this is that retirement plans and annuities carry with them income tax obligations.

Where a couple has sufficient property to fully utilize the applicable exclusion amounts, it is ordinarily recommended that the spouse be the beneficiary of any retirement plans or annuities. The reason for this is that the surviving spouse will have the opportunity to "roll over" or transfer the proceeds from these assets. This allows continued deferred accumulation. In the long run, this will provide greater income and benefit to the surviving spouse.

If a couple does not have sufficient assets to fully utilize the applicable exclusion amount or other circumstances warrant (*e.g.*, subsequent marriage), it may be necessary to fund an exclusion trust using retirement funds and annuities. This is possible. Although continued deferral of income taxes is possible in some circumstances, the payment of income taxes may have to be accelerated.

Where retirement plans are involved, special provisions may be required for any tax planning trust if it will be used to fund the exclusion trust. If these provisions are not included, the surviving spouse will not be able to continue to defer income. The preference, again, is usually to name one's spouse as beneficiary direct and outright. But that is not always possible.

Consider Gifts If Your Estates Exceed the Exclusion Amounts

What if your combined estate exceeds the combined exclusion amounts? Additional estate tax planning may be needed.

> **Annual Gift Tax Exclusion**
> The annual gift tax exclusion is $14,000 (in 2016), allowing a couple to give $28,000 away each year to any number of family members desired.

Where estate taxes will apply notwithstanding use of the exclusion amounts, a gifting program is usually appropriate. Under current law, a person may make a gift of up to $14,000 (for 2016) per year per person. Gifts may be made to any number of persons, provided that each individual recipient's annual gift is within that limit. In other words, you may give each child, child's spouse, and descendant, an annual gift of $14,000. Spouses may make separate gifts or join in a single gift, allowing together gifts of $28,000 each year per person. This gift tax exclusion has changed and can increase based on the cost of living by $1,000 increments. The exclusion has changed over the years from an initial limit of $3,000.

Most couples do not make gifts in excess of the annual exclusion, but this may well be appropriate in some cases. Where gifts exceed that amount, a cumulative lifetime gift exemption may be used. This exemption is unified with the estate tax exemption. This means that the $5 Million plus that may be given at death is reduced by lifetime gifts over the annual exemption. If $1 Million over the annual exemption is given, the lifetime gifting limit would be reduced to $4 Million plus. Again, the gift tax and the estate tax have one and the same exclusion amount. They are one and the same. To the extent the gift tax exemption is used, the estate tax exclusion amount is reduced. There may well be some benefit to making excess gifts, most notably of assets (*e.g.*, farm land) that may well increase in value substantially that will be retained by family members.

> **No Limit on Some Gifts**
> Gifts may be made without limit for educational expenses or medical care. Special requirements must be followed, including payment directly to the provider.

The annual exclusion from gift taxes does not apply to all gifts. There are a number of technical requirements. Among others, the gift must be completed and also be of a present interest. Giving away real estate, for example, but reserving income for life, does not qualify for the gift tax exclusion. Likewise, a gift intended to take effect years in the future would not be a gift of a present interest. A completed gift requires that all benefits over the property be relinquished.

One important point about gifts is that a giver's basis for tax purposes in property becomes the basis of the person to whom the property is given. There is no step up to what it is worth at the time of the gift. There can be larger income taxes to the beneficiary as a result.

Consider Life Insurance

Where estate taxes are likely to be imposed, life insurance might be an appropriate part of a couple's estate plan. Apart from any insurance already obtained, it may be appropriate to acquire additional policies. Insurance may provide a source of funds to family to pay estate taxes and, in effect, replace wealth lost to taxes. Insurance also may provide needed liquidity which may be critical where business assets are held.

Review Your Insurance

- ✓ Are beneficiaries up-to-date?
- ✓ How does the insurance fit into your estate plan?
- ✓ Should ownership of insurance be transferred?

Insurance may be of various types. One or the other spouse may be insured. Second-to-die insurance, which pays a benefit upon the death of both spouses, is another type which is somewhat less expensive than insurance on a single life and provides funds precisely when needed at the death of the surviving spouse.

Gifts and insurance are sometimes combined in estate planning. Couples may make annual gifts and earmark those gifts for the purchase of insurance. Although the gifts may be made directly to family to acquire the insurance, which is often the case where adult children are involved, it also may be accomplished through a trust. The advantage of a trust is that access to the insurance proceeds may be restricted. Various requirements must be met. These trusts are known as *Crummey* trusts after the taxpayer who successfully established this estate planning technique in a case before the Internal Revenue Service.

Apart from considering additional insurance, be certain to review existing insurance. Make certain that beneficiary designations are up-to-date and consistent with your estate plan. Also, consider whether ownership of the insurance should be transferred in order to reduce estate taxes.

What is a Crummey Trust?

A *Crummey* trust is an irrevocable trust. Gifts are made to the trust each year, usually not exceeding $14,000 per trust beneficiary.

After each gift is made, the trust beneficiaries are given a period of time (*e.g.*, 45 days) to withdraw the gift. If not withdrawn – which usually it is not – the gift then is locked in the trust. This withdrawal power is the key aspect of the trust and converts what would otherwise be a future gift to a present gift. This permits the gifts to qualify for the annual gift tax exclusion.

Crummey trusts are frequently used to acquire life insurance. The trust owns the insurance. Gifts are made, subject to withdrawal rights, and then the funds used to pay for the insurance. After death, the proceeds are then distributed as provided in the trust.

Insurance is sometimes maligned. This is unfortunate. In the proper circumstances, insurance provides important and unique support for an estate plan.

Consider Other Estate Planning

Other estate tax reduction techniques or planning opportunities may be worthy of consideration. The use of other methods is typically more complicated, but is appropriate for some couples. The use and popularity of other methods change frequently. As each technique is popularized, the Internal Revenue Service attempts to restrict its use. More advanced planning necessarily involves greater risks. Nonetheless, in some circumstances, they may well be worth considering.

Some Other Estate Planning Techniques Are …

- ✓ **Business Opportunities:** Consider allowing your family to take advantage of special business opportunities, rather than have appreciation accrue to you.
- ✓ **Business Freezes:** If assets are held that will likely appreciate in value, consider whether it is possible to limit their value in your estate.
- ✓ **Generation-Skipping:** Where your children are independently affluent, consider establishing a generation-skipping trust so that assets would not be included in a child’s estate.
- ✓ **Charitable Giving:** If you are so inclined, consider charitable giving. Direct gifts are possible, as well as restricted gifts.
- ✓ **Insurance:** Don’t forget to consider insurance.
- ✓ **Special Valuation:** Attempt to structure assets so that you will qualify for the special valuation of farm real estate.
- ✓ **Limited Partnership:** Consider placing assets in a limited partnership. This permits continued control, but may result in the reduction of the value of assets because of lack of marketability. If gifts are made, a minority discount also may be available.
- ✓ **Partial Interests:** Owning partial or undivided interests in real estate or other assets, especially if a minority interest, may allow for a reduction in value.
- ✓ **Gifts of Residence:** A residence, even a second residence, may be given away at a reduced valuation for gift tax purposes. It is necessary that you live a required time for this to be of benefit, however.

Exemptions From Creditor Claims

The possibility of creditor claims is often worth consideration. There may be simple methods used to protect assets from claims that are suitable as part of one's estate plan. Keep in mind, however, that this is one of the sorts of choices that must be made in estate planning. Tax planning and creditor planning are sometime inconsistent.   You must determine what is most important.

An individual's assets are generally subject to the claims of his or her creditors. Unless properly agreed to, one person is usually not responsible for the debts of others. There are some exceptions. For example, spouses are responsible for the health care obligations of the other. Similarly, parents are responsible for the health care expenses of their dependent children.

Where financial problems arise, certain assets may be exempt from creditor claims. These exemptions may be waived. When a mortgage is taken out, for example, the bank or financial institution will require that any exemption with regard to the home be waived.

The exemptions vary from state to state. Illinois provides a number of very important exemptions from creditor claims.

An important exemption is for one's residence where held as tenants by the entirety. Unless there is a claim against both spouses, a judgment may not be enforced against the real estate. In Missouri, any property may be held as tenants by the entirety.

Another exemption for real estate in Illinois is a homestead exemption. For an individual, this amounts to $15,000.00. For a couple, it amounts to $30,000.00. Missouri limits the homestead exemption to $15,000.00 even for a couple.

An important exemption in Illinois is insurance. It is worthwhile to realize that the net cash value of life insurance, endowment policies and annuity contracts may be exempt from creditor claims even in the event of bankruptcy. Some states, such as Illinois, provide that proceeds payable because of the death of the insured and the aggregate cash value of life insurance, endowment policies and annuity contracts are exempt from creditor claims where payable to a spouse of the insured, or to a child, parent, or other person dependent upon the insured. This applies whether the power to change the beneficiary is reserved to the insured or not and whether the insured or the insured's estate is a contingent beneficiary or not. By naming the spouse, the exemption will usually be preserved. Although it is typically advisable to name one's estate as the alternate beneficiary, the possibility of creditor claims should be considered. If creditor claims are possible or likely, the general advice may not be appropriate. Missouri also exempts insurance under certain circumstances, but limits the exemption as to a policy’s loan value.

Another important exemption in Illinois relates to retirement plans. Retirement plans are exempt, whether vested or not. Retirement plans include, among others, a pension, profit sharing or similar plan. It even includes individual retirement accounts and simplified employee pension plans (that is, IRAs and SEPs). There are a number of other exemptions. However, they are comparatively modest. It is important to be careful before waiving exemptions to assets. Clearly, it is preferable not to waive an exemption where available. Missouri law also exempts retirement plans under certain circumstances.

Don’t Forget Powers of Attorney and Living Wills

As important as a will or trust might be, don’t forget some other important estate planning tools.

Have a Power of Attorney

Don't forget to have a durable power of attorney for property and health care.

This is important.

One of the more important estate planning tools available is a durable power of attorney. A power of attorney is a written instrument whereby one person appoints another to act as an agent or representative. Depending on how the power of attorney is written, the agent may handle both property matters and health care decisions. The power is durable and may continue to be used even if the person appointing the agent becomes disabled.

Living wills are another estate planning tool helpful for many. A living will declares one's desire that no extraordinary means be used to delay the moment of death if death is imminent and inevitable. Although the wishes of family will be considered, living wills often give comfort to family members in knowing your wishes.

Reminder: Don't Delay Making Your Plans

Estate planning takes time. But it should be an important priority. Don't delay in making your plans and implementing them.

Please note that this discussion provides general information.
It is not intended to provide specific or personal legal advice.

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