TAX AND WEALTH ADVISOR ALERT: UNITED STATES SUPREME COURT DECLARES MARYLAND TAX SCHEME UNCONSTITUTIONAL

On Monday, May 18, 2015, in *Comptroller of the Treasury of Maryland v. Wynne*, the United States Supreme Court declared Maryland's income tax scheme unconstitutional. The Supreme Court justices voted 5 to 4 to affirm a Maryland Court of Appeals ruling that Maryland's income tax scheme results in improper double taxation on income earned in other states and creates an incentive for taxpayers to opt for intrastate versus interstate economic activity.

Like most states, Maryland imposes a personal income tax on income earned both within the state of Maryland and in other states. Maryland's income tax is imposed on its residents in the form of both a state income tax and a so-called "county" income tax. Because income is also taxed in the state where it is earned, state tax laws usually give residents a full credit for income taxes paid on their out-of-state earnings to prevent double taxation. Maryland, however, allows its residents a credit against state income taxes, but not "county" income taxes. As a result, some of the income earned by Maryland residents outside the state of Maryland is taxed twice; once in the state where it is earned, and again in Maryland where the credit is withheld.

The Commerce Clause of the Federal Constitution gives Congress the power to regulate commerce among the states. The United States Supreme Court reasoned that the dormant Commerce Clause prohibits a state from taxing a transaction or incident more heavily when it involves commerce across state lines than when it occurs entirely within the boundaries of one state, and further prohibits a state from imposing a tax which discriminates against interstate commerce by, among other things, subjecting interstate commerce to multiple taxations.

Maryland argued that it has the right to tax the income of its residents, regardless of where it is earned, under the due process clause of the Constitution. It argued that withholding the credit from the "county" income tax would require all residents to pay an equitable share for local government services. The Court rejected this argument, stating that states have historically offered a similar credit for out-of-state taxes paid by corporations, which are also beneficiaries of such government services.

The Court notes that the Maryland tax scheme fails what has been termed the "internal consistency test." The test analyzes whether interstate commerce would be at a disadvantage as compared with intrastate commerce if every state adopted the tax scheme in question. Because residents earning income from outside state would pay more in income

taxes than residents who earned income solely within the state, the Court found such tax scheme to be “inherently discriminatory” and operating as a tariff.

According to the Court, by giving less than a full credit to its residents for income earned and taxed in other states, Maryland’s income tax scheme violates the dormant Commerce Clause.

In addition to significant loss of future revenue as a result of the Court’s decision, individuals who tried to claim the credit on their county income tax returns in the last several years may be entitled to refunds, which could cost several million dollars. Additionally, other states, such as New York and Pennsylvania, have schemes similar to the one ruled unconstitutional in Maryland. The Court’s decision will doubtless have significant and far-reaching economic consequences.

If you have any questions, please contact Attorney Megan O. Harried at O’Neil Cannon at 414-276-5000.

TRUSTS AS PARTIES TO BUSINESS AGREEMENTS

Sir Walter Scott wrote, “Oh what a tangled web we weave.” Buyers seeking to purchase a business that is partially held in a trust may face this tangle more than others. They wonder, “With whom am I actually doing the deal?” and, “What are my legal rights should the deal fall through?”

On the flip side, if you are looking to sell your business, and part of the stock in your business is held by a trust, you might wonder how you can accomplish the goals you seek without substantial risk that the sale could be undone later in the event all legal requirements were not strictly followed.

Questions around trusts as shareholders of businesses can be complicated, but Wisconsin recently modified its statutes to include some very clear and specific parameters for buying and selling business interests held in a trust.

This article will help people on both sides of the coin to assess their rights and risks when engaging in business transactions where trusts are parties in one way or another.

Overview of Trusts as Parties to Business Contracts

In contemplating a business contract involving a trust, there are three main questions you

should ask:

1. Does the trustee have the authority to do what I need him or her to do?
2. What is required for the trustee to exercise his or her authority?
3. What is my risk if it turns out after the fact that the requirements above were not met?

Let’s consider each of these questions in turn:

1. Does the trustee have the authority to do what I need him or her to do?

Wisconsin law gives certain powers to a trustee, but those powers can be trumped by the powers granted in the actual trust. This simply means that you need to know what the trust itself says. There are two documents that should lay everything out for you: the trust agreement or a Certification of Trust. As a buyer, you do not always have a legal right to see a trust agreement in its entirety, but you do have the legal right to receive a Certification of Trust.

Therefore, when you are in a business transaction involving a trust, you will want to ask for a copy of the trust agreement itself or a Certification of Trust.

In a Certification of Trust, the trustee certifies, or swears to, the following information:

- That the trust exists, and the date on which it was created
- The identity of the settlor
- The identity and address of the currently acting trustee
- The trustee’s powers (This is the section that will tell you whether a trustee has authority to complete the type of transaction you seek)
- Whether the trust is revocable or irrevocable
- That the trust has not been revoked, modified, or amended in any manner that would cause the representations in the certification to be incorrect
- The authority of a co-trustee to sign and whether all co-trustees are required to sign in order to exercise the powers of the trustee
- The manner in which title to trust property may be taken

Again, Wisconsin law provides certain “default” rules regarding trusts, but those can be changed in the actual trust agreement. Therefore, you need the details from the trust agreement or a Certification of Trust to understand whether and how to accomplish your goals.

2. What is required for the trustee to exercise his or her authority?

You will also want to ask, “Is there more than one trustee?”

Wisconsin’s default rule is that there must be consent by a majority of the trustees in order to

conduct a business transaction, however, the trust agreement may preempt that rule by stating that it is possible for one trustee to delegate a function to a co-trustee, or require more or less than consent by a majority of the trustees to act.

As a buyer, you are mostly concerned with whether there are multiple trustees. What if there are two trustees and one of them says “yes” to your business transaction and one says “no”? Do both trustees need to sign off? If there are three trustees, there may be a majority or unanimous consent rule in the trust agreement. You should know from the Certification of Trust how many trustees are responsible for the trust and how many it will take to get the deal done.

3. What is my risk if it turns out after the fact that the requirements above were not met?

From a buyer’s perspective, one of the biggest concerns about conducting a business transaction that involves a trust is whether they will ultimately have someone to hold accountable should the transaction fail or should there be other issues. From a seller’s perspective, you need to keep this in mind so that you understand a trustee’s risk in engaging in business transactions.

Legally, usually a trustee who signs off on a transaction as trustee cannot be held personally liable by the buyer on that contract. However, the buyer does have legal protections.

If you, as a buyer, enter into a transaction in good faith, you can enforce any legal issues against the trust property, but not against the trustee personally. If you have requested a Certificate of Trust and conducted the transaction properly based on that information, then you can show that you did your due diligence and worked in good faith. These are your remedies:

- A person who in good faith enters into a transaction in reliance upon a Certification of Trust may enforce the transaction against the trust property as though the representations made in the Certification of Trust were correct.
- A person who in good faith deals with a trustee is not required to inquire into the extent of a trustee’s powers, or the propriety of the trustee’s exercise of those powers.
- A person who in good faith and for value deals with a trustee without knowledge that the trustee is exceeding or improperly exercising his powers is protected from liability as though the trustee properly exercised his powers.

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U.S. SUPREME COURT RULES INHERITED IRAS ARE NOT "RETIREMENT FUNDS" EXEMPT IN BANKRUPTCY PROCEEDINGS

On June 12, 2014, the United States Supreme Court held that funds in an inherited individual retirement account (IRA) are not "retirement funds" within the meaning of the Bankruptcy Code, and therefore such funds are not exempt from creditor claims in bankruptcy proceedings.

Ordinarily, when a debtor files for bankruptcy relief, his or her legal and equitable interests in property become part of the bankruptcy estate available to satisfy valid creditor claims. However, the Bankruptcy Code exempts debtors' interests in certain property in order to help debtors obtain a fresh start. Pursuant to 11 U.S.C. § 522(b)(3)(C), debtors are allowed to protect "retirement funds" to the extent they are held in a fund or account exempt from taxation under specified provisions of the Tax Code, such as an IRA.

According to the Court, "retirement funds" are sums of money set aside for the day an individual stops working. Consequently, the Court looked to the legal characteristics of inherited IRAs—as opposed to debtors' personal IRAs—to determine whether such accounts contain funds set aside for the day when the account owner stops working.

The Court held that three legal characteristics of inherited IRAs prevent the funds from coming within the meaning of "retirement funds." First, the owner of an inherited IRA cannot contribute additional money to the account. Second, an owner of an inherited IRA is required to withdraw funds from the account no matter how far he or she is from retiring from the workforce. Third, the owner of an inherited IRA may withdraw all of the funds in the account without incurring a penalty under the Tax Code. If inherited IRAs were exempt under the Bankruptcy Code, a debtor could obtain bankruptcy relief and immediately thereafter withdraw all funds from his or her inherited IRA to purchase a new home, take an extravagant vacation, or go on a shopping spree, even while valid creditor claims went unsatisfied in the bankruptcy proceedings. Since inherited IRAs are not "retirement funds" exempt from a debtor's estate in bankruptcy proceedings, such funds may be used to satisfy valid claims of creditors.

The Court noted that its holding is consistent with the purpose of the Bankruptcy Code's exemptions, and balances the interests of debtors and creditors.

WHAT CONSTITUTES "NET INVESTMENT INCOME" FOR PURPOSES OF THE 3.8% MEDICARE NET INVESTMENT INCOME SURTAX

Effective January 1, 2013, pursuant to the Patient Protection and Affordable Care Act, 26 U.S.C. § 1411 imposes a 3.8% Net Investment Income Tax on individuals, estates and trusts which have “Net Investment Income” and modified adjusted gross income above specified statutory threshold amounts. For individuals, the tax is imposed on the lesser of: (A) the Net Investment Income for the taxable year, or (B) the excess of modified adjusted gross income for the taxable year over the threshold amount ($250,000 for married individuals filing jointly; $125,000 for married individuals filing separately; $200,000 for single individuals). For estates and trusts which are subject to the tax, the tax is imposed on the lesser of: (A) the undistributed Net Investment Income for the taxable year, or (B) the adjusted gross income for the taxable year over the dollar amount at which the highest tax bracket for an estate or trust begins for the taxable year.

For purposes of the tax, “Net Investment Income” is defined as the sum of the following, less any applicable deductions:

- Gross income from interest, dividends, annuities, royalties and rents, which amounts were derived from a passive trade or business activity (as defined by 26 U.S.C. § 469), or from a trade or business involved in trading in financial instruments or commodities (as defined in 26 U.S.C. § 475(e)(2))
- Other gross income derived from a passive trade or business activity, or from a trade or business involved in trading in financial instruments or commodities
- Net gain, to the extent it is taken into account in computing taxable income, which is attributable to the disposition of property from a passive trade or business activity, or from a trade or business involved in trading in financial instruments or commodities

Applicable deductions may include expenses related to investment interest, advisory and brokerage fees, rental and royalty income, and state and local income taxes which are allocable to items included in Net Investment Income.

Net Investment Income specifically does not include such items as wages, unemployment compensation, operating income from non-passive business activities, social security benefits, alimony, tax exempt interest, self-employment income, Alaska Permanent Fund Dividends, and distributions from certain qualified retirement plans. However, these items may be subject to the .9% Additional Medicare Tax.

The following paragraphs highlight a few of the rules specific to particular types of income

which may or may not be subject to the tax. The information provided herein is not intended to address all sources of income subject to the tax, or provide an exhaustive summary of the applicable rules.

S-Corporations. Generally, an interest in a pass-through entity such as an S Corporation is not property held in a trade or business, so that any gain or loss from the sale of such interest would be Net Investment Income. However, the IRS has limited the amount of gain or loss from the disposition from an interest in an S Corporation to the net gain or loss that would result if the S Corporation sold all of its assets at fair market value immediately before the disposition of the interest.

Working Capital. Any income, gain or loss attributable to capital set aside for the future needs of a trade or business is Net Investment Income.

Child's Interest. Any amount included on a parent's Form 1040 as a result of filing Form 8814 for Parent's Election to Report Child's Interest and Dividends is included in calculating Net Investment Income, but does not include any amount excluded on Form 1040 due to threshold requirements.

Pension and Deferred Compensation Distributions. While Net Investment Income does not include distributions from certain qualified employee benefit plans, such distributions are included in determining the threshold amounts if they are included in the taxpayer's gross income.

The rules regarding the Net Investment Income Tax are complex and continue to evolve as final regulations are determined. In making a determination of how you may be impacted by the tax, it is important to contact a professional who may advise you as to the application of specific rules to your particular situation.

If you have any questions regarding this article, please contact Attorney Megan Harried at O'Neil Cannon at 414-276-5000.

USES OF MARITAL PROPERTY AGREEMENTS IN ESTATE PLANNING

Wisconsin is a marital property state, and the applicable laws are set forth in the Marital Property Act (the "Act"), codified in Chapter 766 of the Wisconsin Statutes. The Act determines the property rights of married spouses during life and at death. The Act applies

to a married couple after their “determination date,” which is the date on which the last of the following requirements is met: (i) marriage; (ii) both spouses are domiciled in Wisconsin; and (iii) 12:01 a.m. on January 1, 1986.

Under the provisions of the Act, marriages are generally considered equal partnerships, and after the determination date married spouses are treated as sharing equally in most assets acquired by either spouse during the marriage. Such assets, which include property acquired from the earnings of either spouse, are presumed to be marital property. In effect, each spouse is presumed to own an undivided one-half interest in each item of marital property acquired during the marriage, regardless of how the property is titled. On the other hand, property acquired by a spouse prior to the determination date, and property acquired by a spouse during marriage by gift or inheritance from a third party, is presumptively classified as the individual property of the acquiring spouse. The non-acquiring spouse does not have ownership rights in the acquiring spouse’s individual property during life or at death.

Importantly, the Act sets forth the “default” rules, but a married couple may enter into a marital property agreement to alter any of the provisions of the Act, including the classification of any or all assets as marital or individual property. There are many benefits to entering into such an agreement, especially because determining with exactitude the property classification of an item of property under the Act is at best an uncertain process. A marital property agreement provides certainty as to the classification of property, which is especially important when the couple has created a comprehensive and tax-conscious estate plan for the disposition of their assets at death.

In Wisconsin, it is common for a married couple to enter into a marital property agreement classifying all property of both spouses as marital property, including property which would otherwise be classified as the individual property of one spouse. These “opt-in” agreements are especially suitable for a first marriage where neither spouse has children from a prior relationship. Classifying all property as marital property simplifies estate administration because it is no longer necessary for the couple to keep marital and individual property separate, and because it will not be necessary to analyze which assets are marital property and which are individual property upon the death of a spouse. Additionally, there are ordinarily significant income tax advantages to opt-in marital property agreements. Classifying all of a married couple’s assets as marital property as part of a comprehensive estate plan equalizes each spouse’s estate, and will usually enable the couple to maximize the estate tax exemptions available for each spouse. Further, at the time of death, the basis of assets passing from a decedent for purposes of determining gain or loss for income tax purposes is “stepped-up” (or “down”) to an amount equal to a fair market value of the assets as of the date of death. In the case of marital property, the basis of a surviving spouse’s marital property interest is also stepped-up. “Opt-in” marital property agreements often also contain what is known as a “Washington Will” provision, which states that upon the death of either spouse, all or any of the property of one or both spouses passes to a

designated person, trust or other entity by nontestamentary disposition, and without probate. As such, the provision is a simple mechanism whereby the spouses contract for the disposition of all or a portion of their community property at the time of each of their deaths, and simultaneously avoid probate as to that property.

Alternatively, a married couple may choose to enter into a marital property agreement reclassifying all property of both spouses as the individual property of each spouse, including property which would otherwise be classified as marital property. In these "opt-out" agreements, the wages earned by each spouse, and all property acquired with the earnings, will be classified as the individual property of the earning spouse. The non-earning spouse will not have any ownership rights in such assets, either in life or at death. An "opt-out" marital property agreement may be advantageous in second marriage situations, where one or both spouses have children from a prior relationship, because the agreement will allow each spouse to bequeath his or her individual property to his or her own children at death.

Marital property agreements may also reclassify only certain assets. For example, a spouse may want to bequest a specific asset to a person other than his or her spouse at death. A marital property agreement could classify only the specific asset as the individual property of the spouse. As a result, the spouse would have full ownership rights in the asset during life, and the right to bequeath the entire asset to the third party at death. Without such an agreement, the spouse would only have the right to bequeath his or her one-half interest in the asset.

Marital property agreements are essential tools for creating a comprehensive estate plan tailored to the individual needs of the couple, and have a significant impact on the disposition of a couple's assets both during life and at death.

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GIFTING CLAUSES IN DURABLE POWERS OF ATTORNEY

In a durable power of attorney, the principal appoints someone to oversee his financial affairs, including in the event he becomes incompetent as a result of injury or illness. A broad durable power of attorney may authorize the agent to take any action as fully and effectually in all respects as the principal could do if personally present. However, even the most broadly stated power of attorney does not authorize the agent to make gifts on behalf

of the principal unless the power of attorney expressly grants the agent such power. The law requires that gifting powers be expressly stated in the durable power of attorney in order to reduce the risk that the agent will engage in financial abuse of the principal.

Gifts are an important estate planning tool, as making gifts during life often results in significant tax savings at the principal's death. Therefore, it is advantageous for an agent under a durable power of attorney to be authorized to make gifts for estate planning purposes. Generally, it is best if the scope of an agent's power to make gifts on behalf of the principal is limited, so as to reduce the potential for abuse.

If the durable power of attorney states in general language that the agent is authorized to make gifts, without express limitations, by law the agent is authorized to make a gift up to the amount of the annual federal gift tax exclusion, or twice that amount if the principal's spouse consents to a split gift, as defined by the tax code. Further, such general language authorizes the agent to make a gift of the principal's property if the agent determines doing so is consistent with the principal's objectives, if known, or if unknown, with the principal's best interest, based on all applicable factors, including: (i) the value and nature of the principal's property; (ii) the foreseeable obligations and need for maintenance of the principal; (iii) the minimization of all taxes; (iv) the principal's eligibility for any benefit, program or assistance; and (v) the principal's personal history of making such gifts.

A durable power of attorney may expressly provide that the agent is only authorized to make gifts to specified classes of persons, such as the principal's descendants. Such a provision may be advisable if the agent is someone other than the principal's spouse or family member, in order to reduce the risk that the agent will make gifts to himself or third parties he wishes to benefit, contrary to the principal's desires or best interest.

A durable power of attorney may also expressly require that the agent make gifts only in a manner which continues the principal's previously established pattern of gift-making for estate planning purposes. Such a provision helps ensure that the agent will make gifts which align with the principal's desires and objectives.

Further, a durable power of attorney may expressly provide that the aggregate of all gifts to any one recipient in any one year shall not exceed the amount of the annual federal gift tax exclusion. Such a provision provides the agent with the flexibility to maximize tax-free annual gifts for estate planning purposes, and reduces the risk that the agent will deplete the principal's estate.

It is also possible for the principal to expressly authorize the agent to make any gifts that the agent believes will benefit the principal or the principal's estate, including gifts to the agent himself. Such a provision grants the agent the broadest authority to make gifts on behalf of the principal, but it also provides the greatest potential for abuse. Therefore, it is crucial that

a principal granting such broad authority trust the agent unconditionally.

In drafting a durable power of attorney as part of a comprehensive estate plan, it is important to consider what gifting powers should be granted in light of the principal's personal and financial situation. While gifting powers are useful for estate planning purposes, it is also important to limit gifts to those the principal might have made, and minimize the risk for financial abuse.

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