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Federal and Illinois Law Update –

Is Time to Act Before the Sun Sets?

Dear Clients and Friends:

If Congress does not act by the end of this year, on January 1, 2013, the Federal estate and gift tax applicable exclusion amounts and tax rates (along with other tax rates and exemptions) will return to those in place in 2001.

Illinois, meanwhile, has passed new laws and regulations effective in 2012 impacting Illinois residents in different ways. First, Illinois has increased the amount that individuals may pass upon their deaths free of Illinois estate tax. Also, Illinois has adopted new regulations that restrict the availability of Medicaid benefits. The three articles in this newsletter cover what you need to know about these critical estate issues.

Federal Estate and Gift Tax – The Setting Sun

In 2012, as a result of an inflation adjustment provision, each person may make a total of $5,120,000 in cumulative lifetime 'taxable' gifts without paying gift tax (the "Federal gift tax applicable exclusion amount"). To the extent not used during one's lifetime, this exclusion amount may be used at death to exempt up to $5,120,000 from estate taxes (the "Federal estate tax applicable exclusion amount"). Taxable transfers in excess of $5,120,000 are subject to tax at a rate of 35%.

On January 1, 2013, however, the Federal gift and estate tax applicable exclusion amounts will automatically 'sunset' or return to their 2001 levels, with each dropping to a $1,000,000 applicable exclusion amount after which the top transfer tax rate will jump to 55% - unless action is taken by Congress and the President. The portability provision, which allows a surviving spouse to elect to take advantage of any unused portion of the Federal estate tax applicable exclusion amount of his or her predeceased spouse, is also scheduled to 'sunset' on January 1, 2013. **There is, therefore, a limited remaining window of opportunity to utilize the greater available Federal gift tax applicable exclusion amount before it lapses into the 'sunset'.**

In addition, legislation has been either submitted or suggested which, if adopted directly or as part of a 'compromise' package, would significantly reduce or eliminate the benefits of existing gift and estate tax saving strategies. These techniques include: 1) short-term **Grantor Retained Annuity Trusts (GRATs)** which allow significant amounts of future appreciation to be transferred with little

or no downside risk and 2) **valuation discounts** on interests in family limited partnerships. As this legislation has yet to be enacted into law, timely action is therefore of the essence in order to take advantage of these strategies so that they can be 'grandfathered'.

Alternatives for Capturing the Available Applicable Exclusion Amount in 2012:

In principle, the simplest means of taking advantage of the available Federal gift tax applicable exclusion amount before it "rolls back" is to make a lifetime gift equal to the available exclusion amount. In addition to assuring capture of the available exclusion amount, once the gift is completed, the value of the asset is frozen for estate tax purposes at the asset's value on the date of the gift, and all future appreciation is removed from the estate of the donor. **The planning and implementation of a specific gift strategy can sometimes take several months and, as such, the time to begin planning your 2012 gifts is now.**

Appropriate concerns when making large gifts include how to assure that the transferred assets are handled and managed in a responsible manner and how to provide for access to the transferred assets if a need arises in the future. In many instances, it is preferable that family wealth be managed for the benefit of children or grandchildren in a way that will not adversely impact family values and career motivation. Although there are a number of options available to address these issues, the most commonly employed vehicle is the creation of an irrevocable Gift Trust.

Irrevocable Gift Trust:

As the name suggests, a Gift Trust must be irrevocable to effectively remove the transferred property from the estate of the individual who establishes the Gift Trust (known as the "Grantor"). The right to access, control and distribute the transferred property will belong to the Trustee of the Gift Trust. For this reason, the Trustee that the Grantor names must be someone he or she believes will act responsibly with respect to the transferred property or an appropriate corporate trustee.

Additionally, a lifetime Gift Trust can take advantage of the added annual ability of each person to give $13,000 in value to any recipient in 2012 (the "Federal gift tax annual exclusion amount") without having to use any of the Grantor's $5,120,000 lifetime Federal gift tax applicable exclusion amount. Value equal to $13,000 times the number of trust beneficiaries ($26,000 times the number of trust beneficiaries for a married couple) can therefore be transferred to the Gift Trust before using any of the individual's $5,120,000 Federal gift tax applicable exclusion amount.

1. **Creative Gifts.** Utilizing the allowed maximum of the annual and lifetime exclusion amounts need not require transferring cash or other liquid assets to the Gift Trust. Gifts can include: (a) fractional or complete ownership of a primary or vacation residence or other real estate; (b) interest in a family limited partnership; or (c) life insurance, as discussed further below.

2. **Flexibility.** For a married couple, the Grantor can name his or her spouse as the Trustee, who can then have control over the management and distribution of the assets. The spouse can also be a beneficiary of the Gift Trust and can hold broad authority to alter trust provisions with respect to other beneficiaries. In this way, access to the trust assets can be assured in the event of an unanticipated need as well as the ability to adapt the trust to changes in family circumstances or in the tax laws. This type of trust is sometimes referred to as a 'Spousal Lifetime Access Trust' or 'Special Power of Appointment Trust' as it can be seen as providing **the best of two worlds – removing assets from the Grantor's taxable estate by taking advantage of the currently available Federal gift tax applicable exclusion amount while maintaining control over and access to the assets of the Gift Trust**.

   Another significant means of assuring flexibility in a Gift Trust is the designation of an independent third party (such as a relative who is not a trust beneficiary, a close friend or a trusted advisor) as a "Trust Protector". The Trust Protector can be given the authority to amend the provisions of the Gift Trust or to terminate the Gift Trust and distribute its assets among the beneficiaries.

3. **Income Tax Grantor Trust Status.** The Gift Trust will typically be drafted to be considered a "grantor trust" for Federal income tax purposes. This means that the Grantor will be responsible for including on his or her personal income tax return all trust income, even though the Grantor is not the beneficiary of the trust. While at first surprising, this arrangement is advantageous because it allows the assets in the Gift Trust, which are expected to be exempt from estate taxes, to appreciate on an essentially income tax-free basis. Stated differently, by requiring the Grantor to pay the income tax liability of the Gift Trust, the Grantor is effectively contributing to the Gift Trust the amount which the trust would have otherwise paid in income taxes without the payment being considered a gift to the trust.

4. **Other benefits of Gift Trusts.** There are other benefits which can be obtained through the creation of a well drafted Gift Trust. These can include:

   - **potential creditor protection** for the beneficiaries of the Gift Trust;
   - **exclusion of the transferred property – including future appreciation in value – from the estates of the beneficiaries** through use of the Grantor's generation-skipping transfer tax exemption (such a Gift Trust is often referred to as a 'Dynasty Trust'); and
   - **'leveraging' the gift** to maximize the amount being transferred through discounting or other techniques.

5. **Use of Gift Trust to Purchase Life Insurance.** The benefits of a Gift Trust may be expanded if the trust purchases insurance on the life of the Grantor (thereby using it as an Irrevocable Life Insurance Trust or 'ILIT'). The policy can be viewed as an investment vehicle during the life of the Grantor. Upon the death of the Grantor, the Irrevocable Life

Insurance Trust or ILIT would allow the Grantor's spouse, descendants or other beneficiaries to have access to the insurance proceeds while potentially protecting the proceeds from creditors and from inclusion in the taxable estates of the beneficiaries.

Other Strategies:

While beyond the scope of this newsletter, there are many other techniques for minimizing or avoiding gift and estate taxes, a number of which take advantage of the continuing extraordinarily low interest rate environment. These include:

- intra-family loans;
- installment sales to grantor trusts;
- GRATs;
- family limited partnerships and limited liability companies; and
- charitable planning strategies.

As explained above, however, congressional proposals, if passed, could significantly reduce or eliminate the benefits of a number of the above techniques. **We are experienced in these strategies and would welcome the opportunity to discuss how they could be of benefit to your specific circumstances before it is too late.**

Illinois Estate Tax Update

On December 16, 2011, Governor Quinn signed new estate tax legislation which increases the Illinois estate tax exclusion amount from $2,000,000 in 2011 to $3,500,000 in 2012 and then to $4,000,000 in 2013 and beyond. The differences between the Federal estate tax applicable exclusion amount and the Illinois exclusion amount will therefore continue to differ from year to year. This variation in exclusion amounts requires advanced planning in order to assure that BOTH the Illinois estate tax and the Federal estate tax are minimized or avoided.

Please contact our office if you would like to review whether your documents contain the necessary provisions to assure that the estate tax exclusion amounts afforded to you by Federal and Illinois statutes are fully utilized upon your death.

Illinois Medicaid Regulations

The Medicaid program is a jointly funded Federal and state program which provides, among other things, for the payment of nursing home care for qualifying applicants. Illinois began implementing changes to its Medicaid program on January 1, 2012, and these changes can significantly delay the timing of an applicant's qualification for Medicaid benefits.

Illinois Medicaid applicants are now required to report *all asset transfers* occurring during *the 60-month period* leading up to the application date. Additionally, the amounts of “non-allowable” transfers are combined to determine a single penalty period that does not *begin to run until the Medicaid application date*.

As a result, the new Illinois Medicaid regulations can severely delay access to Medicaid benefits. Advanced planning is vital to ensure that the penalty periods are avoided or limited to the extent possible.

The ‘Bottom Line’

We continue to urge our clients to follow the fundamental estate planning principles which have always guided our practice:

- **Plan based upon current laws, assuming the worst while hoping for the best.**
- **Allow for the greatest possible flexibility to address future changes in the tax laws, as well as in financial and family circumstances.**
- **Review planning regularly to assure that 1) estate planning documents accurately reflect present goals and wishes and 2) title to assets and beneficiary designations for insurance policies and retirement plan assets are correct and current.**

Kindest personal regards,

Rothman Law Group

Rothman Law Group is a Chicago-based law firm specializing in estate planning, business planning and trust and estate administration. We combine the most sophisticated planning techniques with the ability to find practical solutions to individual problems. Our legal expertise coupled with strong relationship skills enables us to effectuate our clients’ goals while providing tax and other cost-saving strategies.

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