BY ROBERT J. KOLASA

Wrapping Your Head Around the Illinois Estate Tax

Practitioners must master a confusing array of rules to advise clients on Illinois estate taxes.

FEDERAL ESTATE TAXES HAVE BEEN EFFECTIVELY REPEALED, AS THE CURRENT inflation-adjusted $11.4 million federal estate tax exclusion[1] ensures that most decedents will escape taxes from the IRS (keep in mind, the exclusion automatically sunsets to $5 million in 2026). But Illinois still sets the bar lower, taxing estates worth more than $4 million. Estate planners know that while an online tax calculator uses only a few variables to churn out one's precise Illinois estate tax, the math underling the tax is befuddling and widely misunderstood. This article explains the peculiarities of the Illinois estate tax and the subsequent and considerable changes in estate planning strategies.

The Illinois estate tax calculation

While the federal and Illinois estate calculations share similarities, they are different in many respects. Illinois' formula selects the *lower* of either: 1) the "2011 calculation" under former Section 2011 of the Internal Revenue Code ("IRC"); or 2) the "hypothetical tax" based on federal estate taxes reckoned with a $4 million estate tax exclusion amount.[2]

The 2011 calculation is grounded in the tax table of IRC Section 2011(b) that reflects graduated rates from .8 percent to 16 percent for taxable estates exceeding $100,000.[3] The table doesn't

1. The Tax Cuts and Jobs Act, Pub. L. No. 115-97 (amending IRC § 2010(c)(3)).
2. 35 ILCS 405/2.
3. IRC § 2011(b)(3).

ROBERT J. KOLASA *is an attorney and CPA in Lake Forest, Illinois. He holds an LL.M. in taxation from Georgetown University Law Center and before entering private practice was an attorney for the IRS Office of Chief Counsel in Washington, D.C.*

robert@kolasalaw.com

TAKEAWAYS >>

- The peculiarities of the Illinois estate tax and the confusing math underlying it require nuanced, cautious approaches to estate planning and gift giving.

- Traditionally, gifting is encouraged if there is a good chance the property's growth will exceed the appreciation hurdle: Tax benefits are realized because property growth over the appreciation hurdle produces estate tax savings greater than income tax costs due to the loss of a stepped-up basis. But making gifts to reduce estate taxes needs to be carefully examined, especially for clients who are not subject to federal estate taxes.

- To determine whether a gift of appreciated property is a good idea, weigh the loss of its stepped-up basis against the estate tax savings of the gift.

consider the $4 million estate tax exclusion used in the hypothetical tax, nor adjusted taxable gifts.

The hypothetical tax employs a $4 million estate tax exclusion computed under the federal rules. The calculation earns its "hypothetical" moniker because, other than being set much lower than the actual federal exclusion, the $4 million figure is arbitrary. The hypothetical tax is irrelevant for tentative taxable estates (the gross estate less deductions other than state estate taxes)[4] valued above $5,359,160, because for those estates a lower tax is produced under the 2011 calculation.

Under the 2011 calculation and hypothetical tax, "circular" calculations are required. Sinister as this sounds, the circular calculations are a necessary and good thing as they decrease the tax under both methods.[5]

The Illinois Attorney General's website contains an online calculator (the "Illinois calculator")[6] that computes the tax under both methods and then outputs the *lower* of these numbers to arrive at the proper measure of Illinois estate taxes. An anomaly in the output is that the hypothetical tax is not shown for estates exceeding $5,359,160, presumably because the 2011 calculation is always lower.

The output from the Illinois calculator for a $5 million tentative taxable estate reflects 21 trial computations (multiple trials are needed for the circular calculations). Trials one through seven produce the 2011 calculation of $352,158. Trials eight through 21 produce the hypothetical tax of $285,714, which constitutes the Illinois estate tax since it is the lower of the two methods. The calculator's answer for a $6 million estate shows eight trials under the 2011 calculation, resulting in Illinois estate taxes of $456,071.

4. IRS Form 706, page 1, line 3a.
5. IRC § 2058 creates the circular calculation.
6. Illinoisattorneygeneral.gov/publications/estatetax.html (last visited May 21, 2019); see also Eileen B. Trost, *Understanding the Illinois Estate Tax*, IICLE 56th Annual Estate Planning Short Course (Apr.-May, 2013) at 2, for an algebraic formula.

Table 1: Illinois estate tax rates

Tentative taxable estate (TTE)	Estate taxes	Rate over $4 million	Rate over last $1 million	Rate over TTE
$4,000,000	$0	$0	0%	0%
$5,000,000	$285,714	28.57%	28.57%	5.71%
$5,360,000*	$388,417	28.56%	28.56%	7.25%
$6,000,000	$456,071	22.80%	17.04%	7.60%
$7,000,000	$565,603	18.85%	10.95%	8.08%
$8,000,000	$680,634	17.02%	11.50%	8.51%
$9,000,000	$801,049	16.02%	12.04%	8.90%
$10,000,000	$926,923	15.45%	12.59%	9.27%
$15,000,000	$1,609,310	14.63%	13.79%	10.73%
$20,000,000	$2,298,965	14.37%	13.79%	11.49%

*For estates above this level, only the 2011 calculation is used.

FOR THOSE SUBJECT TO ILLINOIS ESTATE TAXES, GIFTS OF CASH (OR OTHER HIGH-BASIS ASSETS) CAN BE A PRODUCTIVE PLANNING STRATEGY. CONSIDER ALSO, IF A DONOR IS INCAPACITATED, THE UNDERLYING TRUST OR PROPERTY POWER OF ATTORNEY MUST AUTHORIZE SUCH GIFTS. OTHERWISE, A GUARDIANSHIP PETITION TO MAKE GIFTS CAN BE PURSUED.

Table 2: Effect of gifts on Illinois estate taxes*

Tentative taxable estate (TTE)	Adjusted taxable gifts	TTE plus adjusted taxable gifts	Illinois estate taxes	Overall tax savings
$8,000,000	$0	$8,000,000	$680,634	N/A
$7,000,000	$1,000,000	$8,000,000	$565,603	$115,031
$6,000,000	$2,000,000	$8,000,000	$456,071	$224,563
$4,000,000	$4,000,000	$8,000,000	$253,986	$426,648
$2,000,000	$6,000,000	$8,000,000	$92,910	$587,724
$0	$8,000,000	$8,000,000	$0	$680,634

*No federal estate taxes.

Table 1 ("Illinois estate tax rates") reflects the Illinois estate tax rates for estates worth $4 million to $20 million without federal estate taxes. The table shows the regressive nature of the Illinois estate tax, since estates under $6 million pay higher incremental taxes than larger estates. For planning purposes, the difference between the incremental estate tax rate and income tax rate is a major factor.

Illinois estate taxes and gifts

The two input fields on the Illinois calculator are the "Illinois Tentative Taxable Estate" and the "Illinois Tentative Taxable Estate Plus Adjusted Taxable Gifts." The second field acts like a tripwire. If the amount you enter there is greater than $4 million, Illinois estate taxes are due. The confusing part is that while adjusted taxable gifts are counted to determine if the tripwire is crossed, for estates over $5,359,160 the tax is based on the 2011 calculation that excludes such gifts.

For estates worth more than $5,359,160, gifts can dramatically lower Illinois estate taxes because, while gifts are included in determining whether the $4 million tripwire is crossed, they are excluded from the 2011 calculation. This can be seen in Table 2 ("Effect of gifts on Illinois estate taxes"), which presents gift scenarios for an $8 million estate. (Gifts for estates under $5,359,160 are still productive, except that larger gifts are needed to produce the same reduction of Illinois estate taxes compared with estates above this level.[7])

The figures from Table 2 clearly show that Illinois estate taxes are substantially lowered by making gifts. So why isn't this done all the time? Two reasons.

First, clients are often reluctant to make gifts because they may need such assets later.

Second, if property gifts are not made, the property is includible in the gross estate and, under IRC Section 1014(a)(1), receives a "stepped-up" basis equal to the value of the property at the date of death. This means the predeath appreciation relating to the includible property escapes income taxation. A cash gift, on the other hand, doesn't receive any stepped-up basis (its basis is already set at fair-market value) and would lower Illinois estate taxes without the detrimental loss of a stepped-up basis. For those subject to Illinois estate taxes, gifts of cash (or other high-basis assets) can be a productive planning strategy. Consider also, if a donor is incapacitated, the underlying trust or property power of attorney must authorize such gifts. Otherwise, a guardianship petition to make gifts can be pursued.[8]

Calculating the benefits of gifting property

To determine whether a gift of appreciated property is a good idea, weigh the loss of its stepped-up basis against the estate tax savings of the gift. Table 3 ("Illinois estate tax savings from a $1 million gift") illustrates the effects of a $1 million gift in cash or in appreciated property.

Under Table 3, the family is better off by $115,031 with a $1 million cash gift

ISBA RESOURCES >>

- Dennis J. Jacknewitz, *Estate and Income Planning Tips and Checklists*, Trusts & Estates (Apr. 2019), law.isba.org/2YRm6HJ.
- Sherwin D. Abrams, *Who Owns the Decedent's Real Estate?*, Trusts & Estates (Apr. 2019), law.isba.org/2VWENbl.
- Robert W. Kaufman, *The Illinois Estate Tax: The Surprise Continues*, Trusts & Estates (Feb. 2018), law.isba.org/2w94Kdl.

7. Trost, *supra* note 6, at 6; see also David A. Handler, *Incorporating the Tax Basis Planning in the Estate Plan and Counterintuitive Estate Planning*, 45th Annual Louis Susman Memorial Tax Seminar (Oct. 2, 2017) at 33-36.
8. 755 ILCS 5/11a-18(a-5).

(column 2); better off by $43,781 with a $1 million property gift having $300,000 of appreciation (column 4); no better or worse off with the property gift having $484,341 of appreciation (column 5); and worse off by $51,219 with the property gift having $700,000 of appreciation (column 6).

The above analysis presumes the donor dies immediately after the property is sold ("deemed sale"). The $484,341 amount of appreciation (column 5) constitutes the economic break-even point ("appreciation hurdle"), where estate tax savings equals the increased income taxes incurred from no stepped-up basis. This point is calculated by dividing estate tax savings by the projected income tax rate.[9]

Do gifts still make sense?

Gifts are tax efficient if estate tax savings exceed extra income taxes due to the loss of a stepped-up basis (Table 3, columns 2 and 4). But should gifts be made when extra income taxes from the deemed sale are initially greater than estate tax savings? The traditional analysis, which presumes federal estate taxes at the survivor's death, encourages gifting if there is a good chance the property's growth will exceed the appreciation hurdle. When this happens, tax benefits are realized because property growth over the appreciation hurdle produces estate tax savings greater than income tax costs due to the loss of a stepped-up basis.

Without federal estate taxes, the analysis becomes topsy-turvy—incremental Illinois estate tax rates in many scenarios will be lower than income tax rates (this is especially true for estates worth more than $5 million). A sort of negative appreciation hurdle exists because growth in the gifted property makes the donor's family poorer due to the Illinois estate tax/income tax rate differential (versus if the gift was never made). Under Table 3, the family is $43,781 better off making a $1 million gift of property with $300,000 of built-in appreciation (column 4). Yet, if the same property grows $400,000 before the donor's death, the savings are eliminated.

Do the math

Making gifts to reduce estate taxes needs to be carefully examined, especially for clients who are not subject to federal estate taxes. For these clients, appreciation (both before and after a gift) can be a negative factor. Gifts that are "winners" (Table 3, column 4) under the deemed-sale analysis probably should continue to be made unless the projected post-gift appreciation makes the numbers unpalatable. But gifts that are "losers" under the analysis—when pre-gift gains already exceed the appreciation hurdle (Table 3, column 6)—should probably not be pursued in the first place because any growth usually adds to the overall tax loss. However, gifts reducing Illinois estate taxes are sometimes desirable—irrespective of the loss of a stepped-up basis—if the property will not be sold for a long time or the liquidity benefits of lower estate taxes are deemed beneficial. The possibility of moving out of state or the repeal of the Illinois estate tax, which is more than just a topic of conversation in Illinois, also may discourage clients from making gifts altogether.

The analysis significantly changes if federal estate taxes are assumed at the death of the surviving spouse. If the property's appreciation surpasses the appreciation hurdle, the gift becomes productive.

9. See Joseph C. Mahon, *The TEA Factor*, Trusts and Estates 46 (Aug. 2011); Handler, *supra* note 7, at 12-17 (providing formulas calculating the Appreciation Hurdle for federal estate taxes only).

Table 3: Illinois estate tax savings of a $1 million gift*

	No Gift	Cash Gift	Gifts of property		
			$300,000 gain	**$484,341** gain**	**$700,000 gain**
Gift value	$0	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Tentative taxable estate after gifts	$8,000,000	$7,000,000	$7,000,000	$7,000,000	$7,000,000
Estate taxes	($680,634)	($565,603)	($565,603)	($565,603)	($565,603)
Income taxes on gain (23.75%)***	$0	$0	($71,250)	($115,031)	($166,250)
After-tax value	$7,319,366	$7,434,397	$7,363,147	$7,319,366	$7,268,147
Tax savings	$0 (baseline)	$115,031	$43,781	$0	($51,219)

*No federal estate taxes.

**$484,341 "appreciation hurdle" (Illinois estate tax savings = income-tax costs of no stepped-up basis).

*** 23.75 percent income-tax rate based on 15 percent capital-gains rate, plus 4.95 percent Illinois rate, plus 3.8 percent net-investment-income surtax. Higher income tax rates make gifting less productive due to the loss of a stepped-up basis.

Different assumptions regarding growth and tax rates can materially affect whether the appreciation hurdle is exceeded and what the corresponding tax benefits will be. As the final arbiter of risk, a practitioner should make these projections based on reasonable assumptions communicated to the client.

Credit shelter trust strategies

The credit shelter trust (CST) is a staple of estate planning used to preserve the first-to-die's estate tax exclusion from becoming wasted. CST planning has become less popular with the introduction of estate tax portability under IRC Section 2010(c), which magically preserves the first-to-die's unused federal exclusion for the surviving spouse.

Since there is no portability of Illinois estate taxes, planners for larger estates often recommend funding the CST up to $4 million to preserve the entire Illinois exclusion. While this practice is generally meritorious, CST underfunding in an environment without federal estate taxes can be productive if there is enough growth in the assets retained by the survivor. A variation of the appreciation hurdle analysis assists in determining whether CST underfunding makes sense.

Table 4 (column 1) shows that with no federal estate taxes, $470,852 of extra Illinois estate taxes are incurred by underfunding the CST at zero assets (column 1) versus funding at the baseline $4 million amount (column 3). Under this funding plan, a 49.56 percent growth of the $4 million of assets retained by the surviving spouse must occur (the appreciation hurdle of $1,982,535) for the family to be better off. With 50 percent CST funding at $2 million, the unfunded $2 million must appreciate more than 47.28 percent to achieve tax savings. This analysis defies conventional wisdom that funding of the CST at $4 million is always optimal. (A different way to get the same result involves funding the CST with $4 million combined with forcing estate inclusion of appreciated assets in the survivor's estate. See the next section for more on this approach.)

The $4 million threshold

The decision to fund the CST with less than $4 million is similar to betting on the growth of gifts to decrease estate taxes discussed above. A multitude of factors can affect the analysis, such as the age of the surviving spouse, projected growth and tax rates, whether the spouse will die an Illinois resident, and whether the Illinois estate tax will be repealed. As in the case of gifting, the analysis is flipped if federal estate taxes are assumed. If appreciated assets retained by the surviving spouse (versus CST funding) are subject to both federal and Illinois estate taxes, the family is typically less prosperous because incremental estate taxes will exceed the income taxes saved by a stepped-up basis.

Does it ever make sense to overfund the CST with more than $4 million and incur Illinois estate taxes at the first death? Illinois estate taxes paid at the first death are favorably excluded from the survivor's estate tax base, but this is offset by multiple run-ups at the expensive $4 million-to-$6 million bracket. Table 4 (columns 4-6) shows that extra Illinois estate taxes are generally incurred by CST overfunding above the $4 million baseline.

Table 4: Credit shelter trust (CST) funding strategies*

	CST underfunding		$4M CST baseline	CST overfunding		
Marital trust included in survivor's estate	$10,000,000	$8,000,000	$6,000,000	$4,714,286**	$3,543,929**	$1,319,366**
CST	$0	$2,000,000	$4,000,000	$5,000,000	$6,000,000	$8,000,000
CST (underfunding) & overfunding	($4,000,000)	($2,000,000)	$0	$1,000,000	$2,000,000	$4,000,000
Illinois estate taxes (first to die)	$0	$0	$0	$285,714	$456,071	$680,634
Illinois estate taxes (survivor's death)	$926,923	$680,634	$456,071	$204,082	$0	$0
Total estate taxes	$926,923	$680,634	$456,071	$489,796	$456,071	$680,634
"Extra" taxes over $4M CST baseline	$470,852	$224,563	N/A	$33,725	$0	$224,563
Appreciation hurdle***	$1,982,535	$945,528	N/A	N/A	N/A	N/A
Hurdle rate****	49.56%	47.28%				

*No federal estate taxes.
**Marital trust is reduced by Illinois estate taxes.
***Extra Illinois estate taxes divided by presumed 23.75 percent income tax rate.
****Appreciation hurdle divided by underfunded CST amount.

Without federal estate taxes, this scheme seems to be a bad choice because the loss of a stepped-up basis for appreciating CST assets will usually increase overall taxes. With federal estate taxes, CSTs funded in excess of $4 million (the "gap amount") can result in tax savings as appreciation on such excess escapes the federal estate tax net. Making the Illinois QTIP election[10] on the gap amount defers Illinois estate taxes until the death of the surviving spouse. But paying Illinois estate taxes and not making the Illinois QTIP election can be worthwhile if there is sufficient growth of gap amount assets.

CST funding decisions are closely linked to the size of the taxable estate. For larger estates with assets of more than $8 million, full $4-million-CST funding levels are generally desirable (unless, as discussed, the CST is underfunded with the anticipation of an Illinois exodus, Illinois estate tax repeal, or substantial growth without federal estate taxes). For smaller estates, the CST amount should be calibrated to achieve optimal estate and income tax savings. Of course, the calibration is in the eye of the beholder. One funding scheme for a $5 million estate would be to fund a $1 million CST and hope that growth in the surviving spouse's assets will be nominal. But projected growth may merit higher CST funding.

Forcing estate tax inclusion of CST assets

The unused federal estate tax exclusion available to the surviving spouse constitutes a "basis coupon" for CST assets. Planning techniques forcing estate tax inclusion of appreciated CST assets in the survivor's estate are useful when the income tax benefit of a stepped-up basis beats incremental estate tax costs. Common ways to achieve estate tax inclusion include outright distribution of property to the spouse, the Delaware tax trap, formula general powers of appointment, and trust protectors granting general powers of appointment over CST assets.[11]

For jurisdictions without state estate taxes, the math is simple when federal estate taxes are unlikely. In such circumstance, it makes sense to redeem the basis coupon by forcing estate tax inclusion of appreciated CST assets. The income tax benefit of a stepped-up basis will always exceed zero estate tax costs.

Unfortunately, Illinoisans are at a disadvantage compared with their peers living in jurisdictions without state-level estate taxes. Forcing inclusion of CST assets may trigger Illinois estate taxes if an Illinois tentative taxable estate plus adjusted taxable gifts exceed the $4 million tripwire. But all is not lost, since the favorable arbitrage between income- and Illinois estate tax rates makes this an attractive planning strategy.

For estates worth more than $5 million, Table 1 shows that Illinois incremental estate tax rates are often lower than individual income tax rates. For example, a $5 million estate is subject to a 17.04 percent incremental rate for the next $1 million of assets; a $6 million estate is subject to a 10.95 percent incremental rate. With available unused federal exclusion, why not force estate tax inclusion in the estate of the surviving spouse when the income tax savings of a stepped-up basis exceeds incremental Illinois estate tax costs? The idea can be a home run for appreciated assets taxed at high ordinary income tax rates, which makes the benefit of a stepped-up basis more valuable.

Conclusion

When computing Illinois estate taxes, the two independent calculations can be difficult to understand, but by exploring the differential between estate tax and income tax rates, you may be able to present more options for clients considering making gifts, funding CSTs, and forcing estate tax inclusion of CST assets. IBJ

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10. 35 ILCS 405/2(b-1).

11. See, *e.g.*, Steve R. Akers, *Estate Planning Current Developments and Hot Topics*, at pp. 89-99 (Jan. 10, 2019), *available at* http://www.bessemertrust.com/portal/site/Advisor; Edwin P. Morrow III, *The Optimal Basis Increase and Income Tax Efficiency Trust*, at pp. 18-80 (revised Apr. 28, 2018), *available at* https://ssrn.com/abstract=2436964.

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