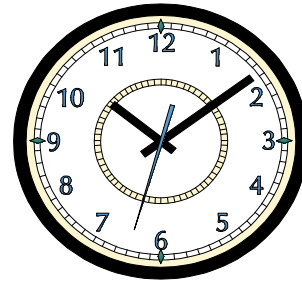


# Two Minute Legal Update

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## HONEY, THEY SHRUNK THE TAX CUT!

We have all had a shirt shrink in the laundry. It is an analogy that may help explain why estate tax relief for Illinois residents has shrunk since the 2001 federal tax cuts were enacted.

**First, the agitation cycle.** Not all of the estate tax relief promised under the 2001 tax legislation came out of the federal government's pocket — part of the burden was passed along to certain states, such as Illinois, in an indirect way. This apparently perturbed a few of these states, including Illinois.

Some background may be helpful in understanding the details of this situation. The Illinois estate tax, as it has existed for years, worked in conjunction with the federal estate tax. Illinois' estate tax has functioned as a "pickup tax," meaning that the Illinois tax basically picked up the maximum credit allowed by the IRS for state

estate tax paid. The net effect of this was that the Illinois tax did not increase the overall estate taxes due because the decedent's estate received a credit on the federal return to offset any estate tax paid to Illinois.

The 2001 federal tax cut legislation, however, which gave taxpayers significant scheduled increases in the estate tax exemption amount (currently \$1.5 million) and decreases in the estate tax rate, also reduced the credit that would be allowed for state estate taxes paid. The new law cut the maximum allowable credit by 25% per year from 2002-2004, until 2005 when the credit is eliminated entirely.

Simply stated, the federal government used to share with the states, but now it is sharing less. For Illinois and many other states, this had translated into the reduction of their estate tax revenues because of the way the state level estate tax has been calculated.

**Now, the spin cycle.** Under these circumstances, many of the affected states argue that if they now reject the pickup tax method of assessing estate tax, they are not really raising taxes, but rather are just keeping them level. The federal government can then point its finger back at the states and say they are standing in the way of tax relief. Regardless of which view you prefer, effective as of January 1, 2003, Illinois "decoupled" from the federal estate tax by rejecting the pickup tax method

of assessing its estate tax. Illinois has basically locked in its estate tax at 2001 rates.

**Finally, taxpayers get hung out to dry.** Essentially, some taxpayers will not get as much tax relief as expected under the 2001 legislation. By 2005, estates subject to the estate tax will now pay an Illinois estate tax *in addition to* the federal estate tax, rather than paying the Illinois tax *in the place of* a portion of the federal tax.

Thankfully, the Illinois estate tax exemption amount will increase in lock-step with the federal estate tax exemption amount through 2008 when the exemption amount is scheduled to be \$2 million. In 2009, it gets interesting because the Illinois exemption amount stays at \$2 million while the federal exemption amount rises to \$3.5 million. If the federal estate tax goes away in 2010, the Illinois tax will too. Then, remember that "sunset provision" that could bring the federal estate tax back at the levels existing prior to the 2001 federal tax cut legislation? Absent further legislation to the contrary, the Illinois estate tax would also return to its prior form, re-starting the cycle.

Illinois is not alone. About a dozen other states, including Wisconsin, Nebraska, and Minnesota have decoupled from the federal law. Half a dozen other states have estate tax laws that automatically decouple. Some states, like Florida, will likely stay with the older, more favorable tax system.

Stay tuned. Few people believe this is the end of the story for the estate tax as this machine is in need of many repairs.



Robert, Bob's son, enjoys a camel ride at a neighbor's 4<sup>th</sup> of July party.