

New Rules for 2011, Part II Estate and Gift Tax Changes

The new year has brought a number of tax law changes at both the federal level and the state level in Illinois. While there was good news from the federal government on income tax rates and other extenders, a significant income tax increase was recently enacted in Illinois. Estate taxes have returned after a one year hiatus in 2010, and a number of changes have been made to federal gift and generation skipping (GST) tax rules. We are covering these developments, which includes our insights into the new rules, in a helpful series over several weeks. Here is Part 2.

Estate and Gift Tax Changes

In 2010, there was no estate tax imposed at the federal level or state level in Illinois. In 2011, the estate tax has returned, but in unprecedented, favorable form as to the Federal estate tax.

The Return of the Federal Estate Tax. The federal estate tax for people dying in 2011 and 2012 is imposed at a top rate of 35%, to the extent that the decedent's estate exceeds the new \$5 million applicable exclusion amount, and the former rule will be restored that allows tax basis in all of the estate's assets to be adjusted to fair market value for decedents who die during 2011-2012. [This new rule contrasts with the former \$3.5 million applicable exclusion amount and the 45% top Federal estate tax rate that was in effect in 2009.]

For the estates of people who died in 2010, an election is available to apply the 2010 rules (no estate tax, and a limited adjustment to tax basis) or the 2011 rules (\$5 million exemption, top rate of 35%, and full step-up in tax basis). This election may provide a unique opportunity to choose among two alternatives for the estates of people who died last year, but also places executors in a potentially difficult situation if some beneficiaries would benefit from the 2010 rule and others would benefit from the 2011 rules.

Changes to Gift and GST Tax. For 2011, a person can make gifts of up to \$13,000 to as many recipients as desired without incurring gift tax or generation skipping transfer (GST) tax. This amount may be adjusted for inflation in 2012. For 2011 and 2012, the amount of lifetime gifts that an individual can make, in excess of the annual exclusion amount without incurring gift tax or GST tax, has been increased to \$5 million, and the tax rate for gifts above the \$5 million limit is 35%.

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Hint: The increase of the gift tax exemption to \$5 million presents an unprecedented opportunity to transfer wealth to future generations tax-free. However, Congress did not make clear what will happen after 2012. Will a subsequent death trigger an estate tax which recaptures the earlier gift tax exemption, if Congress later lowers the exclusion amount?

Portability. One of the most unique aspects of the Tax Relief Act of 2010 made the unused part of the Federal \$5,000,000 lifetime estate tax exclusion amount “portable.” A surviving spouse may utilize the unused portion of the estate tax exclusion of the predeceased spouse in determining his or her lifetime gift and estate tax exclusion, so long as the predeceased spouse elected for the surviving spouse to do so.

Hint: The portability of the gift/estate tax exclusion between spouses is, again, unprecedented. The media has erroneously reported that portability means it is no longer necessary to have a properly tax structured estate plan, and instead, a taxpayer need only pass everything to his/her spouse. That media report is wrong for several reasons. First, the portability, increased gift/estate tax exclusion, and lower rates are only applicable to 2011 and 2012. No one knows whether rates and exclusions in 2013 and beyond will return to more normal conditions (higher rates and lower exclusions), so it is prudent to continue to use a properly tax structured estate plan. Second, there is no portability of the GST exemption, so it remains prudent to utilize a properly tax structured estate plan. Third, the Illinois estate tax exclusion is limited to \$2,000,000 (see discussion below), so it is imperative to plan for, or avoid, a potential unnecessary \$352,000 Illinois estate tax, at the death of the first spouse, by using a properly tax structured estate plan.

Temporary Changes. These federal estate, gift and GST tax rules are only temporary. If Congress fails to act by December 31, 2012, the estate, gift and GST tax rules will return to the way that they were in 2001, with a top rate of 55% and a lifetime exclusion amount of only \$1 million, the same predicament faced by taxpayers in 2010 before Congress enacted the Tax Relief Act of 2010.

The Return of the Illinois Estate Tax. Just as at the federal level, the estate tax has revived in Illinois in 2011. However, in Illinois the estate tax is imposed on estates over \$2 million, which is lower than the federal threshold (in effect for 2011 and 2012) of \$5 million. Illinois does not impose gift taxes.

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Hint: Illinois allows a reduction of the taxable estate for qualified terminable interest property (QTIP). Trusts designed to take advantage of the QTIP deduction can postpone and possibly avoid the Illinois estate tax on the excess of the \$5 million Federal exclusion over the \$2 million Illinois exclusion. This technique should be considered in every properly tax structured estate plan.



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