Making Gifts Can Reduce Illinois Estate Taxes

Recent legislation made the Illinois estate tax permanent and set exclusion amounts at $3.5 million in 2012 and $4 million in future years. While the higher limits exempt many estates, wealthier clients should consider making gifts to substantially reduce Illinois estate taxes.

By Robert J. Kolasa

A year ago (December 16, 2011, to be exact), Governor Quinn signed P.A. 97-0636,[1] widely hailed for its hard-fought tax-cutting provisions designed to keep the Chicago Mercantile Exchange and Sears Holding Company from fleeing the state. Buried in the legislation were estate tax relief provisions increasing the Illinois estate tax exclusion from $2 million in 2011, $3.5 million in 2012, and $4 million for future years.[2] The new Illinois estate tax provisions are permanent and in that respect differ from the existing federal estate tax rules which expire (meaning a $1 million federal exclusion and top 55 percent rate in 2013) if there is no intervening legislation by the end of this year.[3]

1. P.A. 97-0636 (December 16, 2011).
2. Section 15-40 of P.A. 97-0636, amending 35 ILCS 405/2(b).
3. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"; Pub. L. No. 107-16, June 7, 2001), the federal estate tax exclusion was increased to $3.5 million in 2009, with estate tax repeal in 2010. EGTRRA provided for a bizarre "sunset" rule (§ 901 thereto) whereby its provisions were scheduled to be repealed after December 31, 2010, meaning a $1 million federal estate tax exclusion and top 55% rate thereafter. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312, December 17, 2010), postponed the EGTRRA sunset to January 1, 2013 and instituted a new $5 million (inflation adjusted) unified estate and gift tax exclusion amount. What happens after 2012 appears to be entirely unpredictable, although it appears unlikely to many that the law will revert back to the pre-EGTRRA rules.

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The increased Illinois estate tax exclusions were unforeseen by most practitioners and represent a positive development for taxpayers.[4] Happily for Illinois decedents with assets under the $3.5 or $4 million "trip wire" (discussed below), no Illinois estate taxes are due.

But despite the increased Illinois estate tax exclusion amounts, a decedent with an Illinois tentative taxable estate of $6 million would pay the *same* amount ($456,071) of Illinois estate taxes if he or she died in 2011, 2012, or 2013. This seems intuitively wrong to estate planners familiar with the mechanics of the federal estate tax system, where a higher estate tax exclusion amount means lower estate taxes for estates exceeding the threshold.

The Illinois exclusions operate differently because of how the Illinois estate tax is calculated. As a result, the planning strategy of making gifts during a client's lifetime to reduce Illinois estate taxes bears serious consideration.[5] However, the benefit of gifting may be offset by the loss of stepped-up basis at death attributable to the carryover basis of the gifted property. This article discusses the details and helps tax planners assess the alternatives.

The Illinois estate tax – a complicated calculation

Under the Illinois statute[6] and Section 2011 of the Internal Revenue Code ("Code"), Illinois estate taxes are the *lower* of the following two independent calculations:

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

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

The first calculation rests on the state estate tax credit computed under the tax table appearing in Code Section 2011(b) (the "IRC Table"). This table reflects graduated tax rates from .8 percent to 16 percent on adjusted taxable estates over $40,000. Significantly, the IRC Table ignores the following two variables: (i) the Illinois estate tax exclusion amount, and (ii) adjusted taxable gifts made during the client's lifetime.[7] As we will see, this latter omission is why making gifts usually reduces Illinois estate taxes.

The second calculation is referred to as the "Hypothetical Estate Tax" because it requires a pro forma federal estate tax computation based on the applicable Illinois estate tax exclusion and federal estate tax rates, which has no application other than for making that calculation.

Both determinations are mathematically subject to a "circular" calculation.[8] Sinister though it may sound, the circular calculation actually *lessens* the estate tax under both the IRC Table and Hypothetical Estate Tax.[9]

Fortunately for Illinois practitioners not having an advanced degree in mathematics, the Illinois Attorney General's website contains an online calculator (the "Illinois Estate Tax Calculator") that makes the byzantine computations required to arrive at the correct amount of Illinois estate taxes. The 2012 tax year calculator is at http://www.ag.state.il.us/publications/calculator/calculator2012.html.[10]

4. While P.A. 97-0636 represents a concession to two important corporate employers, most other Illinois taxpayers will have no choice but to pay state income taxes which were raised in 2011 for corporations (a 46% increase) and individuals (a 66% increase). *See* P.A. 96-1496 (January 13, 2011).

5. *See* Robert J. Kolasa, *Reducing Illinois Estate Taxes Through Lifetime Gifts*, Illinois Institute for Continuing Legal Education, Advanced Issues in Estate Tax Planning Seminar (February 10, 2012), and Robert J. Kolasa, *How to Use Gifts to Reduce Illinois Estate Taxes*, 96 Ill. B. J. 580 (November 2008), Erratum, 97 Ill. B. J. 115 (March 2009).

6. 35 ILCS 405/2 levies the Illinois estate tax for a "taxable transfer," which means an event giving rise to a "state tax credit," which in turn is defined in part by reference to Code § 2011 with various modifications.

7. Under Code § 2011(b) (3), the "adjusted taxable estate" means the "taxable estate" reduced by $60,000. Section 2053(a) does not include adjusted taxable gifts in the definition of the "taxable estate."

8. The circular computation is necessary because Code § 2058 provides a deduction for state death taxes, which reduces the adjusted taxable estate which reduces the Illinois tax, which again reduces the adjusted taxable estate, and so on, until the calculation ends after 8 to 15 repetitions.

9. A mechanical application of the IRC Table to a $10 million adjusted taxable estate results in a state tax credit of $1,076,720. However, due to the circular nature of the Illinois calculation, the result for Illinois estate tax purposes is $934,653 (a $142,067 reduction).

10. A confusing aspect of the calculator is that it tends to omit the Hypothetical Estate Tax calculation if the IRC Table amount is the lower amount.

Combined Federal And Illinois Taxes (2012)

*Tentative Taxable Estate	**Tentative Federal Estate Tax	***Final Federal Estate Tax	IL Estate Taxes	Combined Taxes & Rates over $5.12 Million	
$4,000,000	$0	$0	$129,630	N/A	N/A
$5,120,000	$0	$0	$364,245	N/A	N/A
$6,000,000	$308,000	$148,375	$456,071	$604,446	68.69%
$7,000,000	$658,000	$460,039	$565,603	$1,025,642	54.56%
$8,000,000	$1,008,000	$769,778	$680,634	$1,450,412	50.36%
$10,000,000	$1,708,000	$1,383,577	$926,923	$2,310,500	47.35%
$20,000,000	$5,208,000	$4,403,362	$2,298,965	$6,702,327	45.04%
$50,000,000	$15,708,000	$13,455,086	$6,436,896	$19,891,982	44.32%

*Taxable estate before deduction for Illinois estate taxes.
**Federal estate tax before deduction for Illinois estate taxes.
***Net federal estate tax after deduction for Illinois estate taxes.

Effect of Gifts on Illinois Estate Taxes (2012)					
1	2	3	4	5	6
Tentative Taxable Estate ("TTE")	Adjusted Taxable Gifts	TTE plus Adjusted Taxable Gifts	IL Estate Taxes*	IL Estate Tax Savings	Overall Estate Tax Savings**
$6,000,000	$0	$6,000,000	$456,071	N/A	N/A
$5,000,000	$1,000,000	$6,000,000	$352,158	$103,913	$67,543
$4,000,000	$2,000,000	$6,000,000	$253,986	$202,085	$131,355
$3,000,000	$3,000,000	$6,000,000	$167,279	$288,792	$187,715
$2,000,000	$4,000,000	$6,000,000	$92,910	$363,161	$236,055
$1,000,000	$5,000,000	$6,000,000	$31,439	$424,632	$276,011
$0	$6,000,000	$6,000,000	$0	$456,071	$296,446

*IL Estate Taxes computed under the IRC Table calculation
**IL Estate tax savings reduced 35 percent for benefit of federal estate tax deduction for such taxes

The Combined Federal and Illinois Taxes (2012) Table ("Combined Table," see sidebar on page 647) illustrates the combined federal and Illinois estate tax rates for 2012. The astounding point of this table is the towering tax rate computed as a percentage over the $5.12 million federal exclusion. Even with the deductibility of Illinois estate taxes in the federal estate tax computation, the incremental estate tax rate for a $6 million tentative taxable estate is a whopping 68.69 percent. While the rates do regressively decrease as the size of the estate increases, even at $10 million the joint federal and Illinois rate is a high 47.35 percent.

The answer to the riddle of why the increased Illinois estate tax exclusions do not reduce estate taxes for a $6 million tentative taxable estate is grounded in the twin computations of the tax. Since it is based on the lower of the results under the IRC Table or the Hypothetical Estate Tax, in all cases the IRC Table produces the *lower* tax number ($456,071) when compared to the Hypothetical Estate Tax.[11] The Illinois estate tax exclusions are meaningless for a $6 million estate because they are not taken into account in the IRC Table calculation, which constitutes the proper measure of Illinois estate tax liability.

The Illinois estate tax "trip wire"

The second field of the AG's Illinois Estate Tax Calculator (the "Illinois Tentative Taxable Estate Plus Adjusted Taxable Gifts") is a sort of "trip wire." If the amount you enter there exceeds the pertinent Illinois estate tax exclusion ($2 million for tax year 2011, $3.5 million for 2012, and $4 million for 2013 and beyond), Illinois estate tax is due.

There is a complicating factor, however: adjusted taxable gifts may trigger the Illinois estate tax to apply as the "trip wire" is crossed, while the calculation of the tax often is based on the IRC Table, which excludes these gifts from its tax base and does not take into account the Illinois estate tax exclusions.

Consider this example. As discussed above, a 2012 decedent having a $6 million tentative taxable estate pays $456,071 of Illinois estate taxes based on the IRC Table calculation (which is lower than the Hypothetical Estate Tax). If the same decedent made a $2.5 million death-bed gift to family members, the "trip wire" is crossed because the sum of the post-gift "Illinois Tentative Taxable Estate Plus Adjusted Taxable Gifts" (i.e., $6 million) exceeds the $3.5 million Illinois estate tax exclusion.

The resulting Illinois estate tax under the IRC Table is $209,124, which is based on a tax base equal to the $3.5 million tentative taxable estate (not the pre-gift $6 million tentative taxable estate). Admirably, the net effect of the gift is that $246,947 of Illinois estate taxes ($456,071 minus $209,124) are saved.

Lifetime gifts generally reduce Illinois estate taxes

While adjusted taxable gifts are added back to the tax base to determine if the Illinois estate tax "trip wire" is crossed, in *many scenarios adjusted taxable gifts reduce Illinois estate taxes because they are not counted in the IRC Table tax base*. Consequently, Illinois estate taxes are lower for many decedents who make adjusted taxable gifts, even if shortly before death, because those gifts are not taken into account in the estate tax calculation.[12] These results are shown by the "Effect of Gifts on Illinois Estate Taxes (2012)" sidebar above.

The Effect of Gifts sidebar speaks for itself in demonstrating the power of lifetime gifts to reduce Illinois estate taxes. Imagine the delight of family members when they learn that $187,715 of estate tax savings may be realized if the family patriarch worth $6 million gifts $3 million of cash or high basis assets to loved

11. *For example*, in 2012 the IRC Table result for a $6 million tentative taxable estate is only $456,071, while the Hypothetical Estate Tax is $648,148.

12. Illinois estate tax savings may result whether or not the gifted property appreciates in value. However, the post–gift appreciation of the gifted property generates additional savings for federal and Illinois purposes. For clients daring enough to incur federal gift taxes, the "tax exclusive" nature of the gift tax (such tax is not counted in the federal estate tax base if the taxpayer survives the gift by three years) is a major additional benefit. *See* Code § 2035(b).

Effect of Carryover Basis on Estate Tax Savings					
	1	2	3	4	5
	No Gift	Cash Gift	Sale by Donee of Gifted Property		
			$700,000 Basis	$662,285 Basis	$300,000 Basis
Gift Before Death	N/A	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Combined Federal & IL Taxes (20%)	N/A	N/A	($60,000)	($67,543)	($140,000)
Tentative Taxable Estate	$6,000,000	$5,000,000	$5,000,000	$5,000,000	$5,000,000
Illinois Estate Tax	($456,071)	($352,158)	($352,158)	($352,158)	($352,158)
Federal Estate Tax	($148,375)	($184,745)	($184,745)	($184,745)	($184,745)
Combined Value to Family	$5,395,554	$5,463,097	$5,403,097	$5,395,554	$5,323,097
Total Tax Savings		**$67,543**	**$7,543**	**$0**	**($72,457)**

ones (versus retaining the property and having those assets counted in the IRC Table's tax base).

A warning: it is imperative to "crunch the numbers" when contemplating gifts for estates marginally over the Illinois estate tax exclusion amount (in 2012, this means tentative taxable estates under about $4,769,000).[13] For a relatively narrow spectrum of cases in this range, gifting will not lead to estate tax savings because the gifts are included in the estate tax base under the Hypothetical Estate Tax calculation.[14]

The countervailing consideration of the loss of stepped-up basis

The consequence of making adjusted taxable gifts to reduce Illinois estate taxes means the loss of the "stepped-up" basis adjustment for the gifted property.[15] If 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).

To determine the true economic effect of gifting, you must consider the "lost" basis step-up of the gifted property. Currently, a combined 20 percent capital gains tax (15 percent federal plus 5 percent Illinois) is levied on most Illinois taxpayers when they sell gifted property.[16] To determine whether gifting is a good idea, those income taxes must be weighed against the projected Illinois estate tax savings attributable to the lifetime gift.

A "liquidation analysis" helps determine the usefulness of gifting in a specified situation. To do a liquidation analysis, make the hypothetical assumption that immediately after the gift, the donor dies and the donee sells the gifted property. Then compare the net benefit of Illinois estate tax savings (offset by income taxes related to the loss of stepped-up basis for the gifted property) with the estate tax that would be owed if the gift were never made. This "with or without" calculation gives a quick view of the impact of gifting.

For example, the Effect of Carryover Basis on Estate Tax Savings Table in the sidebar above ("Carryover Basis sidebar") shows a liquidation analysis using various basis assumptions for a 2012 decedent with a $6 million tentative taxable estate who contemplates making a $1 million gift of cash or appreciated property.

The Carryover Basis sidebar aptly demonstrates how the estate tax benefit of gifting is offset by the loss of stepped-up basis at death attributable to the gifted property.[17] The family is better off by $67,543 with a $1 million cash gift (column 2), but only ahead $7,543 with a $1 million gift of property having a $700,000 basis.

Under the liquidation analysis, the important question is whether the income taxes on the deemed sale would

13. *For example*, a $4 million tentative taxable estate in 2012 will not reap lower Illinois estate taxes until adjusted taxable gifts exceed about $1.5 million (for gifts below that level the Illinois estate tax is based on the Hypothetical Estate Tax, which includes such gifts in its tax base). Likewise, a $4.5M tentative taxable estate in 2012 will not benefit until gifts exceed about $500,000. After the 2012 tentative taxable estate (computed before the gift) reaches about $4,769,000, gifts of any size should result in lower Illinois estate taxes because at that point the IRC Table (which excludes gifts) governs the Illinois estate tax calculation for all scenarios.

14. Under the Hypothetical Estate Tax, Code Section 2001(b) pulls back adjusted taxable gifts into the tax base for purposes of such calculation.

15. Since the gifted property is not included in the decedent's gross estate, there is no basis step-up under Code Section 1014(a). Instead, under Section 1015(a), the donee's basis in the gifted property generally is the same basis that it was in the hands of the donor before the gift.

16. In 2012, the federal income tax rules generally provide that long-term capital gains for individuals, estates and trusts are taxed at a maximum 15%. For taxpayers in the 10% and 15% tax bracket, long-term capital gains are taxed beginning at 0%, up to the amount required to reach the end of the 15% tax bracket, with the balance of long-term capital gains then taxed at 15%.

17. Note that the Carryover Basis Table ignores the scenario of the donor selling the property and gifting the proceeds to the donee (which produces additional tax savings because the capital gains tax reduces the donor's taxable estate). This action is not presented for the reason that donors typically do not want to incur income taxes and miss the benefit of post-gift appreciation, although possibly this tactic would be feasible in a deathbed scenario.

outweigh the projected estate tax savings. Column #4 of the Carryover Basis sidebar shows that if the property has less than $337,715 of appreciation, the Illinois estate tax savings exceeds the income tax costs of gifting. Put another way, the $337,715 of appreciation is the "break-even" point where projected estate tax savings equal the increased income taxes caused by the loss of stepped-up basis.

A helpful "shortcut" for identifying this break-even point is to divide the projected estate tax savings of the gift by the combined federal and Illinois income tax rate. For example, the Effect of Gifts sidebar (Column 6, second row) shows that $67,543 of net estate tax savings are produced by a $1 million gift when there is a $6 million tentative taxable estate. The $67,543 in savings is then divided by 20 percent (the projected joint federal and Illinois income tax rate) to equal $337,715. As discussed with regard to the Carryover Basis sidebar, this number represents the gift's break-even point, where income tax costs equal estate tax savings. Accordingly, if the property has less than $337,715 of appreciation, the family generally is better off making the gift.

The wild card of post-gift appreciation

The liquidation analysis gives the planner a good tool to quickly spot the "winners," revealing whether gifts of appreciated property will generate immediate Illinois estate tax savings. However, what happens to the "losers" – those gifts for whom the income taxes attributable to the pre-gift appreciation exceed the estate tax savings? The answer is that it depends, with the wild card being the amount of appreciation in the post-gift period.

Appreciation is important because in most cases the estate tax savings attributable to the growth of the property in the post-gift period will exceed the corresponding income tax cost of such growth. Accordingly, growth in the post-gift period decreases the impact of the loss of stepped-up basis. In scenarios where the income taxes attributable to the pre-gift appreciation are greater than the estate tax savings under the liquidation analysis, the critical point is to quantify the post-gift appreciation necessary to provide net estate tax savings.

The Carryover Basis Table, Column #5, shows that the family is $72,457 worse off after a $1 million gift of property with a $300,000 basis, assuming that immediately after the gift the donor dies and the donee sells the gifted property. However, if the property is not sold, the question becomes how much post-gift appreciation must occur for the gift to generate estate tax savings that are not offset by the loss of stepped-up basis.[18]

For this example, about $330,000 of post-gift appreciation[19] is needed for the projected estate tax savings to offset the increased income taxes caused by the loss of stepped-up basis. This means that estate tax savings will offset income tax costs only if the property appreciates in the post-gift period by 33 percent of its $1 million value.[20] This may or may not be an achievable goal, depending on the life expectancy of the donor and the expected growth of the property.

Conclusion

Recent legislation makes the Illinois estate tax permanent and increases the Illinois estate tax exclusion amount to $3.5 million in 2012 and $4 million for future years. The new exclusions will encourage gifting for clients having tentative taxable estates more than marginally over such limits, because gifts are not taken into account in the Illinois estate tax calculation and thus reduce Illinois estate taxes. For non-cash gifts, the benefit of gifting is lessened by the loss of stepped-up basis at death, but that may in turn be mitigated by estate tax savings resulting from the property's appreciation during the post-gift period. ■

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18. *See* Joseph C. Mahon, *The "TEA" Factor*, Trusts and Estates 46 (August 2011), for an excellent article on a mathematical formula calculating the aforesaid break-even point for federal estate tax purposes. In footnote #8, the author admirably suggests formula modifications for state estate taxes based on Code Section 2011, but the formula without more tweaking seemingly does not generate exact results for Illinois purposes, which rather uniquely (compared to other states) requires a circular calculation in the state estate tax computation.

19. A $6 million tentative taxable estate in 2012 making a $1 million gift of property having a $300,000 basis, which appreciates to $1,330,000 in the post-gift period, will produce $206,000 of capital gains taxes ($1,030,000 times 20%). The total wealth left for the family is $5,587,097 [$5 million tentative taxable estate, plus $1,330,000, less capital gains taxes ($206,000), less Illinois estate taxes ($352,158), less federal estate taxes ($184,745)], which is about the same value if the gift was never made and the $330,000 appreciation added to the taxable estate.

20. For gifts subject to valuation discounts, presumably less post-gift appreciation would be needed to reach the break-even point. This is because economically a greater amount of property is being transferred, resulting in more estate tax savings than is recognized for transfer tax purposes.

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