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THIS IS ME LEAVING YOU: ¹ ILLINOIS "BREAKS UP" WITH THE FED

The relationship survived the seven-year itch. It celebrated its tenth anniversary September 1, 1999. But after a nearly 14-year-long relationship of mutually sharing federal estate tax revenues, Illinois has now walked out on the federal government.

On June 20, 2003 the Governor signed the divorce decree - an amendment to the Illinois estate tax that "decouples" the Illinois tax from the federal state death tax credit. The new Illinois law is effective retroactively for individuals dying after January 1, 2003. Previously Illinois, like 37 other states, assessed an estate tax equal to the amount of credit granted on the federal estate tax return for the payment of state death taxes (the "state death tax credit"). Thus, although Illinois assessed an estate tax, Illinois's tax did not previously increase the overall estate taxes paid by an Illinois resident. Now that has changed.

In this divorce, alimony payments to Illinois will be paid by the Illinois taxpayers, not by the federal government. How much does this increase your total estate tax rate? The structure of the law does not make this an easy question to answer. The short answer is that the new Illinois law increases your marginal estate tax rate by about 3% to 12%, depending upon the size of your estate and the year of your death. (Table 1 shows the change in marginal estate tax brackets for 2003.) For taxable Illinois estates over \$2,000,000, the marginal combined estate tax rate is now between 50% and 60%. For 2003 Illinois estates, total estate taxes increased about 10% to 24%. For example, the total estate tax on a \$10,000,000 estate increased from \$4,355,000 to \$4,888,800 (10.2%). (See Table 2)

**TABLE 1
COMBINED MARGINAL ESTATE TAX BRACKETS
2003**

<u>Taxable Estate</u>	<u>Prior to Decoupling</u>	<u>After Decoupling</u>
\$1,000,000	41%	43.8%
\$1,250,000	43%	46.2%
\$1,500,000	45%	48.2%
\$2,000,000	49%	52.6%
\$3,000,000	49%	53.4%
\$5,000,000	49%	54.6%
\$10,000,000	49%	56.6%
\$20,000,000	49%	57.0%

**TABLE 2
FEDERAL AND ILLINOIS ESTATE TAX
2003**

<u>Taxable Estate</u>	<u>Prior to Decoupling</u>	<u>After Decoupling</u>
\$1,000,000	0	0
\$1,250,000	\$102,500	\$126,700
\$1,500,000	\$210,000	\$242,200
\$2,000,000	\$435,000	\$484,800
\$3,000,000	\$925,000	\$1,016,000
\$5,000,000	\$1,905,000	\$2,100,800
\$10,000,000	\$4,355,000	\$4,888,800
\$20,000,000	\$9,255,000	\$10,588,400

What happened to the promised reduction in estate tax rates made by the 2001 federal tax legislation? Prior to this legislation, combined marginal estate tax rates for estates over \$2,000,000 were between 49% and 60%. Now the rates are back to almost exactly the same place. Here's what happened.

The 2001 federal tax legislation reduced the *nominal* federal marginal rates (before taking into account the credit for state death taxes or lack thereof) for estates over \$2,000,000 as follows:

TABLE 3 NOMINAL FEDERAL MARGINAL TAX RATES SLIP SLIDING AWAY									
Bracket	2001	2002	2003	2004	2005	2006	2007	2008	2009
2,000,000 – 2,500,000	49%	49%	49%	48%	47%	46%	45%	45%	
2,500,000 – 3,000,000	53%	50%							
3,000,000 – 3,500,000	55%								
3,500,000 – 10,000,000								45%	
10,000,000 – 17,184,000	60%								
17,184,000 – and up	55%								

However, prior to the 2001 legislation, the federal government shared 4% to 16% of the tax paid by the estates of Illinois residents with the State of Illinois by granting a credit against federal estate taxes for Illinois death taxes paid, up to a maximum state death tax credit amount determined under a federal table based on the size of the estate. Illinois in return vowed to impose only estate taxes equal to the maximum state death tax credit. In the 2001 legislation, the federal government began to phase out the state death tax credit, thereby eliminating the prior system of sharing federal tax revenues with the states. The 2001 legislation provided that in 2002 the federal state death tax credit would only be 75% of the amount of credit that would have been granted in 2001; in 2003 the credit would be reduced to 50% of its 2001 amount; in 2004 the credit would be reduced to 25% of its 2001 amount; in 2005 there would no longer be any credit, merely a deduction for state death taxes paid.

Thus if you compare the *effective* 2001 federal tax rates (after taking into account the federal state death tax credit) in Tables 6, 8, 10 and 12 (the light blue bars) with the effective federal tax rates (after taking into account the reduced or eliminated federal state death tax credit and, after 2004, the deduction for state death taxes) after the 2001 legislation (the solid blue bars), you'll see that although the 2001 legislation reduced the *nominal* federal tax rates, it did not significantly reduce (and in some cases increased) the *effective* federal rates. Combined tax rates were only reduced in states that imposed tax only equal to the federal state death tax credit, and only because the tax revenues of those states were decreasing.

Clever of Congress – take credit for reducing estate tax rates without really reducing federal revenue. But it left the states wailing “she’s gone – I’d pay the devil to replace her.”² For example, it was projected that over five years (2003 – 2007) Illinois would lose \$1.2 billion in revenue because of the 2001 federal legislation.

What's a cash-strapped state to do with a partner who's growing increasingly stingy? The logical, but unhappy, answer is to change its law to "decouple" from the federal state death tax credit and to impose state death taxes equal to the taxes the state would have received in 2001, regardless of whether or not there's a federal credit for the state death taxes. In other words, slam the door till the hinges fly, light a match and burn some bridges,³ and, of course, get alimony. Illinois joins about 18 other states that have decoupled (and several other states that are considering decoupling). So the Illinois estate tax rates are now fixed at the rates shown in Table 4, the same rates that were previously used to determine the maximum state death tax credit. And, as shown in Tables 6, 8, 10 and 12, the combined federal and Illinois tax rates (the solid green bars) are very close to what they were, and in some cases higher before the 2001 legislation (the light green bars).

Estate tax calculations are now more complicated too. Calculating the federal tax is now more complicated. Prior to the 2001 legislation, there were effectively five brackets for calculating tax on estates over \$2,000,000, and because of the state death tax credit, those same five brackets could be used to calculate one's total tax (see Table 1). After the 2001 legislation and before Illinois decoupled, there was only one bracket for estates over \$2,000,000, and so long as Illinois limited its tax to the state death tax credit, that same bracket could be used to calculate total tax. Now there are effectively twelve tax brackets for estates over \$2,000,000 for calculating combined federal and Illinois estate taxes. (See Table 4)

<u>Taxable Estate/ Bracket Amount</u>	<u>Tax on Bracket Amount</u>	<u>Tax Rate on Excess Over Bracket Amount</u>
900,000	27,600	5.6%
1,100,000	38,800	6.4%
1,600,000	70,800	7.2%
2,100,000	106,800	8.0%
2,600,000	146,800	8.8%
3,100,000	190,800	9.6%
3,600,000	238,800	10.4%
4,100,000	290,800	11.2%
5,100,000	402,800	12.0%
6,100,000	522,800	12.8%
7,100,000	650,800	13.6%
8,100,000	786,800	14.4%
9,100,000	930,800	15.2%
10,100,000	1,082,800	16.0%

For 2003, Illinois does not impose estate tax on estates less than \$1,000,000.
 For 2004 and 2005, Illinois does not impose estate tax on estates less than \$1,500,000.
 For 2006 and later, Illinois does not impose estate tax on estates less than \$2,000,000.

In addition, after 2004, the calculation of the federal estate tax and the Illinois estate tax becomes an interrelated calculation. The federal tax can only be calculated once you know the Illinois tax, because the Illinois tax is a deduction for federal estate tax purposes. The Illinois tax can only be calculated once you know the federal taxable estate, which is net of the deduction for the Illinois tax. So much for tax simplification.

It could have been worse. Recall that the 2001 legislation did confer a real benefit by increasing the estate tax exclusion (from \$675,000 in 2001) as follows:

	<u>Prior to 2001 Legislation</u>	<u>Under 2001 Legislation</u>
2001	\$675,000	--
2002	\$700,000	\$1,000,000
2003	\$700,000	\$1,000,000
2004	\$850,000	\$1,500,000
2005	\$950,000	\$1,500,000
2006	\$1,000,000	\$2,000,000
2007	\$1,000,000	\$2,000,000
2008	\$1,000,000	\$2,000,000
2009	\$1,000,000	\$3,500,000

As Tables 7, 9, 11 and 13 show, the increase in the estate tax exclusion does lower estate taxes to some extent, especially for smaller estates (see Table 7 showing taxes on a \$3,000,000 estate) and especially in 2006 (when the exclusion increases to \$2,000,000) and later years.

The original legislation proposed in Illinois to decouple from the federal estate tax would have refused to recognize the increased federal estate tax exclusion, as a number of other decoupled states have done. Thus Illinois would have imposed estate tax on estates over \$675,000, even if no federal tax was imposed because of the exclusion. However, the Chicago Bar Association Trust Law Committee, which I chaired, prepared a memorandum commenting on the legislation and describing the estate planning hardships and chaos that would result if Illinois did not recognize the increased federal exclusion. The CBA Trust Law Committee did not support the change in the Illinois law but, once it seemed certain that Illinois would pass some form of decoupling legislation, advocated changes to the bill to make it less onerous. Absent these changes, many married couples would have been required to update their estate plans immediately to avoid the imposition of Illinois estate tax at the first death.

The Illinois legislation as passed recognizes the increases in the federal exclusion only up to \$2,000,000. Thus a problem will arise in 2009, when the federal exclusion increases to \$3,500,000 and the Illinois exclusion remains at \$2,000,000, but there is much time for tax law changes prior to 2009.

The Illinois legislation also makes a subtle but significant change to an Executor's duties. Previously, an Executor had no duty to file an amended estate tax return to report any assets of the estate that were discovered only after the estate tax return was filed. The new Illinois law requires an Executor to file an amended return and pay any additional tax within three months after any increase to the taxable estate is discovered.

Well there's no use crying⁴, as the Rolling Stones used to say. Do you need to revise your estate plan because of the change to the Illinois estate tax? Probably not on an expedited basis, unless you plan to become incapacitated over the next few years. However, the inconsistency that will occur in 2009 between the federal and Illinois estate tax exclusions makes it advisable to modify estate plans for married couples at some time before 2009, barring further changes in the laws before then.

One caveat is that your plan may require immediate review if you own significant property in states other than Illinois. Many states have changed their estate tax laws in response to the 2001 legislation, and each state has adopted its own peculiar law. One might say that there are fifty ways to leave your lover⁵. If you own property in more than one state, the interaction of the applicable state laws is not predictable without studying the specific statutes. Therefore your plan should be reviewed if you have property in more than one state.

In addition, you should also note that the changes to the Illinois estate tax make lifetime gifts more attractive, at least if you agree with me that the estate tax will not be permanently repealed. Aggregate lifetime gifts over \$1,000,000 (the lifetime gift tax exclusion) will be subject to federal gift tax, but there is no Illinois gift tax. Thus the combined tax rate on lifetime gifts will generally be less than the combined tax rate on gifts at death. Further, lifetime gifts have always been cheaper, because no gift tax is imposed on the money used to pay the gift tax, and the gift tax money is removed from your estate for estate tax purposes, if you survive the payment of the gift tax by at least three years. In contrast, estate tax is imposed on the entire estate at death, including the money that could be used to pay the estate tax.

As the Eagles sing, "How did things ever get this crazy?"⁶ The estate tax has not yet been repealed (except, prospectively, for a one-year period during 2010) and keeps getting more complicated. The problem, in my view, is the lack of honesty in tax policy. Congress wanted to take credit for "repealing" the "Death Tax," but did not want to make the spending cuts to replace the decreased revenues that would result. Thus we ended up with absurd legislation that, if not amended, will repeal the estate tax only for 2010.

Congress also wanted to take credit for cutting estate tax rates, but didn't want to cut federal revenues. So Congress cut nominal estate tax rates by cutting out the states' share of estate tax revenues. The Beatles knew that a lover who closed his pocketbook and failed to ask his beloved out was going to lose that girl⁷, so it should be no surprise to Congress that the states are going their separate ways, effectively counteracting the impact of the "decreased" federal rates. It's a bit disingenuous for the federal government now to sing "she's leaving me because she really wants to."⁸

A greater degree of political honesty in dealing with the estate tax could help focus public debate on the real policy issues. Sooner or later, there "ain't no way to hide your lyin' eyes."⁹

by Susan T. Bart

Susan Bart is a partner in the Estate Planning & Private Clients Group of Sidley Austin Brown & Wood LLP. Sidley Austin Brown & Wood's Estate Planning & Private Clients lawyers provide comprehensive tax and estate planning advice to individuals, fiduciary counsel to banks, trust companies and financial services institutions and advice to charitable entities.

1
"He told you to try believing
He asked you to keep the faith
He took all that you were giving, as if it all were his to take.
Now it's the truth that won't let go.
Now it's the facts that you can't shake.
Now it's just time to tell him that you made a big mistake.
Maybe these final words will offer up a clue,
This is me leaving you, this is me leaving you.
This is me, baby, breaking us in two.
This is me leaving you."
"This is Me Leaving You," Mary Chapin Carpenter
Time*Sex*Love

2
"She's Gone," Daryl Hall and John Oates.

3
"Whenever You're Ready," Mary Chapin Carpenter.

4
"No Use in Crying," the Rolling Stones

5
"Fifty Ways to Leave Your Lover," Paul Simon.

6
"Lyin' Eyes," the Eagles.

7
"You're Going to Lose that Girl," the Beatles.

8
"Thank you my friend
I sincerely appreciate the words you say
About how she'll cry
And how she'll grieve and miss me
When she goes away . . .
No she won't be back
I'd be a fool to try to fool myself that way
I know she hasn't one regret
Because she hasn't had one since
The day she came to stay.
She's leaving me
Because she really wants to
And she'll be happy when she's gone
She'll be happy
She'll be so very happy
She'll dance and sing
And even learn to fly
And spend her time with anyone but me."
"She's Leaving Me Because She Really Wants To," Lyle Lovett

9
"You can't hide your lyin' eyes and your smile is a thin disguise
I thought by now you'd realize
There aint no way to hide your lyin' eyes."
"Lyin' Eyes," the Eagles

TABLE 6
MARGINAL ESTATE TAX BRACKETS
\$3,000,000 TAXABLE ESTATE

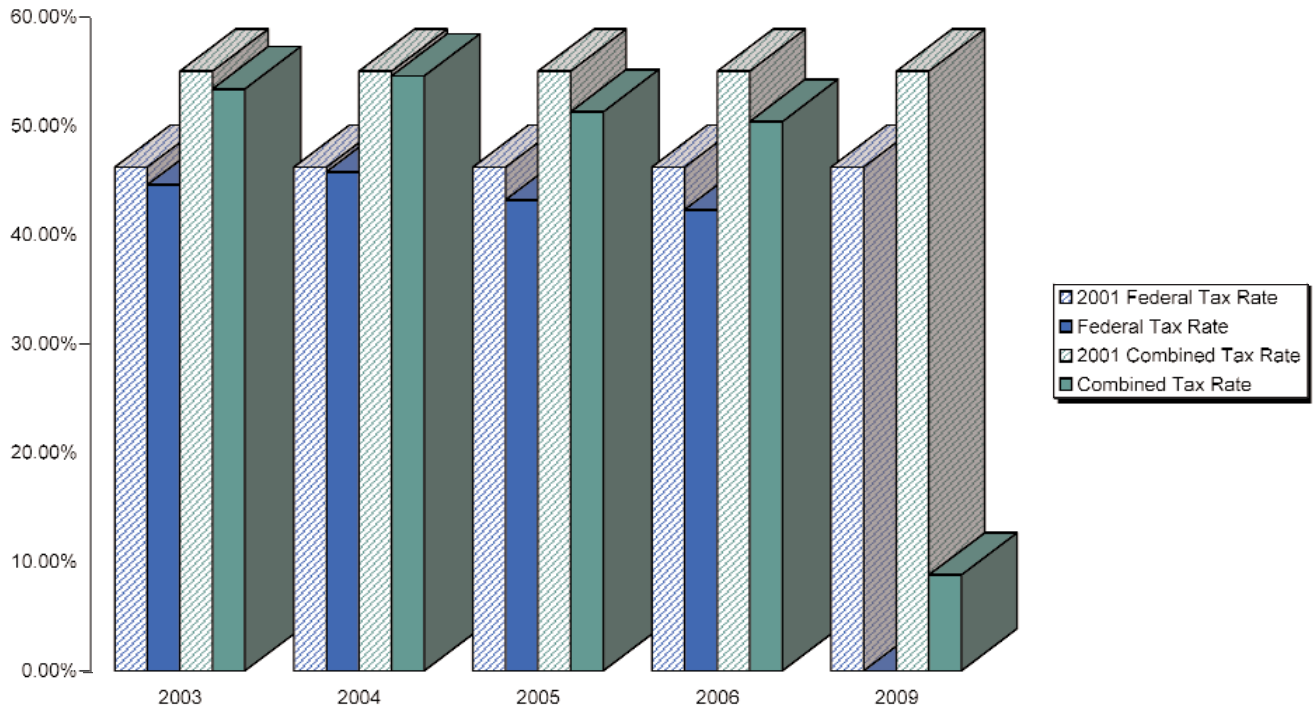


TABLE 7
ESTATE TAX
\$3,000,000 TAXABLE ESTATE

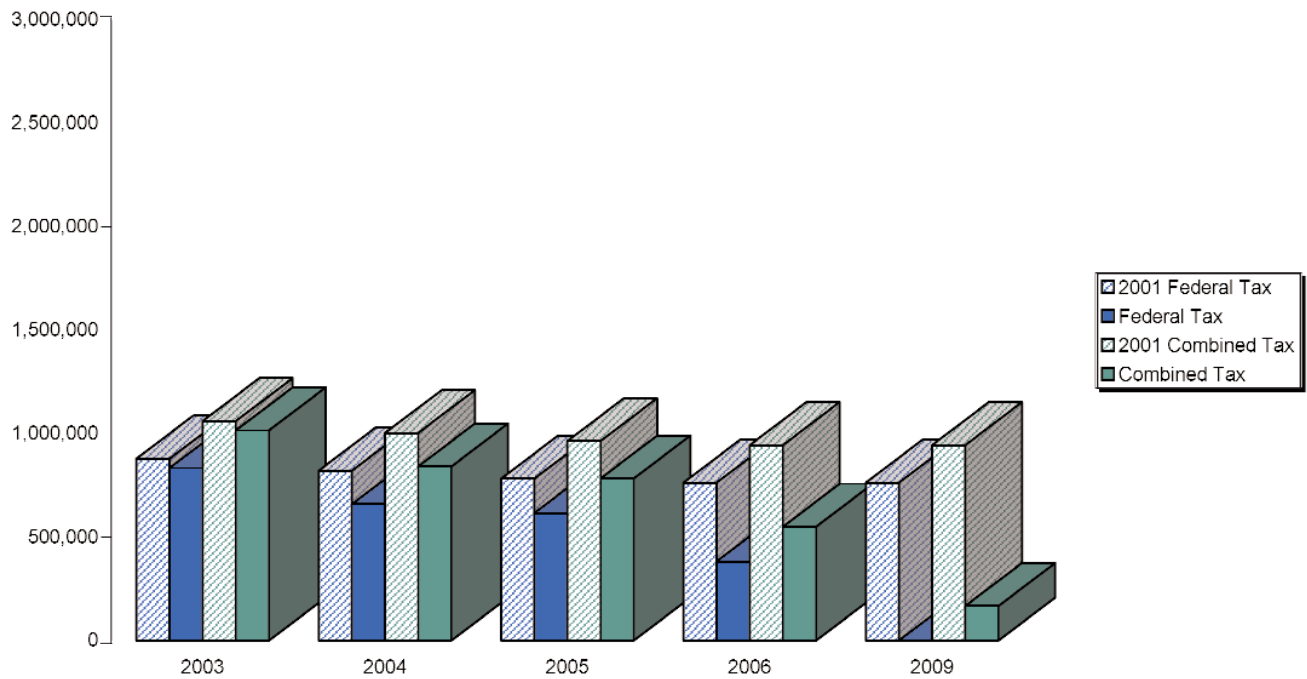


TABLE 8
MARGINAL ESTATE TAX BRACKETS
\$5,000,000 TAXABLE ESTATE

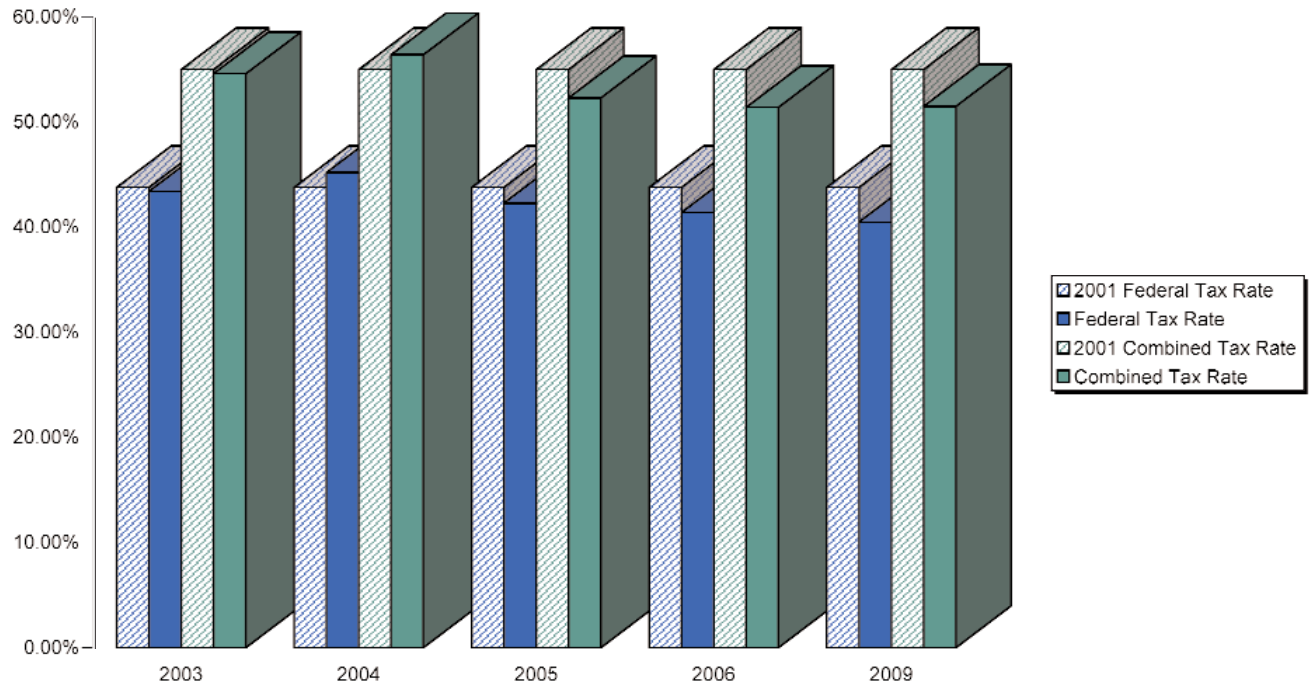


TABLE 9
ESTATE TAX
\$5,000,000 TAXABLE ESTATE

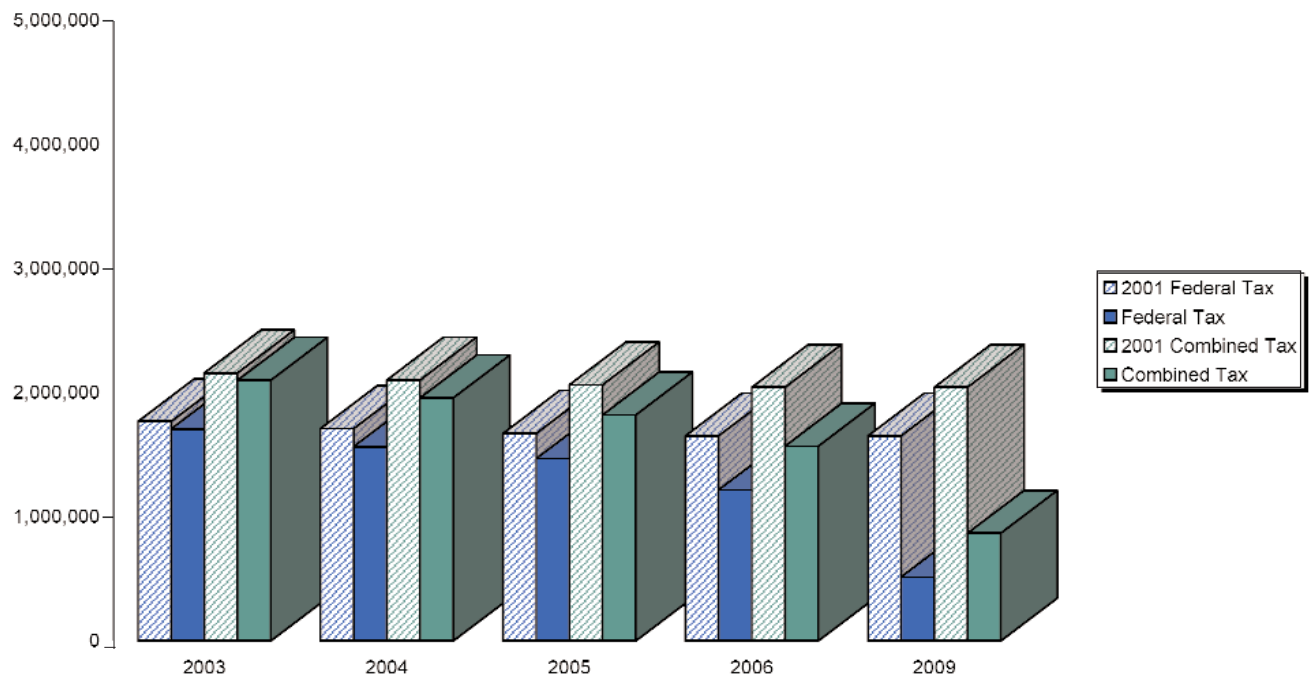


TABLE 10
MARGINAL ESTATE TAX BRACKETS
\$10,000,000 TAXABLE ESTATE

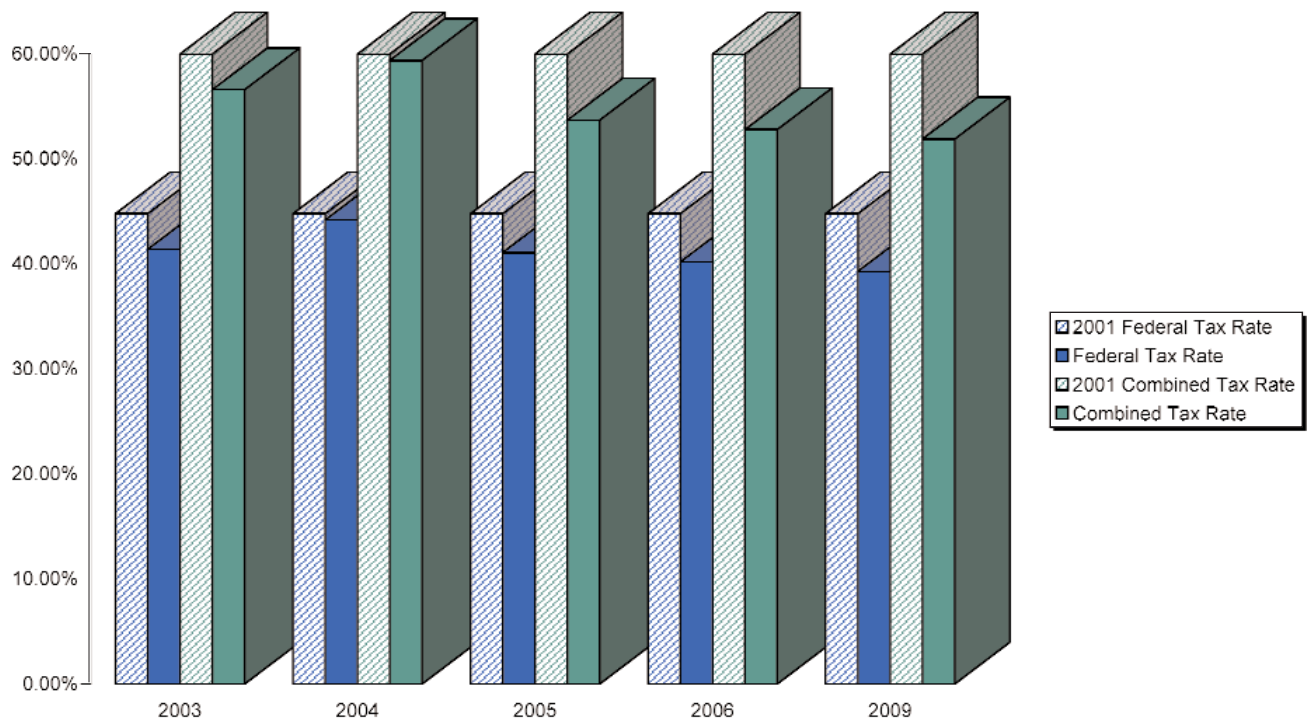


TABLE 11
ESTATE TAX
\$10,000,000 TAXABLE ESTATE

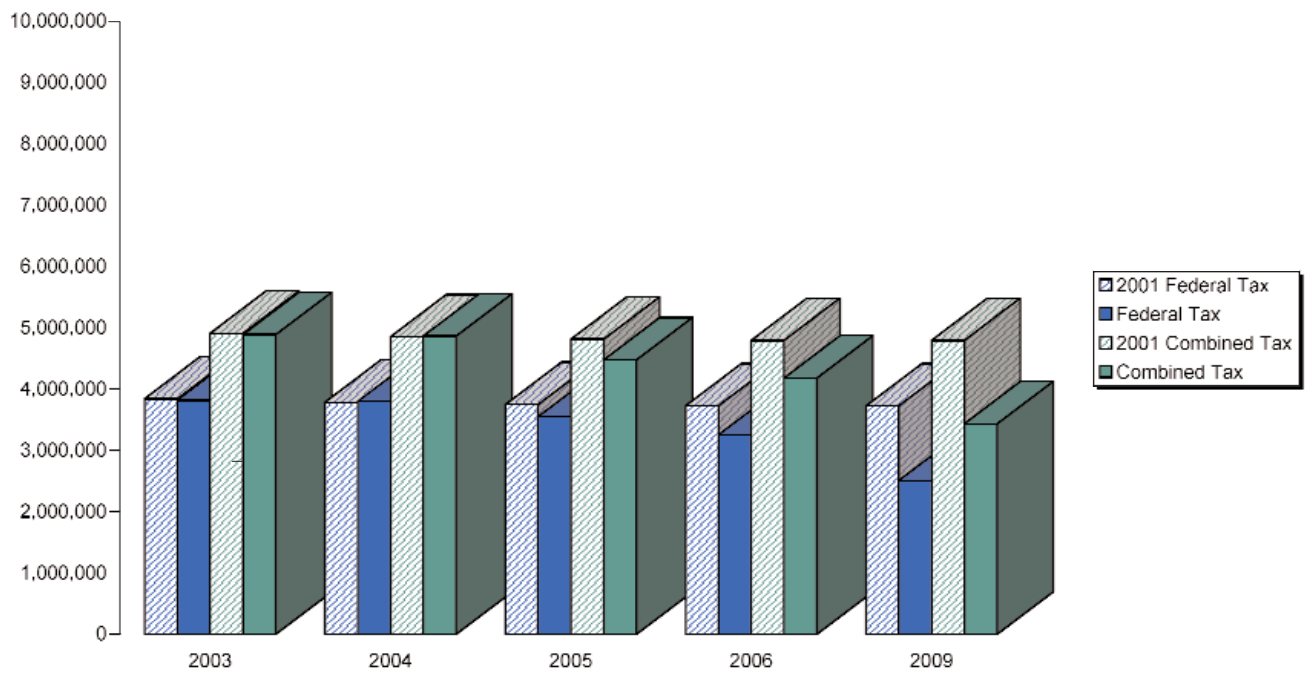


TABLE 12
MARGINAL ESTATE TAX BRACKETS
\$20,000,000 TAXABLE ESTATE

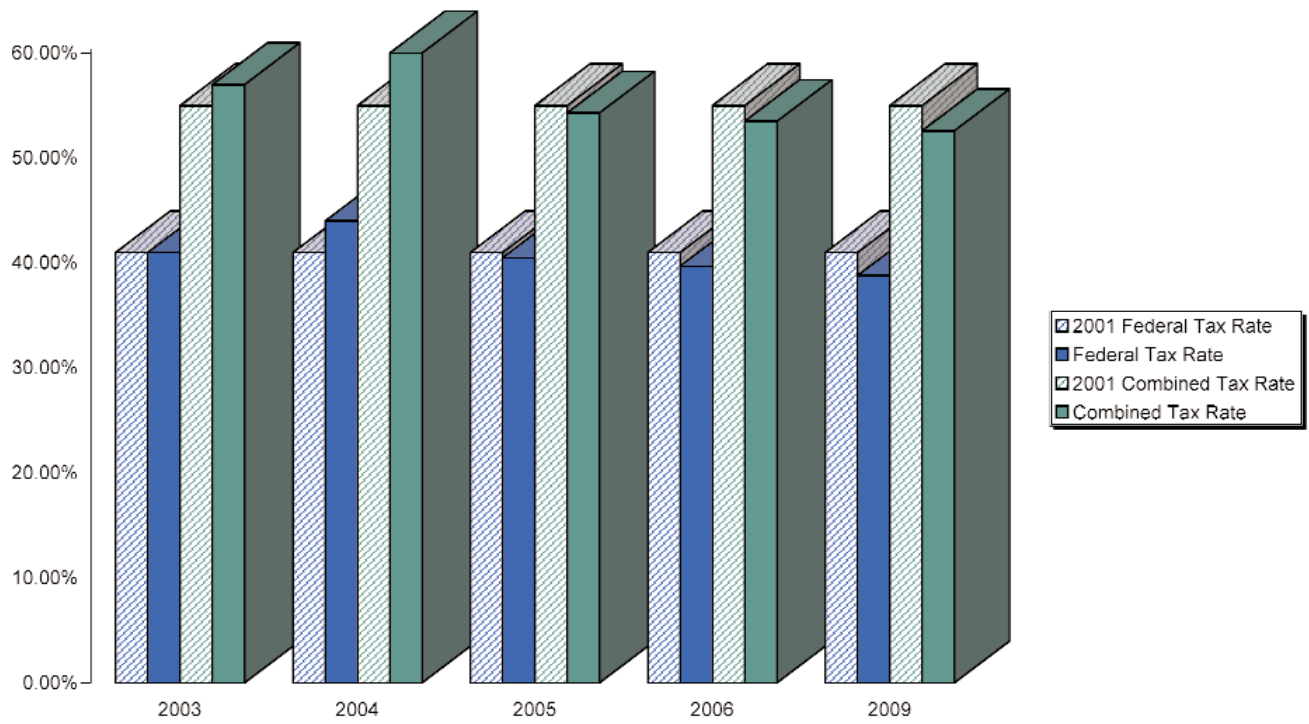
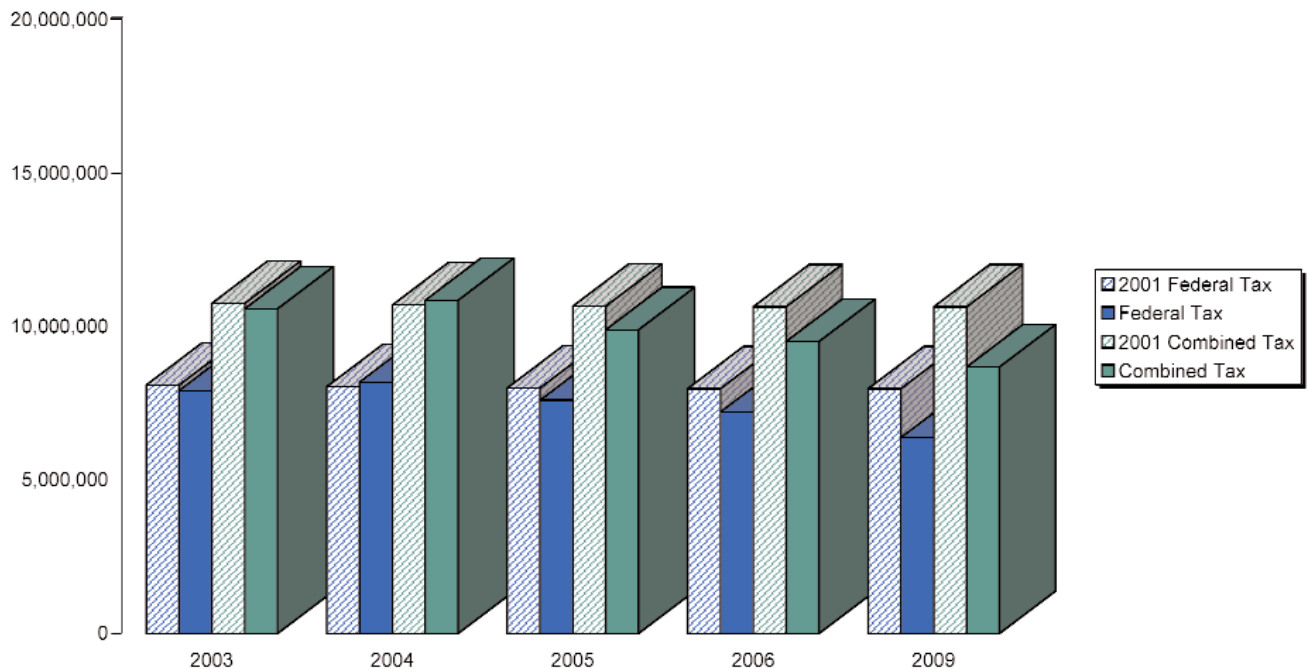


TABLE 13
ESTATE TAX
\$20,000,000 TAXABLE ESTATE



If you would like our assistance to consider and advise whether you need to take any action, please contact your Sidley Austin Brown & Wood LLP Estate Planning - Private Clients Group attorney.

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