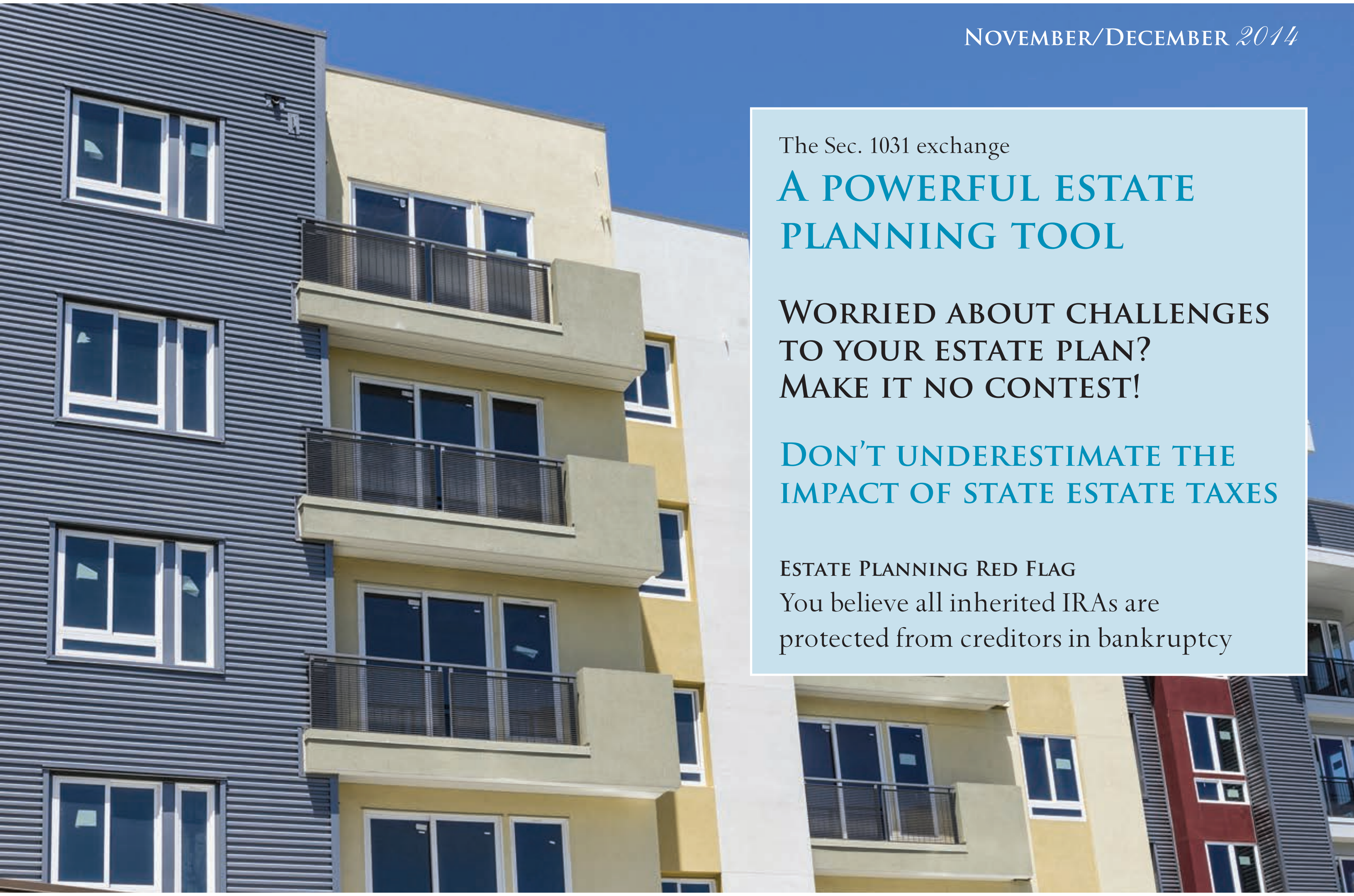
# The Estate Planner

November/December 2014



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## A powerful estate planning tool

## Worried about challenges to your estate plan? Make it no contest!

## Don't underestimate the impact of state estate taxes

**Estate Planning Red Flag**
You believe all inherited IRAs are protected from creditors in bankruptcy

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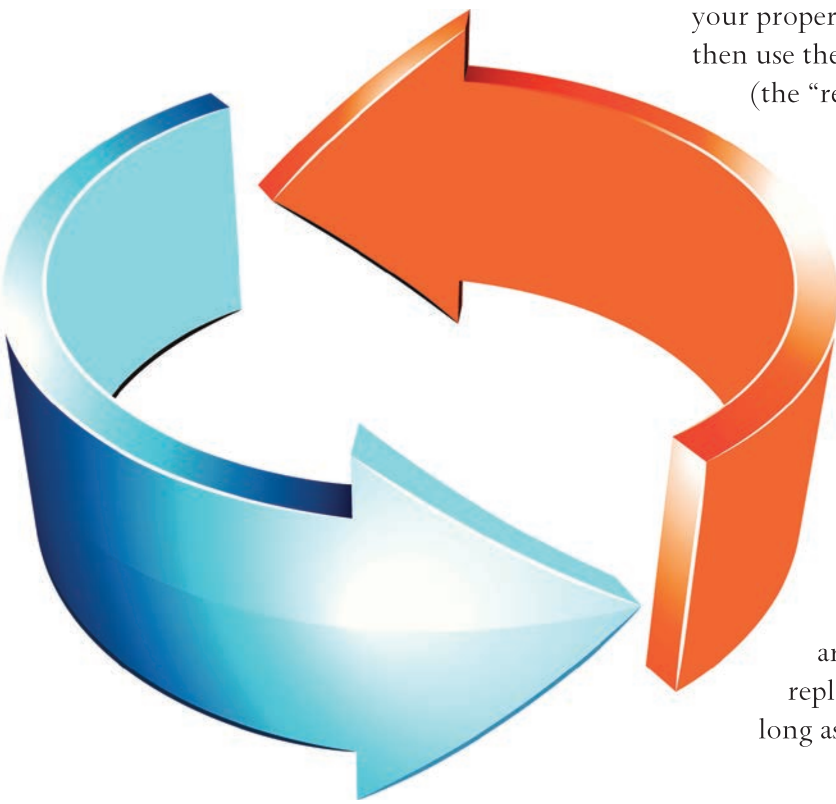
## The Sec. 1031 exchange

# A powerful estate planning tool

Now that the combined gift and estate tax exemption amount has topped $5 million ($5.34 million in 2014), many people planning their estates have turned their attention to income taxes. If you own highly appreciated business or investment real estate, one of the most effective tax strategies at your disposal is the Section 1031 "like-kind" exchange. With careful planning, you can use a Sec. 1031 exchange to defer capital gains taxes on appreciated property indefinitely, and even eliminate them permanently.

### Sec. 1031 in action

Despite the term "like-kind," Sec. 1031 allows you to exchange one or more pieces of business or investment real estate for virtually any other business or investment real estate without recognizing capital gain. You can exchange an apartment complex for an office building, for example, or a farm for a strip mall. The only limitation is that the value of the new properties should be equal to or greater than the value of the existing properties. If you receive any cash or other non-real-estate property, it'll be immediately taxable.



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Few Sec. 1031 exchanges involve a direct exchange of one property for another. Most are structured as "deferred exchanges." In other words, you sell your property (the "relinquished" property) and then use the proceeds to acquire new property (the "replacement" property).

### 2 common safe harbors

The key to avoiding capital gains tax in an exchange is to ensure that you never possess or control the sale proceeds. And the best way to do that is to use one of several IRS safe harbors. The two most common safe harbors are:

**1. Deferred exchanges.** You sell the relinquished property (or properties) and engage a qualified intermediary (QI) to hold the proceeds and buy replacement property (or properties). So long as you identify replacement property within 45 days and complete the purchase within 180 days after the relinquished property is sold, the capital gain is deferred.

**2. Reverse exchanges.** You engage a QI to acquire replacement property (or properties) *before* you sell relinquished property. To defer capital gain, you must identify the relinquished property (or properties) within 45 days and complete the sale within 180 days. Also, to avoid holding title to relinquished and replacement properties at the same time, you must "park" replacement properties with an "exchange accommodation titleholder" until the transaction is completed.

These and other safe harbors (such as trusts and qualified escrow accounts) aren't the only way to complete a Sec. 1031 exchange. But if you do an exchange outside the safe harbors, there's always a risk that the IRS will challenge it and treat the transaction as taxable.

## Estate planning benefits

Although a Sec. 1031 exchange is best known as a tax-deferral technique, it can also be a powerful estate planning tool. Ordinarily, when you sell appreciated real estate you must pay taxes on the gain at rates as high as 20%, leaving less to pass on to your children or other heirs.

If you hold onto property for life, however, the capital gains disappear. Your heirs receive a "stepped-up basis" in the property equal to its fair market value on your date of death, erasing any previous appreciation in value and allowing them to turn around and sell the property tax-free.

But what if you don't want to hold property for life? What if you'd prefer to dispose of it in order to invest in income-producing real estate or to diversify your holdings? That's where a Sec. 1031 exchange comes into play. Rather than selling property, paying capital gains taxes and reinvesting what's left of the proceeds, an exchange allows you to accomplish your goals without losing any of the exchanged property's value to taxes.

## Can you exchange a personal residence?

Generally, the benefits of a Section 1031 exchange (see main article) are limited to business or investment properties. But it may be possible to convert a personal residence into a business or investment property and then enact a Sec. 1031 exchange.

Suppose you wish to dispose of a large home and invest in one or more business properties. To defer the capital gain, you might convert the home to a business use (by renting it out, for example) and then exchange it. To ensure that the IRS treats the home as a legitimate business property, you must use it as a rental property for a substantial period of time (usually, at least two years).


## TIC tactic

One specific tactic to consider is exchanging a single property for several tenancy-in-common (TIC) interests. TIC interests are fractional, undivided interests in larger properties. Exchanging real estate for TIC interests not only defers capital gains taxes, but also gives you access to professionally managed, institutional-grade real estate. And it provides some interesting estate planning opportunities.

Consider this example: Brian owns a highly appreciated apartment building. He wants to divide his estate equally among his three children. But he'd prefer not to leave them the building jointly, for fear it'll lead to conflict over whether to sell the building or hold onto it.

If Brian sells the building, he'll be hit with a capital gains tax bill, leaving less for his kids. Instead, he opts for a Sec. 1031 exchange, trading the building for three equally valued TIC interests in a professionally managed real estate investment. When Brian dies, his children each receive a TIC interest with a stepped-up basis and can decide independently whether to sell or hold their interests.

### Worth a look

If you have significant wealth tied up in business or investment real estate, a Sec. 1031 exchange may minimize your family's income taxes. If your net worth is large enough to make estate taxes a concern, however, be sure to balance the income tax benefits of an exchange strategy against the estate tax benefits of a lifetime gift.

Before taking any action, be sure to talk to your estate tax and financial advisors to help you evaluate whether a Sec. 1031 exchange is right for your particular situation. ✤

# Worried about challenges to your estate plan? Make it no contest!

Estate planning is all about protecting your family and ensuring that your wealth is distributed according to your wishes. So the idea that someone might challenge your estate plan can be disconcerting. One strategy for protecting your plan is to include a "no-contest" clause in your will or revocable trust (or both).

### What's a no-contest clause?

A no-contest clause essentially disinherits a beneficiary who contests your will or trust — typically on grounds of undue influence or lack of testamentary capacity — and loses. It's meant to serve as a deterrent against frivolous challenges that would only create unnecessary expense and delay for your family.

### Is it enforceable?

Most, but not all, states permit and enforce no-contest clauses. And even if they're allowed, the laws differ — often in subtle ways — from state to state, so it's important to consult state law before including a no-contest clause in your will or trust.

Some jurisdictions have different rules regarding which types of proceedings constitute a "contest."

For example, in some states your heirs may be able to challenge the appointment of an executor or trustee without violating a no-contest clause. And in some states in which a no-contest clause is generally enforceable, courts will refuse to enforce the clause if a challenger has "probable cause" or some other defensible reason for bringing the challenge. This is true even if the challenge itself is unsuccessful.

If you live in a state in which no-contest clauses are strictly unenforceable, you might still choose to have one in case you: 1) move to another state that does enforce no-contest clauses, 2) own property — such as real estate — in another state where it's enforceable, or 3) decide to establish a trust that's governed by the laws of another state.

## What if I want to disinherit someone?

If you leave a child — or another person who otherwise would inherit from you — out of your will or trust, a no-contest clause will be ineffective. Why? Because that person has nothing to lose by challenging your plan. A better strategy is to leave that person enough to make him or her think twice before contesting your plan and potentially receiving nothing.

> *A no-contest clause can be a powerful deterrent, but it's also important to design your estate plan in a way that minimizes incentives to challenge your plan.*

## Are there alternative strategies?

A no-contest clause can be a powerful deterrent, but it's also important to design your estate plan in a way that minimizes incentives to challenge your plan. To avoid claims of undue influence or lack of testamentary capacity, there are several steps you can take, including:

- Having a qualified physician or psychiatrist examine you — at or near the time you sign your will or trust — and attest in writing to your mental competence,
- Choosing witnesses whom your heirs trust and whom you expect to be able and willing to testify, if necessary, to your testamentary capacity and freedom from undue influence, and
- Recording the execution of your will and other estate planning documents.

Of course, you should also make an effort to treat your children and other family members fairly, remembering that "equal" isn't necessarily fair, depending on the circumstances. If your plan contains any unusual terms — such as leaving the bulk of your estate to charity — be sure to meet with your family and explain the reasons for your decision.

## Protect yourself

As you develop or update your estate plan, it's important to think about ways to protect yourself against challenges by disgruntled heirs or beneficiaries. A no-contest clause can be an effective tool for discouraging such challenges. Discuss this option with your estate planning advisor to determine whether it's the right fit for your plan. ✤

# Don't underestimate the impact of state estate taxes

True or false: If your estate is worth less than the current $5.34 million federal gift and estate tax exemption, you don't have to implement strategies to minimize or eliminate estate tax.


False! It's true that, if you don't expect your estate's net worth to grow more than the current exemption rate, you no longer have to worry about federal estate tax liability. But you do have to take into account *state* estate taxes, which can generate significant liability for your heirs.

## Rates and exemptions

One challenge in planning for state death taxes is that they're in a constant state of flux. Currently, more than 20 states and the District of Columbia have an estate tax, an inheritance tax or, in two cases (New Jersey and Delaware), both. As the names suggest, estate tax applies to one's estate, and inheritance tax is imposed on those who inherit property.

*Tax rates and exemption amounts vary from state to state and may change over time.*

Tax rates and exemption amounts vary from state to state and may change over time. Inheritance taxes often kick in with the first dollar of an inheritance, but some states offer exemptions for inheritances by certain family members (such as children, parents or siblings). In recent years, there's been a trend toward softening the blow of state death taxes by increasing exemption amounts. Still, exemptions in many states are substantially lower than the federal exemption.

Suppose, for example, that you live in a state that imposes estate tax at a flat rate of 16% beyond an allowed $1 million exemption. If you die with $5 million in assets, your estate will escape federal estate tax but will be liable for state estate tax of $640,000 ($4 million taxable [$5 million – $1 million exemption] × 16% tax rate = $640,000).

## Techniques to offset state estate tax

To avoid surprising your family with an unexpected tax bill, it's important to address state death taxes in your estate planning. For instance, you can use a credit shelter (or "bypass") trust to preserve both spouses' exemptions and defer estate taxes as long as possible. With higher exemption amounts and portability, this strategy is less critical today for federal tax purposes. But it still offers significant benefits for estate tax planning in some states.

Here's how it works, assuming you have a $5 million estate and live in a state with a $1 million exemption: When you die, your estate plan transfers $1 million to a credit shelter trust, which is shielded from taxes by your exemption and provides your spouse with income for life (with the remainder going to your children). The other $4 million goes into a marital trust, which escapes taxation in your estate by virtue of the marital deduction. When your spouse dies, $3 million ($4 million less the $1 million exemption) will be subject to state estate taxes, but you'll have used both of your exemptions and deferred state taxes until the second spouse's death.

### All bases covered

It's common for state estate taxes to take a back seat to federal estate taxes when one is creating or updating their estate plan. But be sure to ask your estate planning advisor to review your state's estate or inheritance tax laws to ensure your plan covers all the bases. ✤

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**Estate Planning Red Flag**

## You believe all inherited IRAs are protected from creditors in bankruptcy

Until recently, it was widely believed that inherited IRAs, like other IRAs, are protected from creditors in bankruptcy. But in a June 2014 decision — *Clark v. Rameker* — the U.S. Supreme Court held that an IRA inherited by the owner's daughter was not.

Specifically, the Court found that an inherited IRA doesn't meet the definition of "retirement fund" for federal bankruptcy purposes, because the beneficiary:

1. Can't make additional contributions,
2. Must take required minimum distributions (RMDs) even if he or she is far from retirement age, and
3. Can withdraw the funds at any time, penalty-free.

If you're concerned that your beneficiaries may go through bankruptcy, consider protecting your IRA by leaving it to a trust. The trust should be designed carefully to ensure that the assets are protected — typically by giving the trustee full discretion over accumulation or distribution of RMDs — and that RMDs are stretched out over the oldest beneficiary's life expectancy.

Keep in mind that accumulated RMDs will likely be subject to higher income taxes. Currently, trusts are taxed at the highest rate (39.6%) to the extent their income exceeds $12,150. Alternatively, the trust can be designed as a "conduit" trust, which immediately pays out RMDs to the beneficiaries. This avoids income taxes in the trust, but it also exposes distributions to creditors' claims.

What happens when a spouse inherits an IRA? The Court didn't say, but the decision may place spouses at risk as well. A spouse can elect to cash out the IRA penalty-free, keep the inherited IRA, or roll the funds into his or her own IRA. The first option and, arguably, the second, would expose the funds to creditors' claims. The third option would offer creditor protection, but might be challenged by existing creditors as a fraudulent transfer.

If you're concerned about bankruptcy, it's a good idea to leave an IRA in trust, whether the beneficiary is a spouse or nonspouse.

Weston Hurd LLP
Attorneys at Law

# HOME IS WHERE THE INTENT IS

## By Shawn W. Maestle and Angela G. Carlin

Justice Paul E. Pfeifer introduced the unanimous opinion of the Ohio Supreme Court on October 14, 2014 in an insurance coverage case, *Schill v. Cincinnati Ins. Co.*, 2014-Ohio-4527 reversing the judgment of the Eighth District Court of Appeals, No. 97715, 2012-Ohio-3813, by stating "we address the meaning of the contract term 'domicile'." The Supreme Court reiterated its previous jurisprudence relative to the definition of domicile: it is where a person resides, where he intends to remain, and where he intends to return when away temporarily.

The issue of domicile versus residency arises in many probate cases. Residency requirements of an executor, administrator, or guardian in Ohio are described in O.R.C. 2109.21, providing that such individual file with the court the fiduciary's permanent address and any change thereto. Under O.R.C. 2151.06, a child has the same residence or legal settlement as his parents, guardian of his person, or custodian. O.R.C. 2107.11 provides that a will shall be admitted to probate in the county in Ohio in which the testator (the person who made the will) was domiciled at the time of testator's death. A guardian is appointed for a ward, who is a minor or incompetent, who is a resident or has a legal settlement in a particular county in Ohio. Municipal taxes of a decedent are paid to the county where the decedent was domiciled.

In August 2008, a John Carroll University professor was riding his bicycle in Geauga County when he was struck by a vehicle driven by Robert Schill ("Robert"). The professor died later that day from his injuries. His wife, the appellee, was the executor of his estate.

Robert was driving his own vehicle, which was insured under a policy with liability coverage limit of $500,000. The executor filed a wrongful-death action against Robert and his insurer. The executor settled with the insurer, and Robert then sought additional coverage under the personal umbrella liability policy of his parents, James ("James") and Jean ("Jean") Schill, issued by appellant, Cincinnati Insurance Company ("CIC"). After CIC denied coverage, Robert filed a declaratory judgment action seeking from CIC a duty of indemnification in the wrongful-death case. CIC answered and filed counterclaims against Robert and cross-claims against the executor.

After the trial court consolidated the declaratory judgment action and underlying wrongful-death action, CIC, Robert and the executor filed motions for summary judgment on the issue of coverage. The trial court granted summary judgment for CIC, and the appellate court reversed. CIC appealed. Under the umbrella policy of his parents with CIC, an insured for occurrences caused by the use of 'automobiles' included "your resident relatives."

"Resident relative" was defined as a person related to "you" by blood, marriage or adoption that is a resident of 'your' household and whose legal residence of domicile is the same as yours.

The only issue in this case was whether Robert shared the same legal residence of domicile as one or both of his parents at the time of the accident.

Robert was a resident of Ohio at the time of the accident.

James, intending to retire, moved to Florida with his wife in 1993. Jean owned their Florida home for which the couple applied for a homestead exemption based upon proof that Florida was their permanent residence and domicile. For years James spent approximately two weeks per month in Ohio, working at a business of which he was the chairman and CEO. When in Ohio, James stayed at Robert's home – for "convenience and practicality." James kept a car in Ohio registered in Florida; he maintained a Florida driver's license since 1993; he and his wife moved family heirlooms, antiques, treasures, and personal property to the Florida home; he had been registered to vote in Florida since 1993 and had not voted in Ohio since that time; his family doctor was in Florida, as was his dentist; he registered at a Catholic parish in Florida; and maintained his checking and savings accounts in Florida banks. James tailored his time in Ohio to fewer than the number of days that Ohio law considered presumptive evidence of being domiciled in Ohio. When asked whether it was always his intention to return to Florida when his business in Ohio was completed, James responded, "Absolutely. That's where I live."

Considering the evidence submitted by the parties, the trial court, finding that no genuine issue of material fact existed, granted summary judgment in favor of CIC, citing *Cincinnati Ins. Co. v. Minser*, 2d Dist Montgomery No. 10976, 1989 WL 567 (Jan. 4, 1989), that a domicile is a "permanent home to which one intends to return in event he should leave."

Under Ohio law, a person can have many residences, but only one domicile. The claimant argued that a person can have a separate domicile "for insurance coverage purposes."

The Supreme Court quoted 1878 Ohio law: "In a strict legal sense, that is properly the domicile of a person where he has his true, fixed, permanent home and principal establishment, and to which, whenever he is absent, he has the intention of returning," citing *Sturgeon v. Korte*, 34 Ohio St. 525, 535 (1878), citing Story, Conflict of Laws, Section 41.

The Supreme Court held that because "domicile" and "residence" are usually in the same place, they are frequently used as if they had the same meaning. "Domicile" however, means living in a locality with intent to make it a fixed and permanent home, while "residence" simply requires bodily presence as an inhabitant in a given place. *Fuller v. Hofferbert*, 204 F.2d 592, 597 (6th Cir. 1953).

In the *Schill* case, the court of appeals reversed the judgment of the trial court, concluding that reasonable minds could only conclude that James was domiciled in Ohio. The Ohio Supreme Court held that the opposite is true. James's clear intent was to work part-time in Ohio and be domiciled in Florida. "He has meticulously ordered his life to make that so."

Therefore, since Robert did not have the same "legal residence of domicile" as either of his parents, he was not an insured "resident relative" under the umbrella policy at issue.

Shawn W. Maestle and John G. Farnan of Weston Hurd represented CIC in the *Schill* case in the Ohio Supreme Court.

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