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Newsletters

Estate Planning Newsletter - December 2011

December 13, 2011

Future of Federal Estate Tax and Its Provisions Remains Unsettled

In December 2010, the U.S. Congress passed the Tax Relief Act of 2010 (Act). The Act reinstated the federal estate tax effective January 1, 2010, and introduced a new provision called portability, which is discussed later in this issue. Under the Act, each taxpayer may transfer up to $5 million free of federal estate taxes if he or she dies in 2011 or 2012. However, unless Congress acts again, the federal estate tax provisions in 2013 will automatically revert to the provisions as they existed in 2001 (see the article *What Will the Federal Estate Tax Look Like in 2013?*). No action by Congress is expected until after the 2012 federal election and a new Congress is seated in 2013.

Portability Under the Tax Relief Act of 2010

As noted in the previous article, the Tax Relief Act of 2010 introduced a new concept known as "portability." Effective January 1, 2011, the surviving spouse may now use a deceased spouse's unused tax-free amount under some circumstances. This means that a surviving spouse may utilize a predeceased spouse's unused tax-free amount to increase the amount which can be transferred free of federal estate taxes when the surviving spouse dies. For example, the tax-free amount for federal estate tax purposes in 2011 and 2012 is $5 million. If a predeceased spouse dies in 2011 and only uses $3 million of his or her tax-free amount upon his or her death, the surviving spouse may use the $2 million excess if certain criteria are met. Based on the portability rules, the surviving spouse may then transfer up to $7 million (i.e., the surviving spouse's $5 million amount plus the deceased spouse's $2 million unused tax-free amount). At first blush, portability appears to be a valuable tax planning possibility. However, because portability only applies in 2011 and 2012 and only for federal estate tax purposes, it should not be relied on as a valuable tax planning possibility at this time.

Portability may be useful to married taxpayers for federal estate tax purposes in specific instances, but has limited usefulness until it is made permanent. Further, portability does not apply for federal gift tax purposes or federal generation-skipping transfer tax purposes. Finally, with respect to Illinois taxpayers, portability never applies to the Illinois estate tax. Consequently, we recommend that married Illinois taxpayers continue to hold assets in the names of their respective revocable trusts or otherwise to utilize fully each spouse's tax-free amount for federal and state estate tax purposes.

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Your Hinshaw attorney is available to discuss portability with you with the intention of maximizing your potential federal and state estate tax savings opportunities.

What Will the Federal Estate Tax Look Like in 2013?

Unless Congress takes additional action, the federal estate tax provisions in 2013 will automatically revert to the provisions as they existed in 2001, which could negatively affect taxpayers.

Beginning in 2013, the applicable exclusion amount (i.e., the tax-free amount) will only be $1 million per taxpayer. Married couples can transfer up to $2 million of combined value, tax-free, if they plan properly. This may sound like a lot of money; however, taxpayers should realize that all of the equity in their homes, and the value of all of their investments—including retirement benefits, and life insurance proceeds—are included in the applicable exclusion amount. Therefore, even middle-class families may end up with taxable estates if they do not plan properly.

Beginning in 2013, the federal estate tax rate will be as high as 55 percent with a 5 percent surtax on large estates. A tax credit (i.e., not a deduction) will be allowed for state death taxes and a deduction for small businesses will be allowed. If a taxpayer has a taxable estate, the estate tax bill may increase if he or she dies after 2012.

Congress is aware that the 2013 estate tax provisions remain generally unpopular among those who may pay the tax, particularly among business owners. Therefore, Congress may change the provisions of the federal estate tax after 2012. Tax-free amounts of $3.5 and $5 million per taxpayer have been discussed. Yet, only time will tell if Congress will timely address this concern.

Those concerned about this issue should contact their representatives in Congress. Hinshaw will continue to follow this issue closely.

Illinois Estate Tax Becomes Permanent

As of January 1, 2011, the Illinois estate tax became permanent. The tax only applies to estates worth more than $2 million. If an estate is worth more than $2 million, the state taxes the entire estate, not just the portion in excess of $2 million. For example, the Illinois estate tax on an estate worth $2.1 million is $25,926. Most taxpayers fail to recognize this aspect of the Illinois estate tax and the significant amount of Illinois estate tax that will eventually be due.

In order to mitigate the impact of the Illinois estate tax law change, the state has also adopted an “Illinois-only” marital deduction for qualified terminable interest property (QTIP) marital trusts. The impact of the Illinois QTIP election is not yet clear. Presumably, the value of the QTIP trust will be included in the value of the Illinois estate upon the surviving spouse’s death. However, it may not be included in the federal gross estate upon the surviving spouse’s death unless a federal QTIP election also was made regarding such marital trust. If a federal QTIP election was not made, the QTIP marital trust would not be included in the gross estate upon the second spouse’s death. If the QTIP marital trust is not included in the federal gross estate upon the death of the surviving spouse, the state death tax deduction under Section 2058 of the Internal Revenue Code of 1986, as amended (IRC Section 2058) may be unavailable for Illinois taxes assessed against the value of the QTIP marital trust. IRC § 2058 requires that any state death taxes to be deducted on a federal estate tax return must be paid with respect to property included in the gross estate of the deceased taxpayer.

Marital Trust Allocation Formula in Wills or Trusts May Need to Be Updated Now

The decoupling of the Illinois estate tax from the federal estate tax creates significant complexities in the estate plans of married couples residing in Illinois. Historically, married couples in Illinois used A/B trust provisions to insure that no estate taxes would be due on the death of the first spouse. A credit shelter trust (i.e., the “B” trust) would receive the federal tax-free amount (i.e., the basic exclusion amount in today’s nomenclature) and a marital trust (i.e., the “A” trust) would receive the balance. Power of appointment marital trusts were often used in first marriage situations. Any will or trust that still uses these traditional approaches may need to be updated because there may be unintended Illinois estate tax consequences upon the death of the first spouse.

First, Illinois only allows a marital deduction for Qualified Terminable Interest Property (QTIP) marital trusts, not power of appointment marital trusts. Therefore, no Illinois-only QTIP election is available for a power of appointment marital trust. This may result in the unnecessary imposition of Illinois estate taxes in some circumstances unless the operative will or trust instrument is updated to address the Illinois tax law changes.

Second, the historical approach to allocating value between a credit shelter trust and a marital trust based solely on the federal estate tax, tax-free amount may cause unnecessary Illinois estate taxes upon the death of a first spouse whenever the tentative taxable estate is worth between $2 million and $5 million. For example, a credit shelter trust funded in 2011 with $5 million will cause $352,158 of Illinois estate tax to be incurred on the death of the first spouse. This problem can be solved by funding the credit shelter trust with the Illinois tax-free amount (i.e., $2 million, and funding a QTIP marital trust [or two QTIP marital trusts] with the balance). The executor will then elect the Illinois only QTIP deduction related to the entire QTIP marital trust, but only elect QTIP treatment for federal estate tax purposes to the extent necessary to maintain the federal taxable estate at an amount equal to the basic exclusion amount. Assuming that the basic exclusion amount is $5 million, the first $2 million will be allocated to the credit shelter trust and the balance to a QTIP marital trust. No federal QTIP election will be made, so the federal taxable estate will be $5 million (i.e., an amount exactly equal to the first spouse's basic exclusion amount). An Illinois QTIP election will be made related to the entire $3 million in the QTIP marital trust. This approach will require that key provisions in the operative will or trust instrument be amended as soon as possible.

Third, because Illinois does not and probably will not allow for portability, married couples with a combined estate worth between $2 million and $4 million must continue to balance their respective estates so that $2 million will be included in each of their respective estates. This will allow such individuals to minimize their combined Illinois estate tax liability.

Gift Tax—the Window of Opportunity

From now through December 31, 2012, individual taxpayers may gift up to $5 million during their lifetime without incurring federal gift taxes. Prior to 2011, aggregate lifetime gifts were limited to $1 million. Thus, a married couple now has the capacity to make aggregate lifetime gifts up to $10 million before 2013.

The increase of the tax-free federal gift amount is a significant gift tax planning opportunity for anyone who will have a taxable estate and currently has substantial assets to gift. Further, the amount of a lifetime gift can be significantly leveraged using sophisticated tax planning strategies. For example, grantor retained annuity trusts, qualified personal residence trusts, family limited partnership interests, and sales to intentionally defective grantor trusts can be used to enhance the value of a lifetime gift. Lifetime gifts can also be used to avoid state taxes in states that have an estate or inheritance tax, but do not have a gift tax. Illinois is an example of such a state.

On January 1, 2013, unless Congress acts again, the amount of lifetime gifts which can be transferred free of federal gift tax will return to $1 million. This reduction of the lifetime, tax-free amount for federal gift tax purposes creates a technical problem. It is possible, though still unclear, whether the IRS will attempt to clawback gifts made in excess of $1 million when such gifts were allowed in 2011 and/or 2012. Although Congress or the IRS may remedy this situation, the clawback could result in additional estate taxes under some circumstances. Unfortunately, no one can predict with certainty how that problem will be resolved at this time.

Please consult your Hinshaw attorney regarding the advisability of making significant gifts prior to December 31, 2013, and the best strategy for optimizing gift tax savings.

2012 Limit for Annual Exclusion Gifts Remains at $13,000

"Annual exclusion" gifts are relatively small gifts that may be made tax-free to a donee. The annual exclusion limit for 2011 is $13,000 per donee. The annual exclusion limit for 2012 will remain the same at $13,000 per donee. Individuals who have the resources with which to make annual exclusion gifts should seriously consider doing so as these gifts generally need not be reported for gift or estate tax purposes and will pass tax-free to the donee. Note that the $13,000 limit includes all gifts to the donee during the year and special rules apply for gifts to trusts. If the donees are grandchildren or trusts for grandchildren, generation-skipping implications will also need to be considered. Note also that a donee will receive a carryover basis in any property received, so income tax implications will need to be evaluated, too.

Illinois Now Recognizes Civil Unions of Same Sex Partners

As of July 1, 2010, Illinois recognizes civil unions of same sex partners and heterosexual partners. Civil union partners are treated as spouses for all purposes under Illinois law. Therefore, civil union partners should be able to hold a principal residence as tenants by the entirety. Transfers between civil union partners should be eligible for marital deduction treatment for purposes of the Illinois estate tax, although this issue has not yet been ruled upon specifically by the Illinois Attorney General or a court of competent jurisdiction. However, civil union partners are not recognized as spouses for purposes of federal estate tax and federal gift tax laws.

Trust and Estate Litigation on the Rise

Trust and estate litigation is an ugly and expensive reality. The rate, intensity and cost of it are constantly increasing. Estate plans with unusual features or that treat children other than equally are typically more susceptible to trust and estate litigation. In these situations, litigation should be anticipated because disinherited or family members who feel slighted are unlikely to remain quiet. In addition, beneficiaries who are unhappy with investment performance of trust assets rarely sit quietly by during a challenging economy. Less common estate plans should be reviewed by an attorney with experience in handling unique estate plans to ensure that all decisions are properly documented.

Undue influence cases are also increasingly common. Individuals with loved ones who have been subjected to another's undue influence should act swiftly and forcefully. Litigation is not a desired result, but it is often a reality and sometimes a necessity. Not just anyone knows how to properly litigate a case involving a trust or estate administration. Individuals who anticipate litigation should contact counsel sooner rather than later because sometimes evidence disappears, money vanishes and/or records are destroyed.

Asset Protection Trusts Can Be Used to Protect Property From Creditors

Special irrevocable trusts formed under the laws of Delaware, South Dakota, Alaska or several other states are increasingly being used for asset protection purposes. Individuals with assets that exceed their liabilities, including contingent liabilities, can use an asset protection trust to guard their excess assets from creditors if all of the rules are followed and the transfer is not deemed to be for the primary purpose of hindering or defrauding known or reasonably foreseeable creditors. Creating an asset protection trust also may be worth considering for individuals who are exposed to professional liability or own rental real estate.

Illinois Power of Attorney Act Amended in 2011

Significant amendments made to the Illinois Power of Attorney Act became effective on July 1, 2011. The new law promotes greater protection of the principal—particularly elderly, incapacitated and disabled persons. The new law affects property and health care powers of attorney. Individuals who have not done so already should consider having their powers of attorney updated.

Illinois Adopts Transfer on Death Deeds

The Illinois Uniform Real Property Transfer on Death Act (Act) becomes effective January 1, 2012. The Act allows an Illinois landowner (or landowners, if real estate is jointly owned) to execute a deed during the landowner's lifetime that transfers the real property located in Illinois to a designated beneficiary upon the death of the landowner. If the Illinois real estate is owned jointly, the transfer-on-death deed allows the Illinois real property to be transferred to a designated beneficiary upon the death of the surviving joint tenant.

The Illinois landowner may revoke a transfer on deed during his or her lifetime. He or she may also sell, mortgage, lease, deed or otherwise dispose of the property without notifying the beneficiary.

Using a transfer-on-death deed avoids probate and administrative costs related to the real property conveyed. The use of transfer-on-death deeds is likely to prove quite useful in Illinois when smaller estates are involved. Having an experienced estate planning attorney guiding the process can help ensure that complications are avoided and that the deed is executed in compliance with Illinois laws.

Changes to Florida Power of Attorney Law

Effective October 1, 2011, Florida substantially revised its Power of Attorney Act (Act) regarding the following issues:

1. The scope of the power
2. The execution, amendment, revocation, suspension and termination of the power
3. The designation, acceptance, compensation and resignation of the agent
4. The duties of an agent
5. The authority of an agent
6. The liabilities of an agent
7. The acceptance, rejection, liability and reliance of third persons on the power
8. Judicial proceedings related to the power

The most significant changes under the new Act were made to Florida durable powers of attorney. A durable power of attorney is one which is not terminated by the principal's incapacity. After the effective date, a durable power of attorney in Florida must be signed by the principal in the presence of two subscribing witnesses and must be acknowledged by the principal before a notary public. Except for military personnel, all durable powers of attorney under the Act must now be effective upon execution (i.e., when signed by the principal). This contrasts with prior Florida law, which allowed for durable powers to become effective at some time in the future when the principal lost capacity.

Because of the sweeping changes to the Act, each Florida resident should contact his or her estate planning attorney to determine if their current Florida power of attorney is in compliance with the new law. Note that amendments to an existing Florida power of attorney are no longer allowed. Rather, an existing Florida power of attorney must be revoked and a new Florida power of attorney that complies with the Act must be executed in its place.

Florida Residency Offers Tax Advantages

For those taxpayers who meet the requirements, establishing residency in Florida has many advantages. First, Florida is a very tax-friendly jurisdiction. It has no personal income tax, no state estate tax, no state gift tax and no intangibles tax. Second, certain assets owned by Florida residents are protected assets, including life insurance, annuities, pensions and individual retirement accounts. Last, a Florida homestead property is generally exempt from forced sale by creditors, except for mortgage and other lienholders and for unpaid property taxes.

The Florida homestead law differs from many states. The equity in a personal residence protected by homestead is unlimited unless a personal bankruptcy is filed. In the event of bankruptcy, there are certain limitations on the amount of equity that can be protected based on the number of days the owner owned the residence and how long the individual had established Florida residency prior to the filing of bankruptcy.

One disadvantage of Florida homestead status is that if an individual is married and/or has minor children, there are constitutional and other restrictions on the ability to transfer the homestead property during an individual's lifetime or upon death by last will and testament or trust. Individuals who live in Florida for a significant portion of the year may want to consider establishing Florida residency to take advantage of all of the benefits it can provide.

Selling to an ESOP May be a Possible Exit Strategy for a Closely Held Business Owner

Transitioning a closely held company is not easy. Owners of closely held companies often want to convert a portion of their shares into cash to reduce investment risk. An owner who is evaluating complete exit strategies should consider selling his or her shares to an ESOP (employee stock ownership plan) as a possible alternative.

An ESOP is a type of employee benefit plan that invests primarily in employer stock. It provides certain tax advantages that are not generally available to other potential buyers. A sale to an ESOP is typically used as a succession tool for owners of closely held companies. An ESOP which buys closely held stock can borrow the purchase price at an attractive after-tax cost as well as provide additional employee benefits to the company's employees.

Selling some or all of a closely held company to an ESOP offers significant tax incentives that are not available in traditional sales transactions. One key advantage is that an owner who sells a portion of the company to an ESOP can still retain control over the company.

When considering whether an ESOP is a viable and sustainable option for a company, the owner should consider the following: (1) value of the company; (2) company's history of profitability; (3) company's debt capacity; (4) strength of the current management team (and/or a management team succession plan); (5) number of employees at the company; (6) amount of the company's payroll; and (6) company's employee turnover statistics.