Differences in state and federal estate tax laws

Estate-Plan Edge
By CURT FERGUSON

Key Points

- Illinois brings back its estate tax on estates over $2 million.
- Lifetime gifts escape all Illinois estate tax.
- Tax planning must be updated to conform to the new law.

WITHIN weeks after Congress extended tax relief to Americans everywhere, our state government struck back! Not only did Springfield increase income taxes by two-thirds as a parting blow to the Illinois economy, but the government also reimposed the Illinois death tax.

In 2010 the Illinois estate tax expired along with the federal estate tax. At expiration of the 2001 Tax Act on Dec. 31, 2010, the federal estate tax was set to return on all estates exceeding $1 million. At the last minute, Congress amended the law to increase that exemption fivefold. However, as the Illinois lame ducks took flight, they were carried by different political winds.

Federal vs. state death tax

Let's compare the two tax schemes and how one must plan for them.

First, the federal tax law is not permanent — although what law ever is, when you think about it? It was only enacted for two years, and will expire at the end of 2012. Illinois' new estate tax is permanent; that is, it will not automatically revert back to something worse unless the politicians are chased into extending or amending it.

Next, the most obvious difference between federal and state taxes is the size of estate that is exempt from tax. The federal government will only tax your estate if it exceeds $5 million. Illinois, however, set the tax-free limit at $2 million.

If your heirs don't mind sending a large check to Springfield, and your estate is between $2 million and $5 million, don't worry about estate taxes.

Death tax rates

The feds lowered their tax rate from a progressive rate of 45% to 60% to a flat rate of 35% on everything in excess of $5 million. Illinois' tax is around 14% on everything over the $2 million exemption. If your estate is large enough to pay both state and federal taxes, the Illinois tax paid is deductible on the federal return, if that makes you feel any better.

An interesting twist in the federal law is a "portable" exemption. If all works out perfectly for a married couple, when one dies and leaves assets to the other, the tax exemption of the first can be transferred to the survivor.

For instance, if the husband dies and leaves his estate to his wife, then when she dies, she can use whatever exemption he did not use at his death, plus her own exemption ($5 million if the law does not change before she dies) to leave assets to her choice of heirs. This "stacking" of his and her exemptions is new.

The Illinois death tax exemption is not portable. If the husband doesn't use it at his death, it is lost forever. A type of trust planning that was standard in federal tax planning since the 1980s is still needed to assure that you use the husband's $2 million Illinois exemption. Trusts and wills drafted prior to 2011 must be updated, however, because they normally used the federal rather than state exemption in their tax formula.

Gift tax exemptions

How do lifetime gifts get taxed under the federal and state laws? There is a $5 million exemption from tax on gifts that exceed the annual limit of $13,000 per individual (discussed at some length in last month's Estate-Plan Edge on Page 62) during your life.

So, in addition to small annual gifts, you can give away up to $5 million before paying gift tax. Illinois finally wins one of our comparisons: Illinois has no gift tax! There is no limit on what you can give during your life without paying tax to the state.

When you make large gifts (beyond the annual limit) during your life, it decreases your federal estate tax exemption by the amount used. For example, say you have a $5 million estate. In 2011 you give a farm worth $3 million to a trust for your descendants. You die in 2011 or 2012. Your federal estate tax exemption is down to $2 million. Why do it then, if it lowers the death tax exemption dollar for dollar?

First, the death tax exemption might be lowered before you die; use the lifetime gifts while you can! Second, if the farm appreciates between your gift and your death, the appreciation is out of your estate. Third, your Illinois death tax exemption of $2 million remains fully available to apply to the assets you have left at death. The $3 million gift completely escaped the state death tax.

Ask the expert

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