Coping With the Decoupling of State Estate Taxes After EGTRRA

Under EGTRRA, the state death tax credit is phased out, and in 2005 state death taxes will become a deduction for federal estate tax purposes. To avoid the resulting loss in revenue, many states are 'decoupling' their state estate taxes from the federal law.

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As a result of the "decoupling" of state estate taxes from the state death tax credit, many estates will have to pay state estate tax even if they are not subject to federal estate tax. This article analyzes the strategies needed to cope with decoupling through 2009.

Background

Before 1982, many states had estate and inheritance taxes that applied to estates even if they were not subject to federal estate tax. In many states, the estate or inheritance tax rates exceeded the state death tax credit. Some states did not even allow a marital deduction for state inheritance tax purposes.

In 1981, ERTA made three major changes to the federal estate tax. First, the exempt amount was increased from $175,625 to $600,000 over six years.[1] Second, the marital deduction became unlimited, and was no longer limited to the greater of $250,000 or 50% of the adjusted gross estate.[2] Third, qualified terminable interest property (QTIP) became eligible for the marital deduction.[3]

In the years following ERTA, most states conformed or substantially conformed their estate and inheritance taxes to the federal estate tax state death tax credit by limiting their estate taxes to the state death tax credit, thus effectively adopting the unlimited marital deduction, QTIP, and the federal exemption amount. By 2001, only 13 states still had estate or inheritance taxes that could sometimes exceed the state death tax credit.[4]

TRA '97 further increased the exempt amount to $625,000 in 1998, $650,000 in 1999, and $675,000 in 2000-01. Under TRA '97, the exempt amount was scheduled to increase to $700,000 in 2002-03, $850,000 in 2004, $950,000 in 2005, and $1 million in 2006.[5]

EGTRRA

In 2001, EGTRRA made three major changes in the estate tax:

1. *Increase in the exempt amount.* EGTRRA increased the exempt amount to $1 million in 2002-03. The exempt amount is scheduled to increase to $1.5 million in 2004-05, $2 million in 2006-08, and $3.5 million in 2009. There is no estate tax in 2010. However, the estate tax returns in 2011, with a $1 million exempt amount.[6]
2. *Reduction in the tax rate.* EGTRRA reduced the top federal estate tax rate (before application of the state death tax credit) from 55% to 50% in 2002, 49% in 2003, 48% in 2004, 47% in 2005, 46% in 2006 and 45% in 2007-09.[7]
3. *Phase-out of state death tax credit.* EGTRRA also phases out the state death tax credit over four years. The top rate is reduced from 16% in 2001 to 12% in 2002, 8% in 2003 and 4% in 2004. Beginning in

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2005, there will no longer be a state death tax credit, but state death taxes will be deductible in determining the federal estate tax. The pre-EGTRRA state death tax credit returns in 2011, with a top rate of 16%.[8]

Impact on the states

The increase in the exempt amount and the phase-out of the state death tax credit will have a significant impact on those states whose estate tax conforms to the federal estate tax. The phase-out of the state death tax credit will reduce state estate taxes in those states by 25% in 2002, 50% in 2003, 75% in 2004, and 100% beginning in 2005. The revenue impact on the states is substantial, both in absolute dollars (close to $1 billion per year in California) and as a percentage of revenue (close to 4% in Florida).[9]

Decoupling of state estate taxes. To avoid a significant loss of revenue, at least 17 states and the District of Columbia have decoupled from the increase in the federal exempt amount or the phase-out of the state death tax credit, either by enacting new legislation or by not adopting the necessary conforming legislation. These states include: Arkansas, the District of Columbia, Kansas, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, North Carolina, Oregon, Pennsylvania, Rhode Island, Vermont, Virginia, Washington, and Wisconsin.[10]

Some states will allow the increases in the federal exempt amount but not the reduction in the tax rates. Some states will allow the increases in the federal exempt amount, but only up to a specified amount, such as $1 million. Some states will allow the increases in the federal exempt amount that had been scheduled to take effect under pre-EGTRRA law (e.g., to $700,000 in 2002-03, $850,000 in 2004, $950,000 in 2005, and $1 million beginning in 2006). Still other states limit the exempt amount to $675,000.

As the scheduled increases in the federal exempt amount and the scheduled reductions in the state death tax credit take effect, the impact on state estate tax revenues will increase, so that it is likely that additional states will decouple from the state death tax credit.

Decoupling the exempt amount is very different from decoupling the rate. The effect of decoupling as to the exempt amount is very different from decoupling as to the tax rate.

If a state decouples as to the tax rate, but conforms to the increases in the exempt amount, there will still be no federal or state estate tax on a taxable estate equal to the federal exempt amount ($1 million in 2002-03). Consequently, in such a state, estates with a typical marital deduction and credit shelter formula will still not pay any federal or state estate tax, nor will estates below the exempt amount. In larger estates, however, upon the death of the surviving spouse or a single individual—assuming that the top state death tax rate does not exceed the top state death tax credit rate of 16% in effect in 2001—the top combined federal and state estate tax is 54% in 2002 (i.e., 50% federal tax plus 16% state tax minus 12% state death tax credit equals 54% in 2002), 57% in 2003, 60% in 2004, 55.48% in 2005, 54.64% in 2006, and 53.8% in 2007-09.

If a state decouples as to the exempt amount, taxable estates above the state exempt amount but below the federal exempt amount will pay state estate tax, even though they will not have to pay federal estate tax.

Because large estates pay most of the estate tax, if a state decouples as to the tax rates, but conforms to the scheduled increases in the exempt amount, that state will preserve most of its estate tax revenue.[11]

Coping with decoupling in the planning process

In analyzing the impact of decoupling on the planning process, it is assumed that the testator resides in a state that has decoupled from the state death tax credit as to both the exempt amount and the tax rate. In other words, assume that the applicable state estate tax is equal to the state death tax credit in effect as if the testator had died in 2001, with a $675,000 exempt amount and a 16% top rate. Planners should make the necessary adjustments for clients in states that have only partially decoupled, or that have applicable inheritance taxes.

If the state death tax conforms to the state death tax credit, a typ-

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1 Section 2010(b). All statutory references are to the Internal Revenue Code of 1986, as amended, except that references to the applicable law prior to the enactment thereof are to the Internal Revenue Code of 1954, as amended.

2 Section 2056(c).

3 Section 2056(b)(7).

4 Conn., Ind., Iowa, Ky., La., Md., Neb., N. H., N. J., Ohio, Okla., Pa., and Tenn. McNichol, Lav, and Tenny, "States Can Retain Their Estate Taxes Even as the Federal Estate Tax Is Phased Out," Center on Budget and Policy Priorities, at 5 (5/10/02) (hereinafter "McNichol, Lav, and Tenny").

5 Section 2010(c).

6 *Id.*

7 Section 2001(c)(2)(B).

8 Section 2011.

9 McNichol, Lav, and Tenny, *supra* note 4, at 10.

10 McNichol and Tenny, "Many States Are Decoupling From the Federal Estate Tax Cut," Center on Budget and Policy Priorities (10/2/02).

11 McNichol, Lav, and Tenny, *supra* note 4, at 3.

ical marital deduction and credit shelter formula results in a taxable estate or credit shelter amount (ignoring lifetime taxable gifts) of $1 million in 2002-2003, and no federal or state estate tax. This amount is scheduled to increase to $1.5 million in 2004-2005, $2 million in 2006-2008, and $3.5 million in 2009. In contrast, if a state allows only a $675,000 exempt amount, this will result in a state estate tax of $33,200 in 2002-2003, $64,400 in 2004-2005, $99,600 in 2006-2008 and $229,200 in 2009, assuming that the taxable estate is equal to the federal exempt amount. There are several ways to cope with this in the planning process.

Limit the credit shelter to the state exempt amount. One solution is to limit the credit shelter share of the estate to the state exempt amount. To accomplish this, a pecuniary credit shelter formula can limit the credit shelter share to the largest amount that can pass free of both federal and state estate tax, or a pecuniary marital formula can limit the marital share to the smallest amount needed to eliminate both federal and state estate taxes. The same result can also be achieved with a fractional share formula. This will eliminate the state (as well as the federal) estate tax in the first spouse's estate. However, it will expose more assets to estate tax in the surviving spouse's estate. Therefore, this solution will be most attractive where the surviving spouse's estate is not expected to exceed the federal exempt amount, or where the surviving spouse's estate is expected to pass to charity. This is likely to be the case for younger clients, since the premature death of one spouse may make it more likely that the surviving spouse's estate will be less than the federal exempt amount.

Shelter based on both the unified credit and the state death tax credit. Another solution is to provide for a credit shelter share equal to the largest amount that can pass free of federal estate tax by reason of both the unified credit and the state death tax credit, or a marital share in the amount necessary to eliminate the federal estate tax, taking into account both the unified credit and the state death tax credit.

This will enable the first spouse's estate to shelter $1,067,663 in 2002 instead of only $1 million. The federal estate tax before credits is $373,542, but is fully offset by the unified credit of $345,800 and the state death tax credit of $27,742. This will result in a state death tax of $36,989, based on the state death tax credit in effect in 2001. Thus, the first spouse's estate can shelter an additional $67,663 from federal estate tax (plus the income and growth thereon during the surviving spouse's estate), at a cost of only $3,789 of additional state estate tax, representing an effective tax rate of less than 6%. This approach is most useful in larger estates where the surviving spouse's estate is expected to be subject to estate tax. The state death tax of $36,989 is payable out of the nonmarital share of the estate, so that the net amount of the nonmarital share is $1,030,674.

These numbers change in 2003 and 2004. In 2003, a taxable estate of $1,043,457 results in a state estate tax of $35,634, so that the additional $2,434 of state estate tax shelters an additional $43,457. In 2004, a taxable estate of $1,537,096 results in a state estate tax of $66,774, so that the additional $2,374 of state estate tax shelters an additional $37,096.

Beginning in 2005, there will no longer be a state death tax credit, so this strategy will no longer be viable. Someone willing to incur the state estate tax ($64,400 on a $1.5 million taxable estate in 2005, $99,600 on a $2 million estate in 2006-08, and $229,200 on a $3.5 million taxable estate in 2009) can then shelter the federal exempt amount and no more.

Statutory provisions and flexibility. Under EGTRRA, the federal estate tax is repealed for persons dying in 2010. Planning with respect to the repeal of the federal estate tax is beyond the scope of this article.

Under EGTRRA, the federal estate tax returns in 2011, with a $1 million exemption. In states that limit the exempt amount to $675,000, the planning considerations beginning in 2011 will be the same as in 2002.

Many clients will want their wills to be flexible, so that the decision about whether to limit the credit shelter to the state exempt amount, or to shelter based on both the unified credit and the state death tax credit, can be deferred until after the first spouse's death.

Combine a credit shelter equal to the state exempt amount with a QTIP trust. Some flexibility can be achieved by limiting the nonmarital share to the state exempt amount, and leaving the balance of the estate (or the difference between the largest amount that can be sheltered using both the unified credit and the state death tax credit and the state exempt amount) in the form of a QTIP trust rather than outright. This allows the executors to decide whether to make a full or partial

QTIP election (or no QTIP election) based on the facts and circumstances at the time of the decedent's death, including the size of the estate, the size of the surviving spouse's estate, and the provisions of both federal and state law at that time. The executors can make a full QTIP election to reduce the taxable estate to $675,000 and eliminate both federal and state estate tax, or the executors can make a partial QTIP election to shelter the largest amount possible ($1,067,663 in 2002, $1,043,457 in 2003, $1,537,096 in 2004, $1.5 million in 2005, $2 million in 2006-08 and $3.5 million in 2009) while still not incurring any federal estate tax, or a partial QTIP election at some intermediate point. To the extent the QTIP election is made, the executors can make a reverse QTIP election for generation-skipping transfer (GST) tax purposes.[12]

The estate tax return is due nine months after death.[13] But the executors can put the estate tax return on extension for an additional six months,[14] which gives them up to 15 months after the decedent's death to decide whether to make a full or partial QTIP election. It is possible to make a QTIP election on a late return.[15] However, if the return is filed late, there may be a late filing penalty.[16]

The disadvantage of a partial QTIP election is that the income from the entire trust is payable to the spouse, thus throwing the income from the non-QTIP portion of the trust back into the spouse's estate. Severing the trust into separate trusts (i.e., one for the QTIP portion and one for the non-QTIP portion), if permitted by the will or by state law, and investing the non-QTIP portion for growth—rather than income—can minimize the effect of this. But such an investment strategy reduces the investment flexibility of the non-QTIP portion, as compared to a credit shelter trust in which the income need not be paid to the spouse.

Combine a credit shelter equal to the state exempt amount with a possible disclaimer. Another approach is to limit the credit shelter share to the state exempt amount and let the surviving spouse decide whether to disclaim all or part of the marital share. This can be done regardless of whether the marital share passes outright or in a QTIP trust. If the will provides for a pecuniary marital and residuary credit shelter, the disclaimed portion of the marital share should pass to the credit shelter trust. However, unless the will provides otherwise, in the case of a pecuniary credit shelter and residuary marital, the disclaimed portion of the marital share will pass to the contingent residuary beneficiaries. To facilitate a disclaimer when using a pecuniary credit shelter trust, the will can provide that if the spouse disclaims a portion of the residuary marital disposition, the disclaimed property will pass to the credit shelter trust, or to a separate disclaimer trust, rather than to the contingent residuary beneficiaries.

If the surviving spouse disclaims, she cannot have any power to direct the beneficial enjoyment of the disclaimed property, unless the power is limited by an ascertainable standard.[17] Suppose that the disclaimed property falls into the credit shelter trust. If the spouse has a power of appointment over the trust, or if the spouse has the power (as a trustee) to make discretionary distributions to other beneficiaries (except if limited by an ascertainable standard), the spouse must disclaim those powers over the disclaimed property. The spouse can disclaim the power to make discretionary distributions and still remain as a trustee.[18] Where state law prohibited the spouse from exercising discretion in favor of herself, the Service permitted the spouse to serve as trustee of a trust receiving property by reason of a disclaimer of which she was the only beneficiary to whom distributions could be made.[19]

Another potential disadvantage of a disclaimer is that the surviving spouse must disclaim, if at all, within nine months after the first spouse's death (or nine months after the surviving spouse reaches age 21, if later), and before accepting the disclaimed property or any benefits from it.[20]

Additional planning

Combine a credit shelter equal to the state exempt amount with a Clayton *QTIP trust.* Limiting the credit shelter share to the state exempt amount, and leaving the balance of the estate in the form of a *Clayton* QTIP trust can achieve some flexibility. In a *Clayton* QTIP trust (named after a Fifth Circuit case by that name[21]), to the extent the executors elect QTIP, the assets are held in a QTIP trust; to the extent the executors do not elect QTIP, the assets pass to the credit shelter trust, or in some other way.

Even though the spouse does not receive all the income of a

[12] Section 2652(a)(3).
[13] Section 6075(a).
[14] Section 6081(a); Reg. 20.6081-1.
[15] Reg. 20.2056(b)-7(b)(4)(i).
[16] Section 6651(a).
[17] Section 2518(b)(4); Reg. 25.2518-2(e)(2).
[18] Ltr. Rul. 9245011.
[19] Ltr. Rul. 9707008.
[20] Section 2518(b).
[21] Estate of Clayton, 976 F.2d 1486, 70 AFTR2d 92-6262 (CA-5, 1992), *rev'g* 97 TC 327 (1991).

Clayton QTIP trust in all events, but receives income only to the extent the executors elect QTIP, the trust nevertheless qualifies for the marital deduction to the extent the executors so elect. After the Fifth, Sixth, and Eighth Circuits reversed the Tax Court to allow the marital deduction, the Tax Court changed its position and now allows the marital deduction for a *Clayton* QTIP trust.[22] The Regulations have similarly been revised to allow the marital deduction for a *Clayton* QTIP trust.[23]

Hence, after providing for a credit shelter equal to the state exempt amount, a testator can leave the difference between the federal exempt amount and the state exempt amount to a *Clayton* QTIP trust, and the balance of the estate to his spouse—either outright or in a QTIP trust.

This strategy permits the executors to decide whether to make a full or partial QTIP election based on the facts and circumstances at the time of the decedent's death. The primary advantage of the *Clayton* QTIP provision is that, to the extent the QTIP election is not made, the income from the non-QTIP portion need not be paid to the spouse. Nevertheless, by not requiring the income from the non-QTIP portion to be paid to the spouse, the opportunity to obtain the credit for tax on prior transfers (TPT) if the surviving spouse dies within ten years is lost.[24] This opportunity to claim the TPT credit is most desirable if the surviving spouse is elderly or is in poor health.

Another advantage of a *Clayton* QTIP trust over a disclaimer is that the spouse can have a power of appointment over the property passing to the credit shelter trust by reason of the executors' not electing QTIP. Similarly, the spouse can have the power, as a trustee, to make discretionary distributions to other beneficiaries of the credit shelter trust.

If the executors put the estate tax return on extension, they will have up to 15 months to decide to what extent to make the QTIP election, and yet will still be able to file a timely estate tax return.[25]

Because the decision of whether to elect QTIP for a *Clayton* QTIP trust has dispositive consequences as well as tax consequences, it can be a difficult one for the executors to make.

Rev. Proc. 2001-38. Under Rev. Proc. 2001-38,[26] if a QTIP election is made that was not necessary to reduce the estate tax to zero, the Service will disregard the election and treat it as null and void. For example, in Ltr. Rul. 200226020, the Service disregarded a QTIP election that was made for a credit shelter trust.

There is some question as to whether the application of Rev. Proc. 2001-38 is automatic, or whether it applies only if the surviving spouse or the surviving spouse's estate applies for relief thereunder. If an application for relief is required to invoke Rev. Proc. 2001-38, it may be possible to leave the difference between the federal exempt amount and the state exempt amount in a separate QTIP trust and make a QTIP election for that trust. When the surviving spouse dies, her estate can then decide whether to invoke Rev. Proc. 2001-38, in which case it may be impossible or impractical for the taxing state to collect the appropriate estate tax in the first spouse's estate. However, if the state takes the position that Rev. Proc. 2001-38 is automatic, it may seek to impose the tax in the first spouse's estate despite the QTIP election.

Alternatively, if the entire excess above the state exempt amount passes in the form of a trust for which a QTIP election is made, the surviving spouse's estate cannot use Rev. Proc. 2001-38 to limit the QTIP election to the portion of the trust needed to eliminate the federal estate tax in the first spouse's estate. The reason is that Rev. Proc. 2001-38 does not apply where a partial QTIP election was required to reduce the federal estate tax to zero and the executor made the election with respect to more property than was necessary to reduce the estate tax to zero.[27]

Retirement benefits. There are income tax advantages to leaving retirement benefits to the spouse. In some cases, the income tax advantages may outweigh the estate tax advantages of fully funding the estate tax exempt amount. The spouse can roll over the retirement benefits into her own IRA and name new beneficiaries, thereby increasing the period over which the benefits can be tax-deferred.[28] The spouse may also be able to convert an IRA to a Roth IRA.[29] Consequently, in many instances, retirement plan participants and IRA owners may want to name the spouse as primary beneficiary, with a QTIP trust, *Clayton* QTIP, or credit shelter trust as contingent beneficiary.

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22 Estate of Spencer, 43 F.3d 226, 75 AFTR2d 95-563 (CA-6, 1995), *rev'g* TCM 1992-579; Estate of Robertson, 15 F.3d 779, 73 AFTR2d 94-2329 (CA-8, 1994), *rev'g* 98 TC 678 (1992); Estate of Clayton, *supra* note 21; Estate of Clack, 106 TC 131 (1996), *acq.*

23 Regs. 20.2056(b)-7(d)(3) and 20.2056(b)-7(h), Example 6.

24 Section 2013.

25 Section 6081(a); Reg. 20.6081-1.

26 2001-1 CB 1335.

27 Ltr. Rul. 200219003.

28 Section 402(c)(9).

29 Section 408A.

Lifetime gifts. Because the state death tax credit is based on the taxable estate, not including lifetime gifts, the effect of decoupling can be reduced or eliminated by making lifetime gifts. This may give some taxpayers an additional incentive to take advantage of their $1 million gift tax exemption amount during lifetime.

If a taxpayer who otherwise would have a $1 million taxable estate makes a $325,000 taxable lifetime gift, this will reduce the taxable estate to $675,000. This will reduce the state death tax from $33,200 to $17,000, but will not eliminate the state death tax. Under the law in effect in 2001, absent any gifts, the total estate tax would have been $125,250, consisting of $92,050 of federal estate tax and $33,200 of state estate tax. If the decedent made $325,000 of taxable gifts, so as to reduce the taxable estate to $675,000, the estate tax would still have been $125,250, consisting of $108,250 of federal estate tax and $17,000 of state estate tax.

A taxpayer with a larger estate may want to make a $1 million taxable gift, using the $1 million gift tax exempt amount. This will reduce the taxable estate, and hence the state estate tax. The gift can be to a trust in which the taxpayer's spouse is a discretionary beneficiary or, if the taxpayer wants to retain some access to the trust assets, to an Alaska trust in which the taxpayer can be a discretionary beneficiary.[30]

Change of domicile. As the state death tax phases out, testators in states that have decoupled may want to consider changing their domicile to states that have conformed to EGTRRA. Due to the phase-out of the state death tax credit, the rate difference in states that have decoupled is as much as 4% in 2002, 8% in 2003, and 12% in 2004. Beginning in 2005, the top state estate tax in states that have decoupled will remain at 16%.

Because the state estate tax will then be allowable as a deduction rather than a credit, this will reduce the net cost to 8.48% based on the top federal estate tax rate of 47% in 2005, 8.64% based on the top federal estate tax rate of 46% in 2006, and 8.8% based on the top federal estate tax rate of 45% in 2007-09. This rate difference may be enough to give taxpayers with large estates in states that have decoupled an incentive to change their domicile to states that have not decoupled. However, the scheduled phase-out of the state death tax credit may put additional pressure on the remaining states to decouple, or to seek repeal by Congress of the phase-out of the state death tax credit.

Postmortem planning

Some testators in states that have decoupled will die without revising their wills to deal with the phase-out of the state death tax credit. In those cases, a taxable estate equal to the federal exempt amount will incur a state estate tax of $33,200 in 2002-03, $64,400 in 2004-05, $99,600 in 2006-08, and $229,200 in 2009. Indeed, in states that decoupled retroactively to 1/1/02, some testators died before the enactment of the decoupling legislation.

Reduce the taxable estate to the state exempt amount. The state estate tax can be eliminated by reducing the taxable estate to the state exempt amount, at the cost of exposing additional assets to estate tax in the surviving spouse's estate. It may be possible to accomplish this if the beneficiaries of the credit shelter trust can disclaim the difference between the federal exempt amount and the state exempt amount (which can be as much as $325,000 in 2002-03, $825,000 in 2004-05, $1,325,000 in 2006-08, and $2,825,000 in 2009), assuming that the disclaimed property will pass to the spouse or a marital deduction trust. Alternatively, if the spouse is entitled to all the income of the credit shelter trust, the executors can elect QTIP for that portion of the credit shelter trust.

If the will provides for a pecuniary credit shelter and residuary marital, the spouse's disclaimer as to a portion of the credit shelter trust should be sufficient, assuming the credit shelter disposition is contingent upon the spouse's survival. If the will provides for a pecuniary marital and residuary credit shelter, all the beneficiaries of the credit shelter trust must disclaim, along with all the contingent residuary beneficiaries and all the intestate takers other than the spouse.

Increase the taxable estate based on both the unified credit and the state death tax credit. As set forth above, before 2005 it is possible to shelter more than the federal exempt amount at a modest cost by taking advantage of both the unified credit and the state death tax credit. This will be desirable where the surviving spouse's estate will be subject to estate tax. The spouse can accomplish this by disclaiming a portion of the marital share. Alternatively, the executor can accomplish this by making a partial QTIP election if the marital share passes in the form of a

30 Alaska Stat. § 34.40.110; Ltr. Rul. 9837007 (ruling on gift tax but not estate tax); Ltr. Rul. 9332006 (offshore trust); *cf.* Paolozzi, 23 TC 182 (1954), *acq.*; Rev. Rul. 76-103, 1976-1 CB 293.

QTIP trust or *Clayton* QTIP trust rather than outright.

Will construction. If it is too late or otherwise impractical to disclaim, and if a partial QTIP election is not possible or not desirable, another possibility is a will construction. It may be possible to construe the marital deduction and credit shelter formula in the decedent's will to reduce the taxable estate to the state exempt amount so as to eliminate both federal and state estate taxes, or to increase the taxable estate so as to use the state death tax credit.

A will construction is based on the testator's intention, taking into account the will as a whole. It is generally presumed that a testator intended to take advantage of available tax benefits. However, a decision of a state court other than the highest court of the state is not binding on the IRS.[31]

Because some estates will prefer a will construction that reduces the taxable estate to the state exempt amount, while other estates will prefer a will construction that increases the taxable estate so as to use the state death tax credit, it may be difficult to obtain the desired construction in a given case.

Hypothetical federal elections. If no federal estate tax return is required, it may be possible to make any elections for state estate tax purposes that could have been made if a federal estate tax return had been required, such as QTIP,[32] alternate valuation,[33] special-use valuation,[34] conservation easement,[35] or qualified family-owned business interest (QFOBI).[36] For example, before New York limited its estate tax to the state death tax credit, New York permitted a QTIP, alternate valuation, or special-use valuation election for New York estate tax purposes if a federal election could have been made but for the fact that a federal return was not required.[37]

Massachusetts intends to permit a QTIP election for state estate tax purposes regardless of whether a QTIP election is made for federal estate tax purposes.[38] Ohio permits separate QTIP, alternate valuation, qualified farm property valuation, or QFOBI elections for state estate tax purposes regardless of whether a federal return is required.[39] However, Minnesota will not allow alternate valuation or special-use valuation for state estate tax purposes if no federal return is required.[40]

Because the QTIP election affects the surviving spouse's estate, it may not be possible to make a QTIP election for state—but not federal—purposes (or to give proper effect to such an election in the surviving spouse's estate if it is permitted) where the state estate tax in the surviving spouse's estate is based upon the state death tax credit in effect at a given date, rather than upon a separately calculated state taxable estate.

If a state will not permit elections for state estate tax purposes where a federal return is not required, it may be possible to claim the administration expenses on the state estate tax return and also on the federal and state fiduciary income tax returns.[41] The QFOBI deduction for federal estate tax purposes applies only to decedents dying before 2004,[42] but it may apply beyond 2003 for state estate tax purposes.

The savings may be illusory

If a state does not ultimately conform to the federal changes, the desired state death tax savings may be largely illusory. Suppose that a husband and wife in a state that has fully decoupled each have a $1 million estate. To avoid paying $33,200 of state estate taxes in the first spouse's estate, the nonmarital share is limited to $675,000. This increases the surviving spouse's estate to $1,325,000. Assuming that the surviving spouse lives until at least 2004, the increase in the federal exempt amount will eliminate the federal estate tax in her estate. However, if the surviving spouse's home state has not conformed to the state death tax credit, the state estate tax on her estate will be $53,200. This is only $13,200 less than it would have been if each spouse had a taxable estate of $1 million. Accordingly, planners should consider whether the anticipated state death tax savings are sufficient to warrant the necessary changes to the dispositive provisions of the first spouse's will.

Conclusion

The present estate tax law under EGTRRA is unstable, and imposes pressure on conforming states to make up the revenue lost by the phase-out of the state death tax credit. In the meantime, attorneys should consider drafting wills so as to allow for flexibility in post-mortem planning, and should monitor any changes in either the federal estate tax or applicable state law, so as to be able to advise their clients properly. ■

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31 Bosch, 387 U.S. 456, 19 AFTR2d 1891 (S.Ct., 1967).

32 Section 2056(b)(7).

33 Section 2032.

34 Section 2032A.

35 Section 2031(c).

36 Section 2057.

37 N.Y. Tax Law § § 954 and 955(c).

38 Mass. Draft DOR Directive 03-X (1/16/03).

39 ORC § § 5731.15(B) (QTIP), 5731.01(D) (alternate valuation), 5731.011 (qualified farm property valuation), and 5731.2 (QFOBI).

40 Minn. Revenue Notice 02-16; see Minn. Stat. § 291.215.

41 Minn. Revenue Notice 02-16.

42 Section 2057(j).