

# Estate Planning Bulletin

## Estate Planning in the Volatile 2011 Environment: *New Developments and Opportunities*

Economic, legislative, and regulatory developments are keeping estate planners and their clients very busy in the second half of 2011. Persons who would like to discuss how these new developments affect their specific situations and existing estate plans should contact a member of the Estate Planning Group of Vedder Price.

### **Executive Summary**

The following is an executive summary of the most notable effects of the most notable new developments; a more detailed discussion of each can be found inside this Bulletin:

- **Interest Rates for Key Estate Planning Transactions Hit New Lows.** Federal fiscal and monetary stimulus has resulted in extremely low rates for Treasury securities, which in turn has reduced the IRS-calculated interest rates used in many estate planning techniques to historic lows. Many of these techniques are fairly simple and easy to implement. **The combination of low interest rates, a \$5 million gift tax exemption, and depressed asset values has created the greatest estate planning opportunity of our lifetimes.**
- **Illinois Estate Tax Justifies Thorough Planning, Even If Federal Exemption Remains High.** While the federal estate tax exemption for 2011–2012 is \$5,000,000, the Illinois estate tax has an exemption of only \$2,000,000, and a tax of up to \$391,600 on a \$5,000,000 estate that would typically be exempt from the federal estate tax. However, the Illinois estate tax can be significantly postponed, reduced, or eliminated, often through simple techniques.
- **Budget Control Act of 2011 May Put Estate Tax Changes on Fast Track.** The federal Budget Control Act of 2011 passed in August created a special “super” committee to design a package of additional spending cuts and revenue enhancements to further reduce the deficit, and to submit its proposals in November 2011 for an expedited vote. Some changes to the federal estate and gift tax could be included as revenue raisers in the super committee’s package; if so, there may be only a very short time to act before those changes go into effect.
- **Estate Tax Returns for 2010, 2011 Finally Released.** After much delay, the IRS has released all of the forms and instructions for estate tax returns for persons who died in 2010, as well as the modified returns and instructions for persons dying in 2011. To avoid hardships created by the delay in release of the forms, filing deadlines have been extended.
- **Portability of Estate Tax Exemptions Will Require Filing Estate Tax Returns.** A new feature of the 2010 tax act permits a surviving spouse to “inherit” the predeceasing spouse’s unused federal estate tax exemption. The IRS has confirmed that an estate tax return will need to be filed for the predeceasing spouse to take advantage of this “portability” feature.
- **Illinois Civil Unions Law Opens Opportunities.** Illinois adopted civil union legislation effective June 1, 2011. This law allows same-sex couples—as well as opposite-sex couples who have reasons not to marry—to have substantially all of the legal rights and obligations of married couples under Illinois state law. This option opens up several estate planning opportunities for those couples.
- **Tax Patents Prohibited.** Estate planners had long been concerned that allowing patents on tax strategies could make using effective estate planning techniques impossible without paying a royalty. A new law effective September 16, 2011 prohibits further patenting of tax strategies.

## Interest Rates for Key Estate Planning Transactions Hit New Lows

Federal monetary stimulus has resulted in extremely low rates for U.S. Treasury securities. This in turn has reduced the IRS-calculated interest rates used in many estate planning techniques to **the lowest in the history of those rates**. Many of these techniques are fairly simple and easy to implement. Donors should not let this opportunity pass them by.

The applicable federal rates (AFRs) are calculated and published monthly by the IRS for use in the following month; the calculation uses formulas that incorporate actual Treasury securities rates from the month preceding the calculation. These rates are used as “safe harbor” interest rates. An intrafamily loan (including a loan to a trust) that uses an interest rate at least as high as the AFR will generally not have imputed interest income for purposes of the income tax or the gift tax. Different rates are published depending on the length of the loan or installment sale or the type of transaction. For example, a split-interest trust such as a grantor retained annuity trust (GRAT) uses the Section 7520 rate (which is 120%, rounded, of the mid-term rate) even if the same transfer would qualify to use the short-term rate if the transaction had been structured as a loan.

Applicable Federal Rates for October 2011 with Selected Prior Periods for Comparison (showing annual rates; more frequent payments may qualify for slightly lower rates)				
Type	Short Term	Mid-Term	Long-Term	Section 7520 Rate
When Used:	3 years or less	More than 3 years, not more than 9 years	More than 9 years	Annuities, GRATs, and split-interest trusts
Oct 1996	6.07%	6.72%	7.13%	8.0%
Oct 2006	5.00%	4.82%	5.02%	5.8%
Oct 2011	0.16%	1.19%	2.95%	1.4%

These low AFRs allow a person to make extremely low interest rate loans to younger-generation family members or to other persons they would like to help (as well as to trusts for those persons). If the borrower is able to earn a decent return by investing the loaned funds (or if the borrower achieves substantial savings by using the borrowed funds to pay off other higher-interest debts), then the borrower can keep the “spread”—the difference between the return on investment and the low interest paid to the lender—as essentially a tax-free gift from the lender. The loan or other leveraged transfer is a particularly attractive option for (i) persons who need to retain some assets and cash flow, but are willing to give away most of the future income and growth from an investment, or (ii) persons who have already used up all of their lifetime gift tax exemption.

The following table demonstrates the power of today’s lower interest rates by comparing otherwise identical loan or GRAT transactions at different interest rates. Today’s October 2011 rates are compared with those of five years before (October 2006) and fifteen years before (October 1996).

The November 2011 AFRs were announced just as this Bulletin went to press, and are substantially identical to the October rates. Transactions that can take advantage of these low rates can be as simple as a loan of cash to children (or to a trust for their benefit). The actual payments could be interest-only, or they could be set higher to amortize some principal, depending on the borrower’s ability to pay and the lender’s need for cash flow. Examples might include:

- a parent becoming the new mortgage lender to his or her child, allowing the child to refinance at a much lower rate;
- a loan to a grantor trust, to take advantage of not only the low interest rates but also the gift tax advantage of paying for the trust’s income taxes;

Illustrations of Different Outcomes from Transfers of \$1,000,000			
Assumed Investment Growth Rates: [1]		5%	Loans [2]
		10%	GRATs
Summary of Outcomes	Oct-96	Oct-06	Oct-11
Short-Term Loan, 3 years (at AFR shown)	6.07%	5.00%	0.16%
Net Tax-Free Transfer	\$ (31,758)	\$ -0-	\$ 152,341
Mid-Term Loan, 9 years (at AFR shown)	6.72%	4.82%	1.19%
Net Tax-Free Transfer	\$ (144,566)	\$ 16,317	\$ 400,080
Long-Term Loan, 15 years (at AFR shown)	7.13%	5.02%	2.95%
Net Tax-Free Transfer	\$ (275,991)	\$ (2,996)	\$ 355,798
3-year GRAT (at §7520 Rate shown)	8.00%	5.80%	1.40%
Net Tax-Free Transfer	\$ 49,466	\$ 103,091	\$ 171,295

*Note [1]: The loans are assumed invested in assets with a modest return of 5%, while the GRATs are assumed to hold a more volatile asset with a greater potential return of 10%.*

*Note [2]: The loans are assumed to be interest-only annual payments with a balloon payment of interest and principal upon maturity.*

- an installment sale to a grantor trust allowing the transfer of an appreciated asset without immediately triggering capital gain;
- a transfer in exchange for a private annuity for life or a self-canceling installment note, which would terminate (with no further obligation by the debtor) at the lender's death;
- a transfer of a particularly volatile or difficult-to-value asset to a GRAT, to keep the downside investment risk with the transferor and to take advantage of the GRAT's features that reduce the risk of gift tax audit adjustments; or
- a transfer to a charitable lead annuity trust (CLAT) which pays a fixed annuity to charity and the pays any trust assets remaining after the final charitable annuity payment to beneficiaries the donor has identified in the CLAT agreement.

These and other leveraged estate planning techniques have been described in detail in prior Estate Planning Bulletins. If any of these techniques sounds particularly useful to you, more information can be made available on request.

Some estate planning and charitable giving techniques are less favorable under low interest rates, including charitable remainder annuity trusts, qualified personal residence trusts (QPRTs), and charitable gift annuities.

### **Summary of Changes to Federal Transfer Tax Rates and Exemptions, 2010 Tax Act:**

Tax:	2009		2010			2011–2012 [3]		2013 (if no action)		
	Exemption	Rate	Exemption		Rate	Exemption	Rate	Exemption		Top Rate
Gift	\$1,000,000	45%	\$1,000,000		35%	\$5,000,000	35%	\$1,000,000		55%
Estate	\$3,500,000	45%	\$5,000,000	[1]	35%	\$5,000,000	35%	\$1,000,000		55%
GST	\$3,500,000	45%	\$5,000,000		0%	\$5,000,000	35%	\$1,400,000	[2]	55%

**Notes:** [1] Executors for decedents dying in 2010 may opt out of estate tax and into carryover basis.  
[2] The GST exemption shown for 2013 is a projection, as it would be \$1,000,000 indexed for inflation.  
[3] As this Bulletin went to press, the IRS announced that after an inflation adjustment factor, the 2012 exemptions for gift, estate, and GST taxes will be \$5,120,000.

## ***Illinois Estate Tax Justifies Thorough Planning, Even If Federal Exemption Remains High***

While the federal estate tax exemption for 2011 is \$5,000,000 and for 2012 will be \$5,120,000, the Illinois estate tax has an exemption of only \$2,000,000. This can result in an Illinois estate tax of up to \$391,600 on a \$5,000,000 estate that would typically be exempt from the federal estate tax. The Illinois estate tax also has complicated and often unexpected impact on the estates of part-year residents and nonresidents owning property in Illinois. However, the Illinois estate tax can be significantly reduced, eliminated, or postponed until the death of the surviving spouse, which justifies continued attention to thorough estate planning by Illinois residents and those nonresidents with any material amount of Illinois property.

## ***Budget Control Act of 2011 May Put Estate Tax Changes on Fast Track***

The federal Budget Control Act of 2011 passed in August created the Joint Select Committee on Deficit Reduction, commonly known as the “super committee” (the “Committee”) to design a package of additional spending cuts and revenue enhancements to further reduce the deficit. The Committee will submit its proposals in November 2011 for an expedited vote. Some changes to the federal estate and gift tax could be included as revenue raisers, including proposals by the Treasury Department that have already been included in previously proposed legislation (such as the proposal to eliminate short-term GRATs). As another example, the Obama Administration has proposed returning to the estate tax exemptions and rates of 2009 (with a \$3,500,000 estate tax exemption, \$1,000,000 gift tax exemption, and 45% top rate). Any of those changes could be included in the Committee’s package, effective upon enactment or possibly with an effective date of January 1, 2012. If changes to the federal estate or gift tax are included in the Committee’s package, there may be only a very short time (weeks, not months) to act between the Committee’s proposal and the effective date of the legislation.

## ***Estate Tax Returns for 2010, 2011 Finally Released***

After much delay, the IRS has released all of the forms and instructions for estate tax returns for those decedents dying in 2010, as well as the modified returns and instructions for decedents dying in 2011. To avoid hardships created by the delay in release of the forms, filing deadlines have been extended for the affected taxpayers.

## ***Portability of Estate Tax Exemptions Will Require Filing Estate Tax Returns***

A new feature of the 2010 tax act permits a surviving spouse to “inherit” the predeceasing spouse’s unused federal estate tax exemption. While this was not clear at the time the law was passed, the IRS has confirmed that it will be necessary to file an estate tax return in the predeceasing spouse’s estate in order to take advantage of the “portability” of that spouse’s estate tax exemption. Smaller estates that would not otherwise have to file a federal estate tax return will now have to consider doing so in order to preserve the valuable estate tax exemption of the predeceasing spouse where the surviving spouse receives all or most of the first spouse’s estate directly.

## ***Illinois Civil Unions Law Opens Opportunities***

Illinois adopted civil union legislation effective June 1, 2011, Public Act 096-1513. This law allows same-sex couples—as well as opposite-sex couples who have reasons not to marry—to have substantially all of the legal rights and obligations of married couples under Illinois state law. This option opens up several estate planning opportunities for those couples. For example, civil union partners may now own property as tenants by the entireties, a form of joint tenancy with right of survivorship that has additional protection against creditors. However, it is not yet certain (and may need to be determined through litigation or further legislation) whether civil union partners will qualify for the estate tax marital deduction for purposes of the

Illinois estate tax. The Illinois estate tax law “piggybacks” on the federal estate tax law, which does not recognize civil union partners as married for purposes of the federal estate tax marital deduction. Civil union partners will still want to use a full suite of estate planning documents (including wills, revocable trusts, and powers of attorney) to be sure their wishes are followed.

### ***Tax Patents Prohibited***

On September 16, President Obama signed the “Leahy-Smith America Invents Act” to reform the U.S. Patent Office and to make some changes in patent law. One provision of that law prohibits, from the date of enactment, any new patents on tax strategies. Estate planners had long been concerned that effective estate planning techniques could become impossible to use without paying a royalty. While the few existing patents on estate planning techniques are not affected by the new law, the prohibition on new patents will keep estate planning simpler and less expensive.

### ***Time for Action***

Some of the opportunities described in this Bulletin, including those involving the lowest-ever applicable federal interest rates, may last only for October, with rates gradually increasing thereafter. Other opportunities may expire by December 31, 2012, if not sooner. Your advisors in the Estate Planning group at Vedder Price can identify the opportunities that are most relevant to your situation and help you implement strategies to take advantage of those opportunities while they remain available. Contacting us soon will help us identify the actual and practical deadlines involved.

If you have any questions about these new developments, please call **Michael D. Whitty** at +1 (312) 609 7812 or one of the other members of the Estate Planning group listed on the next page. ■

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### The Estate Planning Group

Vedder Price has long recognized the importance of estate planning and has been at the forefront of this ever-changing area of the law. The firm's practice has both a national and an international scope. Vedder Price attorneys combine technical experience in all aspects of estate and financial planning with a strong appreciation of personal objectives and concerns in servicing clients in this uniquely personal area.

The firm represents clients with diverse personal objectives and financial interests, including individuals with large estates, individuals with personal situations requiring special planning, owners of closely held businesses, corporate executives and professionals. Vedder Price estate planning attorneys also represent executors, administrators, trustees and guardians. In addition, the firm provides estate and financial planning counsel to businesses and not-for-profit organizations, as well as other professionals who consult Vedder Price with respect to their own clients.

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