Federal and Illinois Estate Tax Laws Under the Obama Administration

by Robert J. Kolasa

The following is a summary of materials presented at the Wills, Trusts & Probate Committee's annual seminar held on November 21, 2008.

Background

Much has been conjectured about the 2008 election and the future course of the estate and gift tax regimen. By way of background, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("2001 Tax Act")[1] in concert with corresponding Illinois legislation crafted the following bizarre "seesaw" series of estate tax exclusions:

Tax Year	Federal Estate Tax Exclusion Amount	Illinois Estate Tax Exclusion Amount
2008	$2,000,000	$2,000,000
2009	$3,500,000	$2,000,000
2010	*Estate Tax Repealed*	*Estate Tax Repealed*
2011	$1,000,000	$1,000,000

Thus, the incident of estate taxation is seemingly dependent upon what year the client passes to his or her greater reward. For those of a thrifty and economical nature, 2010 is the best year to give up the ghost and benefit family members, because in that year estate taxes are repealed leaving the entire inheritance untainted by estate taxes. Jokes which are funny only to tax lawyers have abounded that 2010 indeed is the year to "Throw Grandma from the Train," presuming of course the covering of one's murderous exploits to avoid the "Slayer Statute" of 755 ILCS 5/2-6 (which disgorges one's inheritance if the donee intentionally causes the death of the donor).

The above schedule of cascading estate tax exclusions was always viewed by both proponents and opponents of estate tax repeal as mere hogwash. No one in the "know," especially the Republican majority which passed the 2001 Act, really expected the estate tax exclusion to plummet back to $1 million. The magical return of the $1 million exclusion amount in 2011 was a budgetary ploy to dramatically reduce the cost of the 2001 Tax Act. Many conservative pundits wrongly foresaw that given continued prosperity and budget surpluses (remember those?), a future vote making estate tax repeal permanent would be a foregone conclusion.

Unfortunately, the events of September 11, 2001, and uncontrolled Federal spending made the reality of estate tax repeal politically and fiscally impractical. The many who thought that permanent estate tax repeal was a possibility when the 2001 Act was passed begrudgingly accepted that the best that could be done was the passage of a "high" estate tax exclusion amount. However, while numerous pieces of estate tax reform bills were entertained by Congress in the last five years, no legislative proposal actually became law.

Contrary to popular belief, the Democrats (adopting Republican thinking) supported the relatively significant estate tax exclusion amount of $3.5 million. The political logjam was that the two great parties of our nation could not agree what the top marginal estate tax rate (currently 45%) would be. In simplistic terms, the Republicans wanted lower estate tax rates (15% to 20%), while the Democrats wanted higher rates (maintaining the 45%

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1. Pub. L. No. 107-16 (June 7, 2001).

rate, or some downstroking to a top marginal 35% rate). Efforts to bridge the difference (i.e., the 45% rate would only apply to estates over $25 million) ultimately failed, leading to a tax policy stalemate lasting up to Mr. Obama's inaugural day.

The "Winning" Obama Position on Estate Tax Reforms

Predictably, Senators Obama's and McCain's positions on estate tax reform were remarkably similar and mirrored the divisions of their parties relating to the estate tax rates:

	Federal Estate Tax Exclusion Amount	Top Tax Rate
OBAMA	$3,500,000	45%
MCCAIN	$5,000,000	15%

Since Mr. Obama ultimately won the 2008 Presidential Election, it is reasonably certain that the $3.5 million Federal Estate Tax Exclusion Amount will be made permanent in 2009. Presumably, the top 45% estate tax rate will be maintained, as well as the current $1 million gift tax exclusion amount.

While the ultimate goal of estate tax repeal will certainly not be reached by the new legislation, in reality the Federal estate tax (with a $3.5 million exclusion amount) has effectively been repealed. Statistically, a minuscule percentage of taxpayers will accumulate assets exceeding this threshold, thereby making estate taxes a burden only for the wealthier members of our society.

The Illinois Estate Tax Riddle

Prior to the 2001 Tax Act, Illinois automatically received a portion of Federal estate taxes collected via the Code Section 2011 state death credit. Such credit under the 2001 Tax Act was phased out in 2005. The prospects of losing its rightful share of tax revenues forced Illinois and many other states (in a process known as "decoupling") to pass new state estate tax laws. Consequently, the Illinois Act was amended in 2003[2] to provide that Illinois estate taxes are still based on the repealed Section 2011 credit, using a $2 million estate tax exclusion amount for 2009.

For years after 2009, an intriguing observation is that under the mechanics of the Illinois statute, the Illinois estate tax will be *repealed* if the Federal estate tax exclusion (as expected) is frozen at $3.5 million. Accordingly, the Illinois legislature would then have to act affirmatively to reinstate the Illinois estate tax. In Illinois' current austere fiscal environment, the potential repeal of Illinois estate taxes seems doubtful, but one never knows. Witness the phase-out of the Wisconsin estate tax in 2008, when its legislature failed to pass affirmative estate tax legislation.

The new rules mean that in 2009, Illinois taxpayers are faced with the odd reality of a Federal estate tax exclusion amount of $3.5 million, paired with a $2 million exclusion amount for Illinois estate taxes. Unless changed by legislation, this means that in 2009 a decedent's estate between $2 million and $3.5 million may pay Illinois estate taxes, but no Federal estate taxes. As discussed

2. PA 93-0030 (June 20, 2003), amending 35 ILCS 405/2, -3, -5, -6, -7, -8 and –10. Generally see Susan T. Bart, *This Is Me Leaving You: Illinois Departs from the Federal Estate Tax Scheme*, 92 Ill. Bar J. 20 (January 2004).

above, for future years the result depends on what Federal and Illinois estate tax changes are made.

The 2009 "mismatch" of the Federal and Illinois exclusion amounts makes estate tax planning for married couples extremely challenging. If the surviving spouse will eventually be subject to Federal estate taxes, the family most probably will be better off paying the much lower Illinois estate tax at the first death. In practical terms this means funding the credit shelter trust at $3.5 million, which incurs $209,124 of Illinois estate taxes on the $1.5 million exceeding the Illinois exclusion (the benefit is that such $1.5 million will not ever be subject to the much higher Federal estate tax).

For planning purposes, it is cautioned that nothing substitutes for "crunching the numbers" to determine if it is beneficial to incur Illinois estate taxes as the price to pay for utilizing the full Federal $3.5 million exclusion amount. Presented at the seminar were various charts indicating that it generally does not make sense to fully fund the credit shelter trust at $3.5 million, if total combined assets are less than $5 million. This result was reversed if total combined assets exceed $7 million.

If Illinois legislation does not solve the problem, all is not lost ...

Many practitioners are hoping that the Illinois legislature will pass the proposed "Illinois QTIP" legislation,[3] which (if it ever becomes law) would allow the credit shelter trust to be funded at $3.5 million without Illinois estate tax. The qualifying condition is that the $1.5 million differential be held in a marital trust subject to Illinois estate tax upon the death of the surviving spouse.

If Illinois legislation does not solve the problem, all is not lost as existing drafting techniques may successfully deal with the mismatched Federal ($3.5 million) and Illinois ($2 million) exclusion amounts. If successfully implemented, the following techniques generally allow for post-mortem planning to control "how much" of the credit shelter trust is funded upon the death of the first spouse to die: (i) Disclaimer Trusts; (ii) Single Fund QTIP Trusts; (iii) Clayton QTIP Trusts; (iv) Family/Marital Trusts, with funding language granting the residuary Marital Trust with the "smallest amount" to reduce both Federal and state estate

3. See Katarinna McBride, *The Delayed QTIP: The Illinois Wait-n-See*, Vol. 54, No. 3 ISBA Trusts & Estates newsletter (December 2007); Robert Iverson, *Push Comes to Shove*, Vol. 54, No. 5 ISBA Trusts & Estates newsletter (April 2008); Ray J. Koenig III and Amy Jo Smith, *Trust and Estates Council Legislative Update*, Vol. 54, No. 5 ISBA Trusts & Estates newsletter (April 2008).

taxes to zero. Given the relatively high estate tax exclusion amounts and the collective disdain of many clients to prepay estate taxes, in most cases these methods should generate $2 million credit shelter trusts and zero estate taxes, with the option of increasing the credit shelter trust to $3.5 million (and generating Illinois estate taxes), if that is the correct tax choice.

A gifting strategy is also helpful to lower overall estate taxes and assist clients in utilizing the different Federal and Illinois exclusion amounts.[4] For example, a $1 million lifetime gift of cash or high basis assets to an intervivos credit shelter trust combined with a $2 million testamentary credit shelter trust could utilize the $2 million Illinois exclusion and $3 million of the Federal exclusion, with a reduced Illinois estate tax of $92,910 (versus $167,279 if a $3 million credit shelter trust was funded at death). Furthermore, a $1 million intervivos gift could be combined with a $2.5 million testamentary credit shelter trust generating Illinois estate taxes of $128,518 (versus $209,124 if a $3.5 million credit shelter trust was funded at death). Similar to the analysis in the above paragraph, if the surviving spouse will eventually be subject to Federal estate taxes, the family will probably be better off paying Illinois estate taxes (at the first death) as the price to pay for having assets escape the much higher 45% Federal estate tax rate (at the surviving spouse's death).

A dangerous malpractice trap is that many existing Family/Marital Trusts contain language granting the residuary Marital Trust the "smallest amount" to reduce Federal estate taxes to zero (thereby allowing state estate taxes to be incurred). This funding directive would require that the credit shelter trust be funded at $3.5 million, thereby generating $209,124 of Illinois estate taxes, which may be an avoidable tax for smaller estates. A possible solution would be that if the Family Trust names only the surviving spouse as beneficiary,[5] a "partial" QTIP election[6] prevents this situation from occurring (effectively $1.5 million of the credit shelter trust is converted to a marital deduction). In order to forgo this difficult problem, it is highly recommended that practitioners review all previously drafted Family/Marital Trust estate plans to ensure that needless estate taxes (and liability) will not be triggered.

The Fantastic World of Estate Tax Portability

Both Senators Obama and McCain have supported the idea of estate tax portability. This highly laudable concept revolves around allowing the surviving spouse to use the "wasted" estate tax exclusion of the first to die.

For example, under classical estate planning, a married couple worth $7 million would be advised to establish separate $3.5 million credit shelter trusts for both husband and wife. This is to avoid "wasting" the estate tax exclusion upon the first to die (i.e., if assets are held jointly everything passes to the surviving spouse and the first-to-die's estate tax exclusions are not utilized). This is no small matter as the missed estate tax exclusions would most probably cost the family at least $1,575,000[7] in additional estate taxes upon the death of the surviving spouse.

4. Robert J. Kolasa, *How to Use Gifts to Reduce Illinois Estate Taxes*, 96 Ill. Bar J. 580 (November 2008).
5. If the Family Trust names beneficiaries other than the surviving spouse, such beneficiaries may be able to disclaim their interest in the Family Trust, thereby allowing the surviving spouse to make the partial QTIP election and avoid Illinois estate taxes. Of course, effective disinheritance may be seen as too high a price to pay to avoid Illinois estate taxes. The ultimate solution may be a malpractice suit against the drafting attorney.
6. Internal Revenue Code Section 2056(b)(7).
7. $3.5 million times avoidable 45% Federal estate tax rate, *in addition* to additional Illinois estate taxes incurred upon the death of the surviving spouse. This analysis presumes a static $3.5 Federal exclusion amount and no decrease of assets upon the death of the surviving spouse. If the size of the credit shelter trust grows, the estate tax savings would be higher.

Estate tax portability would allow the surviving spouse to utilize the first-to-die's "wasted" estate tax exclusion amount. Thus, if $7 million of joint assets passed to the surviving spouse, he or she would also have $7 million in combined Federal estate tax exclusions. Thus, the goal of optimally utilizing each spouse's estate tax exclusion amount is accomplished without the difficult "splitting up" of assets among the respective trusts of a married couple.

Estate planning will be simplified with the Obama administration's expected push for a permanent Federal $3.5 million estate tax exclusion amount.

The results of portability are nothing less than revolutionary in the field of estate planning. Many surviving spouses would no longer fall prey to avoidable estate taxes which are incurred by not splitting up assets. At the same time, there may be a perceived lack of the "value added" received by going to qualified estate planners in the first place (by some clients, at least). This would be a mistake, as estate tax planning is only one of the many arrows in the quiver that an estate planner brings to the table. What about probate avoidance, succession planning, charitable giving and the perennially difficult task of drafting estate plans to transfer assets to the younger generation in a productive and worthwhile manner?

Indeed, even with estate tax portability, traditional estate planning would still be suitable for larger estates as a fully funded $3.5 million credit shelter trust exempts the future *appreciation* on such assets from Federal estate taxes (while such appreciation remains in the estate tax base if such trust is not funded). Additionally, while estate tax portability is a distinct possibility on the Federal side, nothing suggests that Illinois would adopt this concept. Thus, the traditional splitting of assets between husband and wife may be continued for Illinois estate tax avoidance whether or not Federal savings would also follow.

Conclusion

Estate planning will be simplified with the Obama administration's expected push for a permanent Federal $3.5 million estate tax exclusion amount. However, the mismatch of the Illinois $2 million estate tax exclusion with the $3.5 Federal exclusion will create many challenges for estate planners to intelligently structure their clients' affairs. It is hoped that the Illinois legislature will pass the proposed "Illinois QTIP" legislation, which would allow the credit shelter trust to be funded with the Federal $3.5 million exclusion amount without incurring immediate Illinois estate tax. If the Federal exclusion is made permanent at $3.5 million, the Illinois legislature will have to act affirmatively in 2010 to avoid the repeal of Illinois estate taxes. Finally, the possible passage of estate tax portability may greatly simplify estate tax planning for married couples by permitting the surviving spouse to directly inherit marital assets without the loss of the first to die's Federal estate tax exclusion. ◊