



By **Bruce D. Steiner** & **Martin M. Shenkman**

Estate Planning in Decoupled States **Post-ATRA**

One of the biggest challenges may be helping clients understand the complexities involved

One of the more difficult challenges practitioners face is advising clients in decoupled states about the interplay of the federal estate tax (including portability), state estate tax, capital gains taxes (including basis step-up) and the clients' objectives. While practitioners are undoubtedly familiar with the recent changes to the federal law, they still must determine the contradictory objectives of state tax minimization and maximization of basis step-up and preserving favorable trust benefits.

ATRA

The American Taxpayer Relief Act of 2012 (ATRA)¹ made the estate and gift tax-exempt amounts and the generation-skipping transfer (GST) tax exemption "permanent" at \$5.25 million in 2013, indexed for inflation. Portability was made permanent for estate tax purposes. However, there's no portability for the GST tax exemption, and no state recognizes portability for state estate tax purposes. The estate, gift and GST tax rates were fixed at 40 percent. The 2001 and 2003 income tax rate cuts were made permanent for taxpayers with taxable income up to and including \$400,000 (single) and \$450,000 (joint), but only \$11,950 for estates and trusts (all indexed for inflation). Above those levels, the 15 percent tax rate on long-term capital gains reverted to 20 percent, and the tax rate on qualified dividends was fixed at 20 percent.

There's also a new 3.8 percent Medicare tax for taxpayers with adjusted gross income (AGI) above \$200,000 (single) and \$250,000 (joint), but only \$11,950 for estates and trusts.

With a \$5.25 million estate tax-exempt amount and portability, very few estates will pay any federal estate tax. However, for many clients, especially those in decoupled states, simplicity remains elusive.

State Estate Tax Decoupling

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)² phased out the state death tax credit and replaced it with a deduction for state estate and inheritance taxes. As a result, most states allowed their estate taxes to lapse. However, about one-third of the states decoupled from the federal estate tax changes and continue to impose estate taxes to stem the resulting revenue loss. In most of these jurisdictions, the state estate tax-exempt amount is less than the federal tax-exempt amount. In addition, a few states have state inheritance taxes, either alone or in conjunction with a state estate tax.³ For most clients in decoupled states where the state exempt amount is less than the federal exempt amount, state estate taxes and income taxes are now more important than federal estate taxes. In estates that might be subject to federal estate tax, the interplay among the federal and state estate taxes, capital gains taxes and asset protection can be complicated.

Different states have different rules as to whether a state-only qualified terminable interest property (QTIP) election is permitted. This creates additional complexity, discussed below.

1. Decoupled states with lower exempt amounts and separate state QTIP elections. In a decoupled

Bruce D. Steiner, far left, is an attorney with Kleinberg, Kaplan, Wolff & Cohen, P.C., in New York. **Martin M. Shenkman** is an attorney in Paramus, N.J.





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state with a state exempt amount that's less than the federal exempt amount and that permits a separate QTIP election, a client has a choice between sheltering the federal exempt amount or sheltering the state exempt amount. The client can shelter the federal exempt amount by creating a gap trust in QTIP form for the balance of that amount and making a state-only QTIP election for the gap trust.

If the federal estate tax isn't a concern, a client in a decoupled state that allows a state-only QTIP election should, generally, have a will dividing the estate into three parts:⁴

- (1) A credit shelter (bypass) trust (CST) for the state exempt amount;
- (2) A "gap" trust equal to the difference between the state and federal estate tax-exempt amount. A QTIP election would be made for the gap trust for state, but not federal, estate tax purposes, if permitted under state law; and
- (3) The balance of the estate in a disposition qualifying for the federal and state marital deduction.

This approach avoids state estate tax in the first estate. If the surviving spouse moves to another state or if the state estate tax is repealed, the state estate tax on the gap trust at the second death is avoided. If not, there's no harm. The gap trust will pay estate tax in the second estate, instead of the first.

This plan may be less attractive in larger estates, in which the income from the gap trust during the surviving spouse's lifetime would be included in the surviving spouse's estate; possibly resulting in additional federal estate tax. So, a client with a large estate in a decoupled state with a state exempt amount less than the federal exempt amount might benefit by sheltering the federal exempt amount, thereby incurring some state estate tax in the first estate.

2. Decoupled states with lower exempt amounts, but no separate state QTIP election. In some decoupled states (for example, New York and New Jersey), the state exempt amount is lower than the federal exempt amount, but a separate state QTIP election isn't permitted. The federal QTIP election or non-election is binding for state estate tax purposes. In these jurisdictions, assuming the state estate tax is equal to the pre-EGTRRA state death tax credit, funding a full \$5.25 million CST would trigger a state estate tax in

the amount of \$478,182.

If the federal estate tax exemption had reverted to \$1 million and the rate increased to 55 percent, it might have been worthwhile to incur this state estate tax at the first spouse's death. However, this isn't always the case with the higher exemption amount under ATRA.

3. New York and New Jersey QTIP conformity rules. If an estate files a federal estate tax return to elect portability, it's bound by the federal QTIP election or non-election and is precluded from making a separate QTIP election for New Jersey or New York state estate tax purposes. If no federal estate tax return is filed, the executor can make a separate state QTIP election. However, if a federal estate tax return is filed, even if only to elect portability, the federal QTIP election or non-election is binding for state estate tax purposes.⁵ This puts many clients in the quandary of having to choose between giving up portability to make a state-only QTIP election or filing a federal estate tax return to elect portability, but giving up the opportunity to make a state QTIP election for the gap amount.

When portability is sufficient to eliminate the possibility of a federal estate tax in the surviving spouse's estate, the client may wish to limit the CST amount to the state exemption amount and leave the balance of the estate to the surviving spouse in a manner that qualifies for the marital deduction. Doing so will eliminate the state estate tax in the first spouse's estate and may avoid state estate tax in the surviving spouse's estate if the surviving spouse moves to another state or the state estate tax is repealed during the surviving spouse's lifetime. In either case, the state estate tax incurred may be less than the capital gains tax saved by the second basis step-up. It should be noted, however, that the deceased spousal unused exempt amount isn't indexed for inflation, and portability isn't available for the GST tax exemption.

If portability is anticipated, the marital share may have to pass outright or in a general power of appointment (POA) trust. Leaving the marital share outright will subject it to the surviving spouse's creditors, including subsequent spouses and Medicaid. If the marital share is in a general POA trust, the principal will be protected against the surviving spouse's creditors in some states. However, in other states, the principal will be exposed to the surviving spouse's creditors or will be so exposed if the surviving spouse exercises the general POA.



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In a larger estate, the first spouse might want to shelter the federal exempt amount, even though that will result in some state estate tax at the first spouse's death. That may be a significant cost to bear, given the uncertainties as to whether a state or federal estate tax will be incurred. The inflation adjustments of the surviving spouse's estate may make an estate that was marginally taxable non-taxable. On the other hand, in larger estates, sheltering the federal exempt amount is more important because, as noted above, portability isn't indexed for inflation, and there's no portability for the GST tax exemption.

If the estate is sufficiently small that there's no need for portability, the first spouse can shelter the state exempt amount and leave the rest of the estate in a QTIP trust, and the executor can make a state QTIP election for that trust. However, sacrificing portability incurs the risk that the surviving spouse's estate will be subject to estate tax, either because it turns out to be larger than anticipated or because the federal estate tax-exempt amount is reduced. In this regard, it should be noted that the Obama administration has proposed reducing the federal estate tax-exempt amount to \$3.5 million, increasing the estate tax rate to 45 percent and eliminating indexing, effective in 2018.⁶ If portability is sacrificed, practitioners should consider documenting that the executor was informed of the benefits and opted not to file Form 706 to secure portability.

Revenue Procedure 2001-38

In Rev. Proc. 2001-38,⁷ the Internal Revenue Service permitted the estate of a surviving spouse to treat as a nullity a wholly unnecessary QTIP election made on the estate tax return of the first-to-die spouse. Some commentators have raised the question whether Rev. Proc. 2001-38 precludes an estate from making a QTIP election if it files a return to elect portability.⁸ This is significant in decoupled states with exempt amounts lower than the federal exempt amount. For example, in a decoupled state with a \$1 million exempt amount, suppose the estate is \$4 million, of which \$3 million passes to a QTIP-type trust and \$1 million to a CST. Can the estate elect portability as well as QTIP for the \$3 million QTIP-type trust? If so, can the surviving spouse's estate nullify the QTIP election? Some commentators have suggested that Rev. Proc. 2001-38 was a leniency afforded to taxpayers who erroneously made an unnecessary QTIP election and that it shouldn't be applied to preclude a QTIP

election in these circumstances.

One solution to this issue is to leave the excess above the state exempt amount to the spouse outright, in a general POA trust or in an estate trust. In this way, the excess above the state exempt amount will qualify for the marital deduction without regard to a QTIP election or the future interpretation of Rev. Proc. 2001-38.⁹ In a general POA trust, the spouse must be entitled to all of the income for life and must have a testamentary general POA over the trust. The client can limit the spouse's control over the principal by limiting its exercise to the

A QTIP trust provides creditor protection at some income tax cost with respect to capital gains.

spouse's creditors or requiring the consent of the trustees for its exercise.

Need for CST

Much of the post-ATRA discussion has involved whether to create a CST at all or to leave the entire estate to the spouse and rely on portability. In making this choice, there are a number of factors to consider:

- **Income taxation.** Trusts reach the top tax rates—43.4 percent on ordinary income and 23.8 percent on qualified dividends and long-term capital gains—at \$11,950 of taxable income. Reaching this point increases the cost of the CST and can be mitigated by drafting for flexibility in the distribution provisions and making distributions to beneficiaries in lower income tax brackets. However, to the extent the income is distributed, it will be thrown into the recipient's estate and will no longer be protected from creditors and spouses. Even if the estate tax in the recipient's estate isn't a concern, making distributions to minimize income taxes may not be consistent with the client's objectives.
- **Loss of second basis step-up.** There's no basis step-up for the assets of the CST (whether for the federal or the state exempt amount) at the surviving spouse's death. However, assets passing to the spouse outright,



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or in a marital trust, will receive a second step-up at the surviving spouse's death. This analysis assumes that the second step-up is valuable. However, the second step-up only applies to the appreciation in the value of the assets between the first spouse's death and the surviving spouse's death. There's no basis step-up for retirement benefits or stocks sold during the surviving spouse's lifetime. There's little or no basis step-up for bonds. The second step-up may not be significant, particularly for older couples and in cases in which the CST is likely to be invested largely in bonds, certificates of deposit or other conservative asset classes.

- **Asset protection.** Despite the income tax cost of the CST, it protects against the surviving spouse's creditors and future spouses, and it allows for control over the disposition of the assets at the surviving spouse's death. Similarly, a QTIP trust provides creditor protection at some income tax cost with respect to capital gains (unless they can be passed through to the spouse, which will depend on the terms of the governing instrument and state law).
- **Changes in state estate taxes.** States will continue to change their estate and inheritance tax laws. A given state could repeal its estate or inheritance tax or increase the exempt amount; or, it could impose a state estate or gift tax or reduce the exempt amount. For example, as we were writing this article, Minnesota added a gift tax.
- **The surviving spouse could move to a different state.** Some retirees move to another state. Many surviving spouses move to be closer to their children and grandchildren. If there's a possibility of the surviving spouse moving to a different state, leave the marital share in a trust for which a state, but not a federal, QTIP election will be made. In that way, the trust won't be subject to state estate tax in either spouse's estate.
- **Asset location.** It may be possible to use asset location¹⁰ to limit the appreciation in the CST. For example, within the desired overall asset allocation, the surviving spouse could hold more equities personally, and the CST could hold more bonds or other conservative investments. The equities will receive a basis step-up at the surviving spouse's

death. If the CST will retain its income, the bonds could be tax-exempt. The tradeoff is that if the total return on the surviving spouse's equities exceeds the total return on the CST's bonds, more value will be included in the surviving spouse's estate for estate tax purposes. However, most surviving spouses' estates won't be subject to federal estate tax. Before using asset allocation to limit appreciation in the CST, the trustees should consider whether it comports with the Prudent Investor Act or whether it's permissible under the will or revocable trust.

- **Distributing income.** The trustees of the CST can distribute the income on a current basis. To the extent the recipients are in lower income tax brackets, doing so will save income taxes. One tradeoff is that the amounts distributed will be included in the recipients' estates for estate tax purposes. However, most recipients won't be subject to federal estate tax. The other tradeoff is that the amounts distributed will no longer be protected against the recipients' creditors and spouses.
- **Including capital gains in distributable net income (DNI).**¹¹ Capital gains generally aren't included in DNI. However, the trust could mandate or permit the trustees to include capital gains in DNI, so that they can be distributed for tax purposes. If not, it may be possible to amend or decant the trust to so provide.
- **Life insurance.** The CST may be able to invest in life insurance (for example, on the surviving spouse or other beneficiaries). Life insurance provides the equivalent of a basis step-up at the insured's death, even if the proceeds aren't included in the insured's estate. However, trustees must consider the cost of the policy, as well as the fact that the policy must be held until the insured's death for the proceeds to be free of income tax. The trustees must also consider whether it's a prudent investment or permitted under the will. Care must be taken to make sure that the insured doesn't have any incidents of ownership in the policy, to avoid having the policy included in the insured's estate.¹²
- **Distribute appreciated assets to the surviving spouse.** If the surviving spouse won't have a taxable estate, the trustees can be authorized to distribute appreciated assets from the CST to the



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surviving spouse. To better protect the trustees if they decide to distribute appreciated assets for the purpose of obtaining a basis step-up at the surviving spouse's death, the CST might specifically authorize the trustees to do so if they deem it advisable. The assets will then be included in the surviving spouse's estate and will receive a basis step-up at the surviving spouse's death. Of course, this may not be practical if the surviving spouse has remarried or if the deceased spouse has children from a previous marriage.

- **Distributions to charity.** CSTs generally don't include charities as permissible beneficiaries. Even if they did, it would, generally, have made more sense to have the surviving spouse make charitable gifts out of his own assets, to reduce the size of the spouse's estate. However, if the CST is in a higher income tax bracket and the surviving spouse's estate won't be subject to estate tax, it may be reasonable to include a charity as a permissible beneficiary of the CST and to make charitable gifts out of the CST.

Division of Assets


Before portability was made permanent, it was important for couples to divide their assets so as to be able to fully fund the CST at the death of the first spouse. When portability is sufficient to eliminate any federal estate tax and taking advantage of both spouses' GST exemptions isn't necessary, the couple has greater flexibility as to the ownership of their assets. For example, if one spouse is a physician concerned about malpractice claims, the couple can put their assets (or their assets in excess of the state exempt amount) in the other spouse's name and rely on portability. Similarly, in a second marriage, the wealthier spouse may rely on portability, rather than transferring assets to the less wealthy spouse. In some cases, funding an inter vivos trust may better accomplish these objectives.

Disclaimer CST

If there won't be a mandatory CST, include disclaimer CSTs in the clients' wills. That would allow the surviving spouse to establish a CST for the state exempt amount or the federal exempt amount, if he deems it advisable after the first spouse's death.

Lifetime Gifts

Connecticut and Minnesota are the only states that

have a gift tax. In the other decoupled states, lifetime gifts can save state estate tax. Since lifetime gifts give the basis step-up at death, they're more attractive for high basis assets, such as bonds and cash. If the gifts are to grantor trusts, the grantor can purchase appreciated assets from the trust during his lifetime, so as to obtain a basis step-up. Consider modifying durable powers of attorney forms to expressly give the agent this right in the event of a grantor's disability. 

Endnotes

1. P.L. 112-240, H.R. 8 (112th Cong., 2d Sess.).
2. P.L. 107-17.
3. For a summary of the various state estate and inheritance taxes, see McGuire Woods LLC State Estate Tax Chart (May 26, 2013), www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf. For a detailed discussion of the various state estate and inheritance taxes, see Lisa M. Rico, "Estate Planning With Portability in Decoupled States," 27 *Probate & Property* No. 3 (May/June 2013), at p. 23.
4. A fourth trust, to take advantage of any unused generation-skipping transfer tax exemption, may also be included. However, a discussion of that technique is beyond the scope of this article.
5. TSB-M-11(9)M (N.Y. State Dept. of Taxation and Finance, July 29, 2011), www.tax.ny.gov/pdf/memos/estate_&_gift/ml1_9m.pdf. See also letter, dated Jan. 31, 2011, from Fred M. Wagner III, Assistant Chief, Individual Tax Audit Branch, New Jersey Division of Taxation, to Robert D. Bortek, reprinted in *Practical Drafting* at 10462 (April 2011).
6. Bruce D. Steiner, "A First Look at the Administration's Revenue Proposals," *Steve Leimberg's Income Tax Planning Newsletter* #42 (April 18, 2013).
7. 2001-1 C.B. 1335. See also Private Letter Rulings 201131011 (April 20, 2011) and 201022004 (Jan. 28, 2010).
8. Jonathan G. Blattmachr and Mitchell M. Gans, "Decoupling, Portability and Rev. Proc. 2001-38," *Eagle River Advisors* (2012), www.eagleriveradvisors.com/pdf/Gans-and-Blattmachr-Decoupling-Portability-and-Rev-Proc-2001-38.pdf; Mitchell M. Gans and Jonathan G. Blattmachr, "Quadrupartite Will: Decoupling and the Next Generation of Instruments Will," 32 *Estate Planning* 3 (April 2005); Bruce D. Steiner, "Coping With the Decoupling of State Estate Taxes After EGTRRA," 30 *Estate Planning* 4 (April 2003), www.kkwc.com/library_cat/uf_AR20041209154501.PDF.
9. See Bruce D. Steiner, "The General Power of Appointment Trust is Back," *Steve Leimberg's Estate Planning Newsletter* #2060 (Feb. 6, 2013).
10. "Asset allocation" refers to the division of assets among different asset classes, such as equities, bonds and cash. "Asset location" refers to which asset class is located in which type of account (for example, the surviving spouse's taxable account, the surviving spouse's individual retirement account or the credit shelter trust) to the extent possible within the desired asset allocation.
11. Internal Revenue Code Section 643(a)(3); Treasury Regulations Section 1.643(a)-3.
12. IRC Section 2042.