The New Federal & Illinois Estate Tax Laws

Having endured most of the year without hope of political compromise on estate taxes, most estate planners in late 2010 were expecting no new legislation to be enacted that year. Political gridlock seemed to be the new normal. Nowhere was this more aptly illustrated than by the spectacle of the 2010 estate tax repeal and carryover basis for clients dying that year. These rules became law after a late-2009 bipartisan attempt failed to broker an estate tax deal, speaking volumes about our political process and inability to craft responsible tax laws.

By Robert J. Kolasa

Estate & Gift Tax Rates & Exclusions

	(Old law) 2010	(New law) 2010	(New law) 2011-2012	("Sunset") 2013
Top Estate/Gift Rate	45%	35%	35%	55%
Federal Estate Tax Exclusion	Tax Repealed	$5 million	$5 million*	$1 million
Carryover Basis	YES	Elective with Estate Tax Repeal	N/A	N/A
Gift Tax Exclusion	$1 million	$5 million	$5 million*	$1 million
GST Tax Exclusion & Rate	Tax Repealed	$5 million (0% Rate)	$5 million* (35% Rate)	$1.4 million* (55% Rate)
Spousal Exclusion *(Estate Tax Portability)*	N/A	N/A	$5 million* (maximum)	N/A
Illinois Estate Tax Exclusion	Tax Repealed	Tax Repealed	$2 million	$2 million

* Indexed for Inflation

Fireworks were expected after December 31, 2010, as this was the date of Armageddon whereby the 2001 Bush tax cuts (promulgated by the Economic Growth and Tax Relief Reconciliation Act of 2001[1]—"EGTRRA") would "sunset" and reinstate the prior $1 million estate tax exclusion and top 55% tax rate. Nobody wanted these draconian estate tax limits to once again return, although more than a few tax planners thought this would happen given the dysfunctional history of the past.

The 2010 Tax Act

It thus became a pleasant surprise when President Obama, on December 17, 2010, shattered the tax stalemate by signing into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[2] (the "2010 Tax Act"). For a price tag of $858 billion, this legislation extended most of the sunsetting EGTRRA provisions to December 31, 2012, and it temporarily reduced payroll taxes and extended unemployment benefits. The 2010 Tax Act's estate tax laws were the most controversial part of the package, drawing the angst of many Democrats for being much too generous to the rich. The following table above illustrates the new law, along with recent Illinois changes.

The following observations take into account the differing array of estate tax rates, exclusions and effective dates.

The Maddening Spectacle of Temporary Federal Estate Tax Measures

The 2010 Tax Act merely extends the EGTRRA's "sunset" for two years from December 31, 2010, to December 31, 2012. Absent legislative change, this means a reversion to the pre-EGTRRA $1 million estate tax exclusion and 55% top rate in 2013. Although a temporary extension may be a convenient political ploy to "let the voters decide" future tax policy (there is a presidential election in 2012), it breeds havoc in trying to intelligently structure a client's estate plan. The $4 million "gap" between the $1 million pre-EGTRRA exclusion and the 2010 Tax Act's $5 million exclusion is staggering. However, since the Democrats supported a $3.5 million exclusion in the negotiations leading up to the 2010 Tax Act, it appears likely that this may set the floor as to what the exclusion may be set to in 2013. Of course, anything is possible, including a series of never-ending "temporary" extensions.

Illinois Joins the Party and Enacts a Permanent Estate Tax with a $2 Million Exclusion

For 2010, the Illinois estate tax was re-

[1] Public Law No. 107-16.

[2] Public Law No. 111-312.

pealed. It was no secret that Springfield was waiting to see what would happen to the federal rules before committing to future Illinois estate taxes. It didn't take Illinois long to play its hand after the 2010 Tax Act was passed. On January 13, 2011, Public Law No. 096-1496 revised the Illinois estate tax code to make permanent a decoupled Illinois estate tax system grounded on the rules of the federal system, with a hypothetical $2 million estate tax exclusion for Illinois purposes only.[3] This was essentially the same Illinois law which previously existed from 2006-2009.

Accordingly, for tax years 2011-2012, there is a $3 million "mismatch" between the federal $5 million estate tax exclusion and the Illinois $2 million estate tax exclusion. Many clients may not be subject to federal estate taxes because of the higher federal limits, but be caught by the net of the lower Illinois exclusion. For married couples, the dilemma is heightened as the funding of a $5 million credit shelter trust results in $352,158 of Illinois estate taxes. Happily, the Illinois legislature in 2009 crafted a solution which permits full funding of the $5 million credit shelter trust without Illinois estate taxes if such a trust qualifies for the Illinois QTIP Election.[4]

The "Revolution" of Federal Estate Tax Portability

Under prior law, a credit shelter trust was critical to save estate taxes for married couples. Fundamental estate tax planning for a married couple revolved around funding the credit shelter trust of the first to die with assets equal to the federal estate tax exclusion amount. Full funding would prevent "wasting" the exclusion of the first deceased spouse, which could result in higher estate taxes.

The 2010 Tax Act turned the above planning on its head with the introduction of federal estate tax portability[5] (this concept is not applicable to Illinois estate taxes or generation skipping transfer taxes). Estate tax portability permits the surviving spouse to utilize the unused exclusion amount of his or her last deceased spouse. For example, under prior law, it would generally be an estate planning mistake for a married couple worth $10 million to hold assets in joint tenancy (the first-to-die's $5 million estate tax exclusion could have been "wasted," because there were no assets funding a credit shelter trust). Under the regime change of the 2010 Tax Act, the "wasted" $5 million exclusion of the deceased spouse (i.e., the "Deceased Spousal Unused Exclusion Amount" or "DSUEA") can now be recaptured by the surviving spouse for his or her lifetime or testamentary use. Hence, in the above example, the surviving spouse would have a $10 million exclusion amount (his or her $5million exclusion, plus the $5 million DSUEA).

The dark side of estate tax portability is that deceased spouses will have differing DSUEAs, thereby triggering dissimilar estate tax savings for the surviving spouse depending on whom he or she marries. Imagine Internet dating ads entitled "Love-Starved Millionaire Needs Terminally-Ill Bride to Generate a $5 Million DSUEA upon Death." Whether a potential new spouse's unused estate exclusion will transmute to a DSUEA benefitting the surviving spouse becomes a relevant premarriage financial question. Trafficking in DSUEAs by bogus marriages is not beyond the realm of possibility. Moreover, since the calculation of DSUEA is based upon the unused exclusion of the "last deceased spouse," it may be proper legal advice to advise a surviving spouse not to remarry if the "new" spouse has a lower DSUEA than the "old" spouse. Technical clarifications will be welcomed in this area as there are a number of abusive planning opportunities.

Given the temporary nature of the 2010 Tax Act, estate tax portability is a reality only if both spouses die in 2011-2012. However, the widespread political popularity of estate tax portability makes it likely this concept will become a permanent fixture of the law.

In order for the surviving spouse to capture the DSUEA of the last deceased spouse, the critical prerequisite is the filing of a timely estate tax return (due nine months after death, plus a possible six-month extension) making the portability election. Typically, one would not expect a married couple with assets substantially below the estate tax exclusion amount to make a portability election if the instance of federal estate taxation is remote. However, this matter constitutes a significant malpractice trap for practitioners to dodge, as not making the portability election negates any DSUEA, which may be sorely missed if the surviving spouse somehow subsequently "strikes it rich." For this reason, the norm may be for planners to always insist on filing an estate tax return for the deceased spouse electing estate tax portability, unless the surviving spouse consents to not filing such a tax return. A new field of law should evolve in this area regarding the ability of the deceased spouse's estate planning documents to control the portability election, as well as exculpatory language in the documents if the election is not made.

Reunification of the Federal Estate and Gift Tax Exclusion Amounts

For many years, the estate and gift exclusions were "unified" (i.e., the same exclusion could be used during life or death). EGTTRA changed this mechanism by imposing differing estate tax ($3.5 million in 2009) and gift tax ($1 million) exclusion amounts. Beginning in 2011, the estate and gift tax exclusions are once again "unified" at $5 million (with adjustments in future years for inflation). Thus, a client can elect to use his or her $5 million credit (plus any applicable DSUEA) during his or her lifetime, or at death.

The "Largeness" of the $5 Million Gift Credit Lessens the Importance of Discount Planning

The increase of the gift-tax exclusion to $5 million (from $1 million) was unanticipated by most observers. The higher gift-tax exclusion makes it much easier to shift wealth to younger generations, especially for clients who had previously exhausted their $1 million exclusion. At the cost of considerable complexity, many clients had relied upon discounting techniques such as family limited partnerships, sales to defective grantor trusts, and grantor retained annuity trusts in order to stuff the pockets of the younger generation. For middle-market clients (i.e., wealth less than $10 million), such techniques may no longer be necessary. If "control" is not an issue, simple outright gifts can be made to descendants, thereby simplifying the

[3] 35 ILCS 405/2(b).

[4] 35 ILCS 405/2 (b-1); also see Robert J. Kolasa, The Illinois QTIP Election to the Rescue, 97 Ill Bar J 612 (December 2009).

[5] Code Section 2010(c)(2) through (c)(6).

gifting process. Expect a rush for clients to "unwind" various discount transactions previously set up, as the higher exclusion amount makes the tax efficiency of such transactions debatable.

Clients making substantial gifts to family members exceeding the pre-EGTRRA $1 million gift level should be wary of being whipsawed by expiring tax provisions.[6] For example, if a $5 million gift is made in 2011 and the law reverts to pre-EGTRRA levels (without appropriate transitional relief), at death the client's estate may be liable for the estate taxes on the $4 million "gap" between the $1 million and $5 million exclusion amounts (the same problem exists if the exclusion is lowered to $3.5 million). While various technical arguments exist against the IRS's ability to collect such a tax from the estate, the risk remains that the decedent's estate may be exhausted by the retroactive tax on the prior (now taxable) gift. While this scenario is harsh and may be unlikely, it does merit a discussion with any client planning to make large inter vivos gifts using the 2010 Tax Act's enhanced $5 million gift-tax exclusion.

The Significance of a $5 Million Federal Exclusion and Estate Tax Portability - Is Estate Tax Planning "Dead as a Doornail?"

Although estate tax repeal has seemingly died a timely death in 2011, the high $5 million exclusion amount paired with estate tax portability has effectively repealed the federal estate tax for most Americans. A married couple worth less than $10 million (presuming the permanency of the 2010 Tax Act's exclusions and portability provisions), may have little need for federal estate tax planning. Of course, Illinois estate tax planning may still be viable.

So, is estate tax planning "dead as a doornail?" Probably not, but the 2010 Tax Act does signal a shifting paradigm for attorneys, since tax-driven strategies should be less useful for many clients. For example, discounting techniques such as family limited partnerships may be meaningless for clients whose estate tax exclusions still exceed the (undiscounted) worth of their assets. This loss of business may force some lawyers to dive into non-tax areas such as asset protection and elder law, although estate tax portability may generate more estate tax preparation work for other practitioners. Nevertheless, the 2010 Tax Act represents a "back to basics" theme for middle-market estate tax planners who may have been too slanted toward transactional estate tax solutions in the first place. Of course, the very wealthy will still need these services if one can attract business from this crowd.

The Future of the Credit Shelter Trust

The seminal question is whether the credit shelter trust is still a viable planning tool. Presuming the permanency of the 2010 Tax Act provisions, the answer is probably "yes" for couples exceeding $10 million in assets because the growth component in the credit shelter trust escapes estate taxation. However, the countervailing tax consideration is that there is no basis step-up[7] for appreciated assets in the credit shelter trust upon the death of the surviving spouse. For estate plans not subject to federal or Illinois estate taxes (i.e., under $2 million), it probably is a planning mistake to fund a credit shelter trust, given the loss of such basis step-up.[8]

On the other hand, for clients worth more than $2 million, the imposition of a permanent Illinois estate tax with a $2 million exclusion should justify the drafting of credit shelter trusts for Illinois estate tax purposes. This is because the Illinois estate savings under many scenarios outweigh the lost basis step-up upon the death of the surviving spouse (versus assets transferred to the spouse outright or through a marital trust, which receive a basis step-up). A case-by-case analysis is recommended, as substantial appreciation in the credit shelter trust may reverse this result. In any event, if federal estate taxes are not foreseeable the lack of credit shelter planning may be much less of a mistake than it was under prior law.

Drafting Trends

What will estate planning documents look like for Illinois practitioners under the new estate tax regime? Flexibility is now probably the key to the game. Disclaimer Trusts will become increasingly popular, by permitting the surviving spouse the ability to decide whether it is productive to fund the credit shelter trust upon the first to die. Joint trusts (with disclaimer or credit shelter trust components) should be drafted more often, as will three-trust plans geared to the Illinois QTIP election. Future planning should consider credit shelter trust distributions to the surviving spouse to the extent such distributions do not increase spousal estate taxes. Usage of "best interest" distribution standards and "springing" spousal general powers of appointments

[6] Section 302(d) of the 2010 Tax Act attempts to fix these problems, but such provision is meaningless if it is allowed to sunset.

[7] Under the basis step-up rules, the decedent's property receives a basis equal to the property's fair market value at death, or sometimes the alternate valuation date.

[8] However, non-tax reasons may dictate the funding of credit shelter trusts irrespective of tax benefits.

(granted by a trust protector, or through the trust language) are also techniques permitting spousal distributions. Naturally, some clients will be lulled into a false sense of security by the heightened estate tax exclusions and use Internet kits and other self-help remedies. From a lawyer's perspective, this is good for business, because such plans invariably blow up.

GST Conundrums

The Generation Skipping Transfer tax ("GST") is a separate transfer tax (in addition to the estate tax) levied upon transfers to grandchildren and other remote descendants ("skip persons"). The GST scheme limits the amount of wealth that can be transferred to generations beyond the decedent's children in an attempt to dodge estate taxes upon a child's death. The GST exclusion instituted by the 2010 Tax Act ($5 million) represents the amount exempted from these rules. Prior to the 2010 Tax Act, the GST was technically repealed for 2010, which would have caused countless technical issues in applying the GST rules after 2011 to 2010 gifts. The quick fix to resolve this problem was the reenactment of the GST in 2010, with a zero GST rate. For the very wealthy, this created a "golden opportunity" to transfer significant wealth to grandchildren in the last days of 2010 without a GST tax or wasting GST exclusion amounts.

2010 Estate Tax Repeal and Carry-over Basis only Applicable to Estates Electing such Treatment in 2010

Prior to the 2010 Tax Act, the estate tax was apparently repealed in 2010 at the price of a modified carryover basis regime being imposed for decedents owning non-cash assets exceeding $1.3 million. The carryover-basis system under Code Section 1022 imposed additional basis increases in addition to historical cost basis, the main ones being (i) increases for unused capital losses and net operating loss carryovers; (ii) a $1.3 million "regular" basis increase; and (iii) a $3 million "spousal" basis increase for outright gifts to spouses and transfers to QTIP trusts. The technical rules relating to these provisions were significant.

The major criticism against carryover basis was the lack of record-keeping by clients (Who would really know the historical cost basis of assets purchased 40 years ago?) making the entire process somewhat of an educated guess. Additionally, under the new rules, the executor was responsible for arbitrarily allocating the $1.3 million and $3 million basis increases to beneficiaries, which could trigger countless disputes among beneficiaries who felt that such basis allocation was unfair.

The 2010 Tax Act makes (for 2010 decedents only) carryover basis and estate tax repeal an elective choice. If no election is made, the estate defaults to an estate tax system with a $5 million exclusion amount. Practically this means that all estates under $5 million will be better off under the $5 million exclusion regime. Alternately, for most estates greater than $10 million, the carryover basis regime (with all its flaws) would be preferable. The real challenge is for estates between $5 - $10 million, for which administrators must choose whether it is productive to pay some estate taxes, or to avoid estate taxes by electing the carryover basis regime with possibly higher income taxes upon the sale of such assets (because the basis allocations may leave some unrealized gains subject to tax). The choice whether to elect carryover basis for these estates compel the practitioner to "crunch the numbers," with the final determina-

tion based on factual variations (size of estate; historical cost basis; estate- and income-tax rates; applicability of basis adjustments, etc.). Due caution must be exhibited in dealing with estates in this range to make sure the correct post-mortem administration choice is made. In regard to 2010 decedents, the due date for filing estate tax returns (including elective carryover basis) is September 17, 2011.

Conclusion

The 2010 Tax Act extended the EGTRRA sunset to December 31, 2012. At that time, Congress will again decide whether to extend or cancel the 2001 Bush tax cuts. The new law also enacted a number of liberal estate tax changes, most notably the raising of the exclusion amount to $5 million, the reunification of the gift- and estate-tax exclusions, and the introduction of estate tax portability. Shortly after enactment of the 2010 Tax Act, the Illinois legislature imposed a permanent Illinois estate tax system with a $2 million exclusion amount. Practitioners will have their hands full in the upcoming years dealing with the mismatch of the federal and Illinois exclusion amounts, the rules relating to estate tax portability, and the viability of drafting estate tax provisions. While the confusion has been reduced for the short term, there still remains substantial uncertainty for planners given the short two-year shelf life of the 2010 Tax Act.

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TABLE

ESTATE & GIFT TAX RATES & EXCLUSIONS

ESTATE & GIFT TAX RATES & EXCLUSIONS				
	(old law) 2010	**(new law) 2010**	**(new law) 2011-2012**	**("Sunset") 2013**
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Federal Estate Tax Exclusion	*Tax Repealed*	$5 Million	$5 Million*	$1 Million
Carryover Basis	YES	*Elective with Estate Tax Repeal*	N/A	N/A
Gift Tax Exclusion	$1 Million	$5 Million	$5 Million*	$1 Million
GST Tax Exclusion & Rate	*Tax Repealed*	$5 Million (& 0% Rate)	$5 Million* (35% Rate)	$1.4 Million* (55% Rate)
Spousal Exclusion (*Estate Tax Portability*)	N/A	N/A	$5 Million* (*maximum*)	N/A
Illinois Estate Tax Exclusion	*Tax Repealed*	*Tax Repealed*	$2 Million	$2 Million

*Indexed for Inflation