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What Will the Federal Estate Tax Look Like in 2011?

The federal estate tax will be resurrected in 2011. But what, exactly, it will look like was unknown as of the date this newsletter was published. Based on President Obama's announcement on December 6, 2010, the federal estate tax rate will be 35 percent for two years and the tax-free amount will increase to $5 million per taxpayer for two years. Provided that the President can secure the votes necessary to pass the agreed provisions — a prospect that is not clear as of the date this newsletter was published — this is good news. However, it is not yet clear that the President has secured the necessary votes, and the unknowns include the details of the so called agreed provisions, and what will happen after two years.

If President Obama cannot secure the necessary votes to pass the provisions agreed to in the deal, the federal estate tax provisions in 2011 will reflect the provisions as they existed in 2001. Also, unless Congress acts, the applicable exclusion amount — i.e., the tax-free sum — will be $1 million per taxpayer beginning in 2011. Married couples will be able to transfer up to $2 million of combined value tax-free, provided that they planned properly. All of the equity in one's home, and the value of all of one's investments — including retirement benefits and life insurance proceeds — count against the applicable exclusion amount. As a result, even middle class families may end up with taxable estates if they have not planned properly. Starting in 2011, the federal estate tax rate may be as high as 55 percent. A tax credit (as opposed to a deduction) will be allowed for state death taxes, as will a deduction for small businesses. Needless to say, the estate tax bill for the estates of individuals who die in 2011 may be much higher than for those who pass in 2010.

Congress is aware that the 2011 estate tax provisions remain generally unpopular among those who may pay the tax, particularly among business owners. Yet, only time will tell whether Congress intends to timely address this issue. Taxpayers who are concerned about this issue may want to contact their representatives in Congress to voice their concerns. Hinshaw will continue to follow this issue closely.

Repeal of the Federal Estate Tax in 2010 Complicates Estate Planning
Because the federal estate tax does not currently exist in 2010, estates will not pay it upon the death of their decedents in 2010. Assuming that Congress does not retroactively reinstate the federal estate tax for 2010, an alternative tax system — EGTRRA — will remain in place in 2010. Unlike the federal estate

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tax, EGTRRA may affect taxpayers' future income tax obligations. To illustrate, a taxpayer who inherits property in 2010 will not generally pay any taxes at the time that he or she inherits the property. However, it is possible that the taxpayer may have to recognize a taxable gain when he or she sells that property in the future. Taxable gains are possible in the future because, as a general rule, the taxpayer will inherit the decedent's tax basis (the cost of an asset used to determine tax liabilities) in the property. For example, if a taxpayer inherits a house from his or her parent in 2010 and the parent paid $100,000 for the house, the taxpayer will recognize a taxable gain on the sale of the house should he or she sell it for more than $100,000.

Prior to 2010, a beneficiary's income tax basis in inherited property was generally its value as of the decedent's date of death. The general rule in 2010 is that a taxpayer inherits the decedent's income tax basis in the property, which is usually its original cost. Fortunately, there are three important exceptions to the general rule denying beneficiaries stepped up basis in inherited property in 2010. First, each decedent may step up to $1.3 million of value in property held at death. Second, each decedent may step up an additional $3 million of value in property transferred to a surviving spouse so long as it was transferred in the correct form. Finally, certain loss carryovers can also increase the basis step up amount.

Distributions from retirement plans and individual retirement accounts (IRAs) remain subject to income taxes whenever the benefits are received. No basis step up allocations are allowed with respect to retirement plans or IRAs.

The amount of basis step up allocated among the decedent's assets must be reported on a return filed with the decedent's 2010 federal income tax return or at a later date specified by the Internal Revenue Service (IRS). The IRS has yet to formally issue any forms or instructions on this issue. Therefore, taxpayers need to be sure that their decedent's final income tax return reflects the basis step up allocation. The decedent's final income tax return will be due on April 15, 2011. If the IRS has not issued guidance by then, taxpayers should consider extending their decedent's final income tax return until it does.

Because the estate tax situation in 2010 remains so unsettled, it is important that taxpayers seek qualified legal and tax counsel. It may also be wise to withhold any distributions from some estates until the executor is sure that the federal estate tax will not be retroactively reinstated in 2010.

Status of the Federal Estate Tax in 2010

The federal estate tax was repealed as of January 1, 2010, despite the expectations of many to the contrary. The repeal will mean nothing to individuals who survive into 2011 but may have significant implications as to the estates of those who died in 2010 and to the heirs of those decedents.

Retroactive reinstatement of the federal estate tax as of January 1, 2010, remains a possibility, but one that diminishes with time. Relevant precedent that might support such action includes U.S. v. Carlton, 512 U.S. 26 (1994), which involved a situation in which Congress had retroactively eliminated an estate deduction more than a year after the estate tax return was filed. The U.S. Supreme Court in that case upheld the retroactive change. However, at least six billionaires have died in 2010. So a retroactive reinstatement of the federal estate tax as of January 1, 2010, would undoubtedly result in significant litigation.

Because the status of the estate tax in 2010 remains uncertain, the current estate planning environment remains frustratingly uncertain. In the meantime, Hinshaw & Culbertson LLP will be watching and waiting for Congress to act.

What Will State Estate and Inheritance Taxes Look Like in 2011?

In addition to the federal government, individual states charge death taxes as well. After 2010, the resurrected federal estate tax and any other changes in the federal estate tax may also have significant state estate and/or inheritance tax implications. For example, many states tie their estate taxes to the federal estate tax state death tax credit. Beginning in 2011, barring other changes by Congress, there will be a state death tax credit on the federal estate tax return. In Illinois and Florida, this would mean that those states would impose a state estate tax equal to the state death tax credit allowed on the federal estate tax return. No estate tax exists in either state in 2010. Further, Florida's estate tax did not apply in years that the state death taxes were allowed as a deduction — rather than as a credit — on the federal estate tax return.

States with their own inheritance tax regime should not be affected by the changes in the federal estate tax. For example, in Indiana, changes to the federal estate tax are unlikely to change liabilities under the Indiana inheritance tax.

State death taxes can be considerable enough that taxpayers need to consider them in their estate plans. Accordingly, taxpayers should discuss the applicable state death tax issues with their tax and estate planning professionals.

The Federal Gift Tax Was Not Repealed in 2010!
Notwithstanding the status of the federal estate tax in 2010, the federal gift tax applicable to lifetime transfers was not repealed. All gift tax provisions in effect at the end of 2009 remain the same in 2010 and for all future years. Therefore, annual exclusion gifts, tuition gifts and medical expense gifts remain tax-free, and each taxpayer may still make $1 million of tax-free gifts throughout his or her lifetime. The federal gift tax remains based on value and the traditional valuation issues remain in play.

One major consideration applicable to gift taxes concerns the federal gift tax rate. Tax planners do not typically suggest incurring actual gift tax liabilities. However, gift taxes related to taxable gifts made in 2010 may be the exception. Taxpayers who have a large estate that they are absolutely sure will be taxable regardless of what Congress does may have a unique opportunity. The federal gift tax rate in 2010 is 35 percent, a percentage that may be lower than the federal estate tax rate that may apply in the future. Taxpayers who want to consider taking advantage of the reduced gift tax rate should model all possible outcomes with a qualified advisor and contact their tax and estate planning advisors immediately. This is not a tax payment strategy for most taxpayers or for the faint of heart, but may be a valuable course of action for wealthier individuals.

Take Advantage of Low Values and Low Interest Rates to Make Gifts in 2010
A taxpayer may make $1 million of tax-free gifts throughout his or her lifetime. It is therefore often wise for a taxpayer — during his or her lifetime — to make large gifts of assets that he or she does not need. Now is the time to make such gifts.

Taxable gifts are based on value. Because the economy is in bad shape, the value of many businesses, real estate and collectibles have been reduced. It is therefore a perfect time to transfer such assets and thereby take full advantage of the low values. When the value of the asset increases, all of the value will have already been transferred to the recipient of the gift, tax-free.

Because interest rates are so low, now is also an excellent time to loan money to children and other family members or to sell children and family members assets in return for promissory notes that bear a low interest rate. Such sales allow the lending taxpayer to freeze the value of his or her assets. If done with sufficient foresight, this can be done tax efficiently for income tax purposes.

Finally, it is an excellent time to take advantage of gifts that are sensitive to interest rates, including qualified personal residence trusts and grantor retained annuity trusts (GRATs). There have been several attempts this year to end the practice of using GRATs, which trigger little, if any, gift tax liability. So the window for this opportunity may close soon. Taxpayers with assets which could generate significant appreciation while returning the value of the original asset to the taxpayer should contact their tax or estate planning advisor immediately.

Today's lowered asset values are also a consideration for individuals seeking to complete a successful ownership and management transition. Successful transitions of a family business require more than the transfer of the stock or membership interest, and so the owners of such businesses should seek counsel with significant business and valuation experience. Hinshaw & Culbertson LLP's estate planning attorneys often help taxpayers transfer assets among one another in order to help them fully utilize their $1 million applicable exclusion amount.

2011 Limit for Annual Exclusion for Gifts Remains at $13,000
"Annual exclusion" gifts are relatively small gifts which may be made tax-free to an individual recipient. The annual exclusion limit for 2010 is $13,000 per individual gift recipient and will remain the same for 2011. Taxpayers who have the resources with which to make annual exclusion gifts should seriously consider doing so as these gifts are not taxed for gift or estate tax purposes and therefore will pass tax-free to the recipient. The $13,000 limit includes all gifts to the same

recipient during the year; special rules apply for gifts to trusts. If the gift recipients are grandchildren or trusts for them, generation skipping implications will also need to be considered. As the recipient of a gift receives a carried over basis in any property received, income tax implications will need to be evaluated, too.

Trust and Estate Litigation on the Rise
Whether it involves a taxpayer who has left his or her entire estate to someone who he or she has only known for a short while, or beneficiaries who are not happy with investment performance of trust assets, trust and estate litigation is an ugly reality of the trust and estate practice. The rate, intensity and cost of such litigation is increasing. It takes attorneys familiar with such cases to successfully resolve them at costs that make sense. Taxpayers whose estate plans have unusual features or treat children other than equally should have their plans reviewed and their decisions properly documented.

Taxpayers who have a loved one who has been subjected to another's undue influence also need to act quickly and forcefully. Litigation in these situations is sometimes a necessity, and is best handled by a lawyer with the relevant technical knowledge, significant experience and the heart of a warrior. Most estate planners refer such work to other attorneys or offices. Hinshaw & Culbertson LLP's lawyers are known for their trust and estate litigation skills. Where litigation is anticipated, it would be wise to contact counsel sooner rather than later as over time evidence may disappear, money may vanish and/or records may be destroyed.

Asset Protection Trusts Can Be Used to Protect Assets
An increasing number of families are looking for ways to protect their property from creditors. The means available to accomplish this goal include the use of special irrevocable trusts formed under the laws of Alaska, Delaware, South Dakota, or several other states. Taxpayers who have sufficient assets in excess of their current liabilities — including contingent liabilities — can use an asset protection trust to protect the excess from creditors, provided that all applicable rules are followed and the transfer is not deemed to be for the primary purpose of hindering or defrauding known or reasonably foreseeable creditors.

Delaware, for example, has adopted a special trust law which limits the ability of creditors whose underlying judgment is against the debtor who created the trust rather than against the trust itself to successfully reach trust assets. Under Delaware law, an individual may create a trust for the benefit of himself or herself in Delaware. The trust must be irrevocable and must have a Delaware trustee who is not the grantor of the trust. The grantor may retain certain rights under the trust, including: (a) the right to manage trust assets; (b) the power to veto trust distributions; (c) a limited power of appointment over trust assets, effective at the grantor's death; and (d) the right to remove a trustee or advisor and appoint a successor who is not related or subordinate to the grantor. The grantor may receive discretionary or mandatory distributions of income, along with discretionary distributions of principal.

There have been no published cases involving a Delaware trust being successfully attacked or sustaining such a trust's validity for non Delaware residents. Some cases have reportedly been settled very favorably for defendants to avoid the expense and uncertainty of that litigation. Taxpayers interested in exploring asset protection trusts should contact their estate planning advisors.

Illinois Power of Attorney Act Amendments
Significant amendments made to the Illinois Power of Attorney Act will become effective on July 1, 2011. The amended law will create more user-friendly statutory power of attorney forms and instructions, promote greater protection of the principal — particularly elderly, incapacitated and disabled persons — and impact powers of attorney for property and for health care.

The new statutory form will consist of the following elements: (1) notice to the principal on a separate page; (2) the form itself with separated notes to the principal; and (3) notice to the agent. Despite these changes, however, a form that substantially complies with the new statutory form will be deemed valid and may be relied upon by a third party. The new law specifies that forms executed in compliance with prior Illinois law will remain valid and provides reciprocity for powers of attorney executed under the laws of other states.

Several significant protections for the principal will also be added or expanded upon. For example, the agent's standard of

care to the principal will be elevated to “acting in good faith using due care, competence, and diligence” rather than simply “due care.” The new law will also expand the remedies available against an agent who abuses his or her fiduciary responsibilities, and amend the venue provision to make it more convenient for the principal.

Additional highlights of the new law include:

- a procedure for the agent to certify that he or she has accepted the position of agent;
- expansion of the mechanism for court review of a power of attorney;
- guidance regarding successor agents; and
- additional limits on who may witness the execution of a power of attorney.

Finally, the amended law will set forth changes specific to the health care power of attorney and, separately, the property power of attorney. For example the amended law will allow a health care power of attorney to become effective on a written determination by the patient’s physician that the principal is incapacitated. Further, it incorporates the latest medical changes required by the Health Insurance Portability and Accountability Act (HIPAA) and the Disposition of Remains Act. With regard to the property power of attorney, the amended law will expand upon the requirements for a nonstatutory power of attorney (one in which the statutory form has not been utilized) to be recognized in Illinois, and acknowledge the ability to name co-agents in nonstatutory powers of attorney (although co-agents are not permitted under the statutory form).

Taxpayers should contact their estate planning advisors to explore whether it might be worthwhile to have their powers of attorney updated to utilize the revised forms.

Illinois Trust and Payable on Death Accounts Act Now Law
Under the Illinois Trust and Payable on Death Accounts Act (Act), trust accounts and payable on death (POD) accounts may be paid to the named beneficiaries upon the death of the account owner. Until July 21, 2010, only natural persons could be proper recipients of proceeds under such accounts. After July 21, 2010, such accounts may be distributed to any living person, or to a trust, corporation, charitable organization, or any other entity that maintains a lawful existence under state or federal authority under which it was organized.

Further, financial institutions that maintain trust accounts or payable on death accounts are not required to distribute the account proceeds until it is provided with: (1) evidence of the death of the account owner; (2) identification from each beneficiary, including business records showing evidence of the lawful existence of any party authorized to collect the funds that is not a natural person; and (3) written direction from each beneficiary to close the account and distribute the proceeds. If the financial institution, in its discretion, cannot identify or determine the lawful existence of one or more of the beneficiaries authorized to collect on the account, or if conflicting claims to the account are made by the beneficiaries or other interested parties, the financial institution may refuse to distribute the proceeds without liability to any party until a court determines the proper ownership of the proceeds.

With the enactment of the Act, the holders of trust accounts and POD accounts — the number of which accounts is on the rise — should contact an estate planning professional to discuss the possible use of such accounts, and the coordination of beneficiaries of these and other estate assets.

Tenancy by the Entirety Asset Protection Treatment Available to Certain Revocable Trusts in Illinois Starting Next Year
After January 1, 2011, an Illinois homestead property held in the name of a trustee or trustees as an asset of a revocable trust and occupied by a married couple can be held as a “tenancy by the entirety” under certain circumstances. The creators of the trust or trusts must be husband and wife, and those parties must be the primary beneficiaries of one or both of the revocable trusts. The rule applies only for a personal residence located in Illinois.

Tenancy by the entirety is similar to joint tenancy in that it also carries with it “rights of survivorship.” However tenancy by the entirety differs from joint tenancy in that it only applies to spouses and neither spouse can obtain partition or defeat the

right of survivorship of his or her spouse. Tenancy by the entirety status also offers asset protection features unavailable to joint tenants.

A residential property owned by a married couple that is held in tenancy by the entirety cannot be subject to a sale in satisfaction of a judgment unless the judgment is against both spouses. This provision would protect the homestead property, for instance, in the case of a malpractice action against one spouse in his or her professional capacity. The tenancy by the entirety property may be protected even in a bankruptcy of a single joint owner. The only exception to this general rule is that the personal residence can be sold if it is to satisfy a tax obligation in favor of a governmental unit.

Married couples who have a personal residence located in Illinois should contact their estate planning professionals to review this major asset protection opportunity.

Check Your IRA and Other Beneficiary Designations

An individual other than a surviving spouse may rollover Individual Retirement Account (IRA) and retirement plan benefits into his or her own inherited IRA account upon the death of the original account owner. Rollovers allow for an extended deferral of income taxes on distributions if done correctly. Often, however, IRA and retirement benefits are taxed inefficiently as a result of poor planning, and taxpayers lose track of their respective life insurance beneficiary designations. Taxpayers should review their beneficiary designations with their tax and estate planning advisors to possibly help avoid expensive and unintended consequences.

Consider Converting Your IRA or Qualified Retirement Plan Into a Roth Account in 2010

Roth individual retirement accounts or Roth accounts in a qualified retirement plan (Roth Accounts) offer several tax advantages. For example, distributions from Roth Accounts are not subject to income tax, and no minimum distributions are required to be made from a Roth Account during the owner's lifetime. Taxpayers should consider converting their individual retirement accounts (IRAs) or qualified retirement plans into a Roth Account in 2010.

Prior to 2010, many IRAs and qualified retirement plans could not be converted into Roth Accounts if the taxpayer's modified gross income exceeded $100,000. In 2010, however, they may be, regardless of the individual's modified gross income.

In addition, prior to the September 27, 2010, enactment of the Small Business Jobs and Credit Act of 2010 (SBJCA) — which was designed to allow taxpayers to convert funds held in a qualified retirement plan to a Roth Account — a distribution from the qualified retirement plan to a Roth IRA was required. Now that conversion may be made within the qualified retirement plan. In order to allow for such conversion within a qualified retirement plan, the plan must contain a Roth feature and be amended to allow for such conversion, and the funds held in the plan must qualify for a distribution (for example as an in-service withdrawals, or due to attaining age 59 and one half or termination of employment).

The amount converted from an IRA or qualified retirement plan into a Roth Account will be subject to ordinary income tax. Normally, the amount converted into the Roth Account is subject to income taxation in the year of the conversion. However, in 2010, taxpayers may elect to have the sum taxed 0 percent in 2010, 50 percent in 2011 and 50 percent in 2012. Generally, converting to a Roth Account will not benefit a taxpayer unless the income taxes due can be paid from sources other than the IRA or taxable qualified retirement plan proceeds.