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An estate plan is a work in progress

By Mary Dory Cascino

An estate plan is a work in progress. You should review it at least every three years - in the current uncertain tax environment, an annual review is recommended.

Your estate plan should keep up with changes in your economic and family circumstances, as well as any changes in your wishes for the disposition of your assets on death.

The terms of your will and living trust are not set in stone when executed, nor do they become irrevocable until your death, and even then, some post-death adjustments may be possible.

The work in process is also affected by tax law changes. Most sophisticated estate plans are based on a formula that takes maximum advantage of an individual's estate and generation skipping transfer (GST) tax exemptions.

However, with the elimination of the federal and state of Illinois estate and GST taxes in 2010 (so far), those formulas may not result in a distribution on death that the testator or grantor intended.

In addition, the current situation is exacerbated by the temporary suspension of stepped-up basis, which is replaced in 2010 with capital gains tax.

In 2010, instead of filing a federal estate tax return, an IRS Code Section 6018 return (yet to be developed by the IRS) for each decedent will be required to allocate the limited stepped-up basis allowed under the current regime. The return or report is due on the due date of the decedent's final income tax return and requires a list of each asset, its fair market value at death, the decedent's basis in the assets, and the executor's allocation of the stepped up basis among the decedent's assets.

Each decedent is allowed $1.3 million in stepped-up basis and, if there is a surviving spouse, an additional $3 million in stepped-up basis for the spouse.

We suggest that our clients begin assembling basis information for each asset and keeping track of any variations. (This suggestion is a good idea in any case, so basis information is available for other purposes, such as gifting or documenting contributions to an entity such as an LLC).

Very few estate planners believed that Congress would fail to act in some manner to impose or reimpose estate and generation-skipping transfer taxes in some form in 2010, particularly in light of the budget deficit.

Many estate planners believe that this lack of action on the part of Congress that creates so much uncertainty is in itself contrary to public policy. It is likely that this uncertainty will lead to contests to interpret or construe an individual's will and trust and determine whether the outcome dictated by the documents in light of current law is consistent with the decedent's intent. These controversies can be avoided by vigilantly monitoring your estate plan in light of current tax laws.

A common estate plan calls for creation of a credit shelter trust (or family trust) to minimize estate taxes by allocating to it the amount of the federal estate tax exemption (less any lifetime gifts applied to the decedent's gift tax exemption, currently $1 million per person).

For married decedents, the remainder is normally allocated to a marital trust that qualifies for the marital deduction, postponing estate tax on the assets allocated to the Marital Trust until the surviving spouse passes away.

In a more advanced estate plan, additional trusts may be created to take advantage of the GST Tax exemption for both spouses and/or adjust the estate tax exemption to minimize state death taxes.

The result of the estate tax hiatus in 2010, according to the commonly used formulae, is that all of the decedent's assets may be allocated to the family trust or the marital trust.

Many times these trusts have different beneficiaries, different requirements or restrictions on distributions and different powers of appointment.

Depending on the formula, the surviving spouse could unintentionally end up with nothing from a decedent's estate and the estate could lose the ability to utilize the $3 million step up in basis for assets passing to the surviving spouse. On the other hand, the surviving spouse could end up with everything, which in some cases would be contrary to the grantor's intent.

The current situation is exacerbated by the temporary suspension of stepped-up basis, which is replaced in 2010 with capital gains tax (as noted above).

Each decedent is allowed $1.3 million in stepped-up basis and if there is a surviving spouse, an additional $3 million in stepped-up basis for assets allocated to the spouse.

In addition, the formulas you use in your trusts may affect the creation of GST Trusts. Commonly, two trusts may be created for each child.

One is exempt from GST taxes on the death of the primary beneficiary and primarily intended to pass to a child's descendants free of GST tax.

The other (the non-exempt trust) generally provides that the child can receive distributions or have withdrawal rights as to the principal at various ages, and the child may have a broad power of appointment over the residue of the non-exempt trust.

Depending on the formula, all gifts may be allocated to the GST exempt trust, with very limited distributions to the child, or to the GST non-exempt trust, which may have liberal distribution or withdrawal rights.

To complicate matters, if the legislature does nothing, we return in 2011 to the estate and GST tax scheme that was in place on December 31, 2001, that is, the federal estate tax exemption would be $1,000,000 and the tax rate will be 55% on everything in the decedent's estate over that amount. The marital deduction should postpone the tax until death of the surviving spouse.

Another, and possibly more insidious, complication is that Congress could pass one of the bills currently pending and apply the estate and GST tax retroactively to January 1, 2010.

Current proposals call for: imposing the estate tax as it was in 2009, that is, a $3.5 million exemption and 45% tax rate (the same as the administration's budget proposal); establishing an exemption of $2 million indexed for inflation with tax rates varying between 45% to 55% depending on the size of the estate; and increasing the exemption to $5 million at 35%.

Let's not forget the state estate tax. In Illinois, Senate Bill 3694 (Third reading March 11, 2010) would retroactively reinstate the Illinois estate tax in 2010 to the 2009 levels with a $2 million estate tax exemption.

Now, more than ever, you need to keep your estate plan current to insure that it carries out your objectives. We recommend that you contact your legal and financial advisors to discuss how these changes in the law could impact the administration of your estate and the distribution of your assets.

Mary D. Cascino is currently chair of the ISBA Trusts & Estates Section Council and concentrates in estate planning, asset protection, and estate and trust administration at Handler Thayer, LLP in its Advanced Planning and Family Office Practice Group. She can be reached at mcascino@handlerthayer.com.