WISCONSIN: AN ESTATE PLANNING PARADISE[1]

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Introduction

Wisconsin is well known for great fishing, hunting, sightseeing, snowmobiling, cross-country skiing and a host of other vacation opportunities. What far too few people realize, however, is that Wisconsin can also be an estate planning paradise for its state citizens who benefit from a variety of advantageous laws. This article describes various aspects of Wisconsin law which should be considered and emphasized when meeting with clients who are in need of estate planning and may be contemplating a change of domicile.

Wisconsin has no state inheritance tax.

The fact that Wisconsin no longer has an inheritance tax is a surprise to most clients. As of January 1, 1992, Wisconsin replaced its inheritance tax with an estate "pick up" tax which is limited to the credit allowed for state death taxes under the federal estate tax system. If a federal estate tax is imposed on the estate of a deceased Wisconsinite, the State of Wisconsin receives the amount of the credit for state death taxes and the Internal Revenue Service receives the remainder. If there is no federal estate tax to pay, then there is no Wisconsin estate tax either. As a result, in either case, Wisconsin's estate tax results in no additional taxes.

Wisconsin does not recognize the common law rule against perpetuities.

The rule against perpetuities is an English law principle that has been carried over to the laws of this country. It requires a person's interest in property to vest (or become absolute) within a certain time period, typically within a life or lives in being plus 21 years. When the rule applies, restrictions placed on the transfer of property beyond that time period will be invalid.

The Rule against Perpetuities can be an obstacle in estate planning in connection with trusts that are intended to continue for many generations to come. These trusts (sometimes called "Dynasty Trusts") will not be effective in states that still follow this old English law rule. Wisconsin, however, is one of only a few states that do not recognize the rule against perpetuities in its common law form. Instead, Wisconsin statutes provide for a rule against the suspension of a power of alienation that voids a future interest or trust if it suspends the power of alienation for longer than the "permissible period", which is set by statute as a life

[1] **This article is current as of 1998. Please contact Willms, S.C. for current information on this topic.**

or lives in being plus 30 years. The statute also provides that a violation of the rule is avoided for trusts if the trustee has the power to sell trust assets, or there is an unlimited power to terminate the trust in one or more persons in being. Therefore, a trust established in Wisconsin can continue indefinitely as long as a grantor of a Wisconsin trust grants the trustee the power to sell trust assets.

Wisconsin Marital Property law

In 1986, Wisconsin adopted the Marital Property Act, which essentially changed Wisconsin from a common law property state to a community property state. As complicated as the marital property law can be, it provides the foundation for significant estate planning benefits for Wisconsin residents.

Transferring assets at death: will substitute agreements

The Wisconsin Marital Property Act provides that married persons may agree that upon the death of either spouse, either or both spouses' property, including any after-acquired property, may be transferred without probate to a designated person, trust, or other entity. As a result, a marital property agreement that directs how a married person's assets are to be distributed can protect those assets from probate, if the asset is located in Wisconsin.

Perhaps the most effective way to make use of this type of provision (sometimes called "Washington Will Provisions" because a more limited version of the concept originated in the State of Washington) is to direct that such assets be transferred to a living trust upon death. Wisconsin is the only state in the nation that permits a living trust to be funded after the Grantor's death while still avoiding probate.

Will substitute provisions in a marital property agreement are often not appropriate, however, as the primary asset transfer document at death. Section 766.58(3)(f) essentially provides a mechanism for transferring legal title of an asset to those persons named in the marital property agreement. Therefore, the statute offers no procedure for post-mortem tax or other planning which usually occurs within the guidelines and protections of the probate process or a trust.

Furthermore, absent specific provisions in the agreement to allow unilateral amendment by one spouse, the will substitute provisions may only be revoked by mutual consent of both spouses in a subsequently executed marital property agreement. This raises potential gift tax issues. By using the will substitute provisions as the primary asset transfer document at death, planners may be inadvertently locking one spouse into a non-testamentary disposition that cannot be changed unless the other spouse consents.

"Double step-up" in capital gains tax basis

Under the Internal Revenue Code, the basis of property received from a deceased person receives an adjustment in basis (called a "step-up" if the value of the asset has increased from the date of acquisition to the date of death) equal to the property's fair market value at the date of death. When a married person who is a resident of a common law state dies, assets titled in the name of the decedent will receive a new basis, but the basis of property belonging to the surviving spouse is not adjusted, and the basis of property owned jointly between spouses only receives a step up in basis equal to one-half of the fair market value of the asset on the date of death of the decedent.

By comparison, in community property states all community property receives a full adjustment equal to the value of the property on the date of death of either spouse. Since marital property is treated as community property by the Internal Revenue Code, all marital property receives a full step up in basis upon the death of either spouse. Furthermore, Wisconsin statutes also provide this same "double step-up" result for state tax purposes. Accordingly, marital property can help a surviving spouse avoid both state and federal capital gain taxes.

Unfortunately, this double step-up in basis is not automatic for Wisconsinites by mere fact of residence; spousal assets must actually be classified as marital property or survivorship marital property. Wisconsin's marital property law took effect on January 1, 1986. Property owned by a married couple prior to that date is not necessarily classified as marital property. Likewise, property owned prior to marriage or received after marriage by gift or inheritance may not be treated as marital property.

However, Wisconsin's Marital Property Act allows married persons to reclassify all assets titled in either spouses name as marital property in a marital property agreement. As a result, in many cases a properly drafted estate plan will include a marital property agreement classifying the assets of the married couple as marital property to insure the adjustment in basis on all marital property at the death of the first spouse.

Equalizing the spousal estates

Under the Internal Revenue Code, every individual is entitled to an "Applicable Unified Credit Amount," which can shelter a specified amount of assets from federal transfer taxes for gifts during lifetime and transfers at death. This credit can shelter $625,000 of assets in 1998, but is scheduled to increase to $1,000,000 of assets for persons dying in 2006 and beyond. If a married couple utilizes both spouses' unified credits, the amount protected from federal transfer taxes can be effectively doubled.

For example, assume a married couple living in a common law state has a combined net worth of $1.25 million. Assume further that 1 million dollars of these assets are held in husband's name. The remaining assets are held in both spouse's name as tenants by the entirety. If wife dies first, then the assets held in husband's name will not be available to fund wife's unified credit. Likewise, the joint assets will pass outright to husband by right of survivorship. As a result, the wife's unified credit will not be used. Instead, all of the assets will be includable in the husband's estate for federal estate tax purposes at the second death. In comparison, if the couple lived in Wisconsin and had executed a marital property agreement that classifies all of their assets as marital property, then ½ of the assets held in husband's name would be includable in wife's estate for federal estate tax purposes. As a result, those assets could be used to fund wife's applicable unified credit amount.

Often, a significant portion of a married person's assets will have been accumulated inside an employer-sponsored qualified retirement plan. Even though the assets inside such retirement plans may be classified as marital property and owned equally by the spouses, federal law under ERISA, which preempts state law, may prohibit a married couple from using a surviving spouse's retirement benefits to fund a deceased spouse's unified credit. As a result, if one spouse has significantly greater qualified retirement benefits than the other, it may be preferable in the marital property agreement to classify some non-retirement plan assets (such as the couple's home) as the individual property of the spouse who has less retirement benefits to promote estate equalization.

Qualifying for the Family-Owned Business Deduction

Newly created I.R.C. §2033A provides estate tax relief for "qualified family-owned business interests" ("Qualified Interests"). If the deduction applies, the estate tax liability is calculated as if the estate were allowed a maximum family-owned business deduction of $675,000 and a unified credit exemption equivalent of $625,000 regardless of the year in which the individual dies. In order for a decedent's estate to be eligible for the deduction, the amount of the qualified interests transferred by the decedent's death to "qualified heirs," both during life and at death, must be greater than 50% of the decedent's gross estate.

Wisconsin's Marital Property Act can be very helpful to insure that a married couple receives the maximum tax savings possible from the family-owned business deduction. If the owner of a qualified interest is married, and the qualified interest is classified as marital property, then both estates are potentially eligible for the family-owned business exclusion. By the same token, however, if both spouses own one-half of the qualified interest because the qualified interest is classified as marital property, it may be more difficult for either spouse's estate to satisfy the requirement that the adjusted value of the qualified interest included in a decedent spouse's estate (plus qualified interest gifted by the decedent during life to family members) exceed 50% of the decedent's adjusted gross estate.

Therefore, careful consideration should be given to the classification of family owned business interests. If the value of the couple's marital property interest in the family-owned business is worth greater than 50% of the sum of the couple's interest in all marital property assets plus each spouses interest in individual property, then consideration should be given to classifying the family-owned business as marital property so that both estates will be potentially eligible for the family-owned business exclusion. If the foregoing is not true, then consideration should be given to classifying part or all of the family-owned business as the individual property of one of the spouses.

Valuation discounts for marital property

The federal transfer tax is imposed on the fair market value of assets, which are transferred either during life or at death for less than full or adequate consideration (i.e., on gifts and inheritances). When determining fair market value, a willing buyer/willing seller test is used. That is, what would the sale price be for the interest being transferred in a sale between unrelated parties?

Applying the willing buyer, willing seller test to a partial interest in property can result in a significant discount in the value of that interest for federal estate and gift tax purposes. As a result, if a married person dies owning a partial interest in an asset, the value of the deceased spouse's interest should be reduced for federal estate tax purposes. For example, the United States Court of Appeals for the Fifth Circuit approved a 45% discount for estate tax purposes when valuing the husband's portion of properties that were owned jointly by the decedent husband and a marital trust, which had been created for his benefit upon his wife's earlier death.

Applying this rationale to marital property can mean big estate tax savings for Wisconsin residents. Since marital property is considered to be owned equally between husband and wife, one-half of marital property is transferred at each spouse's death. As a result, the value of most or all of the assets that belong to a married or widowed Wisconsin resident can be discounted when determining the amount of federal estate taxes that are payable.

Estate planning with FLPs and LLCs

Because the willing buyer, willing seller test can result in significant valuation discounts for federal estate and gift tax purposes, Family Limited Partnerships (FLP) and Limited Liability Companies (LLC) have become increasingly important tools when developing estate plans for affluent individuals. When FLPs or LLCs are used in connection with estate planning, senior family members contribute assets to the entity. Limited interests in the FLP or LLC are then gifted to children or other family members. Giving limited interests in the FLP or LLC generally removes the asset from the donor's estate for federal estate tax purposes, while the donor is able to continue to maintain control of the property. The value of FLP or LLC interests that a donor gives to family members can be significantly discounted for gift tax purposes to reflect: (1) a lack of marketability for those interests; (2) the inability of a limited partner or member to control the FLP or LLC investments and distributions; and (3) restrictions that may be contained in the FLP or LLC agreement on the ability to transfer the limited interests.

Restrictions contained in FLP or LLC agreements are disregarded by the IRS for valuation purposes if they are more restrictive than state law. For example, if state law allows a limited partner or member to withdraw from an FLP or LLC easily, regardless of the terms of the agreement, the IRS will not readily accept valuation discounts for those interests because the membership units can be converted to cash at the option of the limited partner or LLC member. Wisconsin's partnership law and limited liability law both impose restrictions regarding the transferability of FLP and LLC interests and do not allow a limited partner or member to withdraw easily from the entity. As a result, it should be more difficult for the IRS to challenge valuation discounts claimed in connection with FLPs and LLCs established in Wisconsin as compared to many other states.

Conclusion

Wisconsin residents often flock to warmer climates when they retire. Many think that by moving to states like Florida or Arizona they will not only enjoy warmer weather, but a better estate planning climate, too. However, Wisconsin is hard to beat when it comes to state laws that benefit estate planning.