Making Use of the Illinois Rules

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PART I: "REDUCING ILLINOIS ESTATE TAXES THROUGH LIFETIME GIFTS

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REDUCING ILLINOIS ESTATE TAXES THROUGH LIFETIME GIFTS

By Robert J. Kolasa

Introduction

The following outline discusses the advantages of making gifts to reduce Illinois estate taxes. The Illinois estate tax regimen (see 35 ILCS 405/2 et. seq.) is based on the repealed credit for state death taxes under Section 2011 of the Internal Revenue Code ("Code"), as taking into account the following estate tax exclusion amounts: $2 million for taxable year 2011; $3.5 million for taxable year 2012 and $4 million for 2013 and beyond.[1]

Under the Illinois statute and Code Section 2011(e), the Illinois estate tax is the lower of the following two independent calculations:

A. The Illinois estate tax computed under the state death tax table appearing in Code Section 2011(b) (the "2011 Table").

B. The "hypothetical" federal estate tax computed with the relevant Illinois estate tax exclusion amount.

Since the Illinois estate tax calculator (discussed below) has an input field for adjusted taxable gifts, most practitioners are not aware that such gifts may not count in the Illinois estate tax calculation. This is because the 2011 Table, which excludes taxable gifts from its tax base, in many cases constitutes the lower calculated amount (versus the hypothetical federal estate tax, which includes adjusted taxable gifts in its base).

Making gifts during a client's lifetime may permanently lower Illinois estate taxes for the client's family at death. However, the benefit of gifting needs to be balanced against the loss of stepped-up basis at death attributable to the carryover basis attribute of the gifted property. For taxpayers subject to Illinois estate taxes, it is certainly best to gift cash or highly appreciated assets to minimize the loss of stepped-up basis and maximize the advantages of Illinois estate tax savings. This outline will attempt to develop some guidelines on how to quantify the break-even point when the income tax detriment of the loss of stepped-up basis may outweigh the corresponding Illinois estate tax savings.

1. General Benefits of Making Gifts.

A tax motivation to make lifetime gifts is the removal of the post–gift appreciation from the donor's estate. This is due to the adjusted taxable gifts mechanism of Code Section 2001(b), which pulls back such gifts (at their date-of-gift transfer value) into the donor's gross estate, allowing the post-gift appreciation to be excluded. For example, if in 2010 a client used part of his applicable gift tax exclusion amount to gift $500,000 of property to family members and the value of such property has appreciated to $900,000 at the client's death in 2012, the $400,000 post-gift appreciation escapes estate taxation.[2] If the gifted property has not appreciated in value and stays flat, gifting may generate negative tax consequences due to the loss of stepped-up basis for such property. Gift discount planning combined with techniques accruing asset appreciation to the donee, such as family limited partnerships, gifts of fractional interests, GRATS, and sales to grantor trusts all work admirably to maximize assets excluded from the donor's tax base.

The estate tax benefit of giving is complimented by potential income tax savings attributable to the gifted property's income taxes passing to the donee, who may be in a lower marginal income tax bracket than the donor. Also, upon sale of the gifted property, the lower bracket donee may pay less tax (versus if such property was retained by the donor).[3]

A significant benefit of lifetime giving is that the gift tax calculation is "tax exclusive." This means that the gift tax is computed on the value of the transferred property, but only if the donor survives the gift by three years.[4] Contrast this with the estate tax which is "tax inclusive," whereby the estate tax is computed on the total value of the estate, including the assets from which the estate tax will be paid. Since gift taxes are not considered part of a gift, a larger amount can be transferred by making lifetime gifts rather than transfers at death. However, many clients (even if they can afford it) are reluctant to voluntarily pay a current gift tax and reap the rewards of the tax exclusive nature of making gifts, which is only possible once the unified estate and gift exclusion amount (currently $5,120,000) has been exhausted by prior gifts.

Other tax reasons for making gifts include the qualification under various provisions of the Internal Revenue Code which provide favored tax benefits if certain numerical requirements are obtained, which can be manipulated by skillful gifting. For example, see Code Sections 303, 2032A and 6166.

Non-tax reasons for gifting include assisting family members in immediate financial need; providing financial security for the donee; giving the donee experience in handling money and seeing the donee enjoy the property. For example, the desire for the orderly transfer of a family business to the younger generation, while involving tax issues, may also be largely motivated by non-tax reasons to educate the donee of the wisdom or operating and preserving this valuable asset.

2. **General Factors Discouraging Gifts.**

Many donors do not like the "loss of control" over the gifted property which is the natural consequence of making gifts. As a result, the natural temptation of the donor may be to ignore the fact that legal title has been transferred and to exert control over the property. Besides being legally incorrect, this is dangerous from an estate tax viewpoint because too much control may pull the gift back into the estate.[5]

It probably pays to advise a prospective donor that by definition a gift involves an irrevocable transfer to a donee which generally cannot be undone, even though the donor may be critical of the donor's use of the property, suffers an economic downturn, gets a divorce or just otherwise sees an alternative use for the gifted property in a new investment. Of course, some of these concerns can be mitigated by establishing structures to control the property with friendly fiduciaries. In the trust context, the donor may be able under specified conditions to act as trustee of the gifted property for the benefit of the donee, typically with trust distributions limited to an ascertainable standard and the donor having no obligation of support to trust beneficiaries.

Code Section 1014(a) generally provides that property includible in a decedent's estate receives a basis equal to the fair market value of the property at the decedent's date of death. This phenomenon is commonly referred to as "stepped-up" basis. A consequence of making a completed gift is that the gifted property is not includible in the decedent's estate thereby negating application of the stepped-up basis rule, generally meaning that the donee steps in the donor's shoes and receives a carryover basis under Code Section 1015(a).

The loss of stepped-up basis associated with gifting may offset the estate tax savings of a contemplated gift. The donor needs to balance the projected estate tax cost of excluding property from his or her estate, versus the higher income tax costs of carryover basis when the property is sold in the hands of the donee. The benefit of stepped-up basis becomes even more important if the property is ordinary income property, or is otherwise subject to a tax rate higher than the capital gain rates.

If a client is not subject to estate taxes, he or she may resist making gifts to family members, hoping to pass assets estate tax-free at death. Although there may still be non-tax reasons to gift, gifting by clients not subject to estate taxation may result in higher overall taxes because of the negative consequences of carryover basis. Likewise, the possibilities of estate tax repeal and running out of money, are other reasons which commonly discourage life time giving.

3. **The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.**

On June 7, 2001, President George W. Bush made good his campaign pledge and signed the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA").[6] Such legislation for tax years 2002-2009 slowly raised the federal estate tax exclusion amount from $675,000 to $3.5 million, culminating in the repeal of the federal estate tax in 2010 and the imposition of modified carryover basis rules under Code Section 1022. EGTRRA also provided for a bizarre "sunset" rule repealing itself in its entirety after December 31, 2010 "as if" such legislation "had never been enacted."[7] This would have meant that estate tax repeal (along with the other 2001 tax cuts) would magically expire in 2011, reverting to the pre-EGTRRA law.

After endless political intrigue, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Act")[8] became law on December 17, 2010. Under the 2010 Tax Act, the EGTRRA tax cuts were extended for two years through

December 31, 2012, with the following changes made to the estate, gift, and generation-skipping transfer tax system:[9]

1. A reduction in the estate, gift, and GST tax rates to 35%.

2. An increase in the estate tax exclusion amount and GST tax exemption to $5 million (accompanied by an election to opt out of the estate tax and into a modified carryover basis regime for 2010 decedents).

3. An increase in the gift tax applicable exclusion amount to $5 million, with a reunification of the estate and gift tax applicable exclusions (except that the gift tax exclusion was only $1 million in 2010).

4. Indexing of the estate and gift tax applicable exclusion amounts and the GST tax exemption for 2012.

5. An introduction to the concept of portability, which permits the estate of the second spouse to die to take advantage of the unused $5 million applicable exclusion amount of the first spouse to die for 2011 and 2012.

A practical maxim may be "what Congress gives may also be taken away." The 2010 Tax Act did not fully resolve EGTRRA's sunset rule which would have reinstated the $1 million estate and gift tax exclusion amounts in 2011. It simply replaced the date of "December 31, 2010" in the sunset provision with "December 31, 2012." Thus, the 2010 Tax Act was effectively a stopgap legislative effort to prevent the pre-EGTRRA tax laws from returning until 2013.

What happens after 2012 appears to be entirely unpredictable. There's a sense that "anything can happen," especially in light of the temporary (albeit elective) 2011 estate tax repeal, which few in the estate planning community actually thought would happen. Given the Democrats' preference for a $3.5 million exclusion during the negotiations leading up to the 2010 Tax Act (versus the Republicans' preference for a $5 million exclusion), it appears unlikely that the law will ever revert back to the pre-EGTRRA $1 million limits. At the same time, one just never knows what will actually happen, including a probable cascading stream of extensions kicking the can down the road for future legislatures. It should be an interesting ride.

4. **The New $5 Million Federal Gift Tax Exclusion Greatly Enhances Gift Planning. But does the "Clawback" Provision Spoil the Fun?**

The $5 million estate tax exclusion enacted by the 2010 Tax Act was somewhat predictable given the Republicans' well-publicized desire for this change. On the other hand, the escalation of the gift tax exclusion from $1 million to $5 million was totally unforeseen. Suddenly, estate planners had an extra $4 million of gift tax exclusion dropped into their clients' laps. This has turned out to be a boon to promote gifting strategies in 2011 and 2012, while such higher limits are still available before the EGTRRA sunset.

The current tax literature is replete with a "call to action" for estate planners to encourage clients to fully utilize their $5 million gift tax exclusion amounts. For wealthy clients, reducing estate taxes through lifetime gifts (with hopefully appreciating property) has always been a sound estate planning strategy. Gifting also dovetails exceptionally well to avoid Illinois estate taxes as will be demonstrated below.

The problem is what happens if a client made a $5 million gift allowed by the new legislation but then dies in 2013, when the estate tax exclusion amount may have reverted back to $1 million? Under the adjusted taxable gifts add-back, is the $5 million gift added back to his or her estate?[10] This situation is referred to as the "clawback" provision because it sinisterly converts prior year tax-free gifts into taxable gifts counted at death.

For single taxpayers, the issue increases the gross estate, but may not make a major negative difference, especially if the gift removed appreciation from the estate. However, for married couples the clawback rule potentially wreaks havoc. If applicable, it forces the first to die's estate to pay estate taxes relating to the difference between gifts made and the estate tax exclusion existing at the taxpayer's death (this difference being $4 million in the above example). Paying such an unexpected large estate tax liability on the first death could result in a very difficult conversation for the practitioner to have with the surviving spouse. Needless to say, if the IRS ever attempts to enforce the clawback, this would be an extremely unpopular move. Most planners are ignoring such provision and are rushing their clients to fully utilize the new enhanced gift tax exclusion while it is still available.

Most commentators who have examined the issue believe that there should not be any clawback in future years, even if the estate tax exclusion amount is reduced.[11] The prudent thing to do seems to advise the client of the possible application of the clawback rule during the initial planning stages. If this causes a few donors to sit on the fence and not engage in making large gifts, so be it. Simply put, these persons are not suitable prospects for significant giving strategies if they are reluctant to accept the underlying transactional risks.

5. **The Illinois Estate Tax - An Expensive Proposition.**

The top federal estate tax rate is currently 35% for 2011 and 2012. A current tax benefit is the deductibility of Illinois estate taxes in the federal estate tax computation (thereby diminishing the effective rate of the Illinois estate tax by 35%). Even with its deductibility, the separate Illinois estate tax increases overall estate taxes well above the top 35% federal rate for estates having estates over the Illinois estate tax exclusion amount ($2 million for 2011; $3.5 for 2012; and $4 million for 2013 and years thereafter). Table #1 (see Appendix A attached for detailed computations) shows the projected estate tax rates for 2011 through 2013:

Table #1: Projected Federal and Illinois Estate Tax Rates

	-1-		-2-		-3-	
Tentative Taxable Estate	**2011**		**2012**		**2013***	
	IL Rates over 2M	Fed & IL Rates over $5M	IL Rates over $3.5M	Fed & IL Rates over $5.12M	IL Rates over $4M	Fed & IL Rates over $5.24M
$2,000,000	N/A		**N/A**		**N/A**	
$2,500,000	**25.70%**		**N/A**		**N/A**	
$3,000,000	**16.73%**		**N/A**		**N/A**	
$4,000,000	**12.70%**		**25.93%**		**N/A**	
$5,000,000	**11.74%**		**23.48%**		**25.93%**	
$5,120,000	**11.67%**		**22.48%**		**25.93%**	
$5,240,000	**11.62%**		**21.63%**		**25.93%**	
$6,000,000		**64.64%**		**68.69%**		**74.01%**
$7,000,000		**53.38%**		**54.56%**		**55.89%**
$8,000,000		**49.75%**		**50.36%**		**51.03%**
$9,000,000		**48.02%**		**48.42%**		**48.85%**
$10,000,000		**47.05%**		**47.35%**		**47.66%**
$20,000,000		**44.96%**		**45.04%**		**45.12%**

*Presumes no EGTRRA sunset and a 2.4% inflation increase of exclusion to $5.24M

The point jumping out of Table #1 is that the combined Federal and Illinois estate tax rates for tentative taxable estates over $6 million actually increases from 2011 to 2013. How can this be since the Illinois estate tax exclusion has been increased (from its $2 million level in 2011, to $3.5 million in 2012 and $4 million in 2013)? Intuitively, it would seem that the marginal rates would be correspondingly lower taking into account the increased Illinois estate tax exclusion amounts.

The answer to the above riddle rests of what effectively is a dominant theme in this outline. That the Illinois estate tax formula is based on the lower of two independent calculations (i) the state death credit based on the 2011 Table, and (ii) the "hypothetical" federal estate tax computed under the relevant Illinois estate tax exclusion amount. Only the latter calculation takes into account the respective Illinois estate tax exclusions.

For the majority of estates over $3.5 million in 2012 and $4 million in 2013, the 2011 Table produces the lowest tax and is the default calculation to arrive at the Illinois estate tax. The $3.5 million and $4 million Illinois estate tax exclusion amounts are not taken into account in that calculation. In fact, such exclusion amounts only benefits those estates below or marginally above $3.5 million in 2012, and $4 million in 2013 and thereafter. In such cases, the "hypothetical federal estate tax" produces the lowest tax and is the default calculation to arrive at the Illinois estate tax. The ramifications of this rather confusing point for gifting purposes will be discussed more fully below.

Accordingly, the answer to the above dilemma of why the newly increased Illinois estate tax exclusion amounts ($3.5 million in 2012 and $4 million in 2013) do not reduce Illinois estate taxes for a $6 million tentative taxable estate is that such exclusions are meaningless in the 2011 Table calculation.

6. **The Illinois Estate Tax Calculation - A Complicated Recipe.**

A. The Statutory Language.

The initial definition of the Illinois estate tax seems simple enough. 35 ILCS 405/3 (c) provides in part, that:

> "For estates of persons dying on or after January 1, 2003, the amount of the Illinois estate tax shall be the state tax credit, as defined in Section 2 of this Act, reduced by the amount determined by multiplying the state tax credit with respect to the taxable transfer by the percentage which he gross value of the transferred property not having a tax situs in Illinois bears to the gross value of the total transferred property." (Emphasis added)

35 ILCS 405/2 goes on to define the aforesaid "state tax credit" as follows:

"State tax credit" means:

(b) For persons dying after December 31, 2005 and on or before December 31, 2009, and for persons dying after December 31, 2010, an amount equal to the full credit calculable under Section 2011 or 2604 of the Internal Revenue Code as the credit would have been computed and allowed under the Internal Revenue Code as in effect on December 31, 2001, without the reduction in the State Death Tax Credit as provided in Section 2011(b)(2) or the termination of the State Death Tax Credit as provided in

Section 2011(f) as enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001, but recognizing the exclusion amount of only (i) $2,000,000 for persons dying prior to January 1, 2012, (ii) $3,500,000 for persons dying on or after January 1, 2012 and prior to January 1, 2013, and (iii) $4,000,000 for persons dying on or after January 1, 2013, and with reduction to the adjusted taxable estate for any qualified terminable interest property election as defined in subsection (b-1) of this Section. (Emphasis added)

The net effect of the statutory language is that the Illinois estate tax calculation is based on the state death tax credit under Code Section 2011 existing on December 31, 2001, with the following modifications:

1. The "Hypothetical Estate Tax" Modification. The Illinois estate tax formula in the Code Section 2011(e) calculation (discussed below) uses the following estate tax exclusion amounts in a separate estate tax calculation:

   A. $2 million in 2011;

   B. $3.5 million in 2012; and

   C. $4 million in 2013 and future years.

   Note: This calculation is hereinafter referred to as the "Hypothetical Estate Tax" calculation because it requires a pro forma federal estate tax computation based on estate tax exclusions having no relevance other than for the purpose of the Illinois calculation.

2. Illinois QTIP Election Modification. The Illinois estate tax calculation takes into account any marital deduction for the Illinois QTIP election. Please refer to the second part of this presentation for a detailed discussion thereto.

3. The Circular Calculation Modifications. As will be discussed below, circular computations are needed in both the "Hypothetical Estate Tax" and "2011 Table" calculations.

7. Computing the Illinois Estate Tax. A Detailed Analysis.

STEP #1: COMPUTE THE "2011 TABLE" AMOUNT

The beginning point in the Illinois estate tax calculation is computing the state death tax credit under Code Section 2011. Prior to its repeal, the state death tax credit was the mechanical provision apportioning estate tax revenues between the United States Treasury and the various states the decedent was domiciled in, or owned real property.

The backbone of the state death tax credit under is the tax table ("2011 Table") appearing in Code Section 2011(b). This table reflects graduated tax rates from .8% to 16% on the adjusted taxable estate over $40,000 (the "adjusted taxable estate" is the taxable estate minus $60,000):

Table #2: The 2011 Table under Code Section 2011(b)

If the adjusted taxable estate is:		The maximum tax credit shall be:
Not over $90,000		8/10ths of 1% of the amount by which the adjusted taxable estate exceeds $40,000.
Over $90,000 but not over $140,000		$400 plus 1.6% over $90,000.
Over $140,000 but not over $240,000		$1,200 plus 2.4% over $140,000.
Over $240,000 but not over $440,000		$3,600 plus 3.2% over $240,000.
Over $440,000 but not over $640,000		$10,000 plus 4% over $440,000.
Over $640,000 but not over $840,000		$18,000 plus 4.8% over $640,000.
Over $840,000 but not over $1,040,000		$27,600 plus 5.6% over $840,000.
Over $1,040,000 but not over $1,540,000		$38,800 plus 6.4% over $1,040,000.
Over $1,540,000 but not over $2,040,000		$70,800 plus 7.2% over $1,540,000.
Over $2,040,000 but not over $2,540,000		$106,800 plus 8% over $2,040,000.
Over $2,540,000 but not over $3,040,000		$146,800 plus 8.8% over $2,540,000
Over $3,040,000 but not over $3,540,000		$190,800 plus 9.6% over $3,040,000.
Over $3,540,000 but not over $4,040,000		$238,800 plus 10.4% over $3,540,000.
Over $4,040,000 but not over $5,040,000		$290,800 plus 11.2% over $4,040,000.
Over $5,040,000 but not over $6,040,000		$402,800 plus 12% over $5,040,000.
Over $6,040,000 but not over $7,040,000		$522,800 plus 12.8% over $6,040,000.
Over $7,040,000 but not over $8,040,000		$650,800 plus 13.6% over $7,040,000.
Over $8,040,000 but not over $9,040,000		$786,800 plus 14.4% over $8,040,000.
Over $9,040,000 but not over $10,040,000		$930,800 plus 15.2% over $9,040,000.

If the adjusted taxable estate is:		The maximum tax credit shall be:
Over $10,040,000		$1,082,800 plus 16% over $10,040,000.

As previously noted, the 2011 Tax Table calculates a number which does not take into account the federal or Illinois estate tax exclusion amounts. The various federal and Illinois estate tax exclusion amounts are meaningless in the calculation.[12] Furthermore, as will be discussed in the context of gifting, the 2011 Tax Table does not take into account inter vivos gifts made during the client's lifetime.[13] This presents important planning opportunities on how to use gifts to reduce Illinois estate taxes.[14]

STEP #2: CALCULATE THE 2011TABLE AMOUNT

The 2011 Table introduces what at first seems to first be a fairly mechanical computation. For example, the 2011 Table amount for a $10,000,000 adjusted taxable estate would be $1,076,720 ($930,800, plus 15.2% of the excess over $9,040,000).

However, the 2011 Table tax for Illinois estate tax purposes for a $10 million adjusted taxable estate is $934,653 (not $1,076,720). What accounts for the $142,067 difference? The answer is that a "circular calculation" is needed to calculate the 2011 Table amount. This is because Code Section 2058 provides a deduction for state death taxes, which reduces the adjusted taxable estate which reduces the Illinois tax, which again reduces the adjusted taxable estate, and so on, until the calculation ends after 8 to 15 repetitions.

Table #3 illustrates the 2011 Table circular calculation in taxable year 2012 for a $10,060,000 tentative taxable estate:

Table #3: The "2011 Table" Circular Calculation

	-1	-2	-3	-4
	($10,060,000 less prior Col. #4) **Tentative Taxable Estate**	**Adjustment**	**(Col. #1 less #2)** **2011 Table Amount**	**2011(b) Table Tax**
TRIAL 1	$10,060,000**	($60,000)	$10,000,000	$1,076,720
TRIAL 2	$8,983,280	($60,000)	$8,923,280	$913,992
TRIAL 3	$9,146,008	($60,000)	$9,086,008	$937,793

	-1	-2	-3	-4
TRIAL 4	$9,122,207	($60,000)	$9,062,207	$934,175
TRIAL 5	$9,125,825	($60,000)	$9,065,825	$934,725
TRIAL 6	$9,125,275	($60,000)	$9,065,275	$934,642
TRIAL 7	$9,125,358	($60,000)	$9,065,358	$934,654
TRIAL 8	$9,125,346	($60,000)	$9,065,346	$934,653
TRIAL 9	$9,125,347	($60,000)	$9,065,347	---------------- **$934,653** =========
2011 TABLE AMOUNT				**$934,653**

** Trial 1 calculation uses $10,060,000 as the initial amount.

Voila, by virtue of the circular computation, the Illinois Estate Tax is down stroked from $1,076,720 to $934,653, a $142,067 reduction.

STEP #3: COMPUTE THE "HYPOTHETICAL ESTATE TAX" AMOUNT

The Illinois estate tax statute directs the Illinois estate tax to be calculated on the basis of pre-EGTRRA Code Section 2011, taking into account a $2 million estate tax exclusion amount in 2011; a $3.5 million estate tax exclusion amount in 2012; and a $4 million estate tax exclusion amount in 2013 and future years (i.e., the "Hypothetical Estate Tax" calculation).

Mechanically, Code Section 2011(e) requires this separate calculation by providing that:

"(e) Limitation based on amount of tax
The credit provided by this section shall not exceed the amount of the tax imposed by section 2001, reduced by the amount of the unified credit provided by section 2010."

Under pre-EGTRRA law, the Section 2011(e) limitation made perfect sense as it dictated that the state death tax credit could not exceed federal estate taxes payable. However, for the same reasons existing with the 2011 Table calculation, a circular computation is also needed in the Hypothetical Estate tax calculation.

Table #4 illustrates the Hypothetical Estate Tax calculation in taxable year 2012 for a $10,060,000 tentative taxable estate:

Table #4: The "Hypothetical Estate Tax" Circular Calculation

	-1	**-2-**	**-3**	**-4**	**-5**
	Tentative Taxable Estate Plus Gifts	**Estate Tax Exclusion**	**Section 2058 Deduction**	**Net Amount**	**35% Federal Estate Tax**
TRIAL 1	$10,060,000	($3,500,000)	($934,653)**	$7,494,653	$2,623,129
TRIAL 2	$10,060,000	($3,500,000)	($2,623,129)	$3,936,871	$1,377,905
TRIAL 3	$10,060,000	($3,500,000)	($1,377,905)	$5,182,095	$1,813,733
TRIAL 4	$10,060,000	($3,500,000)	($1,813,733)	$4,746,267	$1,661,193
TRIAL 5	$10,060,000	($3,500,000)	($1,661,193)	$4,898,807	$1,714,582
TRIAL 6	$10,060,000	($3,500,000)	($1,714,582)	$4,845,418	$1,695,896
TRIAL 7	$10,060,000	($3,500,000)	($1,695,896)	$4,864,104	$1,702,436
TRIAL 8	$10,060,000	($3,500,000)	($1,702,436)	$4,857,564	$1,700,147
TRIAL 9	$10,060,000	($3,500,000)	($1,700,147)	$4,859,853	$1,700,948
TRIAL 10	$10,060,000	($3,500,000)	($1,700,948)	$4,859,052	$1,700,668
TRIAL 11	$10,060,000	($3,500,000)	($1,700,668)	$4,859,332	$1,700,766
TRIAL 12	$10,060,000	($3,500,000)	($1,700,766)	$4,859,234	$1,700,732
TRIAL 13	$10,060,000	($3,500,000)	($1,700,732)	$4,859,268	$1,700,744
TRIAL 14	$10,060,000	($3,500,000)	($1,700,744)	$4,859,256	$1,700,740

	-1	-2-	-3	-4	-5
TRIAL 15	$10,060,000	($3,500,000)	($1,700,740)	$4,859,260	**-------------** **$1,700,741** =========
HYPOTHETICAL ESTATE TAX AMOUNT					**$1,700,741**

**Trial 1 calculation uses the 2011 Table result as the initial Section 2058 deduction

Note that the Hypothetical Estate Tax calculation adds gifts to the tentative taxable estate to comprise its tax base. On the other hand, the 2011 Table only uses the tentative taxable estate in calculation. Since adjusted taxable gifts are <u>not</u> taken into account in the definition of tentative taxable estate, such gifts are excluded from the 2011 Table tax base. This omission presents important planning opportunities for gifting which will be discussed below.

STEP #4: <u>USE THE LOWER OF THE "HYPOTHETICAL ESTATE TAX" OR THE "2011 TABLE" AMOUNTS.</u>

Code Section 2011(e) places a ceiling on the amount of the state tax credit - the credit cannot exceed the Hypothetical Estate Tax. The means that twin calculations (the "2011 Table" and the "Hypothetical Estate Tax") must be made under Code Section 2011, with the <u>lower</u> of such calculation constituting the correct amount of Illinois estate taxes.

Accordingly, per the above calculations, for a $10,060,000 tentative taxable estate, the 2011 Table amount is **$934,653**, while the Hypothetical Estate Tax is **$1,700,741**. Accordingly, the Illinois estate tax is the <u>lower</u> of these two amounts, which is **$934,653.**

8. **The Attorney General's Illinois Estate Tax Calculator and the Input of Adjusted Taxable Gifts**.

As can be seen by the above discussion, the Illinois estate tax computation is a complicated affair. Happily for Illinois practitioners who do not have a doctorate in mathematics, the Illinois Attorney General's Web site contains an online calculator (the "Illinois Estate Tax Calculator") computing the aforesaid byzantine computations required to arrive at the correct amount of Illinois estate taxes.[15] A confusing aspect of the Illinois Estate Tax Calculator is that it tends to omit the Hypothetical Estate Tax calculation if the 2011 Table amount is the lower amount.

There are two input fields for the Illinois Estate Tax Calculator, each of which are readily available from the decedent's federal estate tax return (Form 706), if one has been prepared:

A. The "<u>Illinois Tentative Taxable Estate</u>**"** (the taxable estate for federal estate tax purposes, excluding the state death tax deduction and adjusted taxable gifts);

B. "<u>Illinois Tentative Taxable Estate Plus Adjusted Taxable Gifts</u>" ("adjusted taxable gifts" generally are the decedent's post 1976 gifts, excluding charitable and marital gifts, over the then existing gift tax exclusion amount, which for 2011 and 2012 is set at $13,000).

More than a few Illinois estate planners have wrongly concluded that adjusted taxable gifts will always increase Illinois estate taxes since the Illinois Estate Tax Calculator takes into account such gifts as an input field. While adjusted taxable gifts are added back to the tax base to determine if the Illinois estate tax "trip wire" is crossed (discussed below), the real answer is that in <u>many scenarios adjusted taxable gifts REDUCE Illinois estate taxes because such gifts are not counted the 2011 Table tax base</u>. Consequently, Illinois estate taxes are generally lower for most decedents who make adjusted taxable gifts, even if shortly before death, because such gifts are not taken into account.

9. **The Illinois Estate Tax "Trip Wire."**

The sum of the first and second input fields of the Illinois Estate Tax Calculator **(**Illinois Tentative Taxable Estate Plus Adjusted Taxable Gifts) can be viewed as "trip wire." If these input fields exceed the pertinent Illinois estate tax exclusion amount ($2 million for taxable year 2011; $3.5 million for taxable year 2012, and $4 million for 2013 and beyond), an Illinois estate tax is due.

The above concept breeds considerable confusion, as <u>adjusted taxable gifts may cause the Illinois estate tax to apply as the "trip wire" is crossed, yet the calculation of such tax often is based on the 2011 Table which excludes such gifts from its tax base and does not take into account the Illinois estate tax exclusion amounts</u>.

For example, a 2012 decedent having a $6 million taxable estate would pay $456,071 of Illinois estate taxes based on the 2011 Table calculation (which is lower than the Hypothetical Estate Tax amount). If the same decedent makes a $2.5 million death bed gift to family members, what are the Illinois estate tax consequences? Remembering that the Illinois estate tax exclusion amount is $3.5 million for 2012 and that the 2011 Table excludes adjusted taxable gifts, one could infer that no estate taxes are due ($6 million estate minus $2.5 million gift equals $3.5 million, which matches the Illinois exclusion amount). This is a wrong answer. The actual estate tax is $209,124 based on the 2011 Table, which <u>does not take into account</u> (i) the $2.5 million gift; or (ii) the $3.5 million Illinois exclusion amount. However, the gift does save $246,947 of Illinois estate taxes ($456,071 minus $209,124) because the tax base of the 2011 Table begins with the tentative taxable estate, which by definition excludes adjusted taxable gifts.

10. **Appendix B - Crunching the Illinois Estate Tax Savings for different Gifting Scenarios.**

Appendix B lists Illinois estate tax savings in 2012 relating to various gifting scenarios in $500,000 increments for tentative taxable estates ranging in value from $4 million to $10 million. For estates in this range, the reader can reference the size of the estate and projected gift, and then quickly look up the Illinois estate tax savings attributable to gifting.

For example, referring to Appendix B, Example #5 ($7 Million Illinois Tentative Taxable Estate in 2012), the following results can be drawn from the table presented:

1. **Compute Illinois Estate Taxes generated without Gift**. A $7 Million Tentative Taxable Estate generates **$565,603** of Illinois Estate Taxes (see 1st row, column 5);

2. **Compute Illinois Estate Tax Generated with Projected Gift**. A $1.5 Million gift (4th row) will generate **$402,518** of Illinois Estate Taxes (see 4th row, 5th column).

3. **The Difference Equals Illinois Estate Tax Savings related to the Gift**. The difference between the above two calculations is **$163,085** (4th row, column 6), which represents the Illinois Estate Tax Savings related to the projected gift.

4. **Decrease Savings by 35% if Illinois Estate Taxes are Deductible for Federal Estate Tax Purposes**. If federal estate taxes apply, Illinois estate tax savings equal $106,005 (4th row, column 7). This reflects a decrease of the Illinois estate tax savings by 35%, which constitutes the net benefit of Illinois estate taxes being deducible on the federal estate tax return. The aforesaid column calculates this 35% diminution, which would apply if it is anticipated that a deduction for Illinois estate taxes will be taken at the federal level.

5. **Beware of Gifts for Estates Marginally over the Illinois Estate Tax Exclusions**. Note that gifts under the scenarios in Appendix B are not productive for tentative taxable estates marginally over the $3.5 million Illinois exclusion. For example, for $4 million and $4.5 million tentative taxable estates (Examples #1 and #2 of Appendix B), there are scenarios where the Hypothetical Estate Tax calculation constitutes the correct measure of Illinois estate taxes (because it produces a result lower than the 2011 Table amount). For these cases, gifting should not result in any estate tax savings because the gift is included in the estate tax base for the calculation. For example, for a $4 million tentative taxable estate, a gift of $1 million

generates the same level of Illinois estate tax ($129,630) versus if no such gift was made. Accordingly, for this narrow range of estates and projected gifts, a gifting strategy will be nonproductive.

In conclusion, the reader can now roughly calculate Illinois estate tax savings in 2012 for a variety of scenarios by referring to Appendix B. Be cautioned that Appendix B is just a guide and does not replace the utility of doing the math for specific cases. Nevertheless, in reviewing the different scenarios in Appendix B, it is obvious that making gifts can significantly lower Illinois estate tax liabilities. The results speak for themselves.

11. **The Countervailing Consideration of the Loss of Basis Step-up**.

The consequence of making adjusted taxable gifts to reduce Illinois estate taxes means the loss of the stepped-up basis adjustment for the gifted assets. If such gifts are not made, the property would otherwise generally be includible in the client's gross estate at death and receive a basis increase to fair market value at date of death, or the alternate valuation date if elected (i.e., the pre-death appreciation relating to the property escapes income taxation).

This outline has demonstrated that Illinois estate taxes can be reduced by adjusted taxable gifts made during the client's lifetime. However, in order to determine the true economic effect of such gifts, the "lost" basis step-up of the gifted property must be taken into account. Currently, a combined 20% capital gains tax (15% Federal, plus 5% Illinois) is levied on most Illinois taxpayers upon the sale of gifted property.[16] This potential income tax must be weighed against the projected Illinois estate tax savings attributable to the lifetime gift, in order to determine whether it is productive to make the gift in the first place.

For practitioners advising clients to make gifts, nothing substitutes for "crunching the numbers" on a case-by-case basis to make certain that the loss of stepped-up basis will not overwhelm the estate tax benefits of gifting.

A. **Liquidation Analysis**.

A "liquidation analysis" is a reasonable beginning calculation to determine the viability of gifting in a specified situation. This involves making the hypothetical assumption that immediately after the gift, the donor dies and the donee sells the gifted property. The net benefit of Illinois estate tax savings (offset by income taxes related to the loss of stepped-up basis for the gifted property) is then compared with the resulting estate tax under the scenario that the gift was not made. This "with or without" calculation offers an initial view on the viability of the projected gifting transaction. However, as discussed in the next section, this may be an incomplete view as such analysis ignores the effect of post-gift appreciation.

For example, under Table #5 the Liquidation Analysis is computed for a taxpayer with a $6 million tentative taxable estate, contemplating making a $1 million gift of property with a

$700,000 basis.

Table #5: "Liquidation Analysis" ($1 Million Gifted Property; $700,000 Basis)

	-1-	-2-	-3-
	No Gift	**Cash Gift**	**Sale by Donee of Gifted Property ($700,000 Basis)**
Gift Before Death	N/A	$1,000,000	$1,000,000
Combined Federal & IL Taxes- (20%)	N/A	N/A	($60,000)
Tentative Taxable Estate	$6,000,000	$5,000,000	$5,000,000
Illinois Estate Tax	($456,071)	($352,158)	($352,158)
Federal Estate Tax	($148,375)	($184,745)	($184,745)
Combined Value to Family	$5,395,554	$5,463,097	$5,403,097
Total Tax Savings (compared to "No Gift" scenario)		**$67,543** =========	**$7,543** =======

The above results[17] demonstrate that the client's family is better off by $67,543 if the decedent makes a $1 million cash gift before death, but only benefits by $7,543 if the decedent makes a $1 million gift of property with a $700,000 basis.

B. **A Shortcut Approach - Computing the "Carryover Basis Break-Even Point."**

A helpful shortcut complementing the liquidation analysis is to determine the "break-even" point of when projected Illinois estate tax savings for the gifted property are offset by the increased income taxes relating to the loss of stepped-up basis. This is important for determining the maximum amount of pre-gift appreciation the property can have and still result in Illinois estate tax savings under the liquidation analysis. The break-even point can be computed by the following steps:

STEP #1: COMPUTE THE ILLINOIS ESTATE TAX SAVINGS.

In the above example, the Illinois estate tax saving related to a $1 million cash gift is **$67,543**. This calculation can be made manually by separately calculating the "with or without" scenarios of the overall estate taxes if (i) the gift is not made; and (ii) the gift is made. It is presumed in this case that Illinois estate taxes are deductible for federal estate tax purposes.[18]

Note: Appendix B (Example #4, 3rd row, 7th column) quickly shows the Illinois estate tax savings of $67,543.

STEP #2: DIVIDE THE TAX SAVINGS BY THE INCOME TAX RATE

The Illinois estate tax savings of **$67,543** is then **divided by 20%** (the projected combined Federal and Illinois income tax rate), which equals **$337,715**. This number represents the maximum amount of pre-gift appreciation the gifted property can have and still generate Illinois estate tax savings under the liquidation analysis. If the property has more than $337,715 of pre-gift appreciation, the family will not be better off making the gift unless the property further appreciates in the post-gift period.

STEP #3: SUBTRACT THE RESULT IN STEP #2 FROM THE VALUE OF THE PROPERTY TO ARRIVE AT THE "CARRYOVER BASIS BREAK-EVEN POINT."

$337,715 less the **$1 million** gift tax value of the property equals **$662,285**. This number represents the least amount of basis the gifted property must have in a liquidation analysis to generate Illinois estate tax savings. If the property has more than $662,285 of basis, the donor is better off making the gift (presuming no post-gift deprecation) as the benefit of the Illinois estate tax savings mathematically exceeds the income tax costs of losing stepped-up basis for the gifted property. In other words, the $662,285 basis represents the break-even point of carryover basis under a liquidation analysis which is needed for the gift to provide Illinois estate tax savings greater than the income tax costs. This will be referred to herein as the "Carryover Basis Break-Even Point."

A proof of this is illustrated in Table #6.

Table #6: Carryover Basis Break-Even Point

	-1-	**-2-**
	No Gift	**Sale by Property with $662,285 Basis**
Gift Before Death	N/A	$1,000,000
Combined Federal & Illinois Income Taxes- (20% x $337,715)	N/A	($67,543)
Tentative Taxable Estate	$6,000,000	$5,000,000

	-1-	-2-
	<u>No Gift</u>	Sale by Property <u>with $662,285 Basis</u>
Illinois Estate Tax	($456,071)	($352,158)
Federal Estate Tax	<u>($148,375)</u>	<u>($184,745)</u>
Combined Value to Family	$5,395,554	$5,395,554
Total Tax Savings (compared to "No Gift" scenario)		**$0** =======

<u>**STEP #4: COMPARE THE "CARRYOVER BASIS BREAK-EVEN POINT" TO THE BASIS OF THE PROPERTY TO DETERMINE THE VIABILITY OF GIFTING**</u>.

In Table #5, the $700,000 adjusted basis of the property exceeded the $662,635 Carryover Basis Break-Even Point. Accordingly, the projected gift is productive as the Illinois estate tax savings are not fully offset by increased income taxes related to the loss of stepped-up basis.

12. **The Wild Card - Post-Gift Appreciation.**

The utility of the liquidation analysis is that it gives the planner a "quick answer" as to whether a gift of appreciated property generates <u>immediate</u> Illinois estate tax savings presuming the deemed death of the donor and subsequent sale of the property by the donee. However, the inherent problem with the "liquidation analysis" is that the calculation does not take into account post-gift appreciation of the property in the hands of the donee.

The liquidation analysis is probably a good tool to help the practitioner quickly spot the "winners" -, i.e., those gifts where the property's basis exceeds the Carryover Basis Break-Even Point. In these cases, the projected gifts most probably will result in Illinois estate tax savings, presuming no significant depreciation of the gifted property, changes in the law, tax rates or residency status of the donor.

However, what happens for the "losers" - i.e., those gifts where the gifted property's carryover basis is less than the Carryover Basis Break-Even Point? In these cases, although the projected gift will not generate Illinois estate tax savings under a liquidation analysis, is the gift necessarily unproductive? The answer is that it "all depends," with the wild card variable being the amount of appreciation generated in the post-transfer period.

Appreciation is important as in most cases the estate tax savings attributable to the growth of the property in the post-gift period will be greater than the corresponding income tax cost of such growth. Accordingly, growth in the post-gift period decreases the negative aspects of the loss of stepped-up basis. In scenarios where the gifted property's carryover basis is less than the Carryover Basis Break-Even Point, the critical analysis becomes how much post-death appreciation must occur for the gift to provide estate tax savings greater than the income tax costs?[19]

Modifying the example in Table #5, presume that the gifted property has only $300,000 of basis, resulting in appreciation under the liquidation analysis of $700,000 ($1 million gift value less $300,000 basis). Table #7 analyzes these numbers under the liquidation analysis.

Table #7: Liquidation Analysis ($1 Million Gifted Property; $300,000 Basis)

	-1-	-2-
	No Gift	**Gift of Property with $300,000 "Carryover Basis**
Gift Before Death	N/A	$1,000,000
Combined Federal & Illinois Income Taxes- (20% x $700,000)	N/A	($140,000)
Tentative Taxable Estate	$6,000,000	$5,000,000
Illinois Estate Tax	($456,071)	($352,158)
Federal Estate Tax	($148,375)	($184,745)
Combined Value to Family	$5,395,554	$5,323,097
Total Tax Savings (Costs) (compared to "No Gift" scenario)		**($72,457)** ==========

Table #7 shows that the family is $72,457 worse off by making the gift under the assumptions of the liquidation analysis that immediately after the gift the donor dies and the donee sells the gifted property. However, if these assumptions are not followed, the question becomes how much post-gift appreciation is needed for the gift to generate positive transfer tax savings which are not offset by the loss of stepped-up basis? This calculation (similar to the Carryover Basis Break-Even Point) involves deducing the break-even point of when projected Illinois estate tax savings are fully offset by increased income taxes relating to the loss of stepped-up basis.

This author to date has been unable to develop a mathematical formula to calculate the aforesaid break-even point and it appears that various trial and error calculations must be made to solve the equation.[20] Nevertheless, after some pencil pushing, Table #8 reflects that the break-even point for the instant example is that about $330,000 of post-gift appreciation is needed for the projected Illinois estate tax savings to offset the increased income taxes relating to the loss of stepped-up basis.

Table #8: Post-Gift Appreciation Break-Even Point Analysis

	-1-	**-2-**
Gift Before Death	N/A	$1,000,000
Combined Federal & Illinois Income Taxes- (20% x $1,030,000 pre-gift ($700,000) & post-gift ($330,000) appreciation	N/A	($206,000)
Tentative Taxable Estate (before post-gift appreciation)	$6,000,000	$5,000,000
Post-gift appreciation	$330,000	$330,000
Illinois Estate Tax	($491,429)	($352,158)
Federal Estate Tax	($251,500)	($184,745)
Combined Value to Family	$5,587,071	$5,587,097
Total Tax Savings (Costs) (compared to "No Gift" scenario)		**($26)**

Again, the property in Table #8 must appreciate $330,000 (33% of its $1 million gift value) in the post-gift period in order to have estate tax savings offset by income tax costs. This may or may not be an achievable result, taking into account the life expectancy of the donor and the expected growth of the property.

It is noted that for leveraged gift transactions (where the property is discounted for gift tax purposes), presumably less post-gift appreciation would be needed to reach the break-even point. This is because economically a greater amount of property is being transferred, resulting in more estate tax savings, than is recognized for transfer tax purposes.

ENDNOTES

1. See PA 97-0636 (December 16, 2011), which amends 35 ILCS 405/2 (b) to account for the higher $3.5 million and $4 million estate tax exclusions in the Code Section 2011 calculation.
2. See Lischer, 845 T.M., Estates Gifts, and Trusts Portfolios, *Gifts* (Tax Management), at A-169. However, the federal transfer savings related to shifting appreciation may not materialize if the client has exhausted his applicable gift tax exclusion amount and both the gift and the taxable estate are taxed at the same rate. For example, if D gifts $2x and the gift tax rate is 35%, a gift tax of $.70x leaves $1.30x. If such amount triples in value, the final sum is $3.90x. Alternately, if the $2x triples in value to $6x and S dies, a 35% estate tax leaves $3.90x, making the gift a zero sum gain in terms of shifting appreciation. See Jeffrey N. Pennell, *The Joseph Trachtman Lecture - Estate Planning for the Next Generation(s) of Clients: It's Not Your Father's Buick, Anymore*, 34 ACTEC Journal 2, 12 (2008). However, this example ignores the advantages of the tax exclusive computation of the gift tax (see footnote #4 below) and possible Illinois estate tax savings related to the gift.
3. If the donee is a family member younger than age 24, the "Kiddie Tax" under Code Section 1(g) may lessen the income tax savings from lifetime gifts.
4. See Code Section 2035(b). At a 35% marginal gift tax bracket, under the tax exclusive gift tax, a donor can gift a net amount of $740,740 out of $1 million. The gift tax of $259,260 results in an effective 25.93% gift tax rate, a 9.07% savings from the 35% rate.
5. Code Sections 2036, 2037, 2038 and 2041.
6. Pub L No 107-16 (June 7, 2001).
7. Section 901 of EGTRRA.
8. Pub L No 111-312 (December 17, 2010).
9. See Aucutt, Belcher, Fox, *Making Sense of the 2010 Estate Tax Legislation* (CCH 2011), Chapter 1.
10. See Gassman, Denicolo, Crotty, *Estate Planning in 2011 and 2012* (BNA 2011), pages 27 - 31.
11. Id.
12.The only amount excluded from the computation is $100,000, which is the $60,000 adjustment in the definition of "adjusted taxable estate," plus the $40,000 which is excluded in the first bracket of taxation.
13. Under Code Section 2053(a), the "taxable estate" does not include adjusted taxable gifts.
14. See Robert J. Kolasa, *How to Use Gifts to Reduce Illinois Estate Taxes*, 96 Ill Bar J 580 (November 2008), Erratum, 97 Ill Bar J 115 (March 2009).
15. See http://illinoisattorneygeneral.gov/publications/calculator/calculator2011.html. At the submission of this outline for print, the 2012 Illinois Estate Tax Calculator had not yet been released by the Illinois Attorney General.
16. In 2012, the Federal income tax rules generally provide that long-term capital gains for individuals, estates and trusts are taxed at a maximum 15%. For taxpayers in the 10% and 15% tax bracket, long-term capital gains are taxed beginning at 0%, up to the amount required to reach the end of the 15% tax bracket, with the balance of long-term capital gains is then taxed at

15%.
17. Note that the above example ignores the scenario of the donor selling the property and gifting the proceeds to the donee. This action is not presented for the reason that donors typically do not want to sell appreciated property and incur income taxes. Perhaps a deathbed gift would be appropriate where this strategy could be explored. Nevertheless, the sale of the property and gift of proceeds by the donor in Table #5 would results in enhanced tax savings of $32,471 to the family (versus $7,543 if the property was gifted and sold by the donee).
18. If the decedent is not subject to federal estate taxes (due to future increases in the federal exclusion amount; estate tax portability, or the possible repeal of the federal estate tax), Illinois estate tax savings of $103,913 (Appendix B , Example #4, 3rd row, 6th column) would be used in the calculation.
19. See Joseph C. Mahon, *The "TEA" Factor,* Trusts and Estates 46 (August 2011), for an excellent article on this question and the development of a mathematical formula to calculate the aforesaid break-even point for federal estate tax purposes. In footnote #8, the author admirably suggests formula modifications for state estate taxes based on Code Section 2011, but the formula without more tweaking seemingly does not generate exact results for Illinois purposes, which rather uniquely (compared to other states) requires a circular calculation in the state estate tax computation.
20. A "starting point" to calculate the amount needed to reach the break-even point at a 20% income tax rate, is to take the projected deficit (in the above example $72,457) and divide such amount by 20%, which equals $362,385. Additional trial and error calculations were performed to reach the solution of $330,000.

EXHIBIT A - TAXABLE YEAR 2011

FEDERAL & ILLINOIS ESTATE TAX CALCULATIONS

(Assumptions: $5M Federal Estate Tax Exclusion; $2M Illinois Estate Tax Exclusion)

(1) Tentative Taxable Estate	(2) Illinois Estate Taxes		(3) Tentative Taxable Estate	(4) Federal Estate Taxes	(5) Combined Federal & IL Estate Tax	(6) IL Estate Tax Rate over $2M	(7) Net Illinois Estate Taxes (Less 35% for 706 Deduction)	(8) Net Illinois Estate Tax Rate over $5M (net of 35%)	(9) Federal Estate Tax Rates	(10) Federal & IL Estate Tax Rates over $5M
$2,100,000	$25,926	***	$2,074,074		**$25,926**	**25.93%**				
$2,300,000	$77,778	***	$2,222,222		$77,778	**25.93%**				
$2,500,000	$128,519		$2,371,481		$128,519	**25.70%**				
$3,000,000	$167,279		$2,832,721		$167,279	**16.73%**				
$3,250,000	$187,500		$3,062,500		$187,500	**15.00%**				
$3,500,000	$209,124		$3,290,876		$209,124	**13.94%**				
$4,000,000	$253,986		$3,746,014		$253,986	**12.70%**				
$5,000,000	$352,158		$4,647,842		$352,158	**11.74%**				
$5,120,000	$364,245		$4,755,755		$364,245	**11.67%**				
$5,240,000	$376,331		$4,863,669		$376,331	**11.62%**				
$6,000,000	$456,071		$5,543,929	$190,375	$646,446		$296,446	29.64%	35%	**64.64%**
$7,000,000	$565,603		$6,434,397	$502,039	$1,067,642		$367,642	18.38%	35%	**53.38%**
$8,000,000	$680,634		$7,319,366	$811,778	$1,492,412		$442,412	14.75%	35%	**49.75%**
$9,000,000	$801,049		$8,198,951	$1,119,633	$1,920,682		$520,682	13.02%	35%	**48.02%**
$10,000,000	$926,923		$9,073,077	$1,425,577	$2,352,500		$602,500	12.05%	35%	**47.05%**
$15,000,000	$1,609,310		$13,390,690	$2,936,742	$4,546,052		$1,046,052	10.46%	35%	**45.46%**
$20,000,000	$2,298,965		$17,701,035	$4,445,362	$6,744,327		$1,494,327	9.96%	35%	**44.96%**
$50,000,000	$6,436,896		$43,563,104	$13,497,086	$19,933,982		$4,183,982	9.30%	35%	**44.30%**

***Illinois Estate Tax calculation subject to Code Section 2011(e) Limitation ("Hypothetical Estate Tax Calculation")

EXHIBIT A - TAXABLE YEAR 2012

FEDERAL & ILLINOIS ESTATE TAX CALCULATIONS

(1) Tentative Taxable Estate	(2) Illinois Estate Taxes		(3) Tentative Taxable Estate	(4) Federal Estate Taxes	(5) Combined Federal & IL Estate Tax	(6) IL Estate Tax Rate over $3.5M	(7) Net Illinois Estate Taxes (Less 35% for 706 Deduction)	(8) Net Illinois Estate Tax Rate over $5.12M (net of 35%)	(9) Federal Estate Tax Rates	(10) Federal & IL Estate Tax Rates over $5.12M
$3,500,000	$0	***	$3,500,000							
$4,000,000	$129,630	***	$3,870,370		$129,630	**25.93%**				
$5,000,000	$352,158		$4,647,842		$352,158	**23.48%**				
$5,120,000	$364,245		$4,755,755		$364,245	**22.48%**				
$5,240,000	$376,331		$4,863,669		$376,331	**21.63%**				
$6,000,000	$456,071		$5,543,929	$148,375	$604,446	N/A	$296,446	33.69%	35.00%	**68.69%**
$7,000,000	$565,603		$6,434,397	$460,039	$1,025,642	N/A	$367,642	19.56%	35.00%	**54.56%**
$8,000,000	$680,634		$7,319,366	$769,778	$1,450,412	N/A	$442,412	15.36%	35.00%	**50.36%**
$9,000,000	$801,049		$8,198,951	$1,077,633	$1,878,682	N/A	$520,682	13.42%	35.00%	**48.42%**
$10,000,000	$926,923		$9,073,077	$1,383,577	$2,310,500	N/A	$602,500	12.35%	35.00%	**47.35%**
$15,000,000	$1,609,310		$13,390,690	$2,894,742	$4,504,052	N/A	$1,046,052	10.59%	35.00%	**45.59%**
$20,000,000	$2,298,965		$17,701,035	$4,403,362	$6,702,327	N/A	$1,494,327	10.04%	35.00%	**45.04%**
$50,000,000	$6,436,896		$43,563,104	$13,455,086	$19,891,982	N/A	$4,183,982	9.32%	35.00%	**44.32%**

***Illinois Estate Tax calculation subject to Code Section 2011(e) Limitation ("Hypothetical Estate Tax Calculation")

ASSUMPTION:
Federal Estate Tax Exclusion = $5,120,000

EXHIBIT A - TAXABLE YEAR 2013

FEDERAL & ILLINOIS ESTATE TAX CALCULATIONS

(1) Tentative Taxable Estate	(2) Illinois Estate Taxes		(3) Tentative Taxable Estate	(4) Federal Estate Taxes	(5) Combined Federal & IL Estate Tax	(6) IL Estate Tax Rate over $4M	(7) Net Illinois Estate Taxes (Less 35% for 706 Deduction)	(8) Net Illinois Estate Tax Rate over $5.24M (net of 35%)	(9) Federal Estate Tax Rates	(10) Federal & IL Estate Tax Rates over $5.24M
4,000,000	0	***	4,000,000							
5,000,000	259,259	***	4,740,741		$259,259	**25.93%**				
5,120,000	290,370	***	4,829,630		$290,370	**25.93%**				
5,240,000	321,482	***	4,918,518		$321,482	**25.93%**				
6,000,000	456,071		5,543,929	106,375	$562,446	N/A	$296,446	39.01%	35.00%	**74.01%**
7,000,000	565,603		6,434,397	418,039	$983,642	N/A	$367,642	20.89%	35.00%	**55.89%**
8,000,000	680,634		7,319,366	727,778	$1,408,412	N/A	$442,412	16.03%	35.00%	**51.03%**
9,000,000	801,049		8,198,951	1,035,633	$1,836,682	N/A	$520,682	13.85%	35.00%	**48.85%**
10,000,000	926,923		9,073,077	1,341,577	$2,268,500	N/A	$602,500	12.66%	35.00%	**47.66%**
15,000,000	1,609,310		13,390,690	2,852,742	$4,462,052	N/A	$1,046,052	10.72%	35.00%	**45.72%**
20,000,000	2,298,965		17,701,035	4,361,362	$6,660,327	N/A	$1,494,327	10.12%	35.00%	**45.12%**
50,000,000	6,436,896		43,563,104	13,413,086	$19,849,982	N/A	$4,183,982	9.35%	35.00%	**44.35%**

***Illinois Estate Tax calculation subject to Code Section 2011(e) Limitation ("Hypothetical Estate Tax Calculation")

ASSUMPTION:
Federal Estate Tax Exclusion = $5,240,000 in 2013 (projected inflation adjusted)

APPENDIX B - ILLINOIS ESTATE TAX COMPUTATIONS

Example #1- $4 Million Illinois Tentative Taxable Estate in 2012

Conclusion: No Illinois estate tax benefit of gifting until gifts exceed about $1,500,000.

Tentative Taxable Estate	Gifts	Computations		Lowest Amount	IL Estate Tax Savings Related to Gifts	Net Savings (reduced 35% for Federal estate tax benefit, if any)
		2011 Table	Hypo Estate Tax			
$4,000,000	$0	$253,986	**$129,630****	**$129,630**	N/A	N/A
$3,500,000	$500,000	$209,124	**$129,630****	**$129,630**	$0	**N/A**
$3,000,000	$1,000,000	$167,279	**$129,630****	**$129,630**	$0	**N/A**
$2,500,000	$1,500,000	**$128,518**	$129,630	**$128,518**	$1,112	**N/A**
$2,000,000	$2,000,000	**$92,910**	$129,630	**$92,910**	$36,720	**N/A**
$1,500,000	$2,500,000	**$60,526**	$129,630	**$60,526**	$69,104	**N/A**
$1,000,000	$3,000,000	**$31,439**	$129,630	**$31,439**	$98,191	**N/A**
$500,000	$3,500,000	**$9,690**	$129,630	**$9,690**	$119,940	**N/A**
$0	$4,000,000	**$0**	$129,630	**$0**	$129,630	**N/A**

**The Hypothetical Estate Tax is lower than the 2011 Table Amount

Example #2- $4.5 Million Illinois Tentative Taxable Estate in 2012

Conclusion: No Illinois estate tax benefit of gifting until gifts exceed about $500,000.

Tentative Taxable Estate	**Gifts**	**Computations**		**Lowest Amount**	**IL Estate Tax Savings Related to Gifts**	**Net Savings** (reduced 35% for Federal estate tax benefit, if any)
		2011 Table	**Hypo Estate Tax**			
$4,500,000	$0	$301,799	**$259,259****	**$259,259**	N/A	N/A
$4,000,000	$500,000	**$253,986**	$259,259	**$253,986**	$5,273	**N/A**
$3,500,000	$1,000,000	**$209,124**	$259,259	**$209,124**	$50,135	**N/A**
$3,000,000	$1,500,000	**$167,279**	$259,259	**$167,279**	$91,980	**N/A**
$2,500,000	$2,000,000	**$128,518**	$259,259	**$128,518**	$130,741	**N/A**
$2,000,000	$2,500,000	**$92,910**	$259,259	**$92,910**	$166,349	**N/A**
$1,500,000	$3,000,000	**$60,526**	$259,259	**$60,526**	$198,733	**N/A**
$1,000,000	$3,500,000	**$31,439**	$259,259	**$31,439**	$227,820	**N/A**
$500,000	$4,000,000	**$9,690**	$259,259	**$9,690**	$249,569	**N/A**
$0	$4,500,000	**$0**	$259,259	**$0**	$259,259	**N/A**

**The Hypothetical Estate Tax is lower than the 2011 Table Amount

<u>Example #3- $5 Million Illinois Tentative Taxable Estate in 2012</u>

Conclusion: Gifting results in Illinois estate tax benefits

Tentative Taxable Estate	Gifts	Computations		Lowest Amount	IL Estate Tax Savings Related to Gifts	Net Savings (reduced 35% for Federal estate tax benefit, if any)
		2011 Table	Hypo Estate Tax			
$5,000,000	$0	**$352,158**	$388,889	**$352,158**	N/A	N/A
$4,500,000	$500,000	**$301,799**	$388,889	**$301,799**	$50,359	N/A
$4,000,000	$1,000,000	**$253,986**	$388,889	**$253,986**	$98,172	N/A
$3,500,000	$1,500,000	**$209,124**	$388,889	**$209,124**	$143,034	N/A
$3,000,000	$2,000,000	**$167,279**	$388,889	**$167,279**	$184,879	N/A
$2,500,000	$2,500,000	**$128,518**	$388,889	**$128,518**	$223,640	N/A
$2,000,000	$3,000,000	**$92,910**	$388,889	**$92,910**	$259,248	N/A
$1,500,000	$3,500,000	**$60,526**	$388,889	**$60,526**	$291,632	N/A
$1,000,000	$4,000,000	**$31,439**	$388,889	**$31,439**	$320,719	N/A
$500,000	$4,500,000	**$9,690**	$388,889	**$9,690**	$342,468	N/A
$0	$5,000,000	**$0**	$388,889	**$0**	$352,158	N/A

Example #4- $6 Million Illinois Tentative Taxable Estate in 2012
Conclusion: Gifting results in Illinois estate tax benefits

Tentative Taxable Estate	Gifts	Computations		Lowest Amount	IL Estate Tax Savings Related to Gifts	Net Savings (reduced 35% for Federal estate tax benefit, if any)
		2011 Table	**Hypo Estate Tax**			
$6,000,000	$0	**$456,071**	$648,148	**$456,071**	N/A	N/A
$5,500,000	$500,000	**$402,518**	$648,148	**$402,518**	$53,553	$34,809
$5,000,000	$1,000,000	**$352,158**	$648,148	**$352,158**	$103,913	$67,543
$4,500,000	$1,500,000	**$301,799**	$648,148	**$301,799**	$154,272	$100,277
$4,000,000	$2,000,000	**$253,986**	$648,148	**$253,986**	$202,085	$131,355
$3,500,000	$2,500,000	**$209,124**	$648,148	**$209,124**	$246,947	$160,516
$3,000,000	$3,000,000	**$167,279**	$648,148	**$167,279**	$288,792	$187,715
$2,500,000	$3,500,000	**$128,518**	$648,148	**$128,518**	$327,553	$212,909
$2,000,000	$4,000,000	**$92,910**	$648,148	**$92,910**	$363,161	$236,055
$1,500,000	$4,500,000	**$60,526**	$648,148	**$60,526**	$395,545	$257,104
$1,000,000	$5,000,000	**$31,439**	$648,148	**$31,439**	$424,632	$276,011
$500,000	$5,500,000	**$9,690**	$648,148	**$9,690**	$446,381	$290,148
$0	$6,000,000	**$0**	$648,148	**$0**	$456,071	$296,446

Example #5- $7 Million Illinois Tentative Taxable Estate in 2012

Conclusion: Gifting results in Illinois estate tax benefits

Tentative Taxable Estate	Gifts	Computations		Lowest Amount	IL Estate Tax Savings Related to Gifts	Net Savings (reduced 35% for Federal estate tax benefit, if any)
		2011 Table	Hypo Estate Tax			
$7,000,000	$0	$565,603	$907,407	**$565,603**	**N/A**	**N/A**
$6,500,000	$500,000	**$509,643**	$907,407	**$509,643**	$55,960	$36,374
$6,000,000	$1,000,000	**$456,071**	$907,407	**$456,071**	$109,532	$71,196
$5,500,000	$1,500,000	**$402,518**	$907,407	**$402,518**	$163,085	$106,005
$5,000,000	$2,000,000	**$352,158**	$907,407	**$352,158**	$213,445	$138,739
$4,500,000	$2,500,000	**$301,799**	$907,407	**$301,799**	$263,804	$171,473
$4,000,000	$3,000,000	**$253,986**	$907,407	**$253,986**	$311,617	$202,551
$3,500,000	$3,500,000	**$209,124**	$907,407	**$209,124**	$356,479	$231,711
$3,000,000	$4,000,000	**$167,279**	$907,407	**$167,279**	$398,324	$258,911
$2,500,000	$4,500,000	**$128,518**	$907,407	**$128,518**	$437,085	$284,105
$2,000,000	$5,000,000	**$92,910**	$907,407	**$92,910**	$472,693	$307,250
$1,500,000	$5,500,000	**$60,526**	$907,407	**$60,526**	$505,077	$328,300
$1,000,000	$6,000,000	**$31,439**	$907,407	**$31,439**	$534,164	$347,207
$500,000	$6,500,000	**$9,690**	$907,407	**$9,690**	$555,913	$361,343
$0	$7,000,000	**$0**	$907,407	**$0**	$565,603	$367,642

<u>Example #6- $8 Million Illinois Tentative Taxable Estate in 2012</u>

Conclusion: Gifting results in Illinois estate tax benefits

Tentative Taxable Estate	Gifts	Computations		Lowest Amount	IL Estate Tax Savings Related to Gifts	Net Savings (reduced 35% for Federal estate tax benefit, if any)
		2011 Table	Hypo Estate Tax			
$8,000,000	$0	**$680,634**	$1,166,666	**$680,634**	N/A	N/A
$7,500,000	$500,000	**$622,340**	$1,166,666	**$622,340**	$58,294	$37,891
$7,000,000	$1,000,000	**$565,603**	$1,166,666	**$565,603**	$115,031	$74,770
$6,500,000	$1,500,000	**$509,643**	$1,166,666	**$509,643**	$170,991	$111,144
$6,000,000	$2,000,000	**$456,071**	$1,166,666	**$456,071**	$224,563	$145,966
$5,500,000	$2,500,000	**$402,518**	$1,166,666	**$402,518**	$278,116	$180,775
$5,000,000	$3,000,000	**$352,158**	$1,166,666	**$352,158**	$328,476	$213,509
$4,500,000	$3,500,000	**$301,799**	$1,166,666	**$301,799**	$378,835	$246,243
$4,000,000	$4,000,000	**$253,986**	$1,166,666	**$253,986**	$426,648	$277,321
$3,500,000	$4,500,000	**$209,124**	$1,166,666	**$209,124**	$471,510	$306,482
$3,000,000	$5,000,000	**$167,279**	$1,166,666	**$167,279**	$513,355	$333,681
$2,500,000	$5,500,000	**$128,518**	$1,166,666	**$128,518**	$552,116	$358,875
$2,000,000	$6,000,000	**$92,910**	$1,166,666	**$92,910**	$587,724	$382,021
$1,500,000	$6,500,000	**$60,526**	$1,166,666	**$60,526**	$620,108	$403,070
$1,000,000	$7,000,000	**$31,439**	$1,166,666	**$31,439**	$649,195	$421,977
$500,000	$7,500,000	**$9,690**	$1,166,666	**$9,690**	$670,944	$436,114
$0	$8,000,000	**$0**	$1,166,666	**$0**	$680,634	$442,412

<u>Example #7- $9 Million Illinois Tentative Taxable Estate in 2012</u>

Conclusion: Gifting results in Illinois estate tax benefits

Tentative Taxable Estate	Gifts	Computations		Lowest Amount	IL Estate Tax Savings Related to Gifts	Net Savings (reduced 35% for Federal estate tax benefit, if any)
		2011 Table	Hypo Estate Tax			
$9,000,000	$0	**$801,049**	$1,425,926	**$801,049**	N/A	N/A
$8,500,000	$500,000	**$740,493**	$1,425,926	**$740,493**	$60,556	$39,361
$8,000,000	$1,000,000	**$680,634**	$1,425,926	**$680,634**	$120,415	$78,270
$7,500,000	$1,500,000	**$622,340**	$1,425,926	**$622,340**	$118,153	$76,799
$7,000,000	$2,000,000	**$565,603**	$1,425,926	**$565,603**	$174,890	$113,679
$6,500,000	$2,500,000	**$509,643**	$1,425,926	**$509,643**	$291,406	$189,414
$6,000,000	$3,000,000	**$456,071**	$1,425,926	**$456,071**	$344,978	$224,236
$5,500,000	$3,500,000	**$402,518**	$1,425,926	**$402,518**	$398,531	$259,045
$5,000,000	$4,000,000	**$352,158**	$1,425,926	**$352,158**	$448,891	$291,779
$4,500,000	$4,500,000	**$301,799**	$1,425,926	**$301,799**	$499,250	$324,513
$4,000,000	$5,000,000	**$253,986**	$1,425,926	**$253,986**	$547,063	$355,591
$3,500,000	$5,500,000	**$209,124**	$1,425,926	**$209,124**	$591,925	$384,751
$3,000,000	$6,000,000	**$167,279**	$1,425,926	**$167,279**	$633,770	$411,951
$2,500,000	$6,500,000	**$128,518**	$1,425,926	**$128,518**	$672,531	$437,145
$2,000,000	$7,000,000	**$92,910**	$1,425,926	**$92,910**	$708,139	$460,290
$1,500,000	$7,500,000	**$60,526**	$1,425,926	**$60,526**	$740,523	$481,340
$1,000,000	$8,000,000	**$31,439**	$1,425,926	**$31,439**	$769,610	$500,247
$500,000	$8,500,000	**$9,690**	$1,425,926	**$9,690**	$791,359	$514,383
$0	$9,000,000	$0	$1,425,926	$0	$801,049	$520,682

Example #8- $10 Million Illinois Tentative Taxable Estate in 2012

Conclusion: Gifting results in Illinois estate tax benefits

Tentative Taxable Estate	Gifts	Computations		Lowest Amount	IL Estate Tax Savings Related to Gifts	Net Savings (reduced 35% for Federal estate tax benefit, if any)
		2011 Table	**Hypo Estate Tax**			
$10,000,000	$0	**$926,923**	$1,685,185	**$926,923**	N/A	N/A
$9,500,000	$500,000	**$863,986**	$1,685,185	**$863,986**	$62,937	$40,909
$9,000,000	$1,000,000	**$801,049**	$1,685,185	**$801,049**	$125,874	$81,818
$8,500,000	$1,500,000	**$740,493**	$1,685,185	**$740,493**	$186,430	$121,180
$8,000,000	$2,000,000	**$680,634**	$1,685,185	**$680,634**	$246,289	$160,088
$7,500,000	$2,500,000	**$622,340**	$1,685,185	**$622,340**	$304,583	$197,979
$7,000,000	$3,000,000	**$565,603**	$1,685,185	**$565,603**	$361,320	$234,858
$6,500,000	$3,500,000	**$509,643**	$1,685,185	**$509,643**	$417,280	$271,232
$6,000,000	$4,000,000	**$456,071**	$1,685,185	**$456,071**	$470,852	$306,054
$5,500,000	$4,500,000	**$402,518**	$1,685,185	**$402,518**	$524,405	$340,863
$5,000,000	$5,000,000	**$352,158**	$1,685,185	**$352,158**	$574,765	$373,597
$4,500,000	$5,500,000	**$301,799**	$1,685,185	**$301,799**	$625,124	$406,331
$4,000,000	$6,000,000	**$253,986**	$1,685,185	**$253,986**	$672,937	$437,409
$3,500,000	$6,500,000	**$209,124**	$1,685,185	**$209,124**	$717,799	$466,569

Tentative Taxable	Gifts	Computations		Lowest Amount	IL Estate Tax Savings	Net Savings
$3,000,000	$7,000,000	**$167,279**	$1,685,185	**$167,279**	$759,644	$493,769
$2,500,000	$7,500,000	**$128,518**	$1,685,185	**$128,518**	$798,405	$518,963
$2,000,000	$8,000,000	**$92,910**	$1,685,185	**$92,910**	$834,013	$542,108
$1,500,000	$8,500,000	**$60,526**	$1,685,185	**$60,526**	$866,397	$563,158
$1,000,000	$9,000,000	**$31,439**	$1,685,185	**$31,439**	$895,484	$582,065
$500,000	$9,500,000	**$9,690**	$1,685,185	**$9,690**	$917,233	$596,201
$0	$10,000,000	**$0**	$1,685,185	**$0**	$926,923	$602,500

PLANNING FOR THE ILLINOIS QTIP ELECTION

By Robert J. Kolasa

Introduction

The following outline discusses the merits and mechanics of making the Illinois QTIP election. Prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"),[1] Illinois was engaged in a form of revenue sharing with the federal government, whereby Illinois estate taxes were based on the state death credit under Section 2011 of the Internal Revenue Code ("Code"). EGTRRA ended this arrangement by fully repealing the 2011 credit for tax years beginning in 2005, along which other estate tax changes (most noticeably increasing the federal estate tax exclusion to $3.5 million in 2009 and temporarily instituting estate tax repeal and carryover basis for 2010).

EGTRRA provided for a bizarre "sunset" rule[2] whereby its provisions were scheduled to be repealed after December 31, 2010 "as if" such legislation "had never been enacted." This would have meant that the law would magically revert back to pre-EGTRRA law on January 1, 2011. However, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Act"),[3] postponed the EGTTRA sunset to January 1, 2013 and instituted a new $5 million unified estate and gift tax exclusion amount (adjusted for inflation beginning in 2012).

Prompted by EGTTRA's repeal of Code Section 2011, Illinois amended its laws in 2003 (in a process known as "decoupling")[4] to provide that state estate taxes would continue to be based on the repealed 2011 credit taking into account a separate Illinois estate tax exclusion amount. For tax years 2006-2008, the "frozen" $2 million Illinois exclusion exactly matched the federal exclusion. However, for 2009 the excess of the newly increased $3.5 million federal exclusion over the $2 million Illinois exclusion produced a $1.5 million differential (for purposes of this paper, the difference between the federal and Illinois estate tax exclusion amounts is generally referred to as the "gap amount").

In 2009, the differing federal and Illinois estate tax exclusions left the Illinois estate planner with the issue of whether to fund the Credit Shelter Trust with the full $3.5 million federal estate tax exclusion amount, thereby generating $209,124 in Illinois estate taxes (because such funding exceeded the Illinois $2 million estate tax exclusion by $1.5 million). Alternately, the Credit Shelter Trust could be funded with only $2 million, thereby avoiding Illinois estate taxation at the cost of "wasting" $1.5 million of the federal estate tax exclusion. If it could be predicted that the surviving spouse would be subject to federal estate taxes, the family probably would be better off funding the $3.5 million Credit Shelter Trust and paying the Illinois estate taxes at the death of the first deceased spouse.

Happily, in 2009 Illinois enacted the Illinois QTIP legislation,[5] which resolved the above dilemma relating to the mismatched Federal and Illinois estate tax exclusion amounts. The Illinois QTIP election in 2009 allowed the estate of the first deceased spouse to utilize the $3.5 million federal estate tax exclusion and defer Illinois estate tax on the $1.5 million gap amount until the death of the surviving spouse. Subsequent Illinois legislation in late 2011[6] changed the Illinois estate tax regimen by incorporating into the Code Section 2011 calculation an Illinois exclusion amount of $3.5 million in 2012, and $4 million for 2013 and thereafter.

Taking into account the aforesaid projected increases in the federal and Illinois estate tax exclusions (assuming for federal purposes a 2.4% annual inflation adjustment, with the nonoccurrence of the EGTRRA sunset), Table #1 estimates the gap amounts (i.e., the difference between the federal and Illinois exclusions) for years 2009 through 2022. The gap amount is important, as this represents the property which can be subject to the Illinois QTIP election.

Table #1: Projected "Gap Amounts" for 2009-2022

	-1-	**-2-**	**-3-**
Tax Year	**Federal Estate Tax Exclusion Amount****	**Illinois Estate Tax Exclusion Amount**	**"Gap Amount" Subject to Illinois QTIP Election**
2009	$3,500,000	$2,000,000	$1,500,000
2010	$5,000,000	N/A	N/A
2011	$5,000,000	$2,000,000	$3,000,000
2012	$5,120,000	$3,500,000	$1,620,000
2013	$5,240,000	$4,000,000	$1,240,000
2014	$5,370,000	$4,000,000	$1,370,000
2015	$5,500,000	$4,000,000	$1,500,000
2016	$5,630,000	$4,000,000	$1,630,000
2017	$5,770,000	$4,000,000	$1,770,000
2018	$5,910,000	$4,000,000	$1,910,000
2019	$6,050,000	$4,000,000	$2,050,000
2020	$6,200,000	$4,000,000	$2,200,000

	-1-	-2-	-3-
2021	$6,350,000	$4,000,000	$2,350,000
2022	$6,500,000	$4,000,000	$2,500,000

1. **The Illinois Statutory Scheme.**

35 ILCS 405/3 (c) provides that for estates of persons dying on or after January 1, 2003, the amount of the Illinois estate tax is the "state tax credit, as defined in Section 2 of this Act, reduced by the amount determined by multiplying the state tax credit with respect to the taxable transfer by the percentage which he gross value of the transferred property not having a tax situs in Illinois bears to the gross value of the total transferred property."

. 35 ILCS 405/2 defines the term "state tax credit" to mean:

> (b) For persons dying after December 31, 2005 and on or before December 31, 2009, and for persons dying after December 31, 2010, an amount equal to the full credit calculable under Section 2011 or 2604 of the Internal Revenue Code as the credit would have been computed and allowed under the Internal Revenue Code as in effect on December 31, 2001, without the reduction in the State Death Tax Credit as provided in Section 2011(b)(2) or the termination of the State Death Tax Credit as provided in Section 2011(f) as enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001, but recognizing the exclusion amount of only (i) $2,000,000 for persons dying prior to January 1, 2012, (ii) $3,500,000 for persons dying on or after January 1, 2012 and prior to January 1, 2013, and (iii) $4,000,000 for persons dying on or after January 1, 2013, and <u>with reduction to the adjusted taxable estate for any qualified terminable interest property election as defined in subsection (b-1) of this Section</u>. (Emphasis added)

35 ILCS 405/2 (b-1) in the context of the Illinois QTIP election, then adopts the federal definition of "qualified terminable interest property" (commonly known as "QTIP" under Code Section 2056(b)(7)):

> (b-1) The person required to file the Illinois return may elect on a timely filed Illinois return a marital deduction for qualified terminable interest property under Section 2056(b)(7) of the Internal Revenue Code for purposes of the Illinois estate tax that is separate and independent of any qualified terminable interest property election for federal estate tax purposes. For purposes of the Illinois estate tax, the inclusion of property in the gross estate of a surviving spouse is the same as under Section 2044 of the Internal Revenue Code.

In the case of any trust for which a State or federal qualified terminable interest property election is made, the trustee may not retain non-income producing assets for more than a reasonable amount of time without the consent of the surviving spouse.

QTIP trusts are a staple of estate planning form books and qualifying drafting language is readily available. The IRS has also promulgated extensive regulatory rules defining the QTIP technical requirements,[7] so it doesn't seem likely that there will be classification issues in qualifying for QTIP treatment (versus other marital deduction trusts). For Illinois purposes, the Illinois Attorney General has wholeheartedly embraced the federal QTIP rules to decipher the complexities of the Illinois law, as indicated by the following declaration found on his web site: "The Illinois QTIP election will follow Federal statutes and rules for treatment of such elected property as passing to the surviving spouse and inclusion for Illinois purposes on any Illinois Estate Tax Return of the surviving spouse."[8]

2. **An Illustration of the Illinois QTIP Election.**

The Illinois QTIP election allows the first deceased spouse's estate to utilize the full federal estate tax exclusion and defer Illinois estate tax on the "gap amount" until the death of the surviving spouse. Table #2 illustrates the mechanics of the Illinois QTIP election for a 2012 decedent with a $7,620,000 tentative taxable estate.

Table #2: Mechanics of the Illinois QTIP Election

	-1-	-2-
A. First Spouse to Die	**Federal**	**Illinois**
Tentative Taxable Estate	$7,620,000	$7,620,000
Marital Trust* *(Federal & IL Marital Deductions)*	($2,500,000)	($2,500,000)
IL QTIP Election *(IL Marital Deduction only)*	$0	($1,620,000)
Taxable Estate	$5,120,000	$3,500,000
Federal Estate Tax Exclusion	($5,120,000)	
Illinois Estate Tax Exclusion		($3,500,000)
Estate Taxes	$0 =========	$0 ==========

	-1-	-2-
<u>A. First Spouse to Die</u>	**<u>Federal</u>**	**<u>Illinois</u>**
<u>B. Surviving Spouse's Death</u>		
Amount Includible in Surviving Spouse's Estate	**<u>Federal</u>**	**<u>Illinois</u>**
Illinois QTIP Property (“Gap Trust Assets”)**	$0	$1,620,000
Marital Trust**	<u>$2,500,000</u>	<u>$2,500,000</u>
Total Includible Amount	$2,500,000 ========	$4,120,000 ==========

**Presumes no growth between death of spouses

Under the above example, $5,120,000 of the federal estate tax exclusion amount is utilized, compared to $3,500,000 of the Illinois exclusion. The $1,620,000 gap amount is subject to a QTIP election for Illinois purposes only (the “Illinois QTIP election”), which avoids immediate Illinois estate taxation of such amount. Upon the surviving spouse's death, Illinois estate taxes are assessed on the Marital Trust and the property subjected to the Illinois QTIP election, while only the Marital Trust is subject to federal estate taxation.

3. The Advantages and Disadvantages of the QTIP Election.

The primary non-tax reason for setting up a QTIP trust is the “control” element which can be retained by the grantor. This factor is highlighted in second marriages, especially where there are children from former nuptials. In such cases, the grantor may establish a QTIP trust for the benefit of the surviving spouse, granting only income rights to the spouse, with the remaining trust principal distributed to the grantor's children upon the spouse's death. A majority of trust assets may thus be preserved for the grantor's family, yet the benefit of the marital deduction is procured, thereby deferring estate taxation until the surviving spouse's death. Even in harmonious first marriages, the QTIP trust lessens the risk that the surviving spouse will remarry and divert marital assets to a plundering new spouse.

From a tax viewpoint, the QTIP trust enjoys wide popularity for the flexibility that it engenders in postmortem administration. That is, under a QTIP trust the executor (or trustee in possession of assets) has discretion whether to make the election for all, none, or a part of the QTIP trust. As the election determines whether or not a marital deduction is obtained for the trust, the executor is able to control how much estate taxes should optimally be paid upon the death of the first spouse to die. This is a tremendous tax benefit not available for other marital deduction trusts. While less noteworthy, other QTIP tax advantages are the Code Section 2652(a)(3) GST exemption election, valuation discount planning[9] and the utility of QTIP trusts in securing the Code Section 2013 credit for tax on prior transfers.

A significant tax drawback of the QTIP trust is the requirement that trust income must be paid to the surviving spouse, thereby increasing the surviving spouse's estate and possibly increasing estate taxation upon the survivor's death. Contrast the Credit Shelter Trust, whereby non-spouse beneficiaries may receive income (possibly at lower income rates than the spouse) and principal distributions, which are not includible in the survivor's estate. The "Clayton" QTIP"[10] attempts to solve this dilemma by directing that the QTIP marital trust is funded only to the extent the executor makes a QTIP election over qualifying property; to the extent the QTIP election is not made, the assets pass to the credit shelter trust (which typically has beneficiaries which may, or may not, include the surviving spouse).

Another disadvantage of the QTIP trust is the potential conflict generated between the surviving spouse and remainder beneficiaries (some of whom may be the grantor's children, and for second marriages may even be of proximate age to the spouse). A natural conflict of interest may exist in such a situation among the parties relating to investment strategy, tax strategy, adequacy of accountings, and trust administration. This conflict may be exacerbated if the spouse (or child) acts as trustee in lieu of a neutral party, such as an independent corporate trustee.

4. **Code Section 2044 - The "Cost" of the QTIP Election.**

35 ILCS 405/2 (b-1) references Code Section 2044, which generally provides that the "cost" of making the election is that the QTIP property is includible in the surviving spouse's estate. For estates of 2012 decedents making the Illinois QTIP election, this generally means that the $1,620,000 gap amount (and any appreciation thereto) is includible in the surviving spouse's Illinois estate tax base.

If a QTIP election is only made to a portion of a trust (a "partial" QTIP" election, discussed below), the amount includible in the surviving spouse's estate is generally equal to the value of the trust assets multiplied by the same percentage for which a QTIP deduction was taken.[11] For example, if the estate of the first deceased spouse elects a 30% QTIP election over a qualifying trust, 30% of the trust assets would also be includible in the survivor's estate upon his or her death. However, as discussed below, it is often tax efficient to sever the trust to which the partial QTIP election relates into QTIP and non-QTIP portions. In such case, the elected QTIP portion would be 100% includible in the surviving spouse's estate.

During trust administration, a common stratagem to mitigate potential estate taxes caused by the Section 2044 inclusion rule is to encourage the surviving spouse to consume the income and principal of the QTIP trust. To encourage this behavior, a trust provision is typically inserted prohibiting principal distributions from other trusts while principal remains in the QTIP Trust. Since there are no limitations on the spouse's usage of QTIP property once it is distributed, the trustee may decide to distribute principal to the surviving spouse to make annual exclusion, charitable and medical/educational gifts, which are excluded from the spouse's tax base. Obviously, the distribution standards in the trust (i.e., best interests; discretionary; health, education, support, or maintenance) affect how aggressively this strategy can be pursued.

A significant loophole to the includibility rules for QTIP property relates to whether the surviving spouse dies as a non-Illinois resident. If a surviving spouse resides outside Illinois, it is doubtful that Illinois will be able to collect estate taxes for property subject to the Illinois QTIP election (except to the extent such assets are comprised of Illinois real estate).[12] The migrating spouse effectively reaps the benefit of reduced Illinois estate taxes upon the death of the first deceased spouse (via the Illinois QTIP election), without corresponding Section 2044 estate tax inclusion. If the primary goal of the surviving spouse is to minimize overall estate taxes, changing residency to another state should avoid Illinois estate taxes on property subject to the Illinois QTIP election.

5. **Is it Better to Pay the Illinois Estate Tax and Not Make the Illinois QTIP Election?**

The executor (or trustee in possession of assets) of the first deceased spouse, with proper marital trust planning should typically have the following choices available regarding the Illinois QTIP election:

1. Not making the Illinois QTIP election and paying Illinois estate taxes on the gap amount (i.e., $364,245 of Illinois estate taxes resulting from a $5,120,000 Credit Shelter Trust).

2. Making the Illinois QTIP election on the gap amount (with the possibility of Illinois estate taxes being assessed on gap amount assets upon the survivor's death);

3. Not making the Illinois QTIP election and funding the Credit Shelter Trust with only the Illinois estate tax exclusion ($3.5 million in 2012, $4 million in 2013 and thereafter). This results in the "wasting" of the federal estate tax exclusion equal to the gap amount (but see Section 6 below, for a discussion on how estate tax portability may resolve this problem).

A disadvantage of the Illinois QTIP election is that the Illinois estate taxes payable at the survivor's death seemingly are nondeductible for federal estate tax purposes. This is because Code Section 2058(a) provides a deduction for state death taxes "in respect of any property included in the [federal] gross estate." Since trusts subject to the Illinois QTIP election are <u>not</u> includible in the surviving spouse's estate for federal purposes, it seems reasonably clear that Illinois estate taxes related to such trust property are federally nondeductible. Contrast this with the scenario of deductible Illinois estate taxes payable upon the death of the first deceased spouse if the Credit Shelter Trust is funded with the full federal exclusion without an Illinois QTIP election (in such case, the deductible Illinois estate taxes have the favorable effect of reducing the marital trust by such amount).

When the Illinois estate tax exclusion amount was set at $2 million (2009 and 2011), the analysis seemed to indicate that in many scenarios the family would be better off by not making the Illinois QTIP election and paying Illinois estate taxes on the gap amount. This was due to the lost Code Section 2058(a) deduction and the mechanics of how the Illinois estate tax was calculated under Section 2011(b). However, with the increase of the Illinois estate tax exclusion to $3.5 million in 2012 and $4 million for following years, the math has changed. Now it seems that the net benefit of not making the Illinois QTIP election and paying the tax (versus making the election and deferring the tax) has lessened and that paying the tax in many scenarios may not be the right choice. Careful and studied analysis should be made for clients contemplating funding the Credit Shelter Trust at $5,120,000 (or the then applicable federal exclusion) and not making the Illinois QTIP election, thereby triggering current Illinois estate taxes on the gap amount. It is noted that this analysis ignores (if the death of both spouses within 10 years is likely) paying some federal and Illinois estate taxes upon the first to die, in a bid to generate a Section 2013 credit for tax on prior transfers.

Nevertheless, most surviving spouses would probably prefer to avoid paying Illinois estate taxes at the death of the first deceased spouse (why pay an estate tax now, that you can defer or avoid until later?). Additionally, paying Illinois estate taxes on the gap amount would not be the optimal result for spouses who are considering moving out of Illinois. Nor does such strategy work if the federal estate tax is repealed, or the surviving spouse's consumption of assets, charitable gifts or other transactions will eliminate the imposition of estate taxes altogether.

It is noted that some practitioners are considering whether at the survivor's death, the Illinois estate taxes related to Illinois QTIPs can be apportioned to other marital trusts with the possible deduction of such taxes for federal purposes. This projected tax position seems wrong as contrary to the literal language of Code Section 2058(a), and may also run afoul of Section 2044.[13]

6. **Does Estate Tax Portability Signify the "Death" of the Illinois QTIP Election?**

Newly enacted Code Section Code Section 2010(c) introduces the concept of estate tax portability, which generally permits the surviving spouse to capture the unused estate tax exclusion amount (the Deceased Spousal Unused Exclusion Amount, or "DSUEA") of the first spouse to die. While the portability provisions technically expire with the EGTRRA sunset on December 31, 2012, it appears likely given its widespread popularity, that such provisions will be extended or made permanent.

Prior to estate tax portability, the Illinois QTIP election was the only solution to deal with the problems caused by the mismatch of the federal and Illinois exclusion amounts. For example, in order to fully fund a 2009 Credit Shelter Trust with the full $3.5 million federal exclusion (without paying Illinois estate taxes), the only alternative was to make an Illinois QTIP election over the $1.5 million gap amount.

For many clients, estate tax portability (if it becomes permanent) may deal with the differing federal and Illinois exclusion amounts in a manner superior to the Illinois QTIP election. For example, if estate tax portability was permanent in 2012, the Credit Shelter Trust could be funded with only $3.5 million. In such situations, the estate planner would not face the dire consequences of “wasting” $1,620,000 of the federal exclusion, since the unused exclusion becomes part of DSUEA, which may be utilized by the survivor during his or her lifetime, or at death. Therefore, tax havoc is not achieved by withholding the Illinois QTIP election.

In a portability environment, the main drawback in not making the Illinois QTIP election is the loss of federal estate tax savings related to the growth of gap amount assets (such growth would escape federal estate taxation if an Illinois QTIP election is made, akin to the workings of a Credit Shelter Trust). For example, presume the Illinois QTIP election is made and the $1,620,000 gap amount increases during the administration period to $2,620,000. In this case, the $1 million growth is excluded from federal estate taxes upon the survivor’s death, although these savings are offset by the loss of stepped-up basis in the survivor’s estate relating to gap amount assets.

Presuming the permanency of estate tax portability for couples whose assets are expected <u>not to exceed</u> their combined federal estate tax exclusion amounts, the Illinois QTIP election may not make sense. This is because such election is not needed to preserve the federal estate tax exclusion amount. Such “wasted” federal exclusion amount is not lost at all, but bundled into the DSUEA which should generally be available at the surviving spouse’s death (with the benefit of stepped-up basis on gap amount assets).[14]

Alternately, presuming the permanency of estate tax portability for couples whose assets are expected <u>to exceed</u> their combined federal estate tax exclusion amounts, for most married clients the choice will be between making or not making the Illinois QTIP election, with no payment of Illinois estate taxes in either instance. In such situations, the growth of gap amount assets becomes an important variable (the greater the growth, the more assets are shielded from federal estate taxes in a fully funded Credit Shelter Trust paired with an Illinois QTIP election). The planner should assist the client to determine whether to:

1. Make the Illinois QTIP election and fund the Credit Shelter Trust with the federal exclusion (currently $5,120,000) and incur at the survivor’s death Illinois estate taxes on appreciated gap amount assets without stepped-up basis (however, such appreciation is <u>excluded</u> from the federal estate tax base); or

2. Decline the Illinois QTIP election and fund the Credit Shelter Trust with the Illinois exclusion (currently $3,500,000), relying upon portability to reclaim the

"wasted" federal exclusion, with Illinois estate taxation at the survivor's death on appreciated gap amount assets with stepped-up basis (however, such appreciation is included in the federal estate tax base).

These choices involve some serious number-crunching. However, the instant analysis becomes relevant only if estate tax portability becomes a permanent fixture in the federal estate tax system. Until then, the Illinois QTIP election remains a viable planning option.

7. **The Technical Requirements of QTIP Property.**

These primary technical requirements for QTIP property under the federal rules are as follows:

A. Spouse must be Sole Income Beneficiary, with Power to Make Unproductive Property Productive. Central to the QTIP definition is the Code Section 2056(b)(7)(B)(ii)(I) requirement that the surviving spouse is entitled to all the income from the QTIP property. Regulation Section 20.2056(b)-7(d)(2) incorporates the provisions of Section 20.2056(b)-5(f) to determine whether this requirement is met. A major tenet of the sole income rule is that the trust must require, or permit the surviving spouse to require, that the trustee must make unproductive property productive, or require it's conversion to productive property within a reasonable time. For example, if a QTIP Trust holds unproductive property (such as unimproved real estate) which is not likely to be income producing and which the spouse cannot compel the trustee to sell or otherwise convert to income producing property, such property will not qualify as QTIP property unless the applicable administrative rules require, or permit the spouse to require, that the trustee provide the required beneficial enjoyment by payments to the spouse out of other assets of the trust.[15]

Almost all form book QTIP Trusts expressly import the requirement from the regulations that the surviving spouse must have the power to convert unproductive property to income producing property. Often Credit Shelter Trusts are candidates for the Illinois QTIP election, although such trusts routinely do not have such required language. The second paragraph of 35 ILCS 405/2 (b-1), provides that for Illinois QTIPs "the trustee may not retain non-income producing assets for more than a reasonable amount of time without the consent of the surviving spouse." This is a direct attempt to import the QTIP "all income" requirement for trusts which were never originally drafted to qualify for QTIP treatment in the first place. Query whether a tax statute can constructively reform a trust if nonspousal remainder beneficiaries object to this provision? Nevertheless, the Illinois statute indicates a broad legislative intent that these trusts qualify for the Illinois QTIP election.

The regulations expressly provide that a power to retain a residence or other property for the personal use of the spouse will not disqualify the property from satisfying the "all income" requirement.[16] Additionally, the income does not have to be physically distributed to the spouse, as long as he or she has a right exercisable annually, or more frequently, to require distribution to him or her of the trust income, even though the undistributed income may then be accumulated and added to corpus.[17] Likewise, the "stub" income earned before the surviving spouse's death but not yet distributed need not be paid to the surviving spouse's estate.[18]

B. Spouse must be the Sole Trust Beneficiary. No other beneficiary other than the spouse may have rights in QTIP property during the surviving spouse's lifetime. This is really a subset of the "all income" rule as it prevents the disfranchisement of the spouse's rights by the distribution of principal (and the income it produces) to non-spouse beneficiaries. However, distribution under the standard "facility of payment" clause of trust principal to third parties for the benefit of the surviving spouse, rather than directly to the spouse are generally permissible.[19]

This provision does not prevent the surviving spouse from having a testamentary (not inter vivos) special power of appointment to appoint the trust to family members, charities or third parties after the death of the surviving spouse. It is generally not a good idea to give the surviving spouse a general power of appointment (inter vivos or testamentary), as this may unknowingly convert the trust to a Code Section 2056(b)(5) power of appointment trust,[20] thereby making the QTIP election unavailable. However, after the surviving spouse's death, trust beneficiaries can possess general or special powers of appointment without fear of QTIP disqualification.

C. Other Miscellaneous Technical Requirements. There are many specialized rules relating to QTIP qualification under Code Section 2056(b)(7) and the reader is advised to exercise special caution in deviating from QTIP trust form book language, or when dealing with specialized assets. For example, an income interest for a term of years, or a life estate subject to termination upon the occurrence of a specified event (e.g., remarriage), are terminable interests which do not constitute QTIP property. Section 2056(d)(7) expressly disqualifies QTIP treatment for property passing to spouses who are not United States Citizens. Other specialized rules relate to annuities and pooled income funds.[21]

8. Making a QTIP Election on Forms 706 and 700.

Code Section 2056(b)(7)(B)(v) expressly requires that for a decedent's estate, a QTIP election be made on the estate tax return (Form 706). In light of various problems in determining whether a proper election was made on Form 706, the IRS has substantially relaxed the formalities for a valid QTIP election. The instructions to the 2011 version of Form 706 provide that as long as the trust or other property (along with valuations) are listed on Schedule M, then unless the executor elects out of QTIP treatment, the executor shall be deemed to have made a QTIP election with respect to QTIP property under Code Section 2056(b)(7).

A "protective" QTIP election may be made if at the time the federal estate tax return is filed, the executor reasonably believes that there is a bona fide issue that concerns whether an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is entitled to receive. The protective election must identify either the specific asset, group of assets, or trust to which the election applies and the specific basis for the protective election.[22] Presumably such protective elections can also be made for Illinois QTIPs.

The federal QTIP election must generally be made on a timely filed Form 706 (or if untimely filed, on the first estate tax return after the due date). The IRS may grant administrative relief under Regulation Section 301.9000-1 to make a QTIP election if such election was not made on Form 706, although it seems that in most cases the relaxed QTIP election procedures will limit the need for such relief. The IRS has also provided relief from the imposition of subsequent estate, gift, and generation-skipping transfer taxes where the decedent's estate's QTIP election was unnecessary to reduce the estate tax liability to zero. Rev. Proc. 2001-38, 2001-1 CB 1335. The executor should exercise caution in making a QTIP election because once the election is made, it is irrevocable.

For Illinois purposes, in 2011 the Illinois QTIP election is made by checking Box 4, page 2 of Form 700 and filling in the adjoining box for the amount of the QTIP election. The preparer then must fill in the value of the QTIP property on Schedule A, Line 2 (for Illinois resident decedents) or Schedule B, Line 2 (for nonresidents or alien decedents). If a formula QTIP election (discussed below) is used, reference to the election should probably be noted next to the amount of the QTIP election on page 2, Box 4, with the formula QTIP election attached as an exhibit to the return. The same practice should be followed on the federal return. Interestingly, the 2011 version of Form 700 still does not have a line to reflect the addition of an Illinois QTIP trust to the surviving spouse's tentative taxable estate, but presumably the form will someday be revised to correct this omission.

Section 20 of the recently passed Illinois Religious Freedom Protection and Civil Union Act (750 ILCS 75/1 et. seq.) provides that "a party to a civil union is entitled to the same legal obligations, responsibilities, protections, and benefits as are afforded or recognized by the law of Illinois to spouses, whether they derive from statute, administrative rule, policy, common law, or any other source of civil or criminal law." Such language suggests that the Illinois QTIP election will be applicable to parties in a civil union.

9. Partial and Formula QTIP Elections.

Under Regulation Section 20.2056(b)-7(b)(2)(i) "partial" and "formula" QTIP elections are expressly allowed:

> (2) Property for which an election may be made—(i) In general. The election may relate to all or any part of property that meets the requirements of section 2056(b)(7)(B)(i), provided that any partial election must be made with respect to a fractional or percentage share of the property so that the elective portion reflects its proportionate share of the increase or decrease in value of the entire property for purposes of applying sections 2044 or 2519. The fraction or percentage may be defined by formula.

A partial election refers to the fact that the QTIP election can be made over a specified fraction of trust property. The partial QTIP election (for federal and Illinois purposes) is a critical tool to optimally utilize the differing federal and Illinois estate tax exclusion amounts. The partial QTIP election is most often expressed as a fractional portion of the trust estate which reduces the federal or Illinois estate tax to zero.

Best practices dictate the partial QTIP election to be expressed on a "formula" basis and this is directly blessed by the above regulation.[23] In such case, the partial QTIP election would incorporate a self-adjusting fraction specifying the result sought (such as to reduce the federal or Illinois estate taxes to zero), rather than portraying the election as a static dollar amount or percentage. This guarantees the optimal marital deduction if asset valuations are changed upon audit, since the formula election takes into account changed values.

The above points are best illustrated by looking at the federal and Illinois QTIP elections available in a traditional marital deduction funding scenario. Accordingly, for discussion's sake, presuming a $7,620,000 tentative taxable estate in 2012, the following federal and Illinois QTIP elections are typically available:

A. **$3,500,000 Credit Shelter Trust with balance to QTIP Marital Trust**. The Credit Shelter Trust funding formula (pecuniary or fractional) is based on the largest amount which can pass free without federal and state estate taxes (i.e., the $3.5 million Illinois estate tax exclusion). The $4,120,000 balance of the estate passes to the residuary QTIP Marital Trust. In this case, to zero out federal estate taxes a partial QTIP election must be made over the $4,120,000 Marital Trust so that $2,500,000 of such trust qualifies for the federal marital deduction. The $1,620,000 remaining marital trust value (the "non-elected portion"), when added to the $3.5 million Credit Shelter Trust, results in optimal usage of the $5,120,000 federal exclusion amount. In addition, in order to avoid Illinois estate taxes, a partial Illinois QTIP election must be made over such $1,620,000 Marital Trust portion.

Accordingly, for federal purposes, a partial federal QTIP election is made over 60.6796% of the Marital Trust, resulting in a $2,500,000 federal marital deduction ($4,120,000 times 60.6796%). For Illinois purposes, a partial Illinois QTIP election is also made over 39.3204% of the Marital Trust, resulting in a $1,620,000 Illinois QTIP deduction ($4,120,000 times 39.3204%). Attached is Exhibit A, which demonstrates such partial QTIP elections expressed on a formula basis.

B. **$5,120,000 Credit Shelter Trust qualifying as a QTIP, with balance Outright to Spouse or a Marital Trust**. The Credit Shelter Trust funding formula (pecuniary or fractional) is based on the largest amount which can pass free without federal estate taxes (i.e., the $5,120,000 federal estate tax exclusion). The $2,500,000 balance of the estate passes as an outright gift to the spouse, or to a residuary trust (does not have to be a QTIP Trust) qualifying for the marital deduction. It is important in this scenario that the Credit Shelter Trust provides that the surviving spouse is the sole beneficiary entitled to all income, and otherwise meets the requisite QTIP qualifying provisions.

The $5,120,000 Credit Shelter Trust optimally utilizes the federal estate tax exclusion amount, but exceeds the Illinois estate tax exclusion amount by the "gap amount" of $1,620,000 ($5,120,000 minus $3.5 million). In order to avoid Illinois estate taxes, a partial QTIP election of the $1,620,000 gap amount must be made with respect to the Credit Shelter Trust (as an alternative planning scenario, the spouse may disclaim the gap amount to the Marital Trust if the trust is worded correctly). The $3.5 million remaining trust assets (the "non-elected portion") results in optimal usage of the $3.5 million Illinois exclusion amount. No federal QTIP election is necessary because the federal estate tax exclusion amount is fully utilized by the $5,120,000 Credit Shelter Trust.

Accordingly, for Illinois purposes only, a partial QTIP election is made over 31.6406% of the Credit Shelter Trust, resulting in a $1,620,000 Illinois QTIP marital deduction ($5,120,000 times 31.6406%). This leaves the remaining $3.5 million of the Credit Shelter Trust ($5,120,000 minus $1,620,000) available to fully utilize the Illinois exclusion amount. Attached is Exhibit B, which demonstrates such partial Illinois QTIP election expressed on a formula basis.

MALPRACTICE ALERT : This marital trust funding strategy, which was widely used prior to EGTRRA, becomes a malpractice trap if the Credit Shelter Trust was not drafted for QTIP treatment. In such case, the Illinois QTIP election is unavailable and the $5,120,000 million Credit Shelter Trust generates $364,245 of Illinois estate taxes, which may be an avoidable tax (compared to zero Illinois estate taxes if the Illinois QTIP election is made). While the nonspousal beneficiaries could disclaim their interests to possibly qualify for QTIP treatment by making the spouse the sole beneficiary (and if the other QTIP criteria are met), disinheritance may be seen as too high a price to avoid paying Illinois estate taxes. Query: Could a Virtual Representation Agreement transmute the nonconforming Credit Shelter Trust into a QTIP Trust and save the day?[24]

C. **<u>$7,620,000 "Single Fund" QTIP Marital Trust</u>**. The entire tentative taxable estate of $7,620,000 is situated in a single trust which qualifies for both federal and Illinois QTIP elections. Such amount exceeds both the federal and Illinois estate tax exclusion amounts, necessitating a QTIP election for both federal and Illinois purposes.

In order to avoid a federal estate tax, a partial QTIP election must be made to generate a $2.5 million marital deduction ($7,620,000 minus $2.5 million, equals the federal exclusion amount of $5,120,000). Accordingly, for federal purposes, a partial QTIP election is made over 32.8084% of the trust, resulting in a $2,500,000 federal QTIP marital deduction ($7,620,000 times 32.8084%). The $5,120,000 remaining assets (the "non-elected portion") results in optimal usage of the federal exclusion amount. Attached is Exhibit C, which demonstrates such partial federal QTIP election expressed on a formula basis.

In order to avoid an Illinois estate tax, a partial Illinois QTIP election must also be made to generate a $1,620,000 marital deduction for Illinois purposes only ($7,620,000 minus $2,500,000 federal and $1,620,000 Illinois QTIP deductions, equals the Illinois exclusion amount of $3.5 million). Accordingly, for Illinois purposes a partial Illinois QTIP election is made over 21.2598% of the trust, resulting in the $1,620,000 Illinois QTIP deduction ($7,620,000 times 21.2598%). The $3.5 million remaining trust (the "non-elected portion") results in optimal usage of the $3.5 million Illinois exclusion amount. Attached is Exhibit C, which demonstrates such partial Illinois QTIP election expressed on a formula basis.

10. **Partial QTIP Elections and Trust Severances.**

Critically related to the partial QTIP election is the severance of the underlying QTIP trust into an elected and nonelected portion. For example, the aforesaid $7,620,000 "Single Fund" QTIP Marital Trust could be physically segregated into three pieces: (i) a $2.5 million piece reflecting the QTIP portion for federal purposes; (ii) a $1,620,000 piece reflecting the Illinois QTIP portion (i.e., the gap amount); and (iii) a $3.5 million piece reflecting the remainder of the trust estate.

Under Regulation Section 20.2056(b)-7(b)(2)(ii) severances relating to partial QTIP elections are allowed with the following limitation:

> (ii) Division of trusts—(A) In general. A trust may be divided into separate trusts to reflect a partial election that has been made, or is to be made, if authorized under the governing instrument or otherwise permissible under accomplished no later than the end of the period of estate administration. If, at the time of the filing of the estate tax return, the trust has not yet been divided, the intent to divide the trust must be unequivocally signified on the estate tax return.
>
> (B) Manner of dividing and funding trust. The division of the trust must be done on a fractional or percentage basis to reflect the partial election. However, the separate trusts do not have to be funded with a pro rata portion of each asset held by the undivided trust.
>
> (C) Local law. A trust may be divided only if the fiduciary is required, either by applicable local law or by the express or implied provisions of the

governing instrument, to divide the trust on the basis of the fair market value of the assets of the trust at the time of the division.

The primary benefit[25] of severing a QTIP trust into QTIP and non-QTIP portions, is to allow principal distributions to the surviving spouse to come from only the QTIP portion, thereby reducing the amount subject to inclusion in the surviving spouse's estate under Code Section 2044.

> Example: Under a $7,620,000 "Single Fund" QTIP Marital Trust, presume that a $1 million principal distribution is made to the surviving spouse and that there are no changes in trust values. Without a severance for federal purposes, $2,171,916 would be includible in the survivor's estate at the partial federal QTIP election ratio (32.8084%, times $6,620,000 remaining trust assets). However, with a $2.5 million severance of the QTIP portion and principal distributions charged against the QTIP portion, at the surviving spouse's death only $1.5 million ($2.5 million minus $1 million) would be included in the survivor's estate. Accordingly, the $671,916 decrease in the Section 2044 includible amount generates substantial estate tax savings.

In regard to a partial Illinois QTIP election, it may not always make sense to recommend a trust severance of the "gap amount" (i.e., in 2012, the $1,620,000 difference between the federal and Illinois estate tax exclusion amounts). This is especially true if it can be anticipated that the surviving spouse will have little or no need for principal distributions from the Illinois QTIP portion. In such case, the administrative burden of maintaining a separate trust structure for the $1.6 million gap amount may trump out any reasons for trust severance of this portion of trust assets.[26]

On the administrative front, the severance of a trust subject to a partial QTIP election typically does not take place until after the filing of the estate tax return. In such case, it is important to realize that the above regulation requires that the intention to make a trust division must be unequivocally disclosed on the estate tax return (preferably in this author's opinion, on the estate tax return exhibit making the formula QTIP election). It would seem for purposes of the Illinois QTIP election, that the notice of a severance should be disclosed only on the Illinois estate tax return (Form 700), as such division would have no practical effect for federal purposes.

Finally, in most trust instruments, there will be detailed instructions relating to trust severances conforming with the regulatory requirement that such severance be done on a fractional basis based on the fair market value of trust assets at the time of the division. Since non-pro rata funding of trust assets is expressly permitted for partial QTIP severances, it may be desirable to stuff high growth assets in the non-QTIP portion as long as trust funding is based on fair market values. However, even if the trust instrument somehow omits trust severance directives, the authority of Section 4.25 in the Illinois Trusts and Trustees Act (706 ILCS 5/4.25) seems sufficient to empower trustees to make trust severances for QTIP purposes.

ENDNOTES

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1. Pub L No 107-16 (June 7, 2001).
2. Section 901 of EGTRRA.
3. Pub L No 111-312 (December 17, 2010).
4. PA 93-0030 (June 20, 2003), amending 35 ILCS 405/2,3,5,6,7,8 and 10.
5. PA 96-0789 (September 8, 2009), amending 35 ILCS 405/2. See Robert J. Kolasa, *The Illinois QTIP Election to the Rescue*, 97 Ill Bar J 612 (December 2009), for an initial review of this legislation.
6. See PA 97-0636 (December 16, 2011), which amends 35 ILCS 405/2 (b) to enact the higher $3.5 million and $4 million estate tax exclusions in the Code Section 2011 calculation.
7. Treasury Regulation 20.2056(b)-7.
8. See the "Estate Tax Instruction Sheet for 2011 Decedents" at http://illinoisattorneygeneral.gov/publications/pdf/2011_Instruction_Fact_Sheet.pdf.
9. Estate of Bonner v. United States, 84 F3d 196 (5th Cir. 1996), holding that the estate was entitled to apply a fractional interest discount in valuing undivided interests in real estate held partly by the surviving spouse and partly by a QTIP trust.
10. Regulation Section 20.2056(b)-7(d)(3).
11. Regulation Section 20.2044-1(d)(1).
12. See 35 ILCS 405/3, paragraph 1(a), which imposes the Illinois estate tax on transferred property having a tax situs within the State of Illinois.
13. Regulation Section 20.2044-1(d) provides that the QTIP property includible in the surviving spouse's estate is the value of such property "determined as of the date of the decedent's death." This makes it a stretch to contend that a QTIP trust can be reduced for estate inclusion purposes by apportioned estate taxes, as such taxes do not really affect the QTIP property's value at date of death.
14. Since the definition of DSUEA is based on the taxpayer's "last such deceased spouse" under Code Section 2010(c)(4), the transactional risk is that the spouse may lose a portion of the DSUEA upon remarriage to a new spouse who then dies with a lower unused federal exclusion amount than the first spouse.
15. Regulation Section 21.2056(b)(f)(5).
16. Regulation Section 21.2056(b)(f)(5)(4).
17. Query whether the spouse in not exercising his or her withdrawal rights over income makes the trust a grantor trust for the spouse as to such portion of the trust? See Code Section 678(a)(2).
18. Regulation Section 20.2056(b)-7(d)(4).
19. See Pennell, 843-2nd T.M., Estates Gifts, and Trusts Portfolios, *Estate Tax Marital*

Deduction (Tax Management), at A-73,74.

20. Id. Nevertheless, a planning tool is to give the spouse an inter vivos general power of appointment beginning some period after the death of the first spouse to die (such as 15 months). This does not disqualify the QTIP status of the trust and facilitates gifting by the surviving spouse of marital trust assets.

21. Regulation Section 20.2056(b)-7(d)(5) and 20.2056(b)-7(e).

22. Regulation Section 20.2056(b)-7(c).

23. Also see Examples #7 and #8 of Regulation Section 20.2056(b)-7(g),.

24. 760 ILCS 5/16.1.

25. Severing the trust into QTIP and non-QTIP portions may also make permit different investment strategies (such as "growth" for the non-QTIP portion and "principal stability" for the QTIP portion) which may be harder to implement in a single trust.

26. It is noted that it is possible to draft a single trust subject to a partial QTIP election which has treats any invasions of principal for the surviving spouse as coming from the QTIP portion. However, this results in a "rolling fraction" requiring a revaluation of trust assets each time principal distributions are made. The administrative complexity of revaluation and adjusting the fraction cause most planners to adopt the trust severance route in lieu of this approach. See Pennell, 843-2nd T.M., Estates Gifts, and Trusts Portfolios, *Estate Tax Marital Deduction* (Tax Management), at A-85.

EXHIBIT A

$3.5M CREDIT SHELTER TRUST. PARTIAL FEDERAL AND ILLINOIS QTIP ELECTIONS OVER QTIP MARITAL TRUST

A. *Illinois QTIP Election* (Attach to Form 700)

Pursuant to 35 ILCS 405/52(b-1) , Section 2056(b)(7) of the Internal Code and Estate Tax Regulation 20.2056(b)-7(h) (Examples #7 and #8 therein), the Executor hereby makes a formula election for Illinois estate tax purposes only to deduct a fractional share of the Marital Trust as qualified terminable interest property ("QTIP"), calculated as follows:

A. Numerator. The numerator of the fraction is the amount of deduction necessary to reduce the Decedent's Illinois estate tax to zero (taking into account final estate tax values and any portion of the Marital Trust which is treated as qualified terminable interest property for federal estate tax purposes); and

B. Denominator. The denominator of the fraction is the final estate tax value of the Marital Trust (taking into account any specific bequests or liabilities of the estate paid out of the Trust).

In determining the fraction, all values shall be those which are finally determined on the Decedent's estate tax return. The above election is a formula election that may change if values are changed on audit.

NOTICE OF DIVISION - OPTIONAL

Pursuant to 35 ILCS 405/52(b-1), Regulation Section 20.2056(b)-7(a)(2) and the authority granted the executor in Section ___ of the trust agreement [*or if no such authority in the trust instrument exists, cite* 706 ILCS 5/4.25*]*, the executor shall during the period of administration divide the Marital Trust on a fractional basis into a QTIP portion and a non-QTIP portion to reflect the above election, taking into account the fair market value of trust assets at the time of division.

B. Federal QTIP Election (Attach to Form 706)

Pursuant to Section 2056(b)(7) of the Internal Code and Estate Tax Regulation 20.2056(b)-7(h) (Examples #7 and #8 therein), the Executor hereby makes a formula election to deduct a fractional share of the Marital Trust as qualified terminable interest property ("QTIP"), calculated as follows:

A. Numerator. The numerator of the fraction is the amount of deduction necessary to reduce the Decedent's federal estate tax to zero (taking into account final estate tax values); and

B. Denominator. The denominator of the fraction is the final estate tax value of the Marital Trust (taking into account any specific bequests or liabilities of the estate paid out of the Trust).

In determining the fraction, all values shall be those which are finally determined on the Decedent's estate tax return. The above election is a formula election that may change if values are changed on audit.

DIVISION - OPTIONAL

Pursuant to Regulation Section 20.2056(b)-7(a)(2) and the authority granted the executor in Section ___ of the trust agreement [*or if no such authority in the trust instrument exists, cite* 706 ILCS 5/4.25], the executor shall during the period of administration divide the Marital Trust on a fractional basis into a QTIP portion and a non-QTIP portion to reflect the above election, taking into account the fair market value of trust assets at the time of division.

EXHIBIT B

$5.12M CREDIT SHELTER TRUST. PARTIAL ILLINOIS QTIP ELECTION OVER "GAP AMOUNT" IN CREDIT SHELTER TRUST (Attach to Form 700)

Pursuant to 35 ILCS 405/52(b-1) , Section 2056(b)(7) of the Internal Code and Estate Tax Regulation 20.2056(b)-7(h) (Examples #7 and #8 therein), the Executor hereby makes a formula election for Illinois estate tax purposes only to deduct a fractional share of the Credit Shelter Trust as qualified terminable interest property ("QTIP"), calculated as follows:

A. Numerator. The numerator of the fraction is the amount of deduction necessary to reduce the Decedent's Illinois estate tax to zero (taking into account final estate tax values); and

B. Denominator. The denominator of the fraction is the final estate tax value of the Credit Shelter Trust (taking into account any specific bequests or liabilities of the estate paid out of the Trust).

In determining the fraction, all values shall be those which are finally determined on the Decedent's estate tax return. The above election is a formula election that may change if values are changed on audit.

NOTICE OF DIVISION - OPTIONAL

Pursuant to 35 ILCS 405/52(b-1), Regulation Section 20.2056(b)-7(a)(2) and the authority granted the executor in Section ___ of the trust agreement [*or if no such authority in the trust instrument exists, cite* 706 ILCS 5/4.25*]*, the executor shall during the period of administration divide the Credit Shelter Trust on a fractional basis into a QTIP portion and a non-QTIP portion to reflect the above election, taking into account the fair market value of trust assets at the time of division.

EXHIBIT C

$7.62M SINGLE FUND QTIP MARITAL TRUST. PARTIAL QTIP ELECTIONS (FEDERAL & ILLINOIS)

A. *Illinois QTIP Election* (Attach to Form 700)

Pursuant to 35 ILCS 405/52(b-1) , Section 2056(b)(7) of the Internal Code and Estate Tax Regulation 20.2056(b)-7(h) (Examples #7 and #8 therein), the Executor hereby makes a formula election for Illinois estate tax purposes only to deduct a fractional share of the Marital Trust as qualified terminable interest property ("QTIP"), calculated as follows:

A. Numerator. The numerator of the fraction is the amount of deduction necessary to reduce the Decedent's Illinois estate tax to zero (taking into account final estate tax values and any portion of the Marital Trust which is treated as qualified terminable interest property for federal estate tax purposes); and

B. Denominator. The denominator of the fraction is the final estate tax value of the Marital Trust (taking into account any specific bequests or liabilities of the estate paid out of the Trust).

In determining the fraction, all values shall be those which are finally determined on the Decedent's estate tax return. The above election is a formula election that may change if values are changed on audit.

NOTICE OF DIVISION - OPTIONAL

Pursuant to 35 ILCS 405/52(b-1), Regulation Section 20.2056(b)-7(a)(2) and the authority granted the executor in Section ___ of the trust agreement [*or if no such authority in the trust instrument exists, cite* 706 ILCS 5/4.25*]*, the executor shall during the period of administration divide the Marital Trust on a fractional basis into a QTIP portion and a non-QTIP portion to reflect the above election, taking into account the fair market value of trust assets at the time of division.

B. Federal QTIP Election (Attach to Form 706)

Pursuant to Section 2056(b)(7) of the Internal Code and Estate Tax Regulation 20.2056(b)-7(h) (Examples #7 and #8 therein), the Executor hereby makes a formula election to deduct a fractional share of the Marital Trust as qualified terminable interest property ("QTIP"), calculated as follows:

A. Numerator. The numerator of the fraction is the amount of deduction necessary to reduce the Decedent's federal estate tax to zero (taking into account final estate tax values); and

B. Denominator. The denominator of the fraction is the final estate tax value of the Marital Trust (taking into account any specific bequests or liabilities of the estate paid out of the Trust).

In determining the fraction, all values shall be those which are finally determined on the Decedent's estate tax return. The above election is a formula election that may change if values are changed on audit.

DIVISION - OPTIONAL

Pursuant to Regulation Section 20.2056(b)-7(a)(2) and the authority granted the executor in Section ___ of the trust agreement [*or if no such authority in the trust instrument exists, cite* 706 ILCS 5/4.25], the executor shall during the period of administration divide the Marital Trust on a fractional basis into a QTIP portion and a non-QTIP portion to reflect the above election, taking into account the fair market value of trust assets at the time of division.