

## TAX & TRANSACTIONS BULLETIN

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***Federal Estate Tax Credit Rises to \$3.5 Million***

- For calendar year 2009, the Federal estate tax credit rises to \$3.5 million
- However, the Illinois estate tax credit remains at \$2 million
- Every individual may transfer \$2 million at death tax-free
- With Proper Planning, a married couple may transfer \$4 million at death tax-free
- The Generation Skipping Tax (GST) Credit increases to \$3.5 million

### FEDERAL ESTATE TAX CREDIT RISES TO \$3.5 MILLION

For calendar year 2009, the Federal Estate Tax Credit<sup>1</sup> rises to \$3.5 million. However, the Illinois Estate Tax Credit remains at \$2 million. The Estate Credit is great news for the Family. With proper planning, a married couple currently may transfer \$4 million to their children tax-free. This tax savings increases Family wealth.

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,<sup>2</sup> 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>
2002 - 2003	\$1,000,000	\$1,000,000	\$1,120,000 <sup>3</sup>	\$1,000,000
2004 - 2005	\$1,500,000	\$1,000,000	\$1,500,000	\$1,500,000
2006 - 2008	\$2,000,000	\$1,000,000	\$2,000,000	\$2,000,000
2009	\$3,500,000	\$1,000,000	\$3,500,000	\$2,000,000

Note that both the Federal Estate tax and GST tax are scheduled to be repealed for individuals dying in 2010. Each tax is then reinstated in 2011. Many practitioners expect Congress to enact legislation during 2009, to clarify this situation.

<sup>1</sup> 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".

<sup>2</sup> Although both the Estate and GST Credits have increased since 2003, the Gift Credit did not increase. Thus, although a person may transfer \$2 Million at death tax-free, a person may transfer only \$1 Million during life tax-free. This discrepancy reflects the fact that Congress might lower the Estate Credit in the future. Congress does not want an individual to make tax-free lifetime gifts now, which exceed the amount the individual could transmit tax-free at death in the future.

<sup>3</sup> The GST credit was \$1,100,000 in 2002, and \$1,120,000 in 2003.

## FEDERAL ESTATE TAX CREDIT RISES TO \$3.5 MILLION (cont'd)

The difference between the Federal Credit (\$3.5 million) and the Illinois Credit (\$2 million) creates tax planning issues. Prior to 2009, the Federal Credit and the Illinois Credit were identical. Upon the 1<sup>st</sup> spouse's death, a traditional estate plan directed<sup>4</sup> 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 \$4 million, 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.<sup>5</sup> Mom and Dad should divide their assets equally. If Dad dies, he<sup>6</sup> allocates \$2 million to the Family Trust, and any (nominal) balance to the Marital Trust.

For a married couple whose combined Estate exceeds \$4 million, the estate plan should create the following three (3) Sub-Trusts upon the 1<sup>st</sup> spouse's death: (1) a Family Trust; (2) a regular Marital Trust;<sup>7</sup> and (3) a QTIP Marital Trust. Assume Dad dies first owning \$10 million. Dad<sup>8</sup> allocates \$2 million to the Family Trust, \$6.5 million to the regular Marital Trust, and \$1.5 million to the QTIP Marital Trust.<sup>9</sup> Dad's Executor may then make a full, partial, or no QTIP election for the QTIP Trust. The QTIP Trust effectively permits Dad's executor to choose whether to: (A) make a full QTIP Election and pay no estate tax currently, at the risk of paying more estate tax on the 2<sup>nd</sup> spouse's subsequent death; or (B) make no QTIP election and pay Illinois estate tax currently, and possibly reduce estate tax on the 2<sup>nd</sup> spouse's subsequent death.<sup>10</sup> The executor's decision is governed by various factors, including Mom's assets and life expectancy.

<sup>4</sup> The Revocable Trusts use a formula to achieve this result.

<sup>5</sup> The formula would generally allocate to the Marital Trust "the smallest amount which, if allowed as a federal estate tax marital deduction, would result in the least possible total of federal estate tax and state estate and inheritance tax."

<sup>6</sup> The allocation is made by Dad's Revocable Trust.

<sup>7</sup> A "regular" Marital Trust refers to a General Power of Appointment Marital Trust. See Code Section 2056(b)(5).

<sup>8</sup> The allocation is made by Dad's Revocable Trust.

<sup>9</sup> Dad's Executor may then make a full, partial, or no QTIP election for the QTIP Trust. This election qualifies the elected amount for the marital deduction and eliminates estate tax on Dad's death. The QTIP Election, however, also requires inclusion of the QTIP Trust Assets in the surviving spouse's (i.e. 2<sup>nd</sup> spouse's) taxable estate. Code Sections 2056(b)(7), 2519, and 2044. For instance, if Dad made a full QTIP Election, then no Illinois estate tax (and no Federal estate tax) would be due on Dad's death, but the QTIP Trust assets would be included in Mom's estate on her subsequent death. If Dad made no QTIP election, then an Illinois estate tax (but no Federal estate tax) would be immediately due on Dad's death, but the QTIP Trust assets would not be subsequently included in Mom's estate. The QTIP Trust thus permits Dad's executor to choose whether to: (A) make a full QTIP Election and pay no estate tax currently, at the risk of paying more estate tax on the 2<sup>nd</sup> spouse's subsequent death; or (B) make no QTIP election and pay Illinois estate tax currently, and possibly reduce estate tax on the 2<sup>nd</sup> spouse's subsequent death. A similar result may be achieved with Disclaimers. However, Disclaimers generally are subject to greater compliance and administrative complexity.

<sup>10</sup> A State-only QTIP Election is also a possibility. Under this scenario, Dad's executor makes a State-only QTIP Election for the QTIP Trust. The result of a State-only QTIP Election would be: (i) no State tax (due to the marital deduction) and no Federal tax (due to the federal credit) on the 1<sup>st</sup> spouse's death; and (ii) inclusion of the QTIP Trust in the surviving spouse's estate for State purposes, but not for Federal purposes, and thus a potential State-only estate tax due on the 2<sup>nd</sup> spouse's death. [Note: The Illinois Attorney General's Office has confirmed that Illinois presently does not permit a State-only QTIP Election. Legislation reportedly has been introduced which, if passed, would permit an Illinois State-only QTIP Election. Several States appear to allow a State-only QTIP Election, including Massachusetts, Rhode Island, Washington, Ohio, and Oregon. Even for an Illinois resident, the State-only QTIP Election may be relevant currently, if the resident owns property in a State permitting the State-only Election.]

## FEDERAL ESTATE TAX CREDIT RISES TO \$3.5 MILLION (cont'd)

Additional Federal tax laws which became effective January 1, 2009, are:

- The annual exclusion for gifts increases to \$13,000.
- The annual exclusion for gifts to a non-citizen spouse increases to \$133,000.
- The maximum Gift/Estate tax rate (and flat GST rate) is 45%.
- Note the state death-tax credit was previously eliminated. For decedents dying after 2004, a Federal deduction is allowed for state death taxes paid.<sup>11</sup>
- 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 2009, the limit on the decrease in value which may result from application of Special Use Valuation increases to \$1,000,000.<sup>12</sup>

<sup>11</sup> Code Section 2058(a).

<sup>12</sup> Code Section 2032A.

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