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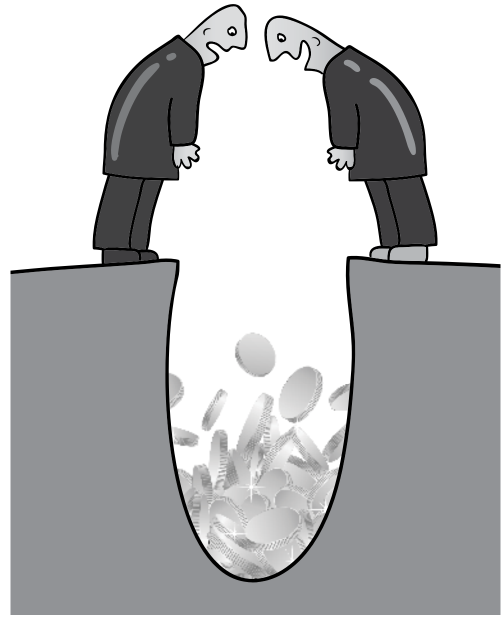
Falling Into the Gap Of State Death Taxes

How to ensure a soft landing.


ISTOCK

BY CATHERINE GREVERS SCHMIDT AND JILL CHOATE BEIER

WITH the recent increase in the federal estate tax exclusion amount from $2 million to $3.5 million per individual,1 the gap between the amount of assets "sheltered" for federal estate tax purposes and the amount sheltered for state estate tax purposes is growing wider in some states. This has led to an increase in the number of clients who want to fully utilize the federal estate tax exclusion amount but are no longer willing to pay state estate taxes on assets not sheltered for state estate tax purposes.

Many practitioners have begun to incorporate "gap trusts" and other planning techniques into their clients' estate planning documents to accomplish this goal. This article will discuss estate planning techniques that avoid or reduce both federal and state estate taxes, such as state QTIP elections, disclaimer trusts, partial QTIP elections, and Clayton trusts, as well as discuss the advantages and disadvantages of each technique.

Credit Shelter Trust

Most practitioners are aware that as of Jan. 1, 2009, each individual may transfer at death assets equal in value to the federal "applicable exclusion amount" ("federal AEA") of $3.5 million without incurring estate tax liability. For a married couple, transfers to spouses are usually not subject to the estate tax because such transfers are eligible for the unlimited marital deduction.2 Assets transferred to a spouse, however, will be subject to estate tax at the death of the surviving spouse without the benefit of using the first spouse's federal AEA. Therefore, special planning techniques must be used for married couples to prevent "wasting" the federal AEA on the death of the first spouse.

Practitioners accomplish this by creating a trust under the will of each spouse which holds assets in the amount of the federal AEA (sometimes referred to as the "credit shelter trust") and which will be funded upon the death of the first spouse. The assets in the credit shelter trust will be sheltered from the estate tax and will not be includable in the estate of the surviving spouse. As a result, the surviving spouse may shelter assets equal in value to the federal AEA from estate tax upon his or her death, thereby fully utilizing the federal AEA for both spouses.

This relatively simple technique is complicated by the imposition of state estate taxes and the "decoupling" of the federal and state estate tax systems. Many states, such as Connecticut, New York and New Jersey, have enacted separate state estate taxes which incorporate tax rates and exclusion amounts that differ from those of the federal tax system.3

In New York, the law will allow an individual to bequeath up to $1 million of his or her assets without incurring state estate taxes ("state AEA"). So, for married couples who wish to take full advantage of the federal AEA by using a credit shelter trust, the estate of the first spouse to die will necessarily incur state estate taxes on the difference between the federal AEA and the state AEA, i.e., the "gap." To illustrate, Husband, a New York resident with $5 million in assets, dies Dec. 1, 2008 (when the federal AEA was $2 million). His will creates a credit shelter trust to be funded with the federal AEA at the time of his death and the remaining assets to pass outright to Wife. Husband's estate will not incur federal estate taxes because the credit shelter trust fully utilizes Husband's federal AEA and the remaining assets passing to Wife qualify for the marital deduction.4 Husband's estate is, however, subject to New York state estate taxes of $99,600 because New York state law only shelters $1 million of Husband's assets from state estate taxes.5

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State QTIP Election

Prior to Jan. 1, 2009, for many married couples, paying a relatively small amount in state estate taxes was a fair trade for sheltering an additional $1 million from federal estate taxes. Because the federal applicable exclusion amount (AEA) has increased to $3.5 million, the gap has grown in New York from $1 million to $2.5 million. Today, if a married couple wishes to fully fund the credit shelter trust, the New York state estate taxes will be $229,200 at the first spouse's death, as opposed to $99,600 just a short time ago.6

In Connecticut, where the state AEA is $2 million, some clients are facing the possibility of paying state estate taxes for the first time. As a result, an increasing number of clients no longer perceive that the payment of state estate taxes is a fair trade for sheltering assets from the federal estate tax.7 At a minimum, many clients would prefer to wait to make the decision whether to pay state estate taxes until all the facts and circumstances can be properly evaluated. As a result, clients want an estate plan that is flexible, but still reduces federal and state estate taxes as much as possible.

One way to provide flexibility is to create a "gap trust" and make a state QTIP election for the trust. The instrument creating these trusts may use formula language to take into account future changes in federal and state tax laws. Of the states that impose a tax on the assets in a fully funded credit shelter trust, 13 permit a separate state QTIP election.8 The gap trust in which the executor makes a state QTIP election accomplishes two important goals: 1) it prevents the federal AEA from being wasted at the death of the first spouse by fully utilizing the deceased spouse's federal AEA, and 2) it ensures that no state estate taxes will be owed at the death of the first spouse.

However, use of a gap trust also has certain disadvantages. One disadvantage is that the gap trust must include statutory QTIP language.9 Therefore, all income must be paid to the surviving spouse, and the descendants of the

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deceased spouse cannot be income beneficiaries of the trust. These mandatory income distributions to the surviving spouse may unnecessarily increase the estate of the surviving spouse, particularly if he or she does not need the income for living expenses.[10]

Another disadvantage, one of which many practitioners may not be aware, is that changing the timing of payment of state estate taxes through the use of a gap trust results in the inability to deduct, on the federal estate tax return, the payment of those taxes which are incurred on gap trust assets at the death of the surviving spouse. Property subject to a separate state QTIP election will be included in the surviving spouse's gross estate for state estate tax purposes but not for federal estate tax purposes.

Code Section 2058 specifies that a deduction may be taken for "state taxes paid to any State in respect of any property included in the federal gross estate." If the credit shelter trust were fully funded at the first death and the state estate taxes were paid at that time, the payment of those taxes would be deductible on the first spouse's federal estate tax return. Conversely, when a gap trust is used, because the gap trust property is not included in the surviving spouse's federal gross estate, the state taxes imposed on that property will not be eligible for a deduction for state estate taxes paid at the second death. This may be significant to some clients.

While the client must ultimately decide whether the advantages of a gap trust outweigh the disadvantages, the practitioner should consider using disclaimer language whereby the surviving spouse may disclaim, from the credit shelter trust into the gap trust, either the total amount of the gap between the federal AEA and the state AEA or some lesser amount if deemed appropriate at the time of the disclaimer. The use of a disclaimer gap trust gives the surviving spouse the flexibility to wait to make such determinations until the death of the first spouse. It is important to keep in mind, however, that the use of a disclaimer will result in the surviving spouse being prohibited from holding a limited power of appointment over the assets in the trust.[11]

If the client resides in a state that does not allow a separate state QTIP election, the use of language providing that the spouse may disclaim property which will then fall into the credit shelter trust is still an effective means for the surviving spouse to have control over how much of the deceased spouse's assets (i.e., assets equal in value to the federal AEA or the state AEA) will be sheltered from state estate tax.

The decision may be made based on the tax law and the financial circumstances applicable at the time of the first death. The requirements for a valid disclaimer are rather technical and must be adhered to.[12] In addition, to enjoy the advantages of a disclaimer, the surviving spouse must affirmatively act in order to carry out the testator's intention and fund a credit shelter trust.

Partial QTIP Election

To eliminate the uncertainty of the surviving spouse making a disclaimer, a partial QTIP election may be an effective alternative. Partial QTIP elections are often used to take advantage of the federal applicable exclusion amount (AEA) and determine whether to limit the credit shelter trust to the state AEA or fully fund the trust. For a partial QTIP election, the testator bequeaths the residue to a trust for the benefit of the surviving spouse which contains the required QTIP provisions.

The executor (as opposed to the surviving spouse, if the client chooses) determines how much of the decedent's AEA to use, based on the current tax laws and the financial situation of the surviving spouse. The executor then makes a QTIP election only for the portion of the estate that will be protected from the estate tax by qualifying for the marital deduction. The remaining portion of the trust will be the amount of either the federal AEA or state AEA, depending upon the executor's determination, and will be sheltered from federal estate tax (and possibly state estate taxes). These two portions are often severed and held as separate trusts.

For some clients, the partial QTIP election technique provides significant advantages. For a client with children from a prior marriage, for example, the executor may be someone other than the surviving spouse, and the client may be more comfortable with a "neutral party" making economic decisions that will affect both the surviving spouse and the deceased spouse's children. Also, no matter what portion of the trust receives the QTIP election, all of the decedent's assets will be held in trust instead of being distributed outright, and the decedent, not the surviving spouse, will be able to direct to whom the assets will ultimately pass. Finally, the time frame for making the partial QTIP election (15 months) is more generous than for a disclaimer (nine months), which gives the executor more time to assess the appropriate amount that should be held in each trust.[13]

Because of frequent changes in the tax laws, practitioners and clients face uncertainty when planning for the future.

As discussed above regarding state QTIP elections, one disadvantage of using a partial QTIP election is that both trusts must contain statutory QTIP provisions, which means that the trust for which QTIP treatment is not elected must require that all income be distributed to the surviving spouse (with no income distributions to the deceased spouse's descendants). Therefore, the property distributed to the surviving spouse may be subject to estate tax in his or her estate. Also, mandatory income distributions to the surviving spouse during his or her lifetime may ultimately reduce the amount of assets passing to remainder beneficiaries at the surviving spouse's death.

Clayton Trust

Last, a relatively new, though increasingly common, technique used to avoid federal and state estate taxes while retaining flexibility is the use of a Clayton trust. A Clayton trust is a trust created under a will or revocable trust for which a QTIP election may be made, but which provides that the portion of the assets for which the election is not made will pour over to a credit shelter trust.[14]

The Clayton trust combines the advantages of a partial QTIP election and a disclaimer. The QTIP portion of the trust has all of the advantages of partial QTIP planning and the portion that is not treated as QTIP property can be structured as a typical credit shelter trust with discretionary income distributions to the surviving spouse and the deceased spouse's descendants. In addition, the surviving spouse may have a limited power of appointment over the assets of the credit shelter trust, unlike with the use of a disclaimer. The Clayton trust also can take advantage of the 15-month time frame for making QTIP elections.

One uncertainty of using a Clayton trust involves the possible gift tax consequences associated with appointing the surviving spouse as the sole executor. The surviving spouse/executor may be deemed to have made a gift because of the power to direct property away from himself or herself without a qualified disclaimer. Consequently, it would be prudent to appoint an independent executor either in lieu of or in addition to the surviving spouse. The independent executor could be appointed for the sole purpose of and with the sole authority to make the QTIP election. Some clients, however, may not want to give a power that will economically impact the surviving spouse to a person who is "independent."

Importance of Flexibility

Because of frequent changes in the tax laws, practitioners and clients alike face uncertainty when planning for the future. In the presence of such uncertainty, it is prudent to build as much flexibility into the client's estate plan as possible. Flexibility allows the client to defer making difficult choices until he or she can properly and adequately evaluate the facts and circumstances existing at the death of the first spouse and the impact of the laws in effect at that time. The techniques described in this article will help build needed flexibility into the client's estate plan and help the practitioner plan for the shifting landscape of federal and state tax laws.

1. Internal Revenue Code §2010(c).
2. Code §2056(a).
3. See Conn. Gen. Stat. §12-391; NY Tax Law §§951(a) and 952; N.J. Stat. §§54:34-2 and 54-38-1.
4. Code §2056(a).
5. This is based on a $2 million taxable estate for New York and assumes that the marital deduction will apply to all remaining assets in Husband's estate.
6. This is based on a $3.5 million taxable estate for New York and assumes that the marital deduction will apply to all remaining assets in Husband's estate.
7. Practitioners should be mindful of the spousal election when drafting documents. In the example, if Husband fully funds the credit shelter trust with $3.5 million, Wife may have the right to elect against his estate to receive more assets outright.
8. See Conn. Gen. Stat. §12-391(f); Burns Ind. Code Ann. §6-4.1-3-7; K.S.A. §79-15,223; K.R.S. §140.080; 36 M.R.S.A. §4062(1-A); Mass. Dept. of Rev. Directive 03-2 (Feb. 19, 2003), Md. Tax-General Code Ann. §7-309; 2003 STT 73-16; O.R.C. Ann. §5731.15; O.R.S. §118.010(7) and Oregon Admin. Rule 150-118.010(7); 72 P.S. §9113; R.I. Ruling Request No. 2003-03, 2003 STT 123-32; Tenn. Code Ann. §67-8-315(a)(6); and R.C.W. §83.100.047. New Jersey permits a separate election when no federal estate tax return is due.
9. Code §2056(b)(7)(B).
10. One solution to this, if the surviving spouse agrees, is to invest the trust assets in non-income producing assets.
11. Code §2518(b)(4).
12. Code §2518.
13. Code §2056(b)(7)(B)(v); Code §2518.
14. Regs. §20.2056(b)-7(d)(3).