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Re: Estate Planning in 2010 and Beyond – The Good, the Bad and the Opportunities

Dear Clients and Friends:

We are writing to provide an update with respect to the status of the Federal estate tax laws for deaths in 2010, as well as in 2011 and beyond. While there is significant uncertainty in the air with respect to potential changes in these laws, the present conditions also provide significant opportunities to which we wish to alert you.

Overall, we continue to urge our clients to follow the fundamental estate planning principles which have always guided our practice:

- **Plan based upon current laws, assuming the worst while hoping for the best;**
- **Allow for the greatest possible flexibility to address future changes in the tax laws, as well as financial and family circumstances; and**
- **Review planning regularly to assure that (i) estate planning documents accurately reflect present goals and wishes and (ii) the title to assets and the beneficiary designations for insurance policies and retirement plan assets are correct and current.**

I. Federal Estate and Gift Tax – Where we are now and what happens on January 1st.

We are currently in an estate and gift tax environment which seemed unthinkable when the present law was enacted in June of 2001. At that time, the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Tax Act") provided that the Federal estate tax applicable exclusion amount (formerly known as the unified credit), which is an amount each person may transfer free from estate taxes at death, would increase at intervals from the then current level of $675,000 to $3,500,000 in 2009. The Tax Act also provided that the estate tax would be repealed for a one-year period beginning January 1, 2010. One of the most unique aspects of the Tax Act is that on January 1, 2011, the provisions will "sunset", or revert to the provisions that were in effect before it was passed. The result of this sunset provision is that the estate tax would be restored and the estate tax applicable exclusion amount will become $1,000,000 (the level it would have been had the Tax Act not been enacted). The Tax Act also provided that the gift tax applicable exclusion amount, which is the amount each person may give free from gift taxes during life, unlike the estate tax applicable exclusion amount, would remain at $1,000,000 and not increase. Under the Tax Act, the tax rate for lifetime gifts in excess of $1,000,000 dropped to 35% in 2010 (for gift taxes only since there is no estate tax in 2010), but will range from 41% to 55% in 2011 for both gift and estate taxes.

From 2001 through 2009, it was widely assumed that if sufficient congressional votes could not be found to make the one-year repeal of the estate tax in 2010 permanent, a compromise - either temporary or permanent - would be reached to extend the estate tax at least through 2010 and provide for an estate tax applicable exclusion amount at least equal to the $3,500,000 reached in 2009. Once the end of 2009 passed without such action, there remained continuing uncertainty as to whether the estate tax would still be reinstated on a retroactive basis during 2010.

We are now over two-thirds through 2010 and Congress has yet to pass legislation regarding the estate tax (or lack thereof). As the year moves along, it becomes less likely that any legislation will be enacted with respect to individuals dying in 2010. Nevertheless, the absence of the estate tax does not equate to a lack of potential tax consequences for the families of individuals dying this year.

II. Taking Advantage of the Current Political and Economic Environment – Making Lemonade Out of Lemons

The economic and political conditions which are the source of financial distress and uncertainly also provide significant planning opportunities for those willing to take advantage of them. Several factors have come together which provide these opportunities:

- **Low asset values**. While it may be obvious, the Dow Jones Industrial Average was recently 28% below its all time high in October 2007. Similarly, the average home value in the Chicago area is down 27% from the values reached in July 2006. Although it is impossible to determine when we will fully recover from the current low value environment, it is reasonable to assume that in time values will recover. There are a number of estate planning strategies which our office can assist in implementing that can shift future appreciation in the value of family assets out of taxable estates while values are depressed.

- **Low interest rates**. The weak economic conditions and the efforts of the Federal Reserve to stimulate the economy have also resulted in historically low interest rates. For example, the fixed interest rate which applies to long-term interfamily transactions is presently 3.66%. Assets can be transferred at this low rate to future generations for extended periods – such as twenty to thirty years – regardless of the levels to which interest rates rise during those years. The result is that future appreciation of the transferred assets in excess of the current low interest rate can be removed from the taxable estate.

- **<u>Possible changes in the law</u>**. During the past year, some of the most successful estate planning strategies have been the subject of proposed congressional legislation which would significantly reduce or eliminate their benefits. These techniques include (i) short-term grantor retained annuity trusts (GRATs) which allow significant amounts of future appreciation to be transferred with little or no downside risk and (ii) family limited partnerships. In general, proposed legislation would apply to transactions completed after enactment by Congress. Timely action is therefore of the essence in order to take advantage of these strategies so that they can be 'grandfathered'.

- **<u>Low gift tax rates</u>**. Finally, as mentioned earlier in this letter, for those in the appropriate circumstances, making gifts which exceed the annual gift tax exclusion amount of $13,000 per beneficiary and the lifetime gift tax applicable exclusion amount of $1,000,000 may be beneficial in order to shift wealth to future generations. There are two potential benefits to making taxable gifts before the end of this year. First, if there is no change in the law, the currently low 35% rate will increase on January 1, 2011 to a minimum of 41% and a maximum of 55%. Second, if the donor survives the making of the gift for three years, all future appreciation on the gifted assets plus the amount of the gift tax paid will both be removed from the taxable estate of the donor.

III. <u>Issues Raised by the Tax Act in 2010</u>.

<u>Possible unanticipated shifting of inheritances</u>. Under many estate plans, upon the death of either spouse, the assets in the Revocable Trust of the deceased spouse (the "Revocable Trust") will be distributed to a "Residuary Trust" (sometimes called a "By-Pass Trust" or "Credit Shelter Trust") to the extent of the maximum amount which can pass free from estate taxes. The remaining assets, if any, are distributed outright to the surviving spouse or to a qualified terminable interest property marital trust (a "QTIP Marital Trust") for the benefit of the surviving spouse. Under the estate tax laws as they existed at the end of 2009, this meant that approximately $3.5 million would be allocated to the Residuary Trust and the balance would be allocated to the surviving spouse or QTIP Marital Trust. Under current tax law, however, this could mean that the entire estate would be allocated to the Residuary Trust and none to the surviving spouse or QTIP Marital Trust. If the Residuary Trust is also for the benefit of the surviving spouse, as is generally the case in estate planning documents prepared by our office, this should not be a problem. If, however, the beneficiaries of the Residuary Trust do not include the surviving spouse, this could disinherit the surviving spouse contrary to the intentions of deceased spouse. **Please let us know if you are concerned that this situation could apply to you.**

<u>Possible adverse capital gains tax consequences</u>. Under the estate tax laws as they existed prior to 2010 (and will again apply after 2010), the holdings of a deceased taxpayer, upon death, receive an adjustment in cost basis for capital gains tax purposes to the values of those holdings on the date of death (or in certain cases, six months after the date of death). This unlimited automatic "step-up" law was enacted as a practical way to address both the difficulty in determining what the deceased taxpayer had paid during life to acquire the holdings and any adjustments in cost basis which may have occurred along the way as well as a trade-off for the payment of estate taxes by taxable estates.

Along with the estate tax, however, the unlimited automatic step-up in cost basis was also eliminated for deaths in 2010 to the extent the built-in gain exceeds $1.3 million. To reduce these adverse capital gain consequences for married taxpayers, the tax law for this year allows for an additional step-up in cost basis of $3.0 million for assets passing either outright to the surviving spouse or to a QTIP Marital Trust for the benefit of the surviving spouse. Thus, a total step-up in cost basis of $4.3 million is available for married decedents in 2010 <u>with proper planning</u>.

The additional $3.0 million step-up in cost basis is not available if all the assets in the Revocable Trust pass to a Residuary Trust since no assets would be allocated either outright to the surviving spouse or to a QTIP Marital Trust for the benefit of the surviving spouse. It should be noted, however, that these benefits relate to the unrealized "built-in" gains in the deceased spouse's assets and *not* the market value of those assets.

In many cases, an amendment to the Revocable Trust of each spouse can provide for the optimum basis adjustment under the tax code, if Congress fails to retroactively pass legislation dealing with estate taxes for deaths in 2010. **Please contact our office if you feel that addressing this issue in your estate planning documents is of concern to you.**

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We hope this letter provides some helpful information and perspective for you. Please contact us if you wish to discuss any of these matters further.

Kindest personal regards,

Rothman Law Group