

Private Clients, Trusts and Estates

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Planning for Year-End 2009 and Beyond

Estate and Gift Tax Reform — 2010 Repeal?

There is little doubt that Congress will intervene to derail the scheduled repeal of the estate tax which otherwise would occur in 2010. At this time, it appears most likely that Congress simply will continue the 2009 rules for one more year. This means for 2010 the federal estate tax exemption will stay at \$3.5 million (\$7.0 million for a married couple) and the tax rate on the excess over the exemption amount will be 45%.

A one-year extension leaves Congress with a great deal of flexibility. It could extend the current exemption amount and rate permanently; it could allow the reversion to a \$1 million exemption and 55% rate in 2011 as current law provides, or it could craft new legislation. The likely long-term solution is still very hard to predict. Congress is grappling with many contentious and complex issues, all costly, and estate tax reform could become entangled with any one of them. Estate planners continue, therefore, to struggle with how to plan in an uncertain tax environment — but plan we must. And many powerful planning opportunities are still available which will generate substantial tax savings regardless of the eventual size and shape of the estate tax laws.

Regular Review of Estate Plans Still Important

No one should postpone a regular review of their existing estate planning documents just because the estate tax laws are uncertain. This is particularly true for those who have experienced a change in personal or financial circumstances. But, it is also true for those whose circumstances have remained the same since their last estate plan update. In considering whether your plan needs to be updated, it is important to recognize that the recent increase in the federal estate tax exemption amount, although a good thing from a tax planning perspective, may have distorted the workings of your estate plan. For example, some estate plans contain a

formula gift of the maximum exemption amount (now \$3.5 million) directly to children or grandchildren. When the exemption was only \$600,000 that presumably left ample assets for the support of a surviving spouse. Query, however, whether a gift today of \$3.5 million to children or grandchildren would leave sufficient assets for the support of a surviving spouse.

Also, as children mature, perhaps accumulating estates of their own, their parents' estate plans may no longer make sense. In particular, significant tax and creditor protection benefits may be achieved by retaining a child's inheritance in trust — and those benefits can be obtained even with trusts over which the child has extensive control as trustee and beneficiary.

Tax Reduction Strategies

Many very effective tax reduction planning tools are still available under current law. But it is possible, indeed likely, that some will be taken away or restricted when Congress finally gets serious about estate tax reform. Moreover, the financial climate continues to be very favorable for many of these planning tools — particularly the continued low interest rates used in IRS gift computations.

GRATs

A GRAT (or Grantor Retained Annuity Trust) is a trust to which the person creating the trust (the "Grantor") makes a deposit of cash or other assets. In return, the Grantor is paid an annuity amount from the GRAT for a set number of years. After the last annuity payment, any assets left in the GRAT may be distributed, free of gift tax, to the Grantor's designated beneficiaries — typically children outright or in trust.

When the IRS values a GRAT gift, it does a one-time computation, at the outset, of what it thinks will be left after all annuity payments have been made to the Grantor. For November 2009, the IRS assumes the deposit made to a GRAT will earn 3.2% per year, every year, during the life of the GRAT. GRATs are typically designed with an annuity that is just large enough so that, if the GRAT earns only the IRS assumed rate, the last annuity payment will consume the last dollar of the GRAT. Thus, the gift the Grantor is treated as making is valued at close to zero. Yet, if the GRAT actually earns more than the assumed 3.2% per year, assets will remain after the last annuity payment is made. These remaining assets may be significant in size if the actual return on the GRAT assets during its term is high. The IRS cannot go back and reevaluate the gift. Whatever is left passes to the designated beneficiaries tax-free. If nothing is left, all the assets will have been returned to the Grantor; but the Grantor was not charged with a gift so that "worst case" scenario is pain-free.



Clients can save millions of dollars in gift and estate taxes with GRATs. So, it is not a surprise that GRATs are getting a close look in Congress. It seems likely that GRATs will be adversely affected whenever Congress gets around to permanent estate tax reform. But, GRATs are alive and well today, and they are basically a "heads you win, tails the IRS loses" proposition.

Low-Interest Loans

For money lent in November, the minimum IRS interest rate allowed for loans with terms up to three years is 0.71% per year. For loans up to nine years, the November rate is 2.59%. For loans of ten years or longer the November rate is 4.01%. These loans can be "balloon," interest-only loans until the final year when all of the principal comes due. If the borrowed funds can be invested to earn more than the required interest, the borrower makes a profit. If the borrower is a trust for children and grandchildren this profit is, in effect, a tax-free gift.

Depressed-Value Opportunities

While the stock markets have recovered somewhat from their recent steep declines, the same is not yet true for real estate and many closely held business assets. This means that this is a uniquely opportune time to transfer those assets to younger generations using a GRAT or a low interest rate loan (the low interest rate loan being used to purchase the depressed assets). The same also may hold true for marketable stocks. Many people believe that the stock market is more likely to go up than down over the coming years. Transferring stocks to a GRAT is an easy way to make tax-free gifts if the stock market goes up, without taking on any real downside risk or cost if the market actually goes down instead.

Required Minimum Distributions from Retirement Accounts

Generally, once the owner reaches the age of 70½, minimum distributions must be taken annually from an IRA, 401(k), or other retirement plan. Required distributions also apply in most circumstances to an inherited IRA. In response to the severe market declines, the U.S. government suspended the required distributions for tax year 2009. Some people, however, still received a minimum distribution in 2009, in many instances because the distributions occurred automatically or because the owners were not aware of the one-year moratorium. The IRS recently announced that those who mistakenly took a minimum distribution in 2009 may roll it back into the IRA or retirement plan so long as they do so no later than November 30, 2009. If they do so, they will avoid paying income tax on the amount mistakenly withdrawn. This "roll-back" rule also applies to



inherited IRAs. For the full text of IRS Notice 2009-82 visit our Web site at www.schiffhardin.com/publications/notice2009-82.pdf.

State Law Developments

Schiff Hardin LLP has estate planning attorneys residing in New York, California, Florida and Illinois. Residents of those states will want to take note of the following recent developments.

Illinois Virtual Representation

In Illinois, a new statute, effective at the beginning of 2010, expands the circumstances in which trust disputes can be fully resolved without going to court. Moreover, with the agreement of the trustee and representative beneficiaries, an otherwise irrevocable trust now can be amended or even terminated early in a broad range of circumstances, again without the necessity of costly and sometimes protracted court proceedings. The application of the new statute is not without limits. For example, early termination of a trust would not be allowed if it would be contrary to a "material purpose" of the trust. Still, the new statute injects welcome flexibility into the administration of irrevocable trusts, many of which have outdated investment, administrative or trustee provisions. Illinois Public Act 96-479; 760 ILCS 5/16.1

Illinois Estate Tax

Starting in 2009, the federal estate tax exemption rose to \$3.5 million, but as is true for many states, the Illinois exemption is lower — \$2.0 million. One consequence of this so-called "decoupling" is that in order to avoid Illinois death taxes at the death of the first spouse to die, only \$2 million of the \$3.5 million federal estate tax exemption can be used. Everything over \$2 million must be given to the surviving spouse or placed in a marital trust in order to avoid Illinois tax at the first death. And while this eliminates tax at the first death, it often will increase the federal estate tax at the second death.

Illinois now offers a partial solution to this problem. Under Public Act 96-0789, the additional \$1.5 million of federal estate tax exemption can be used by placing that amount in an "Illinois QTIP Trust," which is subject to Illinois tax later, when the surviving spouse dies, but is not subject to federal estate tax at either death. At the second death, this can save federal taxes of \$500,000, or potentially many multiples of that amount. Many estate planning documents currently contain tax allocation formulae that would allow an executor to take advantage of Illinois QTIP planning. But some do not. Your estate planning attorney should be able to tell you



if an amendment is needed after a quick review of your estate planning documents.

Illinois estate tax also expires at the end of 2009. While it is likely the Illinois legislature will act to extend it, there is the same uncertainty about where this fix will fit into the Illinois legislative agenda as there is at the federal level.

Temporary Guardianship Forms for Minor Children in Illinois

For those of you with minor children, it is a good idea to have temporary guardianship forms in place if you travel and leave a child in the care of anyone who is not that child's parent or legal guardian. The form enables that caretaker to handle an emergency if you cannot be reached, such as authorizing an emergency surgery if the child is in an accident. In the past, temporary guardianship forms were invalid after 60 days of execution. Illinois has amended its statute and now permits you to name a temporary guardian for up to 365 days. This can be useful if you travel frequently and consistently leave your child(ren) with the same person.

New York Power of Attorney

New York State has made significant changes to its law relating to powers of attorney signed on or after September 1, 2009. The most notable change is that the power will become effective only after it has been executed (signed and notarized) by both the principal and the agent. Another important change is that, if the principal wishes to authorize the agent to make major gifts — generally defined as gifts in excess of \$500 per year per donee — the principal must also execute a "Major Gifts Rider," which is attached to the power of attorney. To emphasize the importance of this safeguard, the law requires that the rider be witnessed by two disinterested persons; i.e., executed with essentially the same formalities as a will. Other aspects of the new law are that the principal may appoint a "monitor" (a person who will be entitled to receive reports from the agent), and may provide that the agent is entitled to compensation (in addition to reimbursement of his or her reasonable expenses). Finally, the new law expands the agent's powers — e.g., the agent is considered to be the principal's "personal representative" under the Health Insurance Portability and Accountability Act (HIPAA) privacy rules — and codifies the agent's fiduciary duties.

A power of attorney executed before September 1, 2009 will continue to be effective as before, but some changes are retroactive including those related to HIPAA and the codification of an agent's fiduciary duty. Needless to say, there are other reasons to review and possibly update your powers of



attorney, especially if you are starting to spend significant time in other jurisdictions or the circumstances of your agents (or successor agents) have changed.

Florida

While by no means a recent development, Florida continues to be an attractive state of residence from a tax point of view. By constitution, Florida has no estate tax, nor does it have an income tax. Because of this, and because many people own homes in Florida, we often get inquiries about how to change residency to Florida.

It is important to remember that changing your residence takes more than simply declaring you are henceforth a resident of a new state. In order to effectively change your residence, you will need to make your new residence your primary residence in actuality and not just in declaration. For more information, go to our Web site at www.schiffhardin.com/binary/milberg-florida_residency.pdf. Please contact us if you would like to quantify the possible estate tax benefits of a change in residence and to discuss in more detail how a change might be accomplished.

California — No-Contest Provisions

No-contest provisions (often referred to as "in terrorem" provisions) are sometimes included in estate planning documents to discourage will contests and other claims. A no-contest clause disinherits a beneficiary who brings a claim. These provisions are controversial because they may punish heirs who bring good-faith claims. But, no-contest provisions can have the salutary effect of discouraging family litigation and spurious claims. California has new state rules governing no-contest clauses. While the new rules confirm the enforceability of no-contest clauses, they limit the circumstances to which they apply. For example, only claims made without probable cause (meaning a reasonable claimant would believe there is a "reasonable likelihood" of success) can trigger disinheritance.

Current California documents that already contain no-contest provisions likely will need to be redrafted because of specific language the new rules require.



Contracts to Make a Will

Although still rare, we have received several inquiries recently from happily married couples who want to contractually bind each other to eventually leave all of their collective assets to their descendants. The primary concern motivating these inquiries seems to be the rise in reported cases where

predators take advantage of elderly people who suffer from reduced capacity. Some people are also worried that assets might be diverted to a second spouse. In most estate plans, the assets of the first spouse to die are placed into trusts that eventually must pass to descendants, but such trusts do not govern the separate assets of the survivor. And, sometimes the survivor is the direct beneficiary (not in trust) of assets such as retirement benefits which, for tax reasons, are better left outright to a surviving spouse. A contract to make a will generally does apply to the survivor's separate assets, including retirement benefits received from the first spouse to die, and can create an enforceable obligation to leave assets to descendants. Go to our Web site at www.schiffhardin.com/publications/hodgman-rediscoveringtools.pdf to see a recent article on this subject. If the contract to make a will is relevant to your circumstances, please contact us.

Year-End Gifts

For many people, this is the time of the year to make tax-free annual exclusion gifts to children or grandchildren. In 2009, the tax-free gifting amount is \$13,000 per recipient from a single donor or \$26,000 per person from a married couple. Annual exclusion gifts may be made to the recipient outright or in trust. For gifts made in trust, it is important to remember that the gift will only qualify for the exclusion if the trust has certain terms and proper documentation is used when the gift is made. This documentation is commonly referred to as a "Crummy Notice." If you are making tax-free gifts to trusts, you should contact us or other advisors to be sure that the documentation is done properly.



For an electronic copy of this newsletter, go to www.schiffhardin.com/binary/private_clients_nov2009.pdf.

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