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Estate Planning | Wills & Trusts

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Estate Tax Update

On November 30, President Barack Obama assigned the task of resolving the standoff on tax cuts that expire at the end of the year to Treasury Secretary Timothy Geithner and White House budget director Jacob Lew. Geithner and Lew are expected to work with Congressional leaders from both parties to achieve the lofty goal. Obama stated that he was confident Republicans and Democrats would find common ground in the coming weeks and that there was wide agreement between leaders of both parties that the tax issues needed to be resolved before the end of the year, which is of course in his party's best interest after having lost control of the House of Representatives in the November elections.

Meanwhile, on November 17 and 18, respectively, Rep. Mike Pence (R-IN) and Sen. Jim DeMint (R-SC) introduced the Tax Relief Certainty Act, which would permanently repeal the "immoral and unfair death tax." Earlier this year, DeMint's proposal to repeal the Federal Estate Tax was voted down, 39-59, in the Senate.

While the Estate Tax largely took a back seat to the declining economy and health care reform throughout 2010, Congressional action will be necessary in order to avoid a return to the pre-Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) exemption and rates (\$1 million; top rate of 55%). The three primary positions for a permanent solution in Washington at this time appear to be (a) permanent repeal, (b) a \$3.5 million exemption with a top rate of 45%, or (c) a \$5 million exemption with a top rate of 35%.

According to the *Congressional Research Service*, the three resolutions stated above, along with the possibility of a return to the pre-EGTRRA exemption and rates, would result in the following percentage of estates affected and revenue:

Exemption	Top Rate	Estates	Revenue
\$1 million	55%	1.76%	\$34.4 billion
\$3.5 million	45%	0.25%	\$18.1 billion
\$5 million	35%	0.14%	\$11.2 billion
No Tax	0%	0%	\$0

The significant Federal deficit makes permanent repeal fairly unlikely. Additionally, all signs continue to indicate that a retroactive Estate Tax for those who died in 2010 remains a possibility. The debate may result in a continuation of the 2009 exemption and rates (\$3.5 million; top rate of 45%) through 2010 or an option for estates to follow either the 2009 or 2010 rates (no estate tax; carryover basis on assets).

How the Estate Tax resolution will affect state inheritance taxes and what will be done with the Gift and Generation Skipping Transfer Taxes remains to be seen.

The Notice Requirement for Gifts in Trust

One of the primary techniques used to reduce a person's taxable estate is for him or her to make gifts during life to other individuals, usually children or grandchildren, using the annual gift tax exemption (\$13,000 in 2010). An individual can make a gift of up to \$13,000 to as many other people as he or she wants in any given year. In other words, if Thomas wants to make gifts of \$13,000 to each of his ten grandchildren, he could reduce his taxable estate by \$130,000 each year. However, Thomas will most likely want to retain some sort of control over the gifts—such as if a grandchild is not yet mature enough to handle large amounts of money, has a drug or alcohol addiction, has creditor issues or has a divorce pending. Thomas can place limitations on the gifts by establishing an irrevocable Gift Trust or an Irrevocable Life Insurance Trust (“ILIT”) and making the gifts to the trust rather than to the beneficiaries outright. The trustee will then administer the trust as provided by Thomas in the trust document. Such trusts are irrevocable and, therefore, require significant thought and consideration of whether the creator (the “giftor”) is willing to part with the assets and under what terms he wishes to make the gifts.

The IRS requires that the giftor follow established procedures for payment and notice in order for the transfer to be considered a present interest gift (see “Definition of the Month” below), which is necessary for the assets to be excluded from the giftor’s estate. For example, assume that Thomas establishes an ILIT for the benefit of his grandchildren. The intention is that by establishing the ILIT to own the life insurance policy, the proceeds of the policy at Thomas’ death, along with the premiums that are paid during his life, will be outside of Thomas’ taxable estate at his death.

In order for this goal to be accomplished, the process for making the gifts and paying the premiums must be as follows: first, Thomas must make the gift (the amount of premium due) to a bank account established by the trustee of the ILIT; second, notice must be given to the beneficiaries of the ILIT in the form of “Crummey Notices” (named after the case establishing the requirement—see “Definition of the Month” in Newsletter #5) stating (a) that a gift has been made to the ILIT, (b) the amount that the beneficiary is entitled to withdraw, and (c) the date by which such withdrawal must be made; and third, after such date has passed, the trustee may pay the premium to the insurance provider. Only by following these steps can the giftor properly make a present interest gift that will be excluded from his taxable estate.

An issue that is far too common arises when the trust is established but the trustee fails to ensure that the necessary procedures are being followed on an annual basis—for example, the giftor makes the premium payment directly from his personal bank account to the insurance company or the trustee fails to send notice to the beneficiaries that a gift has been made. Such a failure can result in significant Gift Tax consequences and essentially eliminate the benefits that the giftor intended to achieve by establishing the ILIT in the first place.

It is critical that the attorney communicate and the giftor understand the requirements of maintaining an irrevocable trust so that the intended goals can be accomplished. An affordable and efficient solution is to have the preparing attorney maintain the irrevocable trust by making sure that the annual notices are prepared and sent in a timely manner. Since the attorney is familiar with the goals and intentions of the giftor as well as the personal situations of the beneficiaries, this is often the best way to ensure that the proper procedures are followed. When done properly, the irrevocable trust is an invaluable tool for reducing Estate and Gift Tax liability.

Definition of the Month: *Present Interest Gift*

In order for a gift to qualify for the annual (\$13,000) or lifetime (\$1 million) Gift Tax exemptions, it must be a present interest gift. A present interest gift is one in which the beneficiary has an immediate, unrestricted right to the use, benefit, and enjoyment of the gifted property. If Thomas gives his son, Smith, \$5,000 and Smith can use it now, it is a gift of a present interest. If Smith is not entitled to such benefits, then the gift is considered a future interest. An example of a future interest would be if Thomas established a trust for the benefit of Smith and made a gift to such trust without granting Smith a present right to withdraw the gift. Such a gift would not be considered a present interest gift and would thus be included in Thomas' taxable estate upon his death.



Manish C. Bhatia is an Illinois attorney focusing his practice in the area of Estate Planning. Manish has focused his education and practice on Tax Planning, Estate Planning and Business Succession Planning since the first year of law school. He has also added Asset Protection, Elder Law and Nonprofit Organizations/Charitable Giving to his fields of practice. Manish is also a member of the Chicago Bar Association, the Asian American Bar Association of Chicago and the Indian American Bar Association.

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