Daniel M. Isard

Gift and Estate Planning in 2015

Dear Dan,
I'm a long-time reader, first-time writer. I have an estate of about $4 million. I am married. My will was written in 2005 by the best law firm in Chicago (Al Capone used it so it must be good). Upon my death, my will creates a family trust and credit shelter trust. I do 200 calls out of one location and own my real estate. I have second-to-die life insurance and life insurance in an irrevocable trust. I fund it each year, giving my kids a present interest in that trust. This plan allows for zero federal estate taxes. I am ill. Not sickly but not buying any green bananas either. Yesterday, I played golf with a young estate lawyer who told me that due to the change in the federal estate tax, all of the wills, insurance and trusts I have are not necessary. Can you sort it out before I die or get a higher handicap?

Signed, Ill in Illinois

Dear III,
I hope that someday your golf score will be less than your age! For now, until Congress makes more changes, that newbie legal beagle who joined your threesome was right. The American Taxpayer Relief Act, signed into law January 2, 2013, made permanent some of the changes of previous legislation continued by executive order and made other changes in the federal estate tax to truly make it a tax on the wealthy. By wealthy, I mean a gross estate for a couple of greater than $10,860,000! While at $4 million I'm sure you get lots of charitable phone calls, you are no longer considered wealthy enough to tax for the right to transfer your estate.

The dollar amount of your estate could be in question, however. First of all, if you own the business and real estate, that is part of your estate. When was the last time you had the business and its real estate valued? The value of the business must be as a "going concern," and that means it will have a goodwill component to its total value. Only qualified and experienced appraisers can tell you the business value; be sure to use one that has experience in valuing funeral homes.

The value of the funeral home is subject to interpretation, but the more experience the appraiser has, the greater the chance that he or she will get the value correct. I once saw an appraisal of a funeral home business with real estate rented from an unrelated third party. This was for a trial situation. The opposing expert's value was almost $1 million more than mine. The key to any valuation is the assumptions being used by the appraiser. Typically, in a "going concern" appraisal, the appraiser looks at the business and assumes the business will be operated as it has been operated. The opposing expert made the assumption that the business would be operated by a big corporation, thus eliminating its $20,000 of accounting costs. He also assumed that its revenue per call would go up about 10 percent per year. He made several other egregious assumptions as well, all of which played to push the value. My point, Ill, is this: Having an appraisal and having an accurate appraisal are two different things.

I saw one valuation on a 300-call business in which the appraiser used comparable sales to confirm his conclusion. The problem was that this business had four locations and the comps he used had one location. We can presume that 300 calls out of one location are going to result in lower average costs and therefore higher profits for that one location. Three hundred calls spread across four locations will result in a diluted profit for each location. Higher profits drive value up. Experienced appraisers often err in their application of this simple principal.

Furthermore, the business real estate should be valued as a funeral home, not as any commercial property. The value of the property as a funeral home will affect the value of the operating business. Do not have one company value the business and another value the real estate as the two must be in harmony! I have seen people use commercial property valuation for their business, which creates a value that is too high and causes problems. The IRS has a special code section for such a matter. It applies to businesses and family farms.

Imagine you are a farmer and own 100 acres. To grow corn, this might be worth $1,000/acre. If you were to die, you want the property valued as a corn-growing farm. You don't want it to be valued at $10,000/acre as it might be for home development. The IRS understands this dilemma. Therefore, if the property was used for this purpose in the past and the family will promise to keep it that way for 10 years, the IRS will allow this special-use value. The key is to be prepared to keep the property being used as a funeral home and get a lower value for your estate.

The federal estate tax started out as a tax on the wealthy, as they would transfer their assets to their next generation(s). In 1916, the tax was on estates of more than $50,000 and would increase up to the top tax rate of 10 percent. It was an expense but not a matter that caused wealthy people to work hard to shelter their assets. While the amount exempt of estate tax did not change too much right off the bat, by 1925, the maximum tax amount went up to 40 percent! During the Depression through 1941, the exemption varied, but the maximum tax rate went up to 77 percent! This essentially said that you can leave 23 percent of your wealth to your kids and the balance goes to the government. In 1977, the exemption went from $60,000 to $120,000, with the maximum tax at about 70 percent.

At these high rates, people began to take efforts to protect their wealth from government seizure. A good estate plan was a must. For example, life insurance, if it is owned or controlled by the decedent at their death, is an asset within their estate. Many people want to protect their business and successors so they have life insurance to pay the estate taxes. However, if you have a $1 million federal es-

tate tax due and purchase $1 million to pay that tax, you may have just increased your estate by the value of the life insurance. You will have increased your federal estate tax by $500,000!

The key to using life insurance to pay federal estate taxes is to keep the life insurance out of your estate. The life insurance should be owned and paid for via an irrevocable life insurance trust. If you do this properly, the insurance is not an asset of your estate. This is a complicated maneuver, however, so professional guidance should be employed. If done correctly, though, it is a great relief from the need to liquidate assets to pay a tax.

Now, with all of that established, the law changed. The aforementioned made a big change so that only really wealthy people are paying estate taxes again. The individual spouse limit is $5,430,000; therefore, a married couple would be taxed only if they have a combined estate of more than $10,860,000. So the estate tax is not a real problem for most business owners any longer. But that has created a whole new set of problems!

If a person has an estate plan put into place prior to 2010, he or she could have a problem today because of the language of the trust. There are typically two trusts we would use in an estate plan. First is the credit shelter trust (also known as residual trust). This trust would take the amount of the federal estate tax credit and set it aside. The money and property funding this trust would provide income to the survivor, but the survivor typically doesn't get the right to invade the principal. Anything beyond the credit shelter trust goes into a family trust (also known as a marital trust), which provides income and almost always provides the principal for the surviving trust to use if the income is not sufficient for his or her needs.

In the past, most people funded a credit shelter trust equal to about half of their assets, and the balance would go into the family trust. Since the credit shelter trust was funded up to the amount of the federal estate tax credit, the funding amount was used up by each spouse. This reduced the total federal estate tax regardless of which spouse died first. Therein lies the problem in 2015. Let me take you back to 2005 as an example. The federal estate tax credit was $1.5 million. So if someone had an estate of $4 million, typically the first $1.5 million of their estate would go into a credit shelter trust and any estate assets left over would go to the family trust.

Imagine you still have a $4 million estate in 2015 and your 2005-drafted wills. If death occurred, the credit shelter trust would be funded with the all of the value of your estate and the family trust would get nothing, which could be a problem for the survivor. The surviving spouse would get income but not have the right to invade the principal if the income was insufficient. In 2005, most people could invest their money and get 8 percent interest; today, we are looking at just 1 percent to 3 percent earnings. Less interest means less income! The survivor would not have access to the principal in most cases.

If you have 2005 wills and trusts in today's more generous estate planning world, you need to get someone to perform what we call in our practice a "hypothetical probate." This is basically pretending that you died today. What does your will direct should happen to your assets? This should be performed regardless of who dies first! Can either survivor live with these trusts or other restrictions? If so, you are fine. However, if not, you should make changes as soon as possible.

The good news is that the wills and trust documents are revocable before one of the spouses dies. However, the irrevocable life insurance trust is irrevocable. The life insurance contained within it may no longer be necessary. Your choice of second-to-die is using a joint policy insuring both spouses but with a twist. A joint insurance policy typically pays off at the death of the first to die. A second-to-die policy insures two lives but pays off on the second to die. This policy is great for paying federal estate taxes, as they are due upon the second death of a couple. However, that is old school.

With our $10,860,000 federal estate tax exemption, you may not have a federal tax any longer. You may still have a state tax, which is sometimes called an inheritance tax. That must be reviewed since some states have one and some don't. However, the state transfer tax, if it exists in your state, could be negligible or it could be substantial. Many people elect to relocate later in life to avoid this transfer tax based on the state of your residence.

Both the federal and state tax might be gone, but without lifetime planning, you may still have "probate," which is the legal fee for transferring assets upon death. And yes, this is enough to make you ill! I'm sure you are very impressed with the lawyers you have seen closing out estates during your career in funeral service (yes, that is sarcasm). It is best to not die, but until they find a cure, do some good planning with the current law! ✶

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