

## PRIVATE WEALTH SERVICES ALERT

September 10, 2009

## Are You Ready to Defer Taxes with the New Illinois QTIP Trust?

## Current Law

Illinois is one of many states that has a state estate tax exemption which differs from the federal estate tax exemption. For 2009, the Illinois statutory applicable exclusion amount is \$2,000,000 per person (or \$4,000,000 per married couple) while the federal applicable exclusion amount is \$3,500,000 per person (or \$7,000,000 per married couple).

## Planning Under Current Law

Estate plans for married couples often share three common goals:

1. Provide a source of financial security for the surviving spouse;
2. Defer estate taxes until the death of the surviving spouse; and
3. Minimize estate taxes on assets which pass to descendants or other takers.

For 2009, the decoupling of the Illinois estate tax has made balancing these goals more difficult. Let's review a couple of examples.

## Example 1 – Defer All Taxes.

Assume a married couple residing in Illinois, each with assets of \$3,500,000, has an estate plan which defers all estate taxes until the death of the second-to-die spouse. Upon the first spouse's death, the first \$2,000,000 of assets will absorb both the Illinois and federal exemptions, and the balance, or \$1,500,000, could be distributed to the surviving spouse in a manner which qualifies for the marital deduction, thereby resulting in no federal and Illinois estate taxes due. On the second death, a combined estate of \$5,000,000 will be subject to federal and Illinois estate taxes (i.e., \$1,500,000 from the first-to-die spouse's estate which qualified for the marital deduction and \$3,500,000 from the surviving spouse's estate). Total estate taxes due are as follows:

<u>First Spouse's Death</u>		<u>Second Spouse's Death</u>	
Gross Estate:	\$3,500,000	Gross Estate:	\$5,000,000
Federal Exemption Used:	\$2,000,000	Federal Exemption Used:	\$3,500,000
Federal Exemption Wasted:	\$1,500,000	Federal Exemption Wasted:	\$ 0
Illinois Exemption Used:	\$2,000,000	Illinois Exemption Used:	\$2,000,000
Illinois Estate Tax	\$0	Illinois Estate Tax	\$352,158
Federal Estate tax	<u>\$0</u>	Federal Estate Tax	<u>\$516,529</u>
Total Estate Tax	\$0	Total Estate Tax	\$868,687

Combined Estate Tax Total: \$868,687

## Example 2 – Maximize the Federal Exemptions.

If the married couple desires to take full advantage of the larger federal exemption, \$3,500,000 of assets from each spouse's estate could escape federal estate taxation. However, absent the new statute, the difference between the Illinois and federal exemptions, or \$1,500,000, will result in each spouse's estate paying Illinois estate taxes as set forth below:

<u>First Spouse's Death</u>		<u>Second Spouse's Death</u>	
Gross Estate:	\$3,500,000	Gross Estate:	\$3,500,000
Federal Exemption Used:	\$3,500,000	Federal Exemption Used:	\$3,500,000
Federal Exemption Wasted:	\$ 0	Federal Exemption Wasted:	\$ 0
Illinois Exemption Used:	\$2,000,000	Illinois Exemption Used:	\$2,000,000
Illinois Estate Tax	\$ 209,124	Illinois Estate Tax	\$ 209,124
Federal Estate Tax	<u>\$ 0</u>	Federal Estate Tax	<u>\$ 0</u>
Total Estate Tax	\$ 209,124	Total Estate Tax	\$ 209,124

Combined Total Estate Tax: \$418,248

By utilizing the full amount of each federal exemption, a couple can reduce the aggregate estate taxes payable by \$450,439 and pass those savings to their descendants or other takers.

Before selecting a planning approach, consideration should be given to the opportunity cost of paying taxes early, the relative ages and health of the couple and projected future spending needs of the surviving spouse. For example, if the surviving spouse is likely to fully consume the assets qualifying for the marital deduction during his or her remaining lifetime, then paying taxes early might not be a tax-efficient option.

### New Law

Notwithstanding the potential estate tax savings, many couples still shy away from paying taxes upon the first's spouse death. Under the new legislation, married couples can fully utilize their federal exemptions without paying Illinois estate taxes at the first death.

Public Act 96-0789, which became law on September 8, 2009, allows the deferral of the Illinois estate tax until the surviving spouse's death if the assets pass to a qualified terminable interest property trust ("QTIP") and the decedent's personal representative files a special election on the first's spouse's Illinois estate tax return. An Illinois QTIP Trust has the following special requirements, which are generally similar to the federal QTIP requirements:

1. The surviving spouse must be the sole beneficiary of such trust;
2. The surviving spouse must receive all trust income;

3. The spouse may not have a power of appointment exercisable in favor of third persons during his or her lifetime; and
4. The trustee may not retain non-income producing assets for more than a reasonable amount of time without the consent of the surviving spouse.

Not paying any taxes on the first spouse's death should make the Illinois QTIP an attractive option for many married couples. Applying the Illinois QTIP to the fact pattern described above appears to produce the following estate tax results:

<u>First Spouse's Death</u>		<u>Second Spouse's Death</u>	
Gross Estate:	\$3,500,000	Federal Gross Estate:	\$3,500,000
Federal Exemption Used:	\$3,500,000	Federal Exemption Used:	\$3,500,000
Federal Exemption Wasted:	\$ 0	Federal Exemption Wasted:	\$ 0
Illinois Exemption Used:	\$2,000,000	Illinois Gross Estate:	\$5,000,000
<b>Illinois QTIP Trust</b>	\$1,500,000	Illinois Exemption Used:	\$2,000,000
Illinois Estate Tax	\$0	Illinois Estate Tax	\$ 368,178
Federal Estate Tax	<u>\$0</u>	Federal Estate Tax	<u>\$ 0</u>
Total Estate Tax	\$0	Total Estate Tax	\$ 368,178

Combined Total Estate Tax: \$368,178\*

The above calculations demonstrate how the use of the Illinois QTIP to defer Illinois estate tax until the survivor's death can reduce the total federal and state estate tax due below the total estate tax due if the federal exemption is maximized and no Illinois QTIP election is made. Note, however, that the tax savings and deferral that the Illinois QTIP offers can be enjoyed only if one's estate planning documents can accommodate the Illinois QTIP. Be sure to have a professional review your documents to confirm that your documents contain the right provisions.

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If you have any questions regarding this Alert, please contact **Lawrence I. Richman** (312-269-8070), **Martin H. Tish** (312-269-8031), **Eric N. Mann** (312-269-8404), **Lauren Geoffrey** (312-269-5653) or any other estate planning attorney at Neal, Gerber & Eisenberg LLP with whom you regularly work.

\*The State of Illinois has not provided guidance on how it will calculate the state estate tax due on Illinois QTIP property, so it is not clear how the total Illinois state estate tax due should be determined. For purposes of this notice, we assumed that the Illinois QTIP property does not benefit from the federal state death tax deduction under Section 2058 of the Internal Revenue Code of 1986, as amended, and that the Illinois estate tax on the Illinois QTIP property is calculated after all other property included in the surviving spouse's estate is considered. Based on the foregoing, the tentative taxable estate of the surviving spouse is \$3,290,876 (using an interrelated calculation) plus \$1,500,000 (the value of the Illinois QTIP property), resulting in a total state estate tax due of \$368,178 (\$209,124 of which is attributable to the surviving spouse's property and \$159,054 of which is attributable to the Illinois QTIP property).

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