

An Article of Interest Death tax hits where you live

Location, the pivotal factor in the real estate, is now playing a big role in tax and estate planning.

The estate tax, which is also called the death tax because it's a levy on those who inherit a large sum, was on its way to its own demise by the federal tax reform package passed in 2001. With that reform, the level at which an estate tax would kick in was set to rise nearly every year, and then disappear by 2010.

But the death tax has been injected with life by new state laws. Where you live, and where you own real estate, will affect how much tax your heirs will owe.

You might think you'll never have to worry about inheriting enough to trigger a tax. But when you couple how escalating real estate values have pushed the net worth of many into millionaire territory, the new state inheritance taxes can have an impact beyond the country club set.

States like Illinois have always collected a tax when someone with sizable wealth died and passed on his or her assets to heirs. Estate taxes typically don't kick in when an estate passes to a surviving spouse but after the death of both partners. Only it didn't seem like a state was staking a claim, because the federal tax form gave filers a credit for state taxes.

"Most of the states designed their tax to conform to the credit so that they were simply picking up the amount granted by the federal credit," explains Bruno Graziano, a senior analyst with Riverwoods-based CCH Inc., which provides tax and legal information. When the federal lawmakers decided to phase out the estate tax by ratcheting up the level that triggers tax, "they also dipped into the pockets of the states by reducing the amount of the state death tax credit," explains Charles D. Fox IV, a partner with Schiff, Hardin & Waite, Chicago.

Many states, already starved for tax revenue in a slow economy, decided to break away, or "decouple," from the old credit system, and establish their laws to keep cash coming in.

The Illinois death tax, signed into law in June, is applicable to taxable estates that exceed \$1.5 million in 2004. For example, if a widow dies in Illinois with a house worth \$900,000 and other assets worth \$2 million, her estate would pay \$129,900 more to the State of Illinois than it would have if the state had not passed new death tax legislation, notes James H. Cundiff, a partner with McDermott, Will & Emery, Chicago.

Illinois' \$1.5 million threshold for 2004 is the same level as the federal threshold. The federal estate tax trigger is scheduled to rise to \$2 million in 2006 and then \$3.5 million in 2009. In Illinois, the state tax trigger will remain at \$2 million, however.

In Wisconsin, state lawmakers have set the tax threshold at \$675,000. Not only will heirs of Wisconsin residents who die with assets above the limit have to worry about paying the state, but so will heirs of anyone who owns real estate there valued above \$675,000. "People have to worry about where their second home is," Fox says. So far, about half of all states have "decoupled" from the federal law or, as in Indiana, have their own completely separate inheritance tax.

Where there are taxes, though, there are shelters. One way to shield a pricey vacation home in another state that has a stiff estate tax law might be to place the home in a limited liability company, or LLC, Cundiff says. "If you put your Wisconsin vacation home in a Delaware LLC, then at your death your executor may not be required to file a Wisconsin estate tax return or pay a Wisconsin estate tax," he says.

But the state laws are changing quickly. The new Wisconsin threshold of \$675,000 is in effect through 2007, while the federal death tax is scheduled to expire in 2010, and then be reincarnated in 2011.

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