Making Use of the Illinois Rules

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PART II: "PLANNING FOR THE ILLINOIS QTIP ELECTION"

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PLANNING FOR THE ILLINOIS QTIP ELECTION

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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EGTRRA provided for a bizarre "sunset" rule[2] whereby its provisions were scheduled to be repealed after December 31, 2010 "as if" such legislation "had never been enacted."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in 2003 (in a process known as "decoupling")[4] to provide that state estate taxes would continue to be based on the repealed 2011 credit taking into account a separate Illinois estate tax exclusion amount.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-
A. First Spouse to Die	**Federal**	**Illinois**
B. Surviving Spouse's Death		
Amount Includible in Surviving Spouse's Estate	**Federal**	**Illinois**
Illinois QTIP Property ("Gap Trust Assets")**	$0	$1,620,000
Marital Trust**	$2,500,000	$2,500,000
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 not to exceed 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 to exceed 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 excluded 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. **$7,620,000 "Single Fund" QTIP Marital Trust**. 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

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.