



Estate Planning Strategies

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A NEWSLETTER HIGHLIGHTING CURRENT ESTATE PLANNING CONCEPTS

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Estate Tax Alert for 2009

The year 2009 brings in some new estate tax rules and may require individuals to reassess their estate plans. The good news is that the federal estate and generation-skipping transfer (GST) tax exemptions increased from \$2 million to \$3.5 million. The bad news is that the federal gift tax exemption remains at \$1 million and the Illinois estate and GST tax exemption (like some other states) remains at \$2 million. In addition, under current federal tax rules, the estate tax will end on December 31, 2009, but be restored on January 1, 2011 with only a \$1 million exemption. Congress is currently considering several bills, most of which will continue the estate tax and set exemption at either \$3.5 million or \$5 million.

What does this changing estate tax environment mean for individuals?

Individuals and married couples with assets of less than \$3.5 million may have greater flexibility in disposing of their assets. For example, a trust for the surviving spouse may not be required for federal estate tax planning (though there may be non-tax reasons for creating a trust). However, a trust may still be needed for state estate tax reasons. Illinois is not alone in having a lower estate tax exemption than the federal exemption. Oklahoma has a \$3 million exemption. Connecticut and Washington have a \$2 million exemption. Many states have an even lower exemption or have a separate inheritance tax. Other states, like Florida, California, Michigan, Nevada and Wisconsin currently have no state estate or inheritance tax.

What to do about the differing federal and state exemption amounts?

The differing federal and state exemption amounts has an impact on the estate planning done for a married couple. Traditionally, for married couples, to use the federal estate tax exemption of the first spouse to die, the exemption amount is placed in a trust, called Trust B, the Credit Shelter or Family Trust (hereafter "Exemption Trust"). Assets in excess of the exemption amount either went outright to the surviving spouse or into a trust for the surviving spouse, called Trust A or the Marital Trust (hereafter "Marital Trust"). This type of plan ensured that both spouses' exemption amounts were utilized and generally deferred any federal or state estate tax until the surviving spouse's death.

Planning for a married couple becomes more complicated if they reside in a state whose exemption amount is different than the federal exemption. Generally, married couples in these states will be faced with one of two choices: (1) put the state estate tax exemption in a trust (\$2 million for Illinois residents) and, assuming all other assets pass to the surviving spouse, pay no state or federal estate taxes until the surviving spouse's death; or (2) put the federal estate tax exemption amount, \$3.5 million, into a trust and pay some state estate taxes at the first spouse's death but possibly pay less federal estate taxes when the surviving spouse dies.



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Although the first choice will eliminate any federal or state estate tax at the death of the first spouse to die (assuming all other assets pass to the surviving spouse), a portion of the deceased spouse's \$3.5 million federal estate tax exemption is wasted. For example, if only \$2 million is placed an Exemption Trust, an additional \$1.5 million that could be sheltered from federal and state estate tax at the surviving spouse's death is not sheltered. This option is best if it seems unlikely that the surviving spouse will be subject to federal estate tax, or if the surviving spouse is willing to risk future additional estate tax for the benefit of not paying any estate tax at the first spouse's death. The second choice identified above is likely to be best if the surviving spouse is or will likely be subject to federal estate tax. In Illinois, funding a \$3.5 million Exemption Trust will result in at least \$209,124 Illinois estate tax at the first spouse's death. However, preserving the full federal estate tax exemption could result in a reduction of \$675,000 or more in federal estate tax at the surviving spouse's death under the current tax rates.

A few states offer a third choice. Connecticut, Massachusetts and Washington allow a special tax election, referred to as a "state QTIP" election. In these states, it would be possible to make an election for part of the Exemption Trust to eliminate or diminish state estate taxes while still placing the full federal estate tax exemption amount into the Exemption Trust. Although there is currently proposed legislation to allow a "state QTIP" election in Illinois, it has not been passed.

Does your estate plan need to be changed?

For a married couple, if your will or trust creates a Trust A/Marital Trust and a Trust B/Exemption Trust, you will need to look at the terms of that Trust B/Exemption Trust. If the surviving spouse receives all income from Trust B and there are no other beneficiaries of the trust, it will be possible for the surviving spouse to make certain tax elections to select among the choices discussed above. If there are other beneficiaries of Trust B and you reside in a state with a lower state exemption than the federal exemption, there will be state estate tax at the death of the first spouse. To give the surviving spouse flexibility to select among the choices described above, your estate plan will need to be modified.

For a married couple with an estate plan that either (1) creates a single trust for only the surviving spouse or (2) gives everything to the surviving spouse but creates a trust if the surviving spouse disclaims some assets, the estate plan will not need to be modified. The surviving spouse can take advantage of any of the choices described above by making certain elections at the death of the first spouse or by disclaiming a certain portion of the assets (e.g., \$2 million or \$3.5 million).

Married couples or individuals whose estate plan ties a gift or bequest to either the federal estate or GST exemption amount should consider the impact of this type of gift or bequest with the changing exemption amounts. For example, if your estate plan leaves the GST exemption amount to grandchildren and leaves everything else to children, in 2001 this would have given your grandchildren only \$1 million but in 2009 gives the grandchildren \$3.5 million. Similarly, if you gave your children the estate tax exemption amount and left everything else to the surviving spouse, in 2009 you are giving your children \$3.5 million and giving the surviving spouse only the excess amount. This type of gift may need to be changed now that the federal estate and GST exemptions are higher.

If you have any questions about the impact of the changing estate tax rules on your estate plan, please contact a Chapman and Cutler LLP Trusts and Estates attorney.