BASIC ESTATE PLANNING AFTER THE TAX RELIEF ACT OF 2010 (“ACT”)

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Tax Relief Act of 2010 ("Act")

The Act was passed and signed into law on December 17, 2010. The Act makes significant changes in the estate, gift, and generation-skipping tax provisions applicable in 2010, 2011, and 2012. The provisions of the Act "sunset" after December 31, 2012, such that if Congress does not take further action to extend or perhaps modify the rules implemented by the Act then the estate, gift, and generation-skipping tax rules in effect in 2001 will become applicable on January 1, 2013.

I. Rules in effect before 2010, i.e. 2009

A. Estate tax

1. $3,500,000 exemption amount applies to persons dying in 2009. (The exemption amount in effect in 2009 was set by legislation in 2001 and periodically increased from 2001 ($1,000,000) to 2009. But for the Act, the rules in effect in 2001, including the $1,000,000 exemption amount, would have again been applicable at January 1, 2011.)

2. Tax rate – 55% (maximum)

B. Gift tax

1. $1,000,000 lifetime exemption amount

2. $13,000 annual exclusion amount

C. Generation-skipping tax

1. $3,500,000 exemption amount

2. Tax rate – 45% (maximum)

D Income tax basis

1. "Step-up" in basis in assets held at date of death equal to date of death value of assets. ("Step-up" does not apply to "income in respect of a decedent" items, such as IRAs and retirement plan accounts.)

2. "Carryover" basis applies to assets which are gifted.

3. **Example –**

David owns Caterpillar shares which he purchased for $25,000 and which have a market value $100,000. If David gifts the shares to Craig, Craig's basis in the shares "carries over" and is $25,000. If Craig then sells the shares, he will have $75,000 of gain for income tax purposes. If instead of gifting the shares to Craig while living, David dies owning the shares the basis in the shares "step-up" to $100,000 (date of death value). If Craig receives the shares pursuant to David's Will, Craig's sale of the shares would result in no gain for income tax purposes (assuming the market value and sale price remains at $100,000).

E. Basic planning approach – "two-trust" plan for spouses generally allows them to protect two times the applicable exemption amount - $7,000,000 in 2009 – from Federal estate tax. Each spouse establishes a trust which provides for the surviving spouse, and there is a division of assets between the spouses with a view toward taking advantage of the applicable estate tax exemption amount in the estate of the first spouse to die.

Example

David and Carolyn have $7,000,000 in total assets. David establishes a trust which creates a Credit Trust at his death for the benefit of Carolyn during her lifetime but is structured in a manner which does not result in Credit Trust assets being includible in Carolyn's estate for estate tax purposes. The Credit Trust is funded at David's death with the estate tax exemption amount, i.e. $3,500,000 in 2009; all remaining amounts go to Carolyn outright. Following Carolyn's death, Credit Trust terminates in favor of Craig and Scott, and Carolyn leaves her assets ($3,500,000) to Craig and Scott. Result – no estate tax at David's death in 2009; no estate tax at Carolyn's subsequent death in 2009.

Compare $1,575,000 of Federal estate tax (without regard to state estate tax) without trust approach.

Caveat – importance of dividing assets between David and Carolyn.

II. Rules in effect in 2010

A. Repeal – But for the Act, the Federal estate tax was scheduled to be repealed for persons dying in 2010 (and to then be reinstated at 2001 levels beginning January 1, 2011).

B. Under the Act, there is an estate tax choice for persons dying in 2010

1. Repeal – no estate tax, irrespective of the value of decedent's assets. But modified carryover basis system would apply – (i) $1,300,000 general

adjustment to basis and (ii) up to $3,000,000 adjustment to basis for assets passing to surviving spouse.

2. Alternatively, $5,000,000 exemption amount and with general "step-up" in basis rules.

3. Choosing the estate tax repeal option is made by filing Form 8939 with the Internal Revenue Service. Form 8939 is due January 17, 2012. Modified carryover basis of assets is addressed on Form 8939.

4. If the repeal option is not elected, then the Form 706 is to be filed (and estate tax paid) for persons dying during 2010 but before December 17, 2010 by March 19, 2012 (assuming the Form 4768 is timely filed by the executor applying for an extension of time to file).

5. Estate tax rate – 35% (maximum)

C. Gift tax

1. $1,000,000 lifetime exemption amount; 35% tax rate (maximum)

2. $13,000 annual exclusion amount

D. Generation-skipping tax

1. $5,000,000 exemption amount

2. 0% tax rate

III. Rules in effect during 2011 and 2012

A. Estate tax

1. $5,000,000 (indexed in 2012) exemption amount

2. Tax rate – 35% (maximum)

3. "Portability" introduced which may provide planning benefits to spouses. Portability allows a surviving spouse to utilize the unused exemption amount from the estate of a deceased spouse who dies in 2011 or 2012. Surviving spouse must die in 2011 or 2012. A "portability election" must be made by the estate of the first spouse to die by timely filing a Form 706 (whether or not the estate tax return is otherwise required to be filed).

Example

David dies in 2011 with $2,000,000 of assets, and his estate makes a "portability election." Carolyn dies in 2012 with $7,000,000 of assets. Portability allows Carolyn to use the $3,000,000 of David's unused estate tax exemption amount ($5,000,000 - $2,000,000) so that the exemption amount available in Carolyn's estate is $8,000,000 ($5,000,000 + $3,000,000). Result – no estate tax in Carolyn's estate.

Query – Will portability continue to apply after 2012??

B. Gift Tax

1. $5,000,000 (indexed in 2012) lifetime exemption

2. $13,000 annual exclusion amount

C. Generation-skipping tax

1. $5,000,000 (indexed in 2012) exemption amount

2. Portability does not apply

D. Basic planning approach – the basic "two-trust" approach discussed above remains the general planning technique for spouses even with portability currently in effect because (i) portability might not apply after 2012, (ii) portability does not apply to generation-skipping transfers, (iii) appreciation of assets in credit trust, and (iv) Illinois estate tax does not allow for portability.

E. Planning point – use of enhanced lifetime gift tax exemption amount in 2011 and 2012 – (i) shift of future income and appreciation after gift and (ii) possibility that $5,000,000 exemption amount may be reduced after 2012. If father makes a $100,000 gift to his son today, no gift tax would be due but father's gift tax exemption amount would be reduced to $4,900,000, and father's estate tax exemption amount would likewise be reduced to $4,900,000. <u>Caution</u> – carryover basis for assets gifted.

Example

David has Caterpillar shares with a value of $500,000 and a basis of $100,000. David is considering gifting the shares to Craig. Assume: (i) Craig will sell the shares immediately following David's death, (ii) 35% estate tax rate, (iii) 15% capital gain rate. In order for the estate tax benefits of making the gift to offset the potential income tax costs (carryover basis), the shares would need to appreciate to more than $800,000 at the time of David's death. (Income tax: $800,000 - $100,000 times 15% equals $105,000. Estate tax: $300,000(appreciation after gift) times 35% equals $105,000.)

IV. Illinois estate tax

A. Repeal in 2010

B. $2,000,000 exemption amount made permanent in January, 2011

C. Illinois has no gift tax – gifts made prior to death may result in reduced amount of Illinois estate tax.

D. Taxability of assets for decedent who is an Illinois resident at the time of death.

Example

David, an Illinois resident, dies in 2011. He has Illinois assets worth $2,000,000 and a ranch in Texas worth $1,500,000. Illinois estate tax on $3,500,000 is $209,124. Illinois estate tax for David's estate is $119,493 ($2,000,000/$3,500,000 times $209,124).

E. Taxability of non-resident decedent who own Illinois real estate.

Example

David, a Florida resident, dies in 2011. He has stocks and bonds, etc. worth $4,000,000 and a farm in Illinois wroth $1,000,000. Illinois estate tax on $5,000,000 is $352,158. Illinois estate tax due from David's estate is $70,432. ($1,000,000/$5,000,000 = 20% times $352,158 = $70,432).

F. Illinois QTIP election available for marital deduction for Illinois estate tax purposes (even though not applicable for Federal estate tax purposes).

G. General planning points:

1. Non-resident decedent who owns Illinois real estate. Consider use of limited liability company to hold title.

2. Resident decedent who owns real estate outside of Illinois. Beware of the proportionate calculation effect – Illinois estate tax could be due even though the value of Illinois assets is less than $2,000,000.

3. Planning to utilize Illinois QTIP as necessary to avoid Illinois estate tax at death of first spouse.

4. Gifting to reduce Illinois estate tax.

V. What to expect in 2013

A. Federal – back to $1,000,000 exemption and 55% tax rate? Stay tuned!

B. Illinois - $2,000,000 exemption amount appears not likely to change.

VI. Planning to 2011 and beyond

1. Two-trust planning for spouses

2. Plan for flexibility

3. Division of assets between spouses remains important

4. Have trust documents allow for Illinois QTIP option

5. Consider lifetime gifts to take advantage of enhanced lifetime gift tax exemption and to reduce Illinois estate tax