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March, 2011

Re: Federal and Illinois Gift and Estate Tax Law Changes

Dear Clients and Friends:

Recent months have included some of the most sweeping legislative changes in years for estate planning matters at both the Federal and state levels.

In this letter we will highlight the new Federal and Illinois estate and gift tax changes, how they may impact existing estate plans, and the potential planning opportunities which they provide.

I. Federal Estate and Gift Tax Legislation.

A. Gift Tax Changes.

Each person may now make a total of $5,000,000 in *cumulative lifetime* 'taxable' gifts without paying a gift tax. This represents a substantial increase from the prior gift tax "Applicable Exclusion Amount" of $1,000,000 per donor. The gift tax rate on gifts in excess of this new limit is now 35%. The *annual* gift tax exclusion amount which each donor can give to each beneficiary before using any of his or her cumulative lifetime gift tax Applicable Exclusion Amount is unchanged at a current level of $13,000 per donee per year. This amount will continue to be indexed for inflation.

B. Estate Tax Changes.

The estate tax (which lapsed in 2010) has been reinstated retroactively to January 1, 2010, with each person able to exempt up to $5,000,000 from Federal estate taxation upon one's death. This amount is reduced, however, by the amount of the cumulative lifetime gift tax Applicable Exclusion Amount which was already used. Taxable estates in excess of $5,000,000 will be taxed at a rate of 35%. In this way, the Federal gift tax and estate tax laws have been 'reunified' – a single $5,000,000 Applicable Exclusion Amount can be used during one's lifetime and the unused amount can be applied at death.

A completely new "portability" provision has been added to the Federal estate tax laws. This will allow a surviving spouse to elect to take advantage of any unused portion of the $5,000,000 Applicable Exclusion Amount of his or her predeceased spouse to make additional lifetime gifts or leave a larger estate at death. "Portability", thus, effectively enables a married couple to fully utilize their *combined* Applicable Exclusion Amounts of $10,000,000 before paying any gift or estate taxes, even if the first spouse to die did not have optimum estate planning documents in place. **In order for a surviving spouse to avail himself or herself of any part of the unused Applicable Exclusion Amount of the first spouse to die, a Federal Estate Tax Return will need to be filed upon the death of the first spouse.**

Special provisions were also enacted providing an estate tax election with respect to the estates of persons who died in 2010. The estates of persons dying in 2010 may opt out of the new estate tax law regime. For an estate making such an election, the assets of the decedent will *not* receive an automatic "step-up" in cost basis, which could result in capital gain income for the beneficiaries of the estate. **Please contact our office for further details if you think these could be of relevance to you.**

C. Generation-Skipping Transfer Tax Changes.

The generation-skipping transfer tax or 'GST' tax is imposed on certain transfers of wealth, either outright or through a trust, to an individual's grandchild or later descendant of the donor, or to any other persons 37.5 or more years younger than the donor. The GST tax has also been reinstated at a tax rate of 35% and with an exemption amount of $5,000,000. There is no portability between spouses for the GST tax exemption, however.

It should be noted that the GST tax laws which were in place prior to 2010, such as those regarding automatic allocations to GST trusts that are not direct skips, the severance of trusts, and the retroactive application of the GST for predeceased children will continue to apply.

D. Sunset Date.

All of the new Federal estate and gift tax provisions described above are temporary, in that they will expire on December 31, 2012. If no further action is taken by Congress before January 1, 2013, the old rules will return (known as the sunset provision). Thus, without further action by the Congress, we will again be faced with top gift tax and estate tax rates of 55% and only a $1,000,000 exclusion amount for both gift and estate tax purposes.

II. Illinois Estate Tax Legislation.

A. Illinois Estate Tax.

As of January 1, 2011, Illinois has reinstituted an estate tax. For Illinois residents, the tax is imposed on all Illinois real estate and all investments and other 'intangible' property wherever located. For non-Illinois residents, the tax is imposed only on real estate and tangible personal property physically located in Illinois.

Taxable estates which exceed $2,000,000 are subject to Illinois estate tax at rates between 8% and 16%. The Illinois estate tax is deductible in calculating the Federal estate tax.

Because the Illinois $2,000,000 threshold for the payment of estate tax is significantly lower than the Federal exclusion amount of $5,000,000 it will therefore be possible, for example, for a $5,000,000 Illinois estate to pay no Federal estate tax but still owe $352,158 in Illinois estate tax.

There is no portability of the Illinois $2,000,000 threshold amount between spouses as is now the case for the Federal estate tax Applicable Exclusion Amount. Therefore, upon the first death of either spouse, the Illinois threshold amount must be used or lost – it cannot be passed to the surviving spouse.

B. <u>Illinois Gift Tax</u>.

Illinois does not impose a gift tax.

C. <u>Illinois GST Tax</u>.

Illinois also reinstated its GST tax on transfers at death, which like the Illinois estate tax, allows for a $2,000,000 threshold amount.

III. <u>Impact on Current Estate Plans</u>.

A. <u>Do Not Rely on Portability</u>.

A properly drafted estate plan should not rely on the newly established portability of the Federal estate tax Applicable Exclusion Amount for at least three reasons. First, the new portability provision is at this point only effective until December 31, 2012, at which point it will 'sunset'. Second, Illinois does not allow portability of the state's $2,000,000 threshold amount. Third, fully utilizing the Applicable Exclusion Amount of the first spouse to die by setting it aside at the first death in a separate trust, generally referred to in our firm's documents as a "Residuary Trust" (also known as a "Credit Shelter Trust" or a "By-Pass Trust") can enable the appreciation in the value of this trust to remain available for the needs of the surviving spouse or other family members, without being subject to estate tax upon the death of the survivor.

B. <u>Optimize use of both the Federal exclusion and Illinois threshold estate tax amounts</u>.

As previously noted, for Illinois residents, the threshold amount of the Illinois estate tax is significantly less than the amount which is exempt from Federal estate tax. It is important to take full advantage of BOTH the Federal exclusion and Illinois threshold estate tax amounts to minimize the total amount of estate taxes which may be due. Failure to properly address the current estate tax laws can result in an Illinois estate tax of up to $352,158, even when there is no Federal estate tax liability.

Optimizing the use of both the Federal exclusion and Illinois threshold estate tax amounts is generally accomplished for clients of our firm by providing in their documents for the allocation of the assets of the first spouse to die into three separate trust funds with different tax attributes.

The first trust is funded with up to $2,000,000 to take advantage of both the Federal exclusion and Illinois threshold estate tax amounts. This Residuary Trust is generally designed to be available to the surviving spouse and other family members during the surviving spouse's lifetime, without being subject to Federal or Illinois estate tax at the time of the surviving spouse's death, *including appreciation in value between the first and second deaths*.

The second trust is funded with the portion of the deceased spouse's estate in excess of $2,000,000 and up to $5,000,000 in value (i.e. the next $3,000,000). This trust is designed to take advantage of the balance of the $5,000,000 Federal estate tax Applicable Exclusion Amount without subjecting these funds to the Illinois estate tax at the first death. This is accomplished by structuring this trust as a QTIP Marital Trust. All trust income is payable to the surviving spouse and he or she can also receive principal from the trust. Upon the surviving spouse's death, the remaining trust balance, *including further appreciation in value,* is excluded from the surviving spouse's estate for Federal estate tax purposes (although it will be includable in the survivor's estate for Illinois estate tax purposes).

Finally, any remaining balance of the estate of the first spouse to die is allocated to an additional QTIP Marital Trust which avoids the payment of any estate tax upon the first death – either Federal or Illinois. This trust will, however, be fully includable in the estate of the surviving spouse for both Federal and Illinois estate tax purposes.

Please contact our office if you would like to discuss whether your estate plan is designed to accomplish these goals.

C. <u>Consider Lifetime Gifts</u>.

An individual who previously made taxable gifts of $1,000,000 or more is now able to make additional gifts of up to $4,000,000 without incurring any Federal gift tax liability. In addition, since Illinois has no gift tax, there is an effective avoidance of Illinois estate tax by making lifetime gifts.

It is critical, however, that lifetime gifts be made in as thoughtful and tax efficient a manner as possible. This generally includes making gifts in a manner which: **(i) provides potential creditor protection for the recipient; (ii) avoids inclusion of the gift property in the estate of the donor and recipient; and (iii) through discounting or other techniques 'leverages' the gift to maximize the amount being transferred.** *These techniques are discussed more specifically in prior newsletters from our office and will continue to be reviewed in future* *communications.* **Please contact us if you would like to discuss how these techniques could be of benefit to your specific circumstances.**

D. <u>Consider Change of Domicile to Another State</u>.

For those in a position to do so, an estate tax savings can be achieved by changing legal domicile from Illinois to another state which does not have an estate tax. This is common for 'snow birds' who maintain second homes in such Sunbelt states as Florida, Arizona, Nevada and Texas. The decision and implementation of this strategy is complex, however, and should be made in conjunction with one's income tax preparer and estate planner since it includes a review of state income taxes and personal lifestyle, such as how much time is actually spent in each locale. **Please contact our office to discuss further the potential benefits and burdens of a change of state domicile.**

E. <u>Utilize Other Estate Tax Saving Techniques</u>.

To the extent that the new Federal exclusion and Illinois threshold amounts are not adequate to eliminate potential estate tax liabilities, including the possibility that these amounts will return to their 2001 levels of $1,000,000 per person, there are a variety of estate planning techniques available to reduce or eliminate the estate tax. These techniques include: charitable planning strategies, intra-family loans, installment sales to grantor trusts and establishing grantor retained annuity trusts ("GRATs"), irrevocable life insurance trusts ("ILITs"), family limited partnerships and limited liability companies. *We are experienced in these strategies and would welcome the opportunity to explore how they can be best utilized for specific situations.*

Please feel free to schedule an appointment with us to discuss how you and your family can make best use of the new estate and gift tax rules.

Kindest personal regards,

Rothman Law Group

Rothman Law Group is a Chicago-based law firm specializing in estate planning, business planning and trust and estate administration. We combine the most sophisticated planning techniques with the ability to find practical solutions to individual problems. Our legal expertise coupled with strong relationship skills enables us to effectuate our clients' goals while providing financial saving strategies.