

# Estate Planning Bulletin

## Estate Planning in the Volatile 2012 Environment: *New Developments and Opportunities*

Economic, legislative and regulatory developments are keeping estate planners and their clients very busy in 2012. 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 new developments; a more detailed discussion of each may be found inside this Bulletin:

- **Conditions Remain Favorable for Lifetime Gifts and Other Estate Planning Transactions.** As covered in our August Estate Planning Notice, the combination of a higher gift tax exemption through 2012 and low interest rates for many powerful leveraged estate planning techniques makes this year the best environment for lifetime gifts, intrafamily loans and other estate planning transactions that planners have ever seen. Persons interested in taking advantage of these conditions should contact a member of the Estate Planning group at Vedder Price soon, while there is still time to act.
- **Deadline to Remedy Roth IRA Conversions.** For those taxpayers who extended their 2011 income tax returns, the deadline to recharacterize Roth IRA conversions is October 15.
- **New 3.8% Investment Income Surtax Applicable to Estates and Trusts.** To help finance the Patient Protection and Affordable Care Act, a new 3.8% surtax will apply to certain passive investment income of individuals as well as estates and trusts, beginning January 1, 2013.
- **Estate Tax Portability Guidance and Clarification.** The IRS has recently issued much-anticipated temporary and proposed regulations, offering guidance and clarification on the requirements for electing portability of a deceased spousal unused exclusion (DSUE) amount to the surviving spouse. The regulations allow executors of estates that need not otherwise file a Form 706 to avoid reporting the value of property that qualifies for the marital or charitable deduction and provide guidance on how to calculate the DSUE.
- **Illinois Estate Tax Exemption Increase.** This year, Illinois decoupled its estate tax from the federal estate tax and imposed an estate tax on estates exceeding \$3,500,000. Despite rumors that the federal estate tax exemption may decrease to \$3,500,000 (or even \$1,000,000) in 2013, the Illinois estate tax exemption is scheduled to increase to \$4,000,000 in 2013. However, unlike federal law, Illinois law does not allow for the portability of a DSUE for Illinois purposes.
- **Illinois Civil Unions Law Now Applied to Illinois Estate Tax.** The Illinois Attorney General has issued an administrative ruling that, as a consequence of the Illinois Religious Freedom and Civil Union Act, civil union partners will be allowed to claim the marital deduction for the Illinois estate tax. Prior to this ruling, there had been some uncertainty about whether civil union partners would receive the Illinois estate tax marital deduction, as the Illinois estate tax is largely based on the federal estate tax, which does not recognize civil unions for federal tax purposes due to the federal Defense of Marriage Act (DOMA), which defines marriage as a legal union between a man and a woman.

## ***Conditions Remain Favorable for Lifetime Gifts and Other Estate Planning Transactions***

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## ***Deadline to Remedy Roth IRA Conversions***

For those taxpayers who extended their 2011 income tax returns, **the deadline to recharacterize Roth IRA conversions is October 15, 2012**. Due to unstable market conditions, many individuals have seen their portfolios significantly decline in value. As a result, individuals who converted their retirement accounts to Roth IRAs in the past year may face a tax liability on an amount no longer in their accounts. To remedy this problem, the IRS allows taxpayers to reverse their Roth IRA conversions by recharacterizing them, so long as such recharacterization is complete before the deadline for filing the individual's tax return for that year, including extensions. Any recharacterized conversion will be treated as though the conversion had not occurred.

Individuals who converted their Roth IRAs in the past year and have decided that a recharacterization would be beneficial should contact their individual tax return preparers to determine the necessary steps to report the recharacterization.

## ***New 3.8% Investment Income Surtax Applicable to Estates and Trusts***

To help finance the Patient Protection and Affordable Care Act, a new 3.8% surtax will apply to certain passive investment income of individuals as well as estates and trusts, beginning January 1, 2013. The amount subject to the tax is determined by a somewhat complex calculation.

For individual taxpayers, the 3.8% surtax will be imposed on the lesser of (1) net investment income, or (2) the amount by which modified adjusted gross income (MAGI) exceeds the threshold amount in that tax year.

For estates and trusts, the 3.8% surtax will be imposed on the lesser of (1) the undistributed net investment income of a trust or estate, or (2) the amount by which adjusted gross income exceeds the top inflation-adjusted bracket for estate and trust income, which is expected to be approximately \$12,000 in 2013. This threshold is substantially lower than the threshold for individual taxpayers, so the tax impact on an estate or trust will be greater than for an individual with the same income. Because distributed net income is not taxed at the trust level, this may create an incentive to distribute the trust income out if the beneficiaries who receive it are below the threshold for the surtax to apply.

In general, the surtax does not apply to active trade or business income, or to distributions from IRAs and qualified plans. In addition, trusts dedicated to charitable purposes are not subject to the new tax, while grantor trusts (which are treated as the grantor's own property for income tax purposes) will not pay the tax directly, instead passing through the taxable income to the grantor's own tax return. However, the surtax does apply to individuals who receive distributions of net passive income from trusts and estates.

This new surtax creates many planning considerations and complexities when it comes to decisions such as whether to create a new trust as a grantor trust, or whether estate and trust income should be retained or distributed out to beneficiaries. Individuals should contact their Vedder Price attorney to determine how the surtax will affect their trusts and estates.

## ***Estate Tax Portability Guidance and Clarification***

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Act) added a feature known as "portability," which allows the unused estate tax exemption of a deceased spouse to be transferred to the surviving spouse. Note that a surviving spouse is only entitled to the unused exemption of the "last deceased spouse." In other words, a surviving spouse may not use the DSUE of multiple deceased spouses.

The IRS recently issued much-anticipated temporary and proposed regulations, offering guidance and clarification on the requirements for electing portability and for establishing the amount of estate tax exemption that is transferred. Previously, the IRS had issued Notice 2011-82, which provided that a deceased spouse's estate is deemed to elect portability by timely filing an estate tax return, Form 706. Before portability, the Form 706 estate tax return was prepared only when an estate exceeded the exemption amount. Accordingly, in order to take advantage of portability, estates must now prepare and file Form 706 even when the return would not be required but for the portability election.

In anticipation of the portability regulations, estate planners speculated that the IRS would issue a simplified Form 706 for estates of less than \$5 million that were filing only to elect portability. Instead, the portability regulations adopted the solution of allowing executors of estates that need not otherwise file the Form 706 to use the same form, but to avoid reporting the value of property that qualifies for the marital or charitable deduction. Some executors will choose not to take advantage of this exemption from full reporting, because the Form 706 also serves to document the step-up in basis for capital gains taxes.

### ***Illinois Estate Tax Exemption Increase***

This year, Illinois decoupled its estate tax from the federal estate tax and imposed an estate tax on estates exceeding \$3,500,000. Despite rumors that the federal estate tax exemption may decrease to \$3,500,000 (or even \$1,000,000) in 2013, the Illinois estate tax exemption is scheduled to increase to \$4,000,000 in 2013. However, unlike federal law, Illinois law does not allow for the portability of the exemption from the Illinois estate tax.

### ***Illinois Civil Unions Law Now Applied to Qualify for Illinois Estate Tax Marital Deduction***

The Illinois Religious Freedom and Civil Union Act (the Civil Union Act) became effective June 1, 2011. The Civil Union Act 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. In other words, if Illinois gives or recognizes a legal obligation, responsibility, protection or benefit to spouses, it must also give or recognize the same legal obligation, responsibility, protection or benefit to parties to a civil union.

Although the Civil Union Act went into effect over a year ago, there remained a tremendous amount of uncertainty surrounding the treatment of civil union partners with respect to the Illinois estate tax. Part of the uncertainty revolves around the fact that civil unions are not recognized for federal tax purposes under the federal Defense of Marriage Act (DOMA), which defines marriage as a legal union between a man and a woman. Under federal law, a decedent is entitled to a marital deduction for property passing to a surviving spouse. Illinois does not recognize a separate marital deduction for Illinois estate tax purposes. However, Illinois does allow an Illinois decedent to elect a marital deduction for certain qualified terminable interest property (known as a QTIP election) that is separate from any federal QTIP election.

Since the Illinois estate tax is computed by taking into account the decedent's taxable estate under federal law (i.e., the gross estate less deductions, including the marital deduction), it had been debatable whether a party to a civil union will benefit from the Illinois QTIP election. However, on August 9, 2012, the Illinois Attorney General issued an administrative ruling that Illinois civil union partners will be allowed to claim the marital deduction for the Illinois estate tax.

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

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. ■

## Principal Estate Planning Members of the Tax & Estate Planning Group

Igor Potym .....	+1 (312) 609 7542
Michael G. Beemer.....	+1 (312) 609 7630
Charles H. Wiggins, Jr.....	+1 (312) 609 7525
Christine M. Rhode.....	+1 (312) 609 7575
Michael D. Whitty.....	+1 (312) 609 7812
Robert F. Simon.....	+1 (312) 609 7550
Amy E. Lewis.....	+1 (312) 609 7837
Maureen Huhs .....	+1 (312) 609 7558

## VEDDERPRICE®

222 NORTH LASALLE STREET

CHICAGO, ILLINOIS 60601

+1 (312) 609 7500 | +1 (312) 609 5005 • FAX

1633 BROADWAY, 47TH FLOOR

NEW YORK, NEW YORK 10019

+1 (212) 407 7700 | +1 (212) 407 7799 • FAX

1401 I STREET NW, SUITE 1100

WASHINGTON, D.C. 20005

+1 (202) 312 3320 | +1 (202) 312 3322 • FAX

200 ALDERSGATE

LONDON EC1A 4HD

+ 44 (0)20 3440 4680 | + 44 (0)20 3440 4681 • FAX

[www.vedderprice.com](http://www.vedderprice.com)

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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; and corporate executives, professionals and inheritors. Vedder Price's estate and financial planning attorneys also represent executors, administrators, trustees and guardians. In addition, the firm provides estate and financial planning counsel to businesses, not-for-profit organizations and other professionals who consult with Vedder Price regarding their own clients.

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