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OhnstadTwichell
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Newsline

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Ohnstad Twichell, P.C., is a full service law firm having a general and trial practice in North Dakota, Minnesota, and federal courts and offering services in the fields of probate, real estate, estate planning, corporate, labor/employment law, family law, elder law, municipal finance and bonding, taxation, personal injury, criminal, negligence, commercial, insurance defense, water rights, oil, gas and wind law, and automobile law.

MINNESOTA GIFT AND ESTATE TAX UPDATE

Jacob L. Geiermann *works in the West Fargo office and devotes his practice to estate planning, trusts, probate and business law.*

During the 2014 Minnesota legislative session, several changes to the Minnesota gift and estate tax laws were adopted. On the whole, these changes can generally be considered as an improvement to the current structure and application of the laws. For those with estates less than $2.5 million in value, the changes will result in significant estate tax savings. For those with larger estates, the savings are minimal, but the changes will generally provide a more predictable and understandable framework for estate planning purposes.

<u>Repeal of Minnesota Gift Tax:</u> Minnesota was only the second state in the nation to institute a state-level gift tax. The Minnesota gift tax statute was poorly drafted, would have resulted in inconsistent and unfair application, and would have required significant time, effort, and expense to comply with. Fortunately, the Minnesota legislature has come to its senses and retroactively repealed the Minnesota gift tax. All references to the tax have been removed from the Minnesota Statutes. While there are many other reasons that estate planning is needed to minimize tax liability, at least we no longer have to be concerned with this tax.

<u>Minnesota Estate Tax Exemption:</u> With the federal estate tax exemption amount fixed at $5 million, annually adjusted for inflation (currently at $5.34 million), and federal law now allowing a decedent's unused exemption amount to be transferred to their surviving spouse, many estates will no longer owe any federal estate tax. Until the recent changes explained below, the Minnesota estate tax exemption amount was $1 million. This meant that many estates that would not owe any federal estate tax liability could still owe significant Minnesota estate tax. While the recent changes don't necessarily eliminate such tax liability, they do at least provide some benefit.

This year, the Minnesota Exemption is $1.2 million. This amount is set to increase $200,000 each year, until it reaches a permanent amount of $2.0 million in 2018. Each year's tax rate tables until 2018 are slightly different. Assets below the exemption amount are not taxed. The tax rate progressively increases as the estate grows larger, with rates beginning at around 9% and up to 16% for the largest estates. These phased-in changes to the exemption amount and tax rates were intended primarily to benefit those families with estates between $1.0 million and $2.5 million. While some benefit is provided to slightly larger estates, there is essentially no tax liability reduction for estates over $4.0 million. Because the first spouse's Minnesota exemption is lost if not used, we often suggest the creation of a trust at the first spouse's passing for purposes of using their Minnesota exemption.

The Minnesota legislature unfortunately did not follow Congress' lead in allowing a deceased spouse's unused exemption amount to be transferred to a surviving spouse. For an example of federal portability, assume that a married couple owns $8 million in net assets. If the first spouse gives all of their assets to the surviving spouse on their passing, no estate tax is due on the first spouse's passing due to the unlimited marital deduction, but that surviving spouse then individually owns $8 million in net assets. If the surviving spouse only had their own $5.34 million federal estate tax exemption available, $2.66 million of the surviving spouse's estate would be estate taxable. With a 40% federal estate tax rate, this would mean that the surviving spouse's estate would owe $1,064,000 in federal estate tax liability. Fortunately, federal law now effectively allows the surviving spouse's estate in the above hypothetical to pass to the next generation without owing any federal estate tax. For such a transfer of the unused exemption amount to occur, a federal Form 706 must be filed.

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A legal newsletter from Ohnstad Twichell, P.C., with offices in West Fargo, Hillsboro, Casselton, and Page, North Dakota, and Barnesville, Minnesota.

Gifts Made Within Three Years of Death: The recent changes in the law clarify the Minnesota estate tax effect of gifts made within three years of an individual's death. For many years, Minnesota residents could make so-called "deathbed gifts" that would reduce their Minnesota taxable estate. Last year's gift tax law attempted to address this issue by including provisions that would pullback Minnesota taxable gifts made within three years of death into the Minnesota taxable estate.

While the Minnesota gift tax law has been repealed, the general principles regarding pullback have not changed. The value of a gift of property that was located in Minnesota and made within three years of death is included in a decedent's Minnesota taxable estate. The value of the gift pulled back into the estate is determined as of the date of the gift, so no appraisal is necessary if adequate documentation of such value exists. However, because only the value of the gift, and not the property itself, is included in the Minnesota estate, no step-up in the tax basis of the property is allowed, meaning that even though the estate might have Minnesota estate tax liability for such gifted amount, the recipient of such gift could potentially incur significant capital gains taxes in the event they wish to sell the property.

Minnesota allows certain increased estate tax deductions for Qualified Small Business and Farm Property.

Minnesota Qualified Small Business and Qualified Farm Property Deductions: Minnesota allows certain increased estate tax deductions for Qualified Small Business and Farm Property. The purpose of these deductions is to allow certain estates owning small business and farm properties to pass those interests on with less of an estate tax burden to the next generation of small business owners and farmers. The allowed deduction amount is currently $3.8 million for 2014. The deduction, plus the allowed exemption of $1.2 million, equals a total of $5.0 million, which is essentially the permanent value of the exemption, plus additional deductions, allowed for a Minnesota estate. Just as the exemption amount will gradually increase by $200,000 each year to $2.0 million in 2018, the allowed exemption will gradually decrease by $200,000 each year to $3.0 million in 2018. Whether an estate is eligible for these increased deductions requires consideration of numerous factors. A summary of the primary factors here follows.

For Qualified Small Business Property to qualify, the property (1) must have been included in the decedent's Minnesota taxable estate; (2) consist of assets of a trade or business or ownership interest in an entity engaged in trade or business; (3) the property or ownership interests in an entity must have been held for at least three years by decedent; (4) the business is not considered a "passive activity" under federal law; (5) the decedent or decedent's spouse must have materially participated in the trade or business during the year before death; (6) gross annual sales for the last taxable year must have been $10,000,000 or less; (7) any cash or cash equivalents not used for the trade or business must be deducted from the property's value; (8) in the three years following decedent's death, the business is not considered a "passive activity" under federal law and a family member of the decedent materially participated in the trade or business; and (9) an election to treat the property as Qualified Small Business Property is made.

For Qualified Farm Property to qualify, the property (1) must have been included in the decedent's Minnesota taxable estate; (2) consist of agricultural land or an interest in an entity owning agricultural land; (3) the property must have been classified as agricultural property under Minnesota law; (4) the property must have been classified as either an agricultural homestead, agricultural relative homestead, or special agricultural homestead in the year of the decedent's death; (5) the property or ownership interest in an entity must have been held for at least three years by the decedent; (6) in the three years following the decedent's death, the property is classified as agricultural property under Minnesota law; and (7) an election to treat the property as Qualified Farm Property is made.

To qualify as an agricultural homestead, agricultural relative homestead, or special agricultural homestead, various different eligibility tests apply depending upon (1) who owns the property, (2) who occupies the property, and (3) who farms the property. While the specific eligibility standards are somewhat technical, in most cases the eligibility requirements seem consistent with the overall policy of allowing increased deductions for family farms.

Interests in Pass-Through Entities: One unsettled area of law that remains relates to the treatment of ownership interests in pass-through entities, such as partnerships, LLC's, S-corporations, and other interests included in a decedent's estate.

For Minnesota residents, the law provides no relief. Any ownership interest in these so-called "intangible" property interests is treated as being located within Minnesota, and therefore is subject to the Minnesota estate tax. This means that Minnesota residents can effectively be taxed on their ownership of real property located in other states simply because it is not an ownership in real property itself but an "intangible" entity interest.

The Minnesota law similarly provides no relief to those living outside of Minnesota, as the law now disregards the entity and treats the nonresident as the owner of any real property located in Minnesota. This is particularly troubling as Minnesota now treats entity interests owned by non-residents in an entirely inconsistent manner with the way it treats entity interests owned by residents. While there is some talk of possible constitutional challenges to the law, at this time we are left trying to comply with the statute as it currently stands.

By way of example, assume a North Dakota decedent owned a single-member LLC which owned only one asset: a Minnesota lake property. Previously, the location of the LLC interest was wherever the decedent lived. If they lived in North Dakota, their interest would be a North Dakota asset and would therefore not be subject to the Minnesota estate tax. Under current law, however, the LLC would be disregarded and the North Dakota decedent would be treated as owning 100% of the value of the Minnesota lake property, therefore potentially subjecting the North Dakota decedent's estate to Minnesota estate tax liability.

While the purpose of this policy is to prevent non-residents from avoiding the Minnesota estate tax by placing their Minnesota real property into an entity, many questions remain as to the actual application of this look-through rule in various contexts. In simpler cases like the above described Minnesota lake property owned by a single-member LLC, the statute will likely not create too much difficulty in its application. But for more complex and sophisticated entity interests, the statute fails to provide adequate guidance. It does not address the distinction between operating and non-operating entities. Neither does it provide guidance as to how to account for situations where the entity owns assets in multiple states, or how to calculate the value if the entity or entity property is subject to liabilities, debts, or other encumbrances. It also fails to address other valuation issues such as the existence of different types of entity interests, as well as whether, and to what extent, valuation discounts for lack of marketability and lack of control can be applied to the value of the decedent's interests. While answers to many of these questions likely will be provided in coming months by the Minnesota Department of Revenue or addressed by future legislative enactments, for the time being, the treatment of entity interests owned by non-residents will likely create some level of difficulty and concern for attorneys and the estates they administer.

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PROFILE OF MARSHALL W. McCULLOUGH

Marshall W. McCullough has been with Ohnstad Twichell since 1994 and became President of the firm in January 2014. Originally from Bottineau, North Dakota, Marshall grew up in Bismarck, attended college in Grand Forks, went to law school in Denver, and worked at Price Waterhouse in San Francisco before settling in Fargo. Also a CPA, Marshall practices in the areas of corporate law, business succession planning, estate planning, probate, and taxation. He is a board member and past President of the Red River Zoo, Red River Valley Estate Planning Council, and Fargo Optimist Club. He also serves as a board member of the International Peace Gardens.

Marshall and his wife, Mari, have been married for 30 years and have three sons. Connor, 23, works as an electrician in Valley City; Finn, 22, will be graduating from Drake University this fall with an accounting degree; and Shane, 20, is majoring in kinesiology at the University of Wyoming. Marshall has two hunting dogs, Wirehaired Pointing Griffons named CJ and Whiskey.

In his free time, Marshall spends time at Lake Metigoshe in Bottineau and Spirit Lake near Vergas, Minnesota. He enjoys water skiing, downhill skiing, golfing, hunting, fishing, and hockey.

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Erin F. Musland *will work in the West Fargo office and will devote her practice to bonding and municipal law.*

OHNSTAD TWICHELL INTRODUCES NEW EMPLOYEE

Erin F. Musland will join Ohnstad Twichell as an associate attorney. Erin grew up in Jamestown, North Dakota. In 2009, she earned a Bachelor of Science degree in journalism and German from Northwestern University in Evanston, Illinois. She recently graduated summa cum laude from William Mitchell College of Law in St. Paul, Minnesota.

While in law school, Erin externed for Chief Federal Magistrate Judge Arthur J. Boylan of the U.S. District Court of Minnesota. She also volunteered for the Minnesota Justice Foundation and clerked at a law firm in Minneapolis.

Erin enjoys yoga, reading, and walking her two dogs, Daisy and Duke. She is also newly engaged and excitedly planning a wedding with her fiancé, Shawn.

Erin will work in the West Fargo office and practice in the area of municipal law and bonding.

Interests in pass-through entities.

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ANNOUNCEMENT

Attorneys from the Ohnstad Twichell Law Firm in West Fargo have been selected by their peers for inclusion into the ***2014 Great Plains Super Lawyers*** list, which recognizes attorneys who have distinguished themselves in their legal practice. The attorneys include: Robert G. Hoy, Susan L. Ellison and Robert E. Rosenvold. These three Ohnstad Twichell lawyers were evaluated and voted on by their professional peers in North Dakota, South Dakota and Nebraska, and only 5% are listed in ***Super Lawyers***. Bob Hoy is a trial lawyer and practices in personal injury, commercial and construction litigation, and criminal defense. Susan Ellison is a trial lawyer and practices in family law, labor law and elder law. Bob Rosenvold practices in estate planning, probate and real estate law.

Three attorneys were selected for the 2014 Great Plains Rising Stars list: Sara K. Sorenson for Estates and Trust Litigation; Sean M. Fredricks for Environmental; and Lukas D. Andrud for Energy and Natural Resources. Sara Sorenson is a trial lawyer and practices in the areas of trust and estate litigation and oil and gas litigation; Sean Fredricks practices in the water law area; and Lukas Andrud practices in the areas of real estate, oil and gas.

GETTING PERSONAL!!

Hannah Schuett joined Ohnstad Twichell in August 2014 as a Litigation Paralegal. She was born in Douglasville, Georgia, and grew up in Glenwood, Minnesota. She graduated from Minnewaska Area High School. Hannah attended Minnesota State University Moorhead and graduated in May of 2011, receiving a Bachelor of Science Degree in Paralegal Studies with emphases in civil and criminal litigation. She is an active member of the Red River Valley Paralegal Association.

Hannah enjoys spending time with her friends and family, traveling, being outdoors, and attempting to cook.

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