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2014 Year-End Illinois Estate Planning: It's Time for a Careful Review

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As 2014 comes to a close, now is the perfect time for careful planning to **address the income, estate, gift and generation-skipping taxes that can directly affect you**. In addition to making sure your estate plan is up to date, making a few important decisions now can reduce your tax liability later.

Transfer Tax Exemption and GST Exemption

The exemption amount that individuals may transfer by gift and/or at death without being subject to federal transfer taxes increased in 2014 to $5,340,000; it will further increase to $5,430,000 in 2015. The maximum federal estate tax rate remains 40%. In contrast, Illinois imposes a state estate tax once a decedent's estate exceeds $4,000,000 (which is not adjusted for inflation). The rates of Illinois estate tax range from 8% to 16% (with the Illinois estate tax paid allowable as a deduction for federal estate tax purposes). Both the federal and Illinois estate tax laws allow for a marital deduction for assets passing outright to a spouse or to qualifying trusts for the benefit of a surviving spouse. Illinois allows this deduction to be claimed even if a marital deduction is not elected for federal purposes.

In order to impose a death tax at each successive generational level, a generation-skipping transfer ("GST") tax – equal to the highest estate tax rate – is assessed on transfers to grandchildren or more remote descendants. However, every taxpayer is also given a separate federal GST exemption equal to the federal transfer tax exemption (i.e., $5,340,000 in 2014 and $5,430,000 in 2015).

Estate planning documents should be reviewed to make certain that beneficial use of the federal and state transfer tax exemptions, federal and/or state marital deductions and federal GST exemption are being utilized.

Annual Exclusion Gifts

Making use of annual exclusion gifts remains one of the most powerful – and simplest – estate planning techniques. For 2014 (and 2015), individuals can make an unlimited number of gifts of up to $14,000 per recipient, per calendar year. Over a period of time, these gifts can result in substantial transfer tax savings, by removing both the gift itself and any income and growth from the donor's estate, without paying any gift tax or using any transfer tax exemption. An individual cannot carry-over unused annual exclusions from one year to the next. If such exclusions are not utilized by the end of the year, the balance of any annual exclusion gifts that could have been made for that year are lost. These transfers may also save overall income taxes for a family, when income-producing property is transferred to family members in lower income tax brackets (who are not subject to the "kiddie tax".)

Tuition and Medical Gifts

Individuals can make unlimited gifts on behalf of others by paying their tuition costs directly to the school or their medical expenses directly to the health care provider (including the payment of health insurance premiums).

Lifetime Utilization of New Transfer Tax Exemption

The ability to transfer $5,430,000 ($10,860,000 per married couple) – after annual exclusion and medical and tuition gifts, and without having to pay gift taxes – paves the way for many planning opportunities. When combined with valuation discounts and leveraging strategies (*e.g.,* family partnerships, sales to grantor trusts, grantor retained annuity trusts, etc.), tremendous amounts of wealth may pass for the benefit of many generations free of federal and Illinois transfer taxes. Lifetime gifts utilizing the exemption amounts will almost always result in overall transfer tax savings (unless the assets which have been transferred decline in value). The main reason is the removal of the income and growth on the gifted assets from the taxable estate.

For individuals who fully used their transfer tax exemptions in prior years, consideration should be given to making gifts of the additional inflation adjusted amount (i.e., the $90,000 increase in the transfer tax exemption from 2013 to 2014, and an additional $90,000 increase in the exemption from 2014 to 2015).

Benefits of Acting Early. The main benefit of making gifts that utilize the transfer tax exemption is to remove from the taxable estate the income and appreciation on those assets from the date of the gift to the date of death. The sooner the gifts are made, the more likely that additional income and growth on such assets will escape taxation.

Gifts in Trust. Despite the tax savings, many individuals are uneasy about making outright gifts to their descendants. Such concerns are usually addressed by structuring the gifts in trust, which allows the donor to determine how the assets will be used and when the descendants will receive the funds. The use of gift trusts can also provide the beneficiaries with a level of creditor protection (including protection from a divorcing spouse) and additional transfer tax leverage. This is particularly effective when coupled with applying GST exemption to the trust (discussed above) and making the trust a "grantor trust" for income tax purposes (discussed below).

Many individuals may not be comfortable giving away significant amounts of wealth. However, the gift trust technique is not limited to trusts for descendants, but may also include a spouse as a beneficiary (or as the sole primary beneficiary). Making the spouse a beneficiary of a gift trust (generally referred to as a spousal lifetime access trust, or "SLAT") provides indirect access to the trust assets, while allowing the income and growth to accumulate in the trust (if not otherwise needed), and pass free of estate and gift taxes.

One of the most powerful estate planning strategies is the utilization of a "grantor trust." Significant additional transfer tax benefits can be obtained by structuring a gift trust as a "grantor trust" for income tax purposes. The creator (or "grantor") of a "grantor trust" is required to report and pay the tax on the income earned by the trust. This allows the grantor to pass additional funds to the trust beneficiaries free of gift and estate taxes and income taxes, as the grantor's payment of the trust's income taxes each year would be considered his or her legal obligation and would not be considered additional gifts.

Taxable Gifts

Although individuals generally dislike paying taxes, making taxable gifts and paying a gift tax may prove to be beneficial. While the federal government imposes a 40% estate tax on taxable estates and a corresponding 40% gift tax on taxable gifts, Illinois does not impose a gift tax. Thus, taxable gifts result in an overall savings of state estate and gift tax. Moreover, the differing manner in which the gift and estate taxes are computed and paid results in overall transfer tax savings.

The gift and estate tax, although "unified," work quite differently. The estate tax is "tax inclusive:" the tax is determined based upon the assets owned at death, and paid from those assets (similar to the income tax, which "after tax" dollars must be used to pay the tax). However, the gift tax is "tax exclusive:" the gift tax is determined based on the assets gifted, and paid from other assets owned by the donor. As an example, if you previously used your transfer tax exemption and then make a $1,000,000 gift you would incur a $400,000 gift tax, $1,400,000 will be removed from your estate, and the donees will receive $1,000,000. However, if you die without making the $1,000,000 gift, you would have the full $1,400,000 included in your estate, resulting in approximately $676,000 of federal and Illinois estate taxes, leaving only $724,000 rather than $1,000,000 for your descendants. In order to leave $1,000,000 for your descendants at death you would need approximately $1,934,000. The estate tax on such amount would be approximately $934,667, leaving $1,000,000 for your descendants. Stated another way, by gifting assets the IRS gets 40¢ for each $1.00 your beneficiaries receive, but by dying with the assets the IRS gets 93¢ for each $1.00 your beneficiaries receive. However, there are also potential downsides: paying a tax earlier than otherwise may be needed, the possibility that the estate tax may be repealed or the rates reduced, the loss of income/growth on assets used to pay the gift tax, the possibility that the transfer tax exemption may be increased which would have allowed the gifts to pass tax free, etc.

Making Use of Historically Low Interest Rates

Interest rates remain very low (with increases likely on the horizon). The current (and historically low) interest rates continue to create an environment ripe for estate planning and transferring wealth to descendants on a tax-advantaged basis. Techniques such as grantor retained annuity trusts ("GRATs"), charitable lead trusts ("CLTs"), intra-family loans (bearing the minimal interest in order to avoid a gift of 0.39% for loans of 3 years or less, 1.90% for loans of 3 to 9 years, and 2.91% for loans of 9 years or more as of November 2014), and sales to "grantor trusts" are sensitive to interest rate changes – and are very beneficial in a low interest rate environment.

Illinois QTIP

Given the disparity between the $5,340,000 federal estate tax exemption and the $4,000,000 Illinois estate tax exemption, married couples domiciled in Illinois should make certain that their estate plans are structured to take advantage of the Illinois QTIP marital deduction. Otherwise, an estate plan that is designed to fully utilize the federal $5,340,000 exemption can inadvertently cause a $382,857 Illinois estate tax upon the death of the first spouse.

Net Investment Income (Medicare) Tax

Higher-income-earners should also plan for the 3.8% surtax on certain unearned income and the additional 0.9% Medicare tax that applies to individuals earning in excess of $200,000 ($250,000 for married couples filing jointly and $125,000 for married couples filing separately.) While the 0.9% additional tax on wages is only imposed on individuals, the 3.8% tax on net investment income is imposed on individuals, estates and trusts. Individuals are only subject to this new 3.8% Medicare tax if their "modified adjusted gross income" exceeds $250,000 for joint filers ($125,000 for a married individual filing a separate return) and $200,000 for single individuals. In 2014, trusts and estates are subject to this tax at a $12,150 threshold ($12,300 in 2015). The approach to minimizing or eliminating the 3.8% surtax depends on each taxpayer's individual situation. Some taxpayers should consider ways to minimize (*e.g.*, through deferral) additional net investment income for the balance of the year, while others should review whether they can reduce modified adjusted gross income other than unearned income. In contrast, others may want to accelerate net investment income and/or modified adjusted gross income that would be received next year so that it is included this year (*e.g.*, to take advantage of deductions this year). Year-end planning (such as timing the receipt of net investment income, the receipt of modified adjusted gross income and the payment of deductible expenses) can save significant taxes.

Retirement Plans and Beneficiary Designations

Contribution limitations for pension plan and other retirement accounts for 2015 were recently released by the IRS. The following adjustments were triggered by an increase in the cost-of-living index:

- Elective deferral contribution limits for employees who participate in a 401(k), 403(b) and 457(b) plans increased from $17,500 in 2014 to $18,000 in 2015.
- The catch-up contribution limit for employees (aged 50 or older) who participate in a 401(k), 403(b) and governmental 457(b) plans increased from $5,500 in 2014 to $6,000 in 2015.

The end of the year is a good time to review the beneficiary designations on your pension plan and other retirement accounts (as well as life insurance policies). Failing to name beneficiaries or keep designations current to reflect changing circumstances can create substantial difficulties and expense (both emotionally and financially) – and may lead to unintended estate, gift and income tax consequences. You should make certain to designate beneficiaries when participating in a new retirement plan and update beneficiary designations when circumstances dictate (*e.g*., death of a spouse). Finally, it is prudent to maintain a current list of accounts with beneficiary designations – which specifies the type of asset, account numbers, account custodians/administrators and beneficiaries designated for each account (primary and contingent).