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Federal Estate Tax Credit Rises to \$5.25 Million

- On January 2, 2013, President Obama signed the American Taxpayer Relief Act of 2012 (“ATRA”).
- For calendar year 2013, the Federal estate tax credit rises to \$5.25 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 \$5.25 million

FEDERAL ESTATE TAX CREDIT RISES TO \$5.25 MILLION

For calendar year 2013, the Federal Estate Tax Credit¹ rises to \$5.25 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> |
|-------------|------------------------------|----------------------------|---------------------------|-------------------------------|
| 2009 | \$3,500,000 | \$1,000,000 | \$3,500,000 | \$2,000,000 |
| 2010 | \$5,000,000 | \$1,000,000 | \$5,000,000 | \$2,000,000 |
| 2011 | \$5,000,000 | \$5,000,000 | \$5,000,000 | \$2,000,000 |
| 2012 | \$5,120,000 | \$5,120,000 | \$5,120,000 | \$3,500,000 |
| 2013 | \$5,250,000 | \$5,250,000 | \$5,250,000 | \$4,000,000 |

Note that the \$5.25 million Estate Tax Credit and the favorable companion rules (including Portability) are now permanent for 2013 and beyond.

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).

FEDERAL ESTATE TAX CREDIT RISES TO \$5.25 MILLION (cont'd)

The difference between the Federal Credit (\$5.25 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 2013, 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 2013, 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 \$10 million. Dad allocates \$4 million to the Family Trust, and \$6 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 a \$4.75 million Marital Trust, and an otherwise identical \$1.25 million Marital Trust. Dad's executor then makes a Federal QTIP Election⁶ for the \$4.75 million Marital Trust, and an Illinois-only⁷ QTIP Election for the \$1.25 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 \$1.25 million is distributed to the Illinois-only QTIP Trust.
3. Dad's excess assets over \$5.25 million are distributed to the QTIP Marital Trust.

In this way, Dad utilizes his entire \$5.25 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 \$1.25 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 \$4.75 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 a \$5.25 million Family Trust qualify as QTIP, so that a partial Illinois-only QTIP Election may be made for the \$1.25 million portion of that Family Trust. A third alternative is to allocate \$4 million to the Family Trust, and transfer Dad's remaining \$1.25 million credit to Mom via Portability. Each approach has various advantages and disadvantages.

FEDERAL ESTATE TAX CREDIT RISES TO \$5.25 MILLION (cont'd)

Additional Federal tax laws which became effective January 1, 2013, are:

- The annual exclusion for gifts increases to \$14,000.
- The annual exclusion for gifts to a non-citizen spouse increases to \$143,000.
- 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.¹⁰
- 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 2013, the limit on the decrease in value which may result from application of Special Use Valuation increases to \$1,070,000.¹¹
- The top income tax bracket is increased from a rate of 35 percent to 39.6 percent on the undistributed net income of Estates and Trusts, under ATRA.¹²
- The top income tax bracket is increased from a rate of 35 percent to 39.6 percent on taxable income exceeding \$450,000 for married couples and \$400,000 for individuals, under ATRA.
- The top tax rate on capital gains and qualified dividends is increased from 15% to 20% for married couples with income exceeding \$450,000 and individuals with income exceeding \$400,000, under ATRA.
- Net investment income is subject to a new 3.8% Medicare tax if adjusted gross income exceeds \$250,000 for married couples and \$200,000 for individuals, under ATRA. The new net investment income tax applies to ordinary investment income and qualified dividends and capital gains. Thus, the maximum Federal income tax rate is 43.4% for ordinary investment income and 23.8% on qualified dividends and capital gains. The new 3.8% net investment income tax also applies to the undistributed net investment income of Trusts and Estates in excess of \$11,950, under ATRA.
- Personal exemptions and itemized deductions are phased out for married couples whose adjusted gross income exceeds \$300,000 and individuals whose adjusted gross income exceeds \$250,000, under ATRA.
- The Alternative Minimum Tax Exemption for individuals is now indexed for inflation, under ATRA.

¹⁰ Code Section 2058(a).

¹¹ Code Section 2032A.

¹² “ATRA” is the American Taxpayer Relief Act of 2012.

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