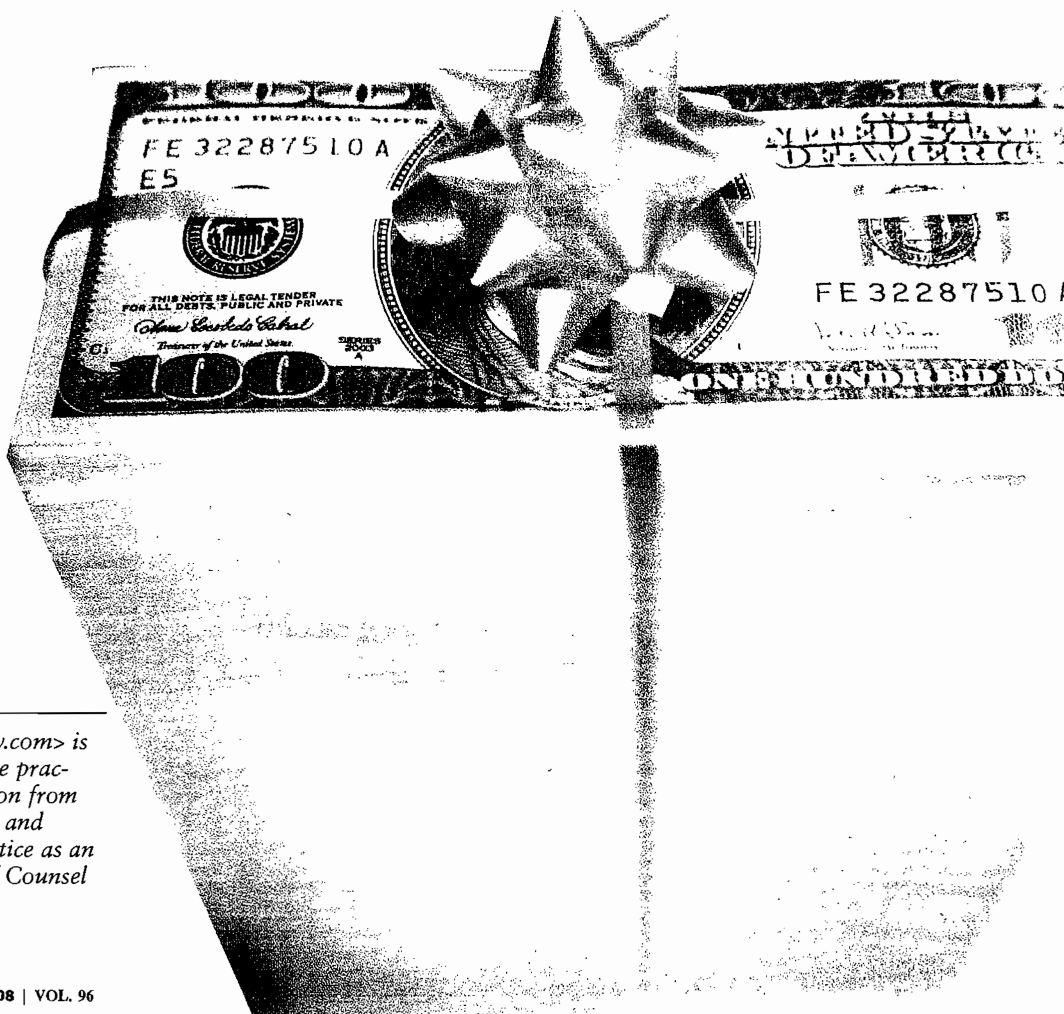
By Robert J. Kolasa

How to Use Gifts
to Reduce Illinois Estate Taxes

In 2009, federal and Illinois estate taxes will be "decoupled" – i.e., the first $3.5 million of an estate will be exempt from federal estate tax, while $2 million will be exempt from Illinois tax. This article explores how estate planners can use gifts to help clients reduce Illinois estate taxes.

Prior to 2001, the Illinois Estate and Generation-Skipping Transfer Tax Act, 35 ILCS 405/1 et seq (the "Illinois Act") operated under a "pick-up" tax system whereby Illinois estate taxes were based on the state death tax credit under section 2011 of the Internal Revenue Code ("Code"). These rules effectively provided a form of revenue sharing, as the section 2011 credit mechanically apportioned estate tax revenues between the United States Treasury and the respective Illinois counties where the decedent was domiciled, or owned real estate.

This grand symbiotic partnership between the IRS and Illinois ended on June 7, 2001, when President Bush signed the Economic Growth and Tax Relief Reconcilia-



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tion Act of 2001 ("EGTRRA").[1] By 2005, this legislation would have completely eliminated Illinois' collection of estate tax revenues based on the section 2011 credit.

The prospects of losing its rightful share of tax revenues forced Illinois and many other states (in a process known as "decoupling") to pass new state estate tax laws. Consequently, the Illinois Act was amended in 2003 to provide that Illinois estate taxes are based on the section 2011 credit using the applicable estate tax exclusion amount ("exclusion amount"), which for 2008 and 2009 is set at $2 million.[2]

The new rules mean that although the federal and Illinois exclusion amounts are both $2 million for 2008, they will be different next year. In 2009, Illinois taxpayers are faced with the odd reality of a federal exclusion amount of $3.5 million, paired with a $2 million exclusion amount for Illinois estate taxes. Unless changed by legislation,[3] this means that in 2009 a decedent's estate between $2 million and $3.5 million may pay Illinois estate taxes, but no federal estate taxes.

In 2010, both the federal and Illinois estate taxes are repealed, only to return in 2011 to the pre-EGTRRA rules providing an exclusion amount of $1 million. Many believe that Congress will never allow the one-year estate tax repeal or allow the law to revert to the $1 million exclusion amount. Nevertheless, until affirmative legislative action is forthcoming (most probably late in 2009), estate tax practitioners have no choice but to abide by the existing rules.

The Code section 2011 credit

Illinois estate taxes are based on the state death credit under Code section 2011 to impose a separate estate tax in addition to the federal estate tax. Under section 2011(b)(1), the credit uses a tax table ("2011 table") formulating graduated tax rates from .8 percent to 16 percent on "adjusted taxable estates"[4] exceeding $40,000. For example, the 2011 table amount for a $10 million adjusted taxable estate would be $1,076,720 ($930,800, plus 15.2 percent of the excess over $9,040,000).

The amount computed under the 2011 table is subject to various modifications. Initially, a "circular calculation" is applied to the 2011 table amount to arrive at the preliminary amount of Illinois estate tax due (i.e., since Code section 2058 provides a deduction for state death taxes, the Illinois tax reduces the federal taxable estate, which reduces the Illinois tax, which again reduces the federal taxable estate, and so on, until the calculation ends after 10 to 20 repetitions).

Then, pursuant to Code section 2011(e), the Illinois estate tax constitutes the *lower* of i) the amount circularly computed under the 2011 table or ii) federal estate taxes due using a $2 million exclusion amount. In 2009, when the $3.5 million federal exclusion amount mismatches the $2 million Illinois exclusion, this creates a hypothetical federal estate tax calculation (based on a $2 million exclusion) solely for purposes of computing the 2011(e) limitation.

The practical effect of the circular calculation is to lessen the tax bite of the 2011 table. For example, even though the 2011 table computes a $1,076,720 tax for a $10 million adjusted taxable estate, the actual Illinois estate tax via the circular computation is $926,923 (a $149,797 reduction from the 2011 Table). In the same vein, for some (but not all) estates having tentative taxable estates and adjusted gifts between $2 million and about $2,360,000, the section 2011(e) limitation reduces the tax computed under the 2011 table because the hypothetical federal estate tax is the lower amount.[5]

Luckily for practitioners who are not math gurus, the Illinois Attorney General's Web site contains an online calculator computing the rather byzantine circular and section 2011(e) calculations to determine the correct amount of Illinois estate taxes.

The more notable significance of the section 2011(e) limitation is that it causes adjusted gifts to be added back to the taxable estate to determine if such sum exceeds Il-

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1. Pub L No 107-16 (June 7, 2001).
2. PA 93-0030 (June 20, 2003), amending 35 ILCS 405/2, 3, 5, 6, 7, 8 and 10. Generally see David A. Berek, *Illinois' New Estate-Tax Law*, 91 Ill Bar J 465 (Sept 2003); Susan T. Bart, *This Is Me Leaving You: Illinois Departs from the Federal Estate Tax Scheme*, 92 Ill Bar J 20 (Jan 2004); Jason S. Ornduff, *The Illinois Estate Tax - One Year Later*, 18 CBA Record 28 (Sept 2004).
3. Current legislative proposals have been made to increase Illinois' exclusion amount to $3.5 million in 2009. See 95th Illinois General Assembly, HB 0406 (Jan 24, 2007); SB 2631 (Feb 15, 2008); and SB1602 (Feb 9, 2007).
4. Under Code Section 2011(b)(3), the term "adjusted taxable estate" means the taxable estate reduced by $60,000.
5. The applicability of the 2011(e) limitation generally depends on the relative size of adjusted gifts to the Tentative Taxable Estate. For example, such limitation applies for an estate having a Tentative Taxable Estate Plus Adjusted Gifts total of $2.3 million, which includes a $100,000 adjusted gift, but doesn't apply for a $2.3 million estate, which includes a $300,000 adjusted gift. The 2011(e) limitation is generally more prevalent for estates having a total Tentative Taxable Estate Plus Adjusted Gifts total under $2.2 million. However, if no adjusted gifts are taken into account, the 2011(e) limitation applies for estates having a Tentative Taxable Estate up to about $2,387,000.

linois' $2 million exclusion amount (i.e., the Illinois "trip wire").[6] If the $2 million mark is exceeded, Illinois estate taxes are due, although as is discussed below, in most cases adjusted gifts are excluded in the actual tax computation.

Luckily for practitioners who are not math gurus, the Illinois Attorney General's web site (www.illinoisattorneygeneral.gov) contains an online calculator computing the rather byzantine circular and section 2011(e) calculations to determine the correct amount of Illinois estate taxes.

The online calculator requires input from information readily available on the decedent's federal estate tax return. The first data entry is for the "Tentative Taxable Estate," which constitutes the taxable estate before the state death tax deduction. The second input entry is for the "Tentative Taxable Estate Plus Adjusted Gifts" ("adjusted gifts" generally are the decedent's post 1976 gifts, excluding charitable and marital gifts, over the then existing gift tax exclusion amount, which for 2008 is set at $12,000).

A current tax benefit is the deductibility of Illinois estate taxes in the federal estate tax computation (there has been talk of this deduction being eliminated, which would make the Illinois estate tax much more expensive). Even with its deductibility, the separate Illinois estate tax increases overall taxes well above the top 45 percent federal rate for estates having a tentative taxable estate over $2 million. So much for estate tax reform, although EGTRRA's increase of the exclusion amount to $2 million, with a scheduled increase to $3.5 million in 2009, translates into the good news that many estates will no longer pay federal (but perhaps Illinois?) estate taxes. Table A illustrates the combined Federal and Illinois estate tax rates (see below).

Lifetime gifts typically reduce Illinois estate taxes

Significantly, the 2011 table does *not* account for adjusted gifts, while the federal estate tax calculation takes into account such gifts.[7] The exclusion of adjusted gifts from the 2011 table has major significance for gift planning and the reduction of Illinois estate taxes, as is shown by Table B (see page 583).

To illustrate the section 2011(e) limitation, under Table B there is no Illinois estate tax on a $1.5 million taxable estate because the hypothetical federal estate tax based on a $1.5 million estate is $0, which "caps" the tax because such

6. The 2011 Table shows an estate tax due for adjusted taxable estates over $40,000. However, under 35 ILCS 405/2(b) and Code section 2011(e), no Illinois estate tax is triggered until at least $1 of hypothetical Federal estate tax (based on a $2 million exclusion amount) is due. This effectively establishes a $2 million Illinois estate tax exclusion or "trip wire."

7. Code section 2001(b).

TABLE A

COMBINED FEDERAL AND ILLINOIS TAXES (2008)

*Tentative Taxable Estate	**Tentative Federal Estate Tax	***Final Federal Estate Tax	IL Estate Taxes	Combined Taxes & Rates over $2 Million	
$2,100,000	$45,000	$31,034	$31,034	$62,068	62.07%
$2,500,000	$225,000	$167,167	$128,519	$295,686	59.14%
$3,000,000	$450,000	$374,724	$167,279	$542,003	54.20%
$4,000,000	$900,000	$785,707	$253,986	$1,039,693	51.98%
$6,000,000	$1,800,000	$1,594,768	$456,071	$2,050,839	51.27%
$10,000,000	$3,600,000	$3,182,885	$926,923	$4,109,808	51.37%
$20,000,000	$8,100,000	$7,065,466	$2,298,966	$9,364,432	52.02%
$50,000,000	$21,600,000	$18,703,397	$6,436,897	$25,140,294	52.38%

*Taxable estate before deduction for Illinois estate taxes.

**Federal estate tax before deduction for Illinois estate taxes.

***Federal estate tax after deduction for Illinois estate taxes.

amount is lower than the circularly computed 2011 table amount of $60,526. On the other hand, there is Illinois estate tax on a $1.5 million tentative taxable estate with $1 million of adjusted gifts, because the total exceeds the $2 million exclusion amount.

More than a few Illinois practitioners have wrongly concluded that adjusted gifts always increase Illinois estate taxes since the attorney general's online calculator takes into account adjusted gifts as an input field. While adjusted gifts are added back to the tax base to determine if the $2 million trip wire is crossed, the real answer is that in most scenarios adjusted gifts *reduce* Illinois estate taxes.

This is because adjusted gifts are excluded under the section 2011 table, which forms the basis of the Illinois estate tax calculation. Consequently, Illinois estate taxes are generally lower for decedents who make adjusted gifts, even if they do so shortly before death, because such gifts are not taken into account.

The only exceptions are for some estates having a "tentative taxable estate plus adjusted gifts" total between $2 million and about $2,360,000, where the section 2011(e) limitation ignores the tax computed under the 2011 table because the hypothetical federal estate tax is the lower amount.[8] For estates in this category, adjusted gifts are taken into account in the Illinois tax computation since the section 2011(e) limitation caps Illinois estate taxes at the hypothetical federal estate tax, which includes adjusted gifts in its tax base.

Accordingly, a gifting strategy to reduce Illinois estate taxes is generally productive for estates having a "tentative taxable estate plus adjusted gifts" total exceeding $2,360,000 (although some estates under this range may also benefit if the section 2011(e) limitation doesn't apply).

The revelation that adjusted gifts generally reduce Illinois estate taxes is a very powerful planning tool. Under Table B, the Illinois estate tax of $128,518 is the same for an estate having a tentative taxable estate of $2.5 million, whether or not pre-death gifts of $500,000, $1 million, or $7.5 million are respectively made. Even though adjusted gifts seemingly are required to be inputted for the attorney general's online calculator, they are excluded from the Illinois estate tax computation, thereby lowering overall Illinois estate taxes (compared to if such

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8. See note 5 above.

TABLE B					
EFFECT OF GIFTS ON ILLINOIS ESTATE TAXES (2008)					
Tentative Taxable Estate ("TTE")	**Adjusted Gifts**	**TTE plus Adjusted Gifts**	**IL Estate Tax**	**IL Estate Tax Savings**	**Overall Estate Tax Savings***
$1,500,000	$0	$1,500,000	$0	$0	$0
$2,500,000	$0	$2,500,000	$128,518	$0	$0
$1,500,000	$1,000,000		$60,526	$67,992	$37,396
$3,000,000	$0	$3,000,000	$167,279	N/A	N/A
$2,500,000	$500,000		$128,518	$38,761	$21,319
$3,500,000	$0	$3,500,000	$209,124	$0	$0
$2,500,000	$1,000,000		$128,518	$80,606	$44,333
$10,000,000	$0	$10,000,000	$926,923	$0	$0
$2,500,000	$7,500,000		$128,518	$798,405	$439,123

* Illinois estate tax savings reduced 45% by higher Federal estate taxes due to lower deduction for state death taxes.

TABLE C				
Gift Planning Illustration -$1,000,000 Gift (Death in 2008)				
			Gift of Property ($750,000 Basis)	
	No Gift	**Cash Gift**	**Property Gift & Sale by Donee**	**Sale by Donor & Gift of Proceeds**
Sale before Death	N/A	N/A	N/A	1,055,000*
Gift before Death	N/A	$1,000,000	$1,000,000	N/A
Combined Federal & IL Income Tax (18%) on Sale**	N/A	N/A	($45,000)	($54,900)
Gross Estate	$5,000,000	$4,000,000	$4,000,000	$3,945,000
Illinois Estate Tax	($352,158)	($253,986)	($253,986)	($248,804)
Federal Estate Tax	($1,191,529)	($1,235,707)	($1,235,707)	($1,213,288)
Combined Value to Family	**$3,456,313**	**$3,510,307**	**$3,465,307**	**$3,483,008**
Total Tax Savings (compared to "No Gift" scenario)		**$53,994**	**$8,994**	**$26,695**

*Required $1,055,000 sale of property to produce about a $1 million cash gift.
**Ignores benefit of possible Federal deduction of Illinois capital gains tax.

gifts were not made and includible in the tentative taxable estate).

The tax-basis dilemma

Alas, all is not rosy in the garden of gifts and Illinois estate taxes. The consequence of making adjusted gifts to reduce Illinois estate taxes means the loss of the "stepped up" basis adjustment for the gifted assets.[9] 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).

For gifts before death, the donee generally takes the same (carryover) basis of the donor immediately before the gift, meaning that the pre-death appreciation is taxed when the asset is subsequently sold by the donee.

Indisputably, Illinois estate taxes can be dramatically reduced by adjusted gifts made during the client's lifetime. However, 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 18 percent capital gains tax (15 percent federal, plus 3 percent Illinois) would be levied on most Illinois taxpayers upon the sale of the gifted property.[10] This potential income tax must be weighed against the projected Illinois estate tax savings attributable to the lifetime gift to determine whether it is productive to make the gift in the first place.

Developing a quantitative model to determine whether Illinois estate tax savings outweigh the potential capital gains tax is beyond the scope of this article. For practitioners advising clients to make gifts before death, such analysis should probably be made on a case-by-case basis to determine the viability of gifting.

Sadly, in most cases the forfeiture of the basis step-up for gifted property seems to limit the tax advantages of this technique to gifts made in cash or high basis assets. It has been suggested that when a cash-starved client has little time to live, a worthwhile strategy is to borrow funds and give away the cash, with a sale of the property after death (with no gain because of the basis step-up) to satisfy the loan.[11]

Table C (see above) is a basic illustration of the tax basis dilemma for a 2008 decedent having an aggregate $5 million estate, who is considering a $1 million

9. Since gifted property is not included in the decedent's gross estate, there is no basis step up under Code section 1014. Instead, under Code section 1015, the donee's basis in the gifted property is generally the same basis the donor had.

10. In 2008, 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, and the balance of long-term capital gains is then taxed at 15%.

11. Robert C. Pomeroy and Susan L. Abbott, *Deathbed Opportunities*, Trusts and Estates 22, 27 (June 2007), available at http://www.goodwinprocter.com/~/media/DD2A4D243AD1406C8290BCFEE736BB89.ashx

gift, presuming no prior adjusted gifts and the donee's (or the decedent's) sale of the gifted property in 2008.

The results of Table C show that the client's family is better off by $53,994 if the decedent makes a $1 million cash gift before death. If the decedent intends to make a gift of property, the family is generally better off if the decedent sells the property during his or her lifetime and makes a gift of the proceeds to family members. This latter result is due primarily to the fact that the capital gains tax on the sale reduces the decedent's gross estate, which lowers overall estate taxes.

It doesn't take much imagination to realize that if the aforesaid property basis is marginally lower than $750,000, a crossover point is reached where the client's family may *not* be better off by the lifetime gift, whether or not the property is sold before death. However, this analysis presumes a static value for the gifted property before death. Any substantial pre-death appreciation of the gifted property would strengthen the case for gifting, because the appreciation would escape estate taxation.[12] Leveraged gift techniques such as GRATs, QPRTs, family limited partnerships, sales to intentionally defective grantor trusts and transfers creating fractional interest discounts would also increase the tax savings of lifetime gifts.

Moreover, what if there is no compulsion to immediately sell the gifted asset, such as in the case of closely held stock or other assets intended to be retained in the family indefinitely? In such case, the lifetime gift to family members preserves estate liquidity by reducing Illinois estate taxes, without countervailing income tax considerations.

In the end, the practitioner is forced to crunch the numbers and make difficult assumptions as to asset growth, tax rates, tax law changes, liquidity and future sales to arrive at a deliberate decision whether gifting makes sense.

Paying gift tax

Most clients would probably prefer not to make gifts greater than their remaining $1 million gift tax exclusion amount, because gifts exceeding such exclusion cause an immediate gift tax. In our current political climate, it presumably is good policy to avoid paying gift taxes because the possible repeal of the estate tax (or even increased exclusions) may make such tax avoidable at the client's death. Nevertheless, for clients in ill health or with such high wealth that they foresee estate taxes at death, a gifting strategy may be a good way to reduce Illinois estate taxes.[13]

The payment of gift taxes for lifetime gifts adds an additional twist to analyzing the expected Illinois estate tax benefit of such gifts. Code section 1015(d) generally adds to the basis of the gifted property the amount of the gift tax attributable to such property.

Because of this provision, some clients might *not* be better off selling the gifted property before death and gifting proceeds. For those clients, the section 1015(d) basis adjustment offsets the lost stepped up basis in the gifted property. Under certain scenarios, the client's family may be better off having the decedent gift the property and pay gift taxes, thereby allowing the donees to reap the benefit of the Section 1015(d) basis increase upon a subsequent sale. This analysis requires careful calculation.

2009 gifting strategies

In 2009, the $3.5 million federal estate tax exclusion amount will be higher than the $2 million Illinois exclusion, unless legislation is enacted to change that. Thus, a surviving spouse whose wife or husband died in 2009 might be looking at the painful choice of paying Illinois estate taxes now to fully fund the credit shelter trust using the $3.5 million federal exclusion amount (the $1.5 million federal/Illinois exclusion differential is subject to Illinois estate taxes).

If the surviving spouse will eventually be subject to federal estate taxes, the family will probably be better off paying the much lower Illinois estate tax at the first death, although mathematics do not always displace the angst of clients unwilling to pay current taxes, whatever the tax benefit.

A gifting strategy would help lower transfer taxes and enable clients to use the different federal and Illinois exclusion amounts. For example, a $1 million lifetime gift of cash or high basis assets to an intervivos credit shelter trust (excluded from the Illinois tax base), combined with a $2 million testamentary credit shelter trust, could come within the $2 million Illinois exclusion and $3 million of the federal exclusion. If the client is not afraid to pay some estate tax at the first death, the $1 million intervivos gift could be combined with a $2.5 million testamentary credit shelter trust, which would cause $500,000 to be subject to Illinois estate tax as the price to pay for fully using the $3.5 million federal exclusion amount.

Lifetime gifts may also offer a better solution for some to the federal/Illinois exclusion mismatch than the proposed Illinois QTIP legislation,[14] which (if it ever becomes law) in 2009 would allow the estate of the first to die to be funded at $3.5 million without Illinois estate tax. The qualifying condition is that the $1.5 million differential be held in a marital trust subject to Illinois estate tax upon the death of the surviving spouse. In contrast, a $1.5 million intervivos credit shelter trust would not ever be subject to Illinois estate taxes.

Of course, the real bonanza would be if the Illinois exclusion amount were simply increased to $3.5 million in 2009, which would "recouple" it with the federal exclusion. Unfortunately, in today's austere fiscal environment the potential revenue loss makes this change doubtful.

On the other hand, given the already bizarre seesaw results of the current estate tax law ($3.5 million federal and $2 million Illinois exclusions in 2009; estate tax repeal in 2010; $1 million federal/Illinois exclusions in 2011), anything may be possible. We must simply wait and see. ■

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12. The pre-death appreciation is entirely excluded from the Illinois estate tax base, as well as from the Federal estate tax base in regard to gifts utilizing the $1 million gift tax exclusion. However, the flat 45% estate and gift tax rate (for estates exceeding $2 million and taxable gifts exceeding $1.5 million) lessens the estate tax benefit of appreciation, although the other advantages of gifting discussed herein would still apply. 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 (Summer 2008).

13. Federal estate tax advantages are also realized by the exclusion of the post-gift appreciation from the tax base, the Code section 1015(d) basis adjustment, and the section 2035(b) exclusion of gift taxes from the Federal estate tax base if the decedent survives the gift by three years.

14. The Chicago Bar Association and Illinois State Bar Association (ISBA) have recommended an Illinois "QTIP" election which would permit married couples in 2009 to utilize the full $3.5 million Federal exclusion upon the death of the first spouse, without immediate Illinois estate taxation. The ISBA is seeking to have the proposed legislation inserted into SB 2236. See Katarinna McBride, *The Delayed QTIP: The Illinois Wait-n-See*, Vol 54, No 3 ISBA Trusts & Estates newsletter (December 2007); Robert Iverson, *Push comes to shove*, Vol 54, No 5 ISBA Trusts & Estates newsletter (April 2008); Ray J. Koenig III and Amy Jo Smith, *Trust and Estates Section Council legislative update*, Vol 54, No 5 ISBA Trusts & Estates newsletter (April 2008).

Erratum – Gifts and Estate Taxes

My article *How to Use Gifts to Reduce Illinois Estate Taxes* (November 2008 IBJ), in discussing the use of lifetime gifts to deal with the mismatched federal ($3.5 million) and Illinois ($2 million) estate tax exclusion amounts, mistakenly implied that there would be no Illinois estate tax associated with an intervivos credit shelter trust.

In fact, a $1 million lifetime gift of cash or high basis assets to an intervivos credit shelter trust combined with a $2 million testamentary credit shelter trust would result in a *reduced* Illinois estate tax of $92,910 (versus $167,279 if a $3 million credit shelter trust was funded at death). Alternatively, a $1 million intervivos gift could be combined with a $2.5 million testamentary credit shelter trust generating Illinois estate taxes of $128,519 (versus $209,124 if a $3.5 million credit shelter trust was funded at death).

Accordingly, a gifting strategy is helpful to lower overall estate taxes and assist clients in using the different federal and Illinois exclusion amounts. If the surviving spouse will eventually be subject to Federal estate taxes, the family will probably be better off incurring Illinois estate taxes (at the first death) as the price to pay for having assets escape the much higher 45 percent Federal estate tax rate (at the surviving spouse's death). Robert J. Kolasa.