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Federal Estate Tax Credit Rises to \$11.4 Million

- On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act of 2017 (“TCJA”).
- For calendar year 2020, the Federal estate tax credit and gift tax credit rises to \$11.58 million
- However, the Illinois estate tax credit is \$4 million
- Every individual may transfer \$4 million at death tax-free
- With Proper Planning, a married couple may transfer \$8 million at death tax-free
- The Generation Skipping Tax (GST) Credit increases to \$11.58 million

FEDERAL ESTATE TAX CREDIT RISES TO \$11.58 MILLION

For calendar year 2020, the Federal Estate Tax Credit¹ rises to \$11.58 million. However, the Illinois Estate Tax Credit is \$4 million. The Estate Credit is great news for the Family. With proper planning, a married couple currently may transfer at death \$8 million to their children tax-free. This tax savings increases Family wealth.²

People often desire to keep their wealth within the Family. Typically, a married couple distributes assets for each other during their joint lifetimes, and then distributes assets to younger generations. These distributions are subject to 3 transfer taxes: Gift tax, Estate tax, and Generation Skipping tax (GST). These taxes are interrelated, and apply to all transfers of wealth from one individual to another.

Each tax has its own Credit. The Credit reduces tax on a dollar-for-dollar basis. A Credit thus permits tax-free transfers of Family wealth. The Credits assist a married couple in providing for each other during their joint lifetimes, and then distributing property to their children and grandchildren. Careful planning with Credits can maximize Family tax savings.



The Tax Credits, respectively, are as follows:

<u>Year</u>	<u>Federal Estate Credit</u>	<u>Federal Gift Credit</u>	<u>Federal GST Credit</u>	<u>Illinois Estate Credit</u>
2016	\$5,430,000	\$5,450,000	\$5,450,000	\$4,000,000
2017	\$5,490,000	\$5,490,000	\$5,490,000	\$4,000,000
2018	\$11,200,000	\$11,200,000	\$11,200,000	\$4,000,000
2019	\$11,400,000	\$11,400,000	\$11,400,000	\$4,000,000
2020	\$11,580,000	\$11,580,000	\$11,580,000	\$4,000,000

Note that the \$11.58 million Estate Tax Credit and the favorable companion rules (including Portability) are now permanent for 2013 and beyond, subject to possible sunset of the \$11.58 million credits in 2026.

¹ Every U.S. taxpayer receives an Applicable Exclusion Amount which permits tax-free gifts during life or tax-free bequests upon death. This Applicable Exclusion Amount thus functions as a credit (or credit equivalent) to reduce tax, and is conveniently referred to as the “Tax Credit”.

² For calendar year 2013 and beyond, the maximum Federal Gift/Estate tax rate (and flat GST rate) is 40%. Any Credit that remains unused as of the death of a Spouse who dies in calendar year 2013 and beyond is available for use by the Surviving Spouse as an addition to the Surviving Spouse’s Credit (Portability of unused Credit between Spouses). [Note that the Generation Skipping Tax Credit and the Illinois Estate Credit both are not portable between spouses.]

FEDERAL ESTATE TAX CREDIT RISES TO \$11.58 MILLION (cont'd)

The difference between the Federal Credit (\$11.58 million) and the Illinois Credit (\$4 million) creates tax planning issues. Prior to 2009, the Federal Credit and the Illinois Credit were identical. Upon the 1st spouse's death, a traditional estate plan directed this uniform Credit Amount to the Family Trust, and the entire balance to a Marital Trust. For example, if Dad died in 2008, his Revocable Trust would allocate \$2 million to the Family Trust for Mom and the children, and the remaining balance of Dad's assets would be allocated to a Marital Trust.

Beginning in 2009, the divergence between the Federal Credit and the Illinois Credit requires a more thoughtful approach. For a married couple whose combined Estate does not exceed \$8 million in calendar year 2020, a traditional estate plan is still appropriate. The formula in the Revocable Trusts should take into account the divergence in the Federal and Illinois Credits. Mom and Dad should divide their assets equally. If Dad dies, he allocates \$4 million to the Family Trust, and any (nominal) balance to the Marital Trust.

For a married couple whose combined Estate exceeds \$8 million in calendar year 2020, the estate plan should create the following two (2) Sub-Trusts upon the 1st spouse's death: (1) a Family Trust; and (2) a QTIP Marital Trust.³ Assume Dad dies first owning \$20 million. Dad allocates \$4 million to the Family Trust, and \$16 million to the QTIP Marital Trust.⁴ Dad's executor makes a partial QTIP election for the Marital Trust.⁵ The Marital Trust is divided into an \$8.42 million Marital Trust, and an otherwise identical \$7.58 million Marital Trust. Dad's executor then makes a Federal QTIP Election⁶ for the \$8.42 million Marital Trust, and an Illinois-only⁷ QTIP Election for the \$7.58 million Marital Trust. The final result is as follows:

1. Dad's first \$4 million is distributed to the Family Trust.
2. Dad's next \$7.58 million is distributed to the Illinois-only QTIP Trust.
3. Dad's excess assets over \$11.58 million (i.e. \$8.42 million) are distributed to the QTIP Marital Trust.

In this way, Dad utilizes his entire \$11.58 million Federal Credit and his entire \$4 million Illinois Credit, and Dad pays no Estate Tax. Any Estate Tax is deferred⁸ until Mom's subsequent death.⁹

³ The QTIP Marital Trust provides all of the following for the surviving spouse: (i) mandatory income, (ii) discretionary principal for Support, (iii) no right to withdraw principal, and (iv) an optional testamentary limited power of appointment. Absent a QTIP Election, this Trust is not included in the surviving spouse's taxable estate.

⁴ The funding formula in Dad's Revocable Trust creates a Family Trust and a separate QTIP Marital Trust based on "the least possible total of federal estate tax and state estate and inheritance tax."

⁵ Partial QTIP elections are authorized by the Internal Revenue Code and Regulations, and they should also be authorized by the estate plan. See *Regulation §20.2056(b)-7(b)(2)(i)*. Furthermore, a trust may be divided into separate trusts to reflect a partial QTIP election that has been made, or is to be made, if authorized under the governing instrument or otherwise permissible under local law. See *Regulations §20.2056(b)-7(b)(2)(ii); §20.2056(b)-7(h), Ex. 14*. The Illinois Trusts and Trustees Act authorizes a Trustee to "To sever any trust estate on a fractional basis into 2 or more separate trusts for any reason;...to reflect or result in differences in federal tax attributes, to satisfy any federal tax requirement or election..." See 760 ILCS 5/4.25.

⁶ **Note:** A Federal QTIP Election automatically creates a corresponding Illinois QTIP Election.

⁷ See 35 ILCS 405/2.

⁸ The \$4 million Family Trust is excluded from Mom's taxable estate for both Federal and Illinois purposes. The \$7.58 million Illinois-only QTIP Marital Trust is excluded from Mom's taxable estate for Federal purposes (although it is included in Mom's taxable estate for Illinois purposes). The \$8.42 million QTIP Marital Trust is included in Mom's taxable estate for both Federal and Illinois purposes.

⁹ There are several reasonable alternatives to this overall strategy. One alternative is to create three (3) Sub-Trusts immediately upon Dad's death (the "3 Sub-Trust Estate Plan"). A second alternative is to have an \$11.58 million Family Trust qualify as QTIP, so that a partial Illinois-only QTIP Election may be made for the \$7.58 million portion of that Family Trust. A third alternative is to allocate \$4 million to the Family Trust, and transfer Dad's remaining \$7.58 million credit to Mom via Portability. Each approach has various advantages and disadvantages.

FEDERAL ESTATE TAX CREDIT RISES TO \$11.58 MILLION (cont'd)

The above strategy using the Illinois-only QTIP Trust is helpful as an example to illustrate the application of the Estate Tax Credits and Sub-Trusts. However, the Illinois-only QTIP Trust may not be the optimal strategy for most families.¹⁰

An alternative strategy – and generally the best approach for most families – is to allocate \$4 million to the Family Trust, and transfer Dad's remaining \$7.58 million Credit to Mom via Portability. Mom would then have her own Federal Credit of \$19.16 million which she can use for the benefit of her children and grandchildren in a variety of ways, including Lifetime Gifts, Irrevocable Life Insurance Trusts, and Generation Skipping Planning.

Lifetime Gifts can take various forms, one of which is a technique is called a "Preferred Common Family LLC."¹¹ This technique is similar to a Family Limited Partnership, and is typically used for a Gift of Marketable Securities of approximately four million dollars (\$4,000,000) or more. The primary benefits of the Preferred Common Family LLC are:

1. Additional asset protection since all assets are owned in a Limited Liability Company (LLC).
2. The Discount for Lack of Marketability for Gift & Estate Tax purposes.
3. If the assets grow above the Preferred payout rate, that growth is delivered to the Children and Grandchildren.
4. All LLC Interests are owned by Irrevocable "Grantor Trusts", so the Senior Generation pays all income taxes, resulting in an additional Tax-Free Gift each year to the Children.
5. Lifetime Gifts have the following six (6) advantages:
 - a. It is more tax-efficient to make lifetime Gifts, because the Gift Tax is exclusive (as opposed to the Estate Tax which is inclusive). The Gift Tax applies only to the amount received by the donee-children exclusive of the amount taken from the donor-parent's wealth to pay the Gift Tax. However, the Estate Tax is imposed on the entire amount transmitted at death including the amount used to pay the Estate Tax. Here is a brief example: If Mom has \$150 available to give to Child, she can make a lifetime gift of \$100 to Child, and pay \$50 of gift tax. But if Mom bequeaths \$150 to child at death, there is an Estate Tax of \$75, so Child only receives \$75 (not \$100 as in the Gift).

¹⁰ Note: The Illinois-only QTIP approach may not be the optimal strategy for most families for the following five (5) reasons: (a) The Illinois QTIP increases Estate Taxes on the 2nd spouse's death because it must pay out income to the surviving spouse; (b) The Illinois QTIP has less creditor protection than a Family Trust because it must pay out income to the surviving spouse; (c) The Illinois QTIP increases the family's compliance costs because there is an additional third (3rd) Trust which must be maintained and funded and must file annual Federal and State income tax returns, and the Estate Tax Return Filings are also more complicated and thus more costly; (d) The use of QTIP Trusts in general might create problems for the family, because the QTIP Trust provides the surviving spouse with solely the income and distributions of principal based on a very restrictive Support standard. Thus, the assets held in a QTIP Trust are subject to significant limitations on distribution to the surviving spouse. In short, the assets are locked up in the QTIP Trust and not available for distribution to the surviving spouse nor to the children. This might be a harsh result for the surviving spouse and children, as it greatly reduces their access to the assets and their financial options and flexibility; and (e) after Dad allocates his \$7.58 million Federal Credit to the Illinois-only QTIP Trust, upon Mom's subsequent death there is an Illinois Estate Tax due on that \$7.58 million at a projected Illinois Estate Tax rate of 18%. Thus, there is an Illinois Estate Tax due of approximately \$1,360,000. In short, there is an Estate Tax due of approximately \$1,360,000 on Dad's use of his \$7.58 million Federal Credit. There are likely more efficient ways for Dad to use his Federal Credit. In short, the Federal Credit should be used to eliminate Estate Tax at the Parents' generation level (not postpone it).

¹¹ Code Section 2701

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- b. A \$15,000 per-donee, per-year Exemption is allowed for Lifetime Gifts (but not for transfers at death).
- c. A Lifetime Gift may be structured using Irrevocable “Grantor Trusts”, so the Senior Generation pays all income taxes, resulting in an additional Tax-Free Gift each year to the Children (over and above the \$15,000 per-donee, per-year Exemption).¹²
- d. Lifetime Gifts tend to grow and appreciate over time, and the Credit transfers more wealth tax-free if it is applied against the smaller tax on a reduced value of an earlier Gift (rather than against the greater tax on a larger value on a later transfer at death).
- e. It may be more efficient to use the Parent’s Unified Credit earlier rather than later.
- f. The Parent can lock-in the higher Unified Credit today, to protect against a future legislative reduction.

Additional Federal tax laws which became effective (or remain in existence on) January 1, 2020, are:

- The annual exclusion for gifts remains at \$15,000.
- The annual exclusion for gifts to a non-citizen spouse increases to \$157,000.
- The maximum Gift/Estate tax rate (and flat GST rate) is 40%.
- Note the state death-tax credit was previously eliminated. For decedents dying after 2004, a Federal deduction is allowed for state death taxes paid.¹³
- Note the deduction for a qualified family-owned business interest (“QFOBI”) was previously repealed for estates of decedents dying after December 31, 2003.
- For estates of decedents dying in 2020, the limit on the decrease in value which may result from application of Special Use Valuation is \$1,180,000.¹⁴

¹² Revenue Ruling 2004-64.

¹³ Code Section 2058(a).

¹⁴ Code Section 2032A.

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