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Client Alert

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November 13, 2015

Do I Need to Be Concerned about the Illinois Estate Tax?

Due to the increasing federal estate tax exemption amount and the federal rule that allows one spouse to "carry-over" a deceased spouse's unused federal exemption amount, many individuals no longer face a federal estate tax or need to be concerned with dividing assets between spouses for tax planning purposes. But for individuals residing in Illinois, and even non-residents who own Illinois property, not only is there still an estate tax, but the exemption is much smaller. Planning to reduce the Illinois estate tax may be required even if planning for federal estate taxes is not relevant.

Illinois remains 1 of 19 states (including the District of Columbia) that still impose some form of state estate or inheritance tax.

To understand the Illinois estate tax and planning for the Illinois estate tax, it is useful to understand some of the history of estate taxes and estate tax planning. The first part of this alert will cover some of that history, and then the second part will answer some basic questions regarding the Illinois estate tax and planning.

History — The Pick Up Tax

Historically, most states had a so-called "pick up" estate tax. The federal estate tax provided a state death tax credit for state estate or inheritance taxes. The states simply "picked up" the maximum amount of this credit as their own estate tax. As a result of this "pick up" structure, a portion of the federal estate tax that could be assessed was actually paid to the state. Because the federal and state estate taxes operated together, a person's state of residence generally made very little estate tax difference and any changes to the federal estate tax rules automatically adjusted the states' "pick up" taxes.

When Congress passed the 2001 Tax Act, it phased out the state death tax credit, making the credit $0, which effectively eliminated many states' estate tax. Some states, like Illinois, "decoupled" their estate tax law from the federal law and continued to compute their state estate tax based on the state death tax credit amount prior to the 2001 Tax Act. Because of Illinois' disconnect from the federal estate tax, Illinois developed some unique rules for its estate tax, as discussed below.

History — Spousal Planning

Prior to 2012, a basic estate tax planning tool for married couples was to create a trust at the death of the first spouse in order to "use" that spouse's estate tax exemption. Because married individuals typically leave property to each other first, before passing assets along to children or other beneficiaries, the deceased spouse's estate tax exemption can be wasted without proper estate planning. For example, when the estate tax exemption was $3,500,000, a married couple using a so-called "credit shelter" trust could pass $7,000,000 tax-free to their children and other beneficiaries. If all property passed outright to the surviving spouse instead, only $3,500,000 could pass tax-free to the children and the first spouse's $3,500,000 exemption would not be used.

Since 2012, under the federal estate tax rules, the first spouse's unused estate tax exemption will pass to the surviving spouse (although a federal estate tax return must be filed to claim this carry-over of exemption). Because of this carry-over or portability rule, married couples no longer are required to have a "credit shelter" trust to maximize use of the couples' federal estate tax exemption, although there are other reasons, including other tax-related reasons, to have such a trust. As discussed below, Illinois has no such carry-over rule for its estate tax exemption.

Will you be subject to Illinois estate tax?

When Illinois "decoupled" from the federal estate tax, it also adopted a different "exemption" rule. If you are an Illinois resident, or a non-resident with property located in Illinois, your Illinois assets are subject to Illinois estate tax if the total value of all assets at death *plus all taxable gifts made during life* are more than $4,000,000. This

exemption is less than the federal exemption, which is $5,430,000 for 2015. Because the federal exemption is indexed for inflation and the Illinois exemption is not, the disconnect between the exemptions will continue to grow unless Illinois changes its laws.

It is also important to note that if only part of your total assets are "Illinois assets," you will still be subject to Illinois estate tax if the total assets plus prior gifts is more than $4,000,000. For example, if the total value of your assets is $4,500,000 and $500,000 of those assets are in a jurisdiction that does not impose an estate tax (such as Florida), there is still an Illinois estate tax of $126,984 (which is 88%—4,000,000/4,500,000—of $142,857, the total estate tax on $4,500,000). The same would be true if you were not a resident of Illinois but had assets located in Illinois. Reversing the numbers from above, if you live in Florida and have assets of $4,500,000, and $500,000 of those assets are in Illinois, there is an Illinois estate tax of $15,873 (which is 11%—500,000/4,500,000—of the total $142,857).

When is planning to reduce the Illinois estate tax appropriate?

For a single individual, planning is appropriate if, collectively, assets owned or previously gifted are currently, or are expected to be, more than $4,000,000.

The same is true for a married couple. Furthermore, unlike the federal exemption, one spouse's $4,000,000 Illinois exemption cannot be passed along to his or her surviving spouse if unused. Because of the federal carry-over or portability rule, planning directed at reducing *federal* estate taxes for a married couple is applicable when collective assets are, or will be, over $10,860,000 (for 2015). However, for married couples whose collective assets are over $4,000,000, planning to make maximum use of the Illinois estate tax exemption for married couples is still relevant.

If I am subject to Illinois estate tax, what can I do to reduce this tax?

Making non-taxable and taxable gifts is one way to reduce the Illinois estate tax. Illinois does not have a gift tax (i.e., there is no gift tax return or gift tax on gifts that exceed the exemption amount). Making gifts that are non-taxable under federal law will eliminate any Illinois estate tax on those gifts. Non-taxable gifts include gifts that fall within the annual federal gift-tax exclusion, which are direct gifts of $14,000 per person, and making direct payments of medical and tuition expenses.

Making taxable gifts will also reduce, although not eliminate, the Illinois estate tax. As indicated above, the Illinois estate tax will apply if the total value of assets at death *plus* the value of taxable gifts during lifetime exceeds $4,000,000. Nevertheless, if a person has more than $4,000,000, he or she can reduce (but not eliminate) the Illinois estate tax by making taxable gifts during his or her lifetime. For example, if a person has $5,500,000 of assets and makes taxable gifts of $1,500,000 (leaving her with $4,000,000), the amount of estate tax on that $4,000,000 at death will be $253,986. In comparison, if the person made no taxable gifts (i.e., held all $5,500,000 at death), the Illinois estate tax would be $402,518. In this case, there is an Illinois estate tax savings to making the taxable gift.

Additionally, for married couples, planning for a "credit shelter" trust tied to the Illinois exemption amount can ensure that both spouses' $4,000,000 exemption amounts are used. This type of planning could require re-titling of assets to ensure that both spouses have assets that can fund a "credit shelter" trust at death no matter which spouse dies first.

Moreover, if a married couple has an estate plan that creates a "credit shelter" trust tied to the federal estate tax exemption, because of the difference between the Illinois estate tax exemption ($4,000,000) and the current federal estate tax exemption ($5,430,000), it will be best if all or at least the difference between the two exemption amounts ($1,430,000) can qualify for the special Illinois "spousal QTIP" election. For example, if a married person passes away with $5,000,000, and all of that is left to a "credit shelter" trust, there would be an Illinois estate tax of $285,714 (on the amount over the Illinois exemption amount of $4,000,000). However, if that credit shelter trust is structured solely for the surviving spouse so that it qualifies for the Illinois "spousal QTIP" election, it will eliminate any Illinois estate tax at the death of the first spouse. The "spousal QTIP" portion of the credit shelter trust will be subject to Illinois estate tax at the death of the surviving spouse, if he or she is an Illinois resident, and may be covered by the surviving spouse's $4,000,000 exemption amount.

What if I am in a Civil Union?

Illinois is among the few states that adopted, and have retained, recognition of civil unions between same-sex and opposite-sex couples. Illinois expressly recognizes and treats civil union couples the same as married couples for all purposes, including Illinois income and estate taxes. In contrast, following the U.S. Supreme Court's decision in *Windsor*, while the federal government recognizes same-sex marriage, most government agencies, including the

Internal Revenue Service, make a distinction between married couples and those in a civil union or domestic partnership. As such, for federal estate and gift tax purposes, a civil union couple is not treated as married and therefore cannot qualify for special marital rules. However, Illinois makes no such distinction. Planning for civil union couples requires navigating this different treatment between federal law and Illinois law.

For More Information

Chapman and Cutler Trusts and Estates attorneys are familiar with federal and Illinois transfer tax issues and the myriad tax and non-tax estate planning options. If you have any questions or would like more information regarding Illinois estate tax or estate planning in general, please contact Molly Carney (312.845.3438), David Crossett (312.845.3011), David Lullo (312.845.3902) or Rebecca Wallenfelsz (312.845.3442), or visit us online at www.chapman.com.