

The Illinois QTIP Election to the Rescue

Illinois estate planners in 2009 face the challenge of planning for the differing federal and Illinois estate tax exclusion amounts (\$3.5 million for the former, \$2 million for the latter). Thankfully, new Illinois legislation permits married clients to use the full federal exclusion without Illinois estate tax consequences by permitting an Illinois QTIP election over the \$1.5 million gap amount.

By Robert J. Kolasa

After much anticipation,¹ Illinois estate planners finally got what they wished for when the Illinois QTIP legislation became law on September 8, 2009.² For married couples it is now possible to make an election on the first to die's Illinois estate tax return to help solve the conundrums practitioners faced in dealing with the differing federal and Illinois estate tax exclusion amounts.

1. Gary R. Gehlbach and Emily R. Vivian, *Illinois Estate Tax Planning in 2009 and Beyond*, 97 Ill Bar J 80 (Feb 2009); Robert Iverson, *Push comes to shove*, Vol 54, No 5 ISBA Trusts & Estates newsletter (Apr 2008); Ray J. Koenig III and Amy Jo Smith, *Trusts and Estates Council legislative update*, Vol 54, No 5 ISBA Trusts & Estates newsletter (Apr 2008); Katarinna McBride, *The Delayed QTIP: The Illinois Wait-n-See*, Vol 54, No 3 ISBA Trusts & Estates newsletter (Dec 2007).

2. PA 96-0789 (Sept 8, 2009), amending 35 ILCS 405/2.

The genesis of the new law dates to 2001, with the passage by Congress of the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”).³ Prior to that time, Illinois was peaceably engaged in a form of revenue sharing with the federal government,

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whereby Illinois estate taxes were based on the state death credit (the “2011 credit” computed under section 2011 of the Internal Revenue Code (“Code”)). EGTRRA ended this arrangement by fully repealing the 2011 credit for tax years beginning in 2005.⁴

Rather than lose its rightful share of tax revenues, Illinois correspondingly amended its laws in 2003 (in a process known as “decoupling”)⁵ to provide that state estate taxes would continue to be based on the repealed 2011 credit taking into account a separate Illinois estate tax exclusion amount.⁶ For tax years 2006-2008, the “frozen” \$2 million Illinois exclusion exactly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 produces a \$1.5 million differential (the “\$1.5 million gap amount”) subject to Illinois estate taxes. For a fully funded \$3.5 million credit shelter trust in 2009, Illinois estate taxes of \$209,124 would be attributable to the \$1.5 million gap amount.

The day of reckoning for both the federal and Illinois estate tax systems is 2010. Under EGTRRA’s bizarre “sunset” rule,⁷ the federal estate tax is fully repealed in 2010 but reinstated in 2011 adopting the pre-EGTRRA \$1 million federal estate tax exclusion. In the absence of legislative intervention, the existing Illinois statutory scheme parallels

EGTRRA’s sunset by providing no Illinois estate taxes for 2010, with a return in 2011 to the good old days of the \$1 million estate tax exclusion amount and 2011 credit computations.⁸

The problem with the sunset rule is that most estate planners believe that federal legislation will soon prevent a return to the pre-EGTRRA estate tax rules. It is widely anticipated that the Obama administration will freeze or extend the \$3.5 million federal estate tax exclusion for years after 2009.

If this happens and the Illinois statute remains unchanged, the Illinois estate tax is repealed for years after 2009.⁹ Illinois would then have to affirmatively act to maintain its estate tax. Many feel that Illinois estate taxes will somehow be preserved, although repeal is also a distinct possibility.

The problem addressed by the legislation

For years, fundamental estate tax planning for a married couple revolved around funding the credit shelter trust of the first to die (“first deceased spouse”) with assets equal to the federal estate tax exclusion amount. Full funding would prevent “wasting” the estate tax exclusion amount of the first deceased spouse, which could result in higher estate taxes upon the death of the surviving spouse. EGTRRA turned this planning on its head by encouraging states such as Illinois to decouple from the federal system and adopt differing estate tax exclusion amounts.

The 2009 mismatched federal and Illinois exclusions caused Illinois estate planners to worry about the following planning dilemma (which the Illinois QTIP legislation addresses). Should the credit shelter trust be funded with the full \$3.5 million estate tax exclusion amount, thereby generating \$209,124 in Illinois estate taxes? Or, is it better to fund the credit shelter trust with only \$2 million, thereby avoiding immediate Illinois estate taxation at the cost of not fully using the \$3.5 million federal exclusion?

The answer to the above query depended on predicting the size of the surviving spouse’s estate to determine if it

would be beneficial to incur Illinois estate taxes on the \$1.5 million gap amount. If the surviving spouse would eventually be subject to federal estate taxes using the lower \$2 million state exclusion in the first deceased spouse’s estate, the family probably would be better off increasing the credit shelter trust to \$3.5 million and paying the much lower Illinois estate taxes at the death of the first deceased spouse.

The Illinois QTIP allows the first deceased spouse’s estate to use 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. The sidebar on page 614 shows that upon the death of the first deceased spouse, \$3.5 million of the federal estate tax exclusion is used, compared to \$2 million of the Illinois exclusion. The \$1.5 million gap amount is subject to a QTIP election for Illinois purposes only (the “Illinois QTIP election”), which avoids Illinois estate taxation of such amount.

That funding scheme optimally uses the differing federal and Illinois estate tax exclusion amounts. Upon the surviving spouse’s death, Illinois estate taxes are assessed on the marital trust and the property subjected to the Illinois QTIP election (“gap trust assets”), while only

3. Pub L No 107-16 (June 7, 2001).

4. Code section 2011(b)(2).

5. PA 93-0030 (June 20, 2003), amending 35 ILCS 405/2, 3, 5, 6, 7, 8 and 10. Generally see David A. Berbek, *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*, CBA Record 28 (Sept 2004).

6. Code section 2011(e) directs the Illinois estate tax to constitute the lower of the amount circularly computed under the 2011 Table, or Federal estate taxes due using a \$2 million exclusion amount. This calculation encourages lifetime gifts which may not be taken into account in the Illinois estate tax base. See Robert J. Kolasa, *How to Use Gifts to Reduce Illinois Estate Taxes*, 96 Ill Bar J 580 (Nov 2008); Robert J. Kolasa, Letters, *Erratum*, 97 Ill Bar J 115 (Mar 2009).

7. EGTRRA section 901. See Howard M. Zaritsky, *Waiting out EGTRRA’s Sunset Period* (Warren, Gorham & Lamont 2004), for a thorough discussion with forms relating to EGTRRA’s sunset rule.

8. 35 ILCS 405/2(c), which generally sets the Illinois estate tax after Dec 31, 2009, to the “credit allowable” under Code section 2011 or section 2604.

9. If the EGTRRA sunset does not occur under 35 ILCS 405/2 there would be no “credit allowable” under Code section 2011 or section 2604, effectively repealing the Illinois estate tax.

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the marital trust is subject to federal estate taxation.

The Illinois QTIP election

The language of the new law relating to making the Illinois QTIP election¹⁰ reads as follows.

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.

The statutory scheme revolves around the concept of “qualified terminable interest property” (commonly known as “QTIP”), which is defined as a subset of marital deduction trusts under Code section 2056(b)(7). In general, a QTIP trust must provide that: (1) all trust income is paid to the surviving spouse; (2) no one other than the surviving spouse can receive principal distributions from the trust; (3) trust income cannot be terminated by remarriage or any other event; (4) the spouse must have the power to require that non-income producing assets be reinvested to produce reasonable income;¹¹ and (5) the spouse must be a United States citizen.

QTIP trusts are a staple of estate planning form books, and qualifying drafting language is readily available. The IRS has promulgated extensive regulatory rules defining the QTIP technical requirements,¹² so it should not be difficult to qualify for QTIP treatment. The Illinois Attorney General apparently agrees, having declared that 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.”¹³

The newly revised 2009 Illinois estate tax return (Form 700, page 2) requires that a box be checked to make the Illinois QTIP election, along with insertion of an amount relating to such election. It would seem advisable in many cases that a separate exhibit to Form 700 be attached making a formula Illinois QTIP election.¹⁴

In the typical case where the Illinois

QTIP election provides a deduction for the \$1.5 million gap amount, a formula election ensures the optimal state marital deduction if asset valuations are changed upon audit. Form 700 aptly describes the Illinois QTIP election as the “additional amount in excess of Federal QTIP” (which is another way of stating the novelty of the new law, which per-

10. 35 ILCS 405/2 (b-1).

11. Treasury Regulation 20.2056(b)-5(f) and 20.2056(b)-7(h), example 2. Similarly, 35 ILCS 405/2, paragraph (b-1), provides that for Illinois QTIP trusts “...the trustee may not retain non-income producing as-

sets for more than a reasonable amount of time without the consent of the surviving spouse.” This may be helpful for credit shelter trusts which were never originally drafted to qualify for QTIP treatment. Query whether a tax statute can constructively reform a trust if non-spousal beneficiaries object to this provision?

12. Treasury Regulation 20.2056(b)-7.

13. See the filing and payment instructions to Form 700 (for 2009 decedents), along with the “Estate Tax Instruction Sheet for 2009 Decedents” published by the Illinois Attorney General at <http://www.illinoisattorneygeneral.gov/publications/estatetax.html>.

14. Treasury Regulation 20.2056(b)-7(b)(2); 20.2056(b)-7(h)(2), examples 7 and 8 (partial QTIP formula elections). Also see Jeffrey N. Pennell, 843-2nd Estates Gifts, and Trusts Portfolios, *Estate Tax Marital Deduction* (Tax Management 2007), A-83 to A-84, for a discussion of formula elections and examples which can be adapted for Illinois QTIPs.

How the Illinois QTIP election works: an example		
	Federal	Illinois
Total trust assets	\$6,500,000	\$6,500,000
Marital trust* (Federal & IL marital deductions)	(\$3,000,000)	(\$3,000,000)
IL QTIP Election (IL marital deduction only)	\$0	(\$1,500,000)
Taxable estate	\$3,500,000	\$2,000,000
Federal estate tax exclusion	(\$3,500,000)	
Illinois estate tax exclusion		(\$2,000,000)
Estate taxes	\$0 =====	\$0 =====
Amount includible in surviving spouse's estate	Federal	Illinois
Illinois QTIP property** ("Gap Trust Assets")	\$0	\$1,500,000
Marital trust**	\$3,000,000	\$3,000,000
Total includible amount	\$3,000,000 =====	\$4,500,000 =====

* Generated through marital trust funding formulas

** Presumes no growth between death of spouses

mits a QTIP election for Illinois but not federal purposes).

The “sizzle” of a QTIP trust is that the executor has the discretion whether to make the election for all, none or a part of the QTIP trust. The election is inversely related to the size of the credit shelter trust – a higher amount of elected property increases the marital deduction, thereby decreasing the credit shelter trust, and vice versa. Accordingly, this planning technique gives the executor great flexibility in controlling how much estate tax should be paid in any given situation.

The statutory reference to Code section 2044 represents the cost of making the Illinois QTIP election.¹⁵ This section generally provides that upon the death of the surviving spouse, the estate tax value of elected QTIP property is includible in the survivor’s estate. For estates making an Illinois QTIP election to deduct the \$1.5 million gap amount, this means that the surviving spouse’s estate would include the gap trust assets for Illinois,¹⁶ but not federal, purposes.

If a QTIP election is only made to a portion of a trust (“partial QTIP” election),¹⁷ 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 in the first place.¹⁸ For example, if the estate of the first deceased spouse elects a 40 percent QTIP election over a qualifying trust, 40 percent of the trust assets would also be includible in the survivor’s estate upon his or her death.

Significantly, if the surviving spouse dies a non-Illinois resident, it is doubtful that Illinois will be able to collect estate taxes for gap trust assets (except to the extent such trust holds Illinois real estate).¹⁹ In effect, the migrating surviving spouse reaps the benefit of reduced Illinois estate taxes upon the death of the first deceased spouse (via the Illinois QTIP election), without the 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 Il-

linois estate taxes on property subject to the Illinois QTIP election.

Use of the Illinois QTIP election may mean the loss of deducting the Illinois estate taxes attributable to gap trust assets in the surviving spouse’s estate for federal purposes.²⁰ Code section 2058 provides a deduction for state death taxes “in respect of any property included in the [federal] gross estate...” Since gap trust assets are *not* includible in the surviving spouse’s estate for federal purposes, arguably state estate taxes related to such trusts are federally nondeductible. The lost 2058 deduction associated with the Illinois QTIP election under some scenarios will generate higher overall estate taxes (versus funding a \$3.5 million credit shelter trust and not making the Illinois QTIP election).²¹

Despite possible tax savings in not making the Illinois QTIP election, most qualifying estates will probably make such election to avoid paying a tax they can defer to a later date. This decision is further supported by hope of evading Illinois estate taxes altogether by the surviving spouse changing residency, consuming gap trust assets, or otherwise having a nontaxable estate, along with the eternal dream that the Illinois legislature will repeal Illinois estate taxes.

Drafting for the mismatched federal and Illinois exclusions

The Illinois QTIP election dovetails with many existing trusts drafted before passage of the legislation, without the need for conforming amendments or specific reference to the Illinois statute in the underlying documents. The following are some common drafting techniques that will enable you to use the Illinois QTIP election to take advantage of both the \$3.5 million federal and \$2 million Illinois estate tax exclusion amounts.

\$2 million credit shelter trust with QTIP marital trust. The credit shelter trust funding formula (pecuniary or fractional) is based on the largest amount that can pass free without *federal and state estate taxes* (i.e., the \$2 million Illinois estate tax exclusion). The balance

of the estate passes to a residuary QTIP trust, allowing the executor to make a QTIP election to zero out federal estate taxes (a disclaimer of property may also suffice)²² and an Illinois QTIP election over the \$1.5 million gap amount. After EGTRRA, numerous estate plans adopted this formula provision to ensure that no Illinois estate taxes would be incurred upon the death of the first deceased spouse.

\$3.5 million credit shelter trust. The credit shelter trust funding formula (pecuniary or fractional) is based on the largest amount which could pass free without *federal estate taxes* (i.e., \$3.5 million), leaving the balance to a residuary marital trust. If the credit shelter trust qualifies for QTIP treatment, the executor may make a partial Illinois QTIP election for the \$1.5 million gap amount portion of such trust. This structure was

15. The disposition of a spouse’s QTIP interest under the federal rules (Code section 2519) results in the surviving spouse incurring a taxable gift of the entire QTIP trust. This is an anti-abuse rule intended to disallow the surviving spouse from disposing of his or her QTIP interest for a discounted price less than trust assets. Since Illinois does not impose a gift tax, it is unlikely a similar rule can be adopted for state inheritance purposes, thereby presenting some planning opportunities.

16. Form 700 (for 2009 decedents) does not have a line to reflect the addition of gap trust assets to the surviving spouse’s tentative taxable estate, but presumably the form will eventually be revised to correct this omission.

17. For a trust for which a partial QTIP election has been made, severing the trust into QTIP and non-QTIP portions may make sense if the non-QTIP portion can be invested for growth and/or the QTIP portion consumed by the surviving spouse.

18. Treasury Regulation 20.2044-1(1)(d)(1).

19. See 35 ILCS 405/3, 1(a), which imposes the Illinois estate tax on transferred property having a situs within the State of Illinois. After a surviving spouse moves out of Illinois, it is hard to see how gap trust assets, excluding Illinois real estate, would have a situs in Illinois for estate tax purposes (admittedly, such trust would be subject to Illinois income taxes under 35 ILCS 5/1501(20)). Even if this point is disputed, the collection of Illinois estate taxes on out-of-state gap trust assets would probably be administratively difficult and impractical.

20. Catherine Grevers Schmidt and Jill Choate Beier, *Falling Into the Gap of State Death Taxes*, New York Law Journal (Jan 26, 2009).

21. Without the 2058 deduction, the Illinois estate taxes on gap trust assets are subject to federal estate taxes on the surviving spouse’s death. If the surviving spouse is subject to federal estate taxes, the nondeductibility of Illinois estate taxes on gap trust assets may create higher taxes than if no Illinois QTIP election had been made and Illinois estate taxes paid on the \$3.5 million credit shelter trust. This tax cost is even higher if gap trust assets have appreciated since the death of the first deceased spouse. Moreover, if the Illinois QTIP election is not made, income on the credit shelter trust can be paid to nonspousal beneficiaries, thereby avoiding Illinois estate taxes on such income.

22. If trust assets are \$3.5 million or lower, no federal QTIP election would generally be made (unless the surviving spouse has few assets and it is desirable to include assets in the surviving spouse’s estate for stepped up basis treatment upon his or her death).

More on the QTIP

For more on the QTIP, see Jason S. Ornduff’s article *The new Illinois QTIP election: answers to your question and more questions* in the November 2009 ISBA Trusts and Estates newsletter, online at www.isba.org/Sections/trustsestates/11-09.html.

very common prior to EGTRRA and is still present in many estate plans.

This strategy becomes a malpractice trap if the credit shelter trust was not drafted for QTIP treatment and has current beneficiaries other than the surviving spouse. In such case, the Illinois QTIP election is unavailable and the \$3.5 million credit shelter trust generates \$209,124 of Illinois estate taxes, which may be an avoidable tax (compared to if the Illinois QTIP election is made, with the surviving spouse not subject to Illinois estate taxes upon his or her death). While the nonspousal beneficiaries could

QTIP treatment.

The three-trust approach is specifically geared to the Illinois QTIP election and should be widely used if and when it becomes clear that the mismatched federal/Illinois estate tax exclusion amounts are permanent. Even if the Illinois estate tax is repealed, this form can continue as a hedge if the clients move to a state with mismatched federal/state exclusions permitting state-only QTIP elections.

Single QTIP marital trust. The residuary trust qualifies for QTIP treatment under this scenario. The executor would then make a partial QTIP election for a portion of the trust to zero out federal estate taxes²³ and an Illinois QTIP election over the \$1.5 million gap amount.

Disclaimer trusts. Under this method the residuary estate is typically given outright to the surviving spouse, who retains the right to disclaim any portion of it to a disclaimer trust (which functions as the credit shelter trust). With the increased estate tax exclusion amounts wrought by

EGTRRA, disclaimer trusts have undergone a surge of popularity because of their flexibility in planning. These trusts also adapt well to dealing with the mismatched federal/Illinois estate tax exclusions if they qualify for QTIP treatment, thereby permitting an Illinois QTIP Election for the \$1.5 million gap amount of the disclaimer trust.

Disclaimers can be used to optimize the estate tax exclusions under variations of other approaches, but in drafting it is important to direct that the disclaimed

property passes to the disclaimer/credit shelter trust (rather than to residuary beneficiaries).

Clayton QTIP trust. This new form of marital deduction planning²⁴ directs 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 would have different beneficiaries than the surviving spouse).

Variations of the Clayton QTIP can be combined with the different approaches discussed herein, with the Illinois QTIP election for the \$1.5 million gap amount. To avoid arguments that the surviving spouse is making a gift, the Clayton QTIP election should probably be made by an independent party other than the spouse.

Conclusion

Illinois estate planners in 2009 are faced with the challenge of planning for the differing \$3.5 million federal and \$2 million Illinois estate tax exclusion amounts. New Illinois legislation permits married clients to use the full federal exclusion without Illinois estate tax consequences by permitting an Illinois QTIP election over the \$1.5 million gap amount.

However, the Illinois estate tax may also be repealed in 2010 and later years if the federal estate tax exclusion is frozen at \$3.5 million and the Illinois legislature does not act to maintain the Illinois estate tax. ■

23. Id.

24. Treasury Regulation 20.2056(b)-7(d)(3). See Pennell, 843-2nd Estates Gifts, and Trusts Portfolios (cited in note 14), for a discussion of Clayton QTIPs and other marital deduction drafting techniques.

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disclaim their interests in the credit shelter trust to possibly qualify for QTIP treatment if the spouse is the sole beneficiary and the other QTIP criteria are met, disinheritance may be seen as too high a price to avoid paying Illinois estate taxes.

Three-trust approach. The \$2 million credit shelter trust is established under a formula that also funds a separate trust holding the \$1.5 million gap amount subject to the Illinois QTIP election. The balance of the estate flows to a marital trust, which may or may not qualify for

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