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Estate Planning in a Decoupled State Post-ATRA for Married Clients Under the Federal Exclusion Amount

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This article was originally published in CCH's CPA Client Advisor Library.

Part 1—Introduction

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One of the more difficult challenges practitioners face is advising clients who are domiciled in decoupled states as to how to minimize state estate taxes and maximize the increases in available income tax basis to reduce the impact of the now higher capital gains taxes, all while addressing clients' personal wishes. This six-part article will explore many of the nuances and options that might be considered.

Practitioners are by now quite familiar with the American Taxpayer Relief Act of 2012[1] (ATRA), which was enacted on January 2, 2013. The estate and gift tax exclusion amounts and the generation-skipping transfer (GST) tax exemption amount were made permanent at $5 million, indexed for inflation. Portability was made permanent for estate and gift tax purposes. However, there is no portability for the GST tax exemption, and so far only one decoupled state, Hawaii, 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 $400,000 (single), $450,000 (joint), but only $11,950 (2013 amount, indexed for inflation) for estates and trusts. Above those levels, the 15 percent tax rate on long-term capital gains was increased to 20 percent, and the tax rate on qualified dividends was fixed at 20 percent. These higher tax rates have been compounded by the new 3.8 percent Medicare tax which is applicable to taxpayers with adjusted gross income (AGI) above $200,000 (single), and $250,000 (joint).

Post-ATRA Planning Complexity, Not Simplicity

The Congressional objective of simplifying the tax code was a motivator for the enactment of the portability of the estate tax exclusion amount. Unfortunately, this often results in more "choices" than those that had to be considered for the traditional "A/B," or marital/bypass, trust plan that had been the staple of planning for many years. These "choices" beget complications. Unlike income tax planning where the "tax year" ends each December 31st, planning for the estate tax has been difficult not only due to the changing tax landscape, but also because clients do not know when they will pass away. On top of all of these uncertainties, although the law has been made "permanent," planners (as well as clients) realize that the permanency of any law is subject to the vagaries of the political winds.

It is anticipated that, under ATRA, fewer than 4,000 decedents per year will pay a federal estate tax (some estimates are even lower). Thus, the expectation is that the federal estate tax will be irrelevant for most clients of most practitioners. For clients residing in one of the approximately 20 states that have "decoupled" from the federal estate tax, planning to minimize *state* estate tax, while cognizant of the new post-ATRA tax paradigm, will present a key challenge. This post-ATRA tax paradigm includes a more costly income tax system making the opportunities to step-up income tax basis on death a priority. For clients not subject to a federal estate tax, this may have greater tax import than the state estate tax savings.

While some practitioners might believe that it is only a narrow group of taxpayers that will be subject to state estate tax without the federal tax, it is likely a large component of many practices. Because of the challenges these clients will present, this article will endeavor to provide some guidance to resolving these issues, and raise questions that practitioners should consider in evaluating the planning options.

Historical Review of State Estate Tax Decoupling

The Economic Growth and Tax Relief Reconciliation Act of 2001[2] (EGTRRA) phased out the state

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death tax credit, and replaced it with a deduction for state estate and inheritance taxes. As a result, some states allowed their estate taxes to lapse. However, other states "decoupled" from the federal estate tax law, and continued to impose estate taxes to stem the resulting revenue loss.

Tax Factors to Consider

There are a number of variables to consider when planning for clients in decoupled states:

- What types of transfer taxes does the particular state assess?[3] Gift (Connecticut and Minnesota only), estate (a number of states, *e.g.*, New York, Massachusetts, Vermont), inheritance (including, Iowa, Nebraska, Pennsylvania, Tennessee, and Kentucky) or both estate and inheritance (Maryland and New Jersey).[4]
- If the state assesses an estate tax, how does the decoupled state's exclusion amount compare to the federal exclusion amount? Most are substantially less than the federal exclusion complicating the planning process and generating tax planning opportunities for smaller estates.
- Are the clients likely to remain in their current home state that assesses an estate tax? If one spouse passed away, how likely is it that the survivor will remain in that state? If not, where might the surviving spouse move to, and what tax structure might his or her new state of domicile have?
- Does the state permit a separate qualified terminable interest property (QTIP) election for state estate tax purposes? While some states do, like Massachusetts, many do not. In some states, such as New York and New Jersey, if no federal estate tax return is filed, the estate can make a QTIP election for state estate tax purposes. These issues are addressed in greater detail in later parts of this series.[5]

This Introduction is a cursory overview of a few of the many tax issues to consider in evaluating planning options for clients in decoupled states post-ATRA. But this brief discussion gives an indication of the complexity of the planning process that Congress and the news media have depicted as simplified. These issues will be explored in greater detail in the subsequent articles in this series. A challenge for practitioners will be to educate clients that the simplicity they have been promised, in many cases, is not real. Further, simplicity will result in sub-optimal planning in many situations.

Non-Tax Factors to Consider

Although this series of articles focuses primarily on tax aspects of planning in a decoupled state, practitioners are all aware of the myriad of non-tax considerations that might "trump" the tax planning decisions. Some of these that should be considered include:

- Asset protection benefits of assets held in a bypass trust.
- Flexibility of a bypass trust to sprinkle income and principal to different beneficiaries.
- Management of trust assets.
- Protecting assets for children from a prior marriage.
- The cost and complexity of maintaining a trust.

Conclusion

Estate planning in a decoupled state post-ATRA is incredibly complex. Practitioners serving clients facing state estate tax will have to creatively and cost-effectively balance a series of competing client objectives.

ENDNOTES

1. P.L. 112-240
2. P.L. 107-16.
3. See CCH's State Inheritance, Estate and Gift Tax Reporter, ¶12,090, Classification of State Inheritance, Estate, and Gift Tax Laws for up-to-date information on each state's laws and CCH's Multistate Transfer Tax Laws Smart Chart. For a discussion of various states see Ashlea Ebeling, "Where Not to Die in 2013," Forbes (Jan. 28, 2013), http://www.forbes.com/sites/ashleaebeling/2013/01/28/where-not-to-die-in-2013/print/. See also Lisa M. Rico, "Estate Planning with Portability in Decoupled States," 27 Probate & Property No. 3 at 23 (May/June 2013).
4. McGuireWoods LLP State Death Tax Chart, Revised July 24, 2013 at http://www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf.
5. See *Estate Planning in a Decoupled State Post-ATRA for Married Clients Under the Federal Exclusion Amount: Part 3--State Bypass and QTIP Trusts, Estate Planning in a Decoupled State Post-ATRA for Married Clients Under the Federal Exclusion Amount: Part 4--Ancillary Issues That Affect Bypass and Portability Planning in a Decoupled State, Estate Planning in a Decoupled State Post-ATRA for Married Clients Under the Federal Exclusion Amount: Part 5-- Alternative Planning Approaches Based on Outright Marital Bequests, and Estate Planning in a Decoupled State Post-ATRA for Married Clients Under the Federal Exclusion Amount: Part 6--Alternative Planning Approaches Based on Bequests to Marital Trusts.*

Part 2—An Historical Perspective

By: Martin M. Shenkman, Esq., Richard H. Greenberg, Esq., Glenn A. Henkel, Esq., and Bruce D. Steiner, Esq.

To understand how to optimally plan an estate in a decoupled state, it is helpful to understand the common planning approaches that have long been used. Many of these same techniques will continue to be useful in some circumstances, but modifications to reflect the new planning environment after the enactment of the American Taxpayer Relief Act of 2012[1] (ATRA) will be important. This historical discussion will provide the foundation to understand the modifications and new planning strategies discussed in later installments of this series of articles.

Common Plan Under Prior Law - Three Part Decoupled Estate Plan

The nearly ubiquitous estate plan for a client in a decoupled state in past years would likely have proceeded as a tri-part plan. A fourth trust might have been added to utilize any generation-skipping transfer (GST) exemption in excess of the federal estate tax exclusion amount, but that complexity is not addressed in this discussion. The three-part plan was structured as follows:

- Fund a bypass trust up to the state exclusion amount.
- Fund a "gap" trust with assets equal to the difference between the state estate tax exclusion and the federal exclusion amount. The gap trust's treatment was dependent on state law and client circumstances.
- The balance of the estate would have passed in a disposition qualifying for the marital deduction (for federal and state tax purposes), most commonly a qualified terminable interest property (QTIP) trust.

Bypass Funding Decisions Pre-ATRA

The logic of this tri-part framework was compelling. Funding a state bypass trust on the death of the first spouse would save state, and possibly federal, estate tax. If the state exclusion amount was materially below the federal exclusion amount, some clients would not have wished to intentionally trigger a state estate tax cost on the first death. To that end, they would fund a bypass trust up to the state exclusion amount. Then, they would next fund a so-called "gap trust" which would be characterized as either a "state only QTIP/federal bypass" trust or as a "state and federal QTIP" (marital deduction bequest) trust, depending on the tax laws in that particular state. There are also some issues as to whether this trust, still under the federal estate tax exclusion amount, could qualify for the federal estate tax marital deduction. This is explored in a later article in this series. This plan would have deferred state and federal estate tax on the remainder of the estate above the state exclusion amount until the second spouse's later death. This plan was often employed even if there would ultimately be a greater estate tax cost incurred on the second death.

Specifically, many clients were not willing to incur a state estate tax cost on the death of the first spouse in order to fund a larger bypass trust, thereby removing more assets from the reach of the federal and state estate tax on the second spouse's later death. This decision was generally made from the psychological perspective, "a tax deferred is a tax saved," not from the more quantitative perspective of lowering the present value of all projected tax costs.

One notable exception had been for clients who were quite elderly or infirm, for whom the reality of the ultimate total tax cost was more real. In such instances, the clients may have been willing to intentionally incur some state estate tax on the first spouse's death in order to maximize the use of the available federal exclusion. This would typically have been achieved by characterizing, for both federal and state estate tax purposes, the maxi-

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mum federal exclusion amount, even if in excess of the state exclusion amount, as the non-marital portion (i.e., as the bypass trust). For states that tax estates by the amount of the pre-2002 state death tax credit,[2] the clients may have also considered the graduated marginal tax rates (under $10 million) to lower the overall tax effect to the family.

The approach of mandatorily funding the bypass trust for many wealthy clients' estates was rarely questioned because of the potential for a significant state and federal estate tax savings. The funding of a state exclusion bypass trust would have been undertaken in many situations as the minimum mandatory funding because of a concern about the possibility of a future federal estate tax, especially if the exclusion had declined to $1 million in either 2011 or 2013. If the "permanent" $5 million inflation-adjusted exclusion remains, planning to minimize the federal estate tax is only of academic relevance to most clients. The exceptions for many clients are a windfall (e.g., lottery), unexpected business success, or another change to the federal estate tax rules.[3]

There has been a significant change in this planning dynamic after ATRA. Most clients will never be subject to a federal estate tax. The marginal state estate tax rates are generally not more than 16 percent so while significant, it never will rise to the confiscatory level of prior law when federal and state estate taxes may have consumed 55 percent of an estate. Thus, clients subject to state estate tax, but not a federal estate tax, will be less willing to address planning, or bear the cost and complexity of a state-only bypass trust. More important, if the bypass trust holds assets that appreciate in value and the basis step-up is not available for those assets on the second spouse's death, the incremental capital gains tax cost incurred by the heirs could exceed the state estate tax savings. The impact of these new dynamics is discussed below, and in much greater detail later in this series. It is not only the tax changes, but the relationship of the different taxes to each other, that has so significantly affected planning.

Characterization of the Gap Trust Under the Traditional Decoupled State Plan

In a decoupled state plan, as described above, the marital bequest would ideally be structured as a state-only marital trust, *e.g.*, a state-only QTIP trust if feasible under state law, such as in Washington or Massachusetts. If so, the QTIP election would not be made for federal tax purposes resulting in the trust's characterization as a "bypass" (or non-marital) trust for federal estate tax purposes avoiding estate taxation in the estate of the surviving spouse. This trust has been referred to by some planners as a "gap" trust since it fills the gap between the state exclusion amount and the federal exclusion amount.

If state law did not permit a state-only QTIP trust, then the client faced the more difficult decision of paying a state estate tax on the gap amount in order to secure the full federal exclusion, or limiting the funding of the bypass trust to only the state exclusion amount and forgoing the benefits of the remaining federal exclusion, up to the extent of the gap amount. Many times, the spouse's estate plan was arranged in a manner that deferred the decision as to how the gap trust would be characterized (*i.e.*, as qualifying for the marital deduction or not) until after the death of the first spouse.

ATRA Changes the Foundation of the Traditional Decoupled Plan

ATRA has set a permanent and high inflation-adjusted exclusion amount that leaves the vast majority of clients, even wealthy clients, below the federal estate tax threshold. Without a substantial and meaningful prospect of a federal estate tax, the assumptions at the foundation of the typical historical estate plan described above have changed dramatically. Even for those who might face a federal estate tax, portability may mitigate the federal estate tax exposure, and in some instances, lessen the planning burdens (but not necessarily the planning complexity). For many clients, the increased capital gains cost in the future, resulting from losing the basis step-up of assets inside a bypass trust, may outweigh the state estate tax savings. More specifically, a 20 percent federal capital gains tax, supplemented perhaps by a 3.8 percent Medicare tax, and possibly state income tax, could result in some clients facing a capital gains rate approaching 30 percent. The highest estate tax rate in most decoupled states is 16 percent. This new estate planning "math"

changes the planning paradigm. There are a number of approaches to address this basis step-up issue, which will be explored later in this series.

The question now for practitioners is whether there can be a new default approach to estate planning (*i.e.*, the post-ATRA version of the ubiquitous pre-ATRA "A/B trust plan"), and if so, what that default planning platform should look like. Finally, consideration should be given to what common scenarios would result in modification of that plan. If there is no reasonable default platform, then planning will be more complex and costly than before ATRA. Since fewer clients fear the federal estate tax and most clients have accepted the implication of most media reports that planning is now simpler, they may well expect lower fees and less complexity. The opposite will be true for many moderate wealth estates, thereby creating a conflict between planning needs versus client perceptions. This is in sharp contrast to the past decade in which the possibility of a much harsher federal estate tax had been influencing planning decisions for clients and advisers alike.

Conclusion

The common approach to planning in a decoupled state has been to fund a state bypass trust, a "gap" trust, and a marital QTIP trust for assets above the exclusion amount. This type of plan will still be useful post-ATRA, but the planning environment has changed. As a result, even when this type of plan is used different techniques and drafting will be required.

ENDNOTES

1 P.L. 112-240.

2 Code Sec. 2011.

3 See for example the proposals in the General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (commonly referred to as the Greenbook) at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf

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Part 3—State Bypass and QTIP Trusts

By: Martin M. Shenkman, Esq., Richard H. Greenberg, Esq., Glenn A. Henkel, Esq., and Bruce D. Steiner, Esq.

After the passage of the American Taxpayer Relief Act of 2012[1] (ATRA), a number of considerations need to be factored into the planning analysis for clients domiciled in decoupled states. The benefits and detriments of marital and bypass trust planning are discussed in this part of the series, "Estate Planning in a Decoupled State Post-ATRA for Married Clients Under the Federal Exclusion Amount." While practitioners are undoubtedly familiar with these options, they warrant a brief mention to assure consideration.

- Non-grantor trusts face compressed income tax rates and reach the highest income and capital gains tax rates at much lower levels of income than do individuals. The Medicare tax on passive investment income applies at the same low levels, when it might not have applied to the beneficiary. Drafting trust distribution provisions for non-marital trusts to allow for flexibility in permitting distributions to pass out income to lower bracket taxpayers can mitigate these tax costs. Where this is not feasible, *e.g.* in a qualified terminable interest property (QTIP) trust that mandates that income be distributed to the spouse, the income tax negatives may offset other possible benefits. One issue is whether an irrevocable complex trust permits defining capital gains as constituting part of accounting "income" so that the capital gains can flow out to the beneficiary. The distribution of income is, in many cases, a neutral or positive factor, since the surviving spouse is usually in a lower tax bracket than the QTIP trust or not in a higher bracket. Addressing the basis step-up, as discussed later, creates a different set of concerns.
- A significant theoretical detriment to bypass trust planning, whether to the maximum federal exclusion amount, or even if limited to a much lower state exclusion amount, is the possible lack of step-up in income tax basis on the second death. As will be discussed below and in later parts of this series, there are a number of steps that might mitigate this consequence, and for many clients, it may not really be an issue.
- The only means of determining the impact of a client's estate plan is to consider the possible impact on state and federal estate taxes and the income tax implications to the client and the client's heirs. Pre-ATRA, and certainly prior to the enactment of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010[2] (2010 Tax Act), it had generally been assumed that an estate tax savings would outweigh any income tax or basis detriment. This is no longer the case. The difficulty with this analysis is that, in many cases, and more often than ever before in recent estate planning history, an asset-by-asset analysis may be necessary. For example, if a particular asset will be retained in the family for decades, such as a family business or vacation home, the loss of basis step-up may be insignificant in present value terms on a sale that may only occur decades in the future. In contrast, an asset that might be disposed of shortly after death might create a different result. such that the present value of the tax cost that would be incurred without a basis step-up would be material. Therefore, in some instances, planning will have to be more granular to be effective.
- Even if the federal estate tax rules remain largely unchanged for many years, state tax systems have been subject to changes and

may continue to be amended in reaction to ATRA.[3] Some states may view the high federal exclusion amount as making a state estate tax system more difficult to administer. Others may view the increased number of returns that permanent portability will trigger as a strong backstop to a state estate tax system that will make state level enforcement much easier than it has been in recent years. Finally, some states might actually strengthen their transfer tax systems to increase revenues. Minnesota's recent enactment of a gift tax (joining Connecticut as the only other state with a gift tax) is one sign of this. Will we see a rash of other decoupled states add a gift tax component? Does this risk justify inter vivos gift planning now?

- While the simplicity and low cost of an outright distribution are appealing, especially to address selected state QTIP concerns, discussed below, an outright bequest provides no asset protection, no possibility of porting the unused gift or estate tax exclusion amount or allocating GST exemption, and no protection from the risks of remarriage (and future divorce).

Decoupled States With Lower Exclusion Amounts and Separate State QTIP Elections

In a decoupled state with an exclusion amount lower than the federal exclusion amount and a separate state QTIP election (e.g. Massachusetts and Washington) the client gets the "best of both worlds." The client can shelter the entire estate up to the federal exclusion amount from future federal estate tax and the state exclusion amount from future state estate taxes by creating a gap trust in QTIP form for the balance of the estate in excess of the state exclusion amount up to the federal exclusion amount. By making a state-only QTIP election for the gap trust, the gap trust is treated as a bypass trust for federal purposes although it is treated as a QTIP trust for state purposes.

By creating a gap trust, the state estate tax is deferred until the surviving spouse's death. The state tax could be eliminated if the surviving spouse moves to another non-taxing state or if the state estate tax is repealed during the surviving spouse's lifetime. While this approach can be prudent from an *estate* tax perspective, for some clients, the incremental *income* tax cost of using a QTIP-type gap trust may offset some or all of the state estate tax benefit. For example, the requirement that all income be distributed at least annually only to the surviving spouse precludes the opportunity to sprinkle or spray income to other beneficiaries who may be in lower income tax brackets in a particular year.

There is also an obvious loss of economic flexibility in that, as a QTIP trust, income must be distributed annually to the surviving spouse, which will increase the estate of the surviving spouse and could have adverse estate tax consequences. From an asset protection perspective, the mandatory income payout is also not ideal. In addition, limiting the distribution to only the surviving spouse eliminates flexibility the client might prefer. To compare, children can be current beneficiaries of a bypass trust but not a QTIP trust. This state estate tax benefit may only provide a deferral of a tax that may be imposed at the survivor's death, not an actual savings. If the surviving spouse is in a higher income tax bracket than other trust heirs, a "sprinkle" bypass trust would be more beneficial than the QTIP trust. Greater income tax savings could be achieved each year during the surviving spouse's life by exercising the ability to distribute income to heirs in lower brackets. This incremental income tax cost might offset much, or even all, of the state estate tax savings of having made a state-only QTIP election. The longer that the surviving spouse lives, the more years this income tax savings could be realized with a bypass trust.

Decoupled States With Lower Exclusion Amounts But No Separate State QTIP Election

In some decoupled states, the state exclusion amount is lower than the federal exclusion amount, but a separate state-only QTIP election is not permitted. The federal QTIP election (or nonelection) is binding for state estate tax purposes as well. Pre-ATRA, practitioners had to help clients evaluate whether incurring a state estate tax on the first spouse's death in order to maximize funding the bypass trust to the maximum federal exclusion amount was the best

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strategy. In New York and New Jersey, funding a bypass trust with the maximum federal exclusion amount of $5.25 million triggers state estate tax of over $400,000. If the federal estate tax exclusion had been reduced to $1 million and the rate increased to 55 percent in 2013, the tradeoff would have been worthwhile. However, with a higher exclusion amount and the portability of the unused federal exclusion amount both made permanent, the federal estate tax savings may not be realized. As such, assuming that ATRA is really permanent, there is less incentive to incur a state estate tax cost on the first death to fund a bypass trust for any family where the aggregate family estate is not likely to be subject to the federal estate tax.

New York and New Jersey QTIP Conformity Rules

If the estate files a federal estate tax return to elect portability, the estate is bound by its choice regarding the federal QTIP election (or nonelection), 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 nonelection is binding for state estate tax purposes.[4]

In an estate where the use of the predeceased spouse's unused exclusion amount is sufficient to eliminate the possibility of a federal estate tax in the surviving spouse's estate, the client may wish to limit the bypass trust amount to the state exclusion amount and leave the balance of the estate to the surviving spouse in a manner that qualifies for the state estate tax marital deduction. If the estate is small enough that there is no concern about a federal estate tax, the will (or revocable living trust) can limit the bypass trust amount to the state exclusion amount. This would eliminate the state estate tax in the first spouse's estate. State estate tax may be avoided in the surviving spouse's estate if the surviving spouse moves to another state, the state estate tax is repealed during the surviving spouse's lifetime, or more sophisticated planning is pursued. Options to address this are discussed in great detail in the final installments in this series of articles.

This seemingly simple solution is not assured. Contrary to legal advice, many estates may forgo the modest cost of filing a federal estate tax return to secure portability. However, what if the survivor's estate increases in value? What if there is a windfall? What if the federal exclusion amount is reduced in a future year? Sacrificing the possible benefit of portability to secure a state estate tax marital deduction may not be the optimal approach. Will any practitioner be fully comfortable advising a client to simply forgo the federal filing to elect portability?

If electing portability is anticipated, the marital share may have to pass outright or in a general power of appointment trust. It should be noted that portability is not available for GST tax purposes. Of even greater concern is that by leaving the marital share outright it will be subject to the surviving spouse's creditors, including the reach of subsequent spouses and Medicaid. If the marital share is in a general power of appointment 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 in all instances. Finally, in some states, assets in the general power of appointment trust will only be exposed to the surviving spouse's creditors if the surviving spouse exercises the general power of appointment.

In a larger estate, the first spouse might want to shelter the federal exclusion amount, even though that will result in some state estate tax at the first spouse's death. If the state estate tax is equal to the former state death tax credit, sheltering the full federal exclusion amount, $5.25 million in 2013, will result in a state estate tax of over $400,000. That may be a significant cost to bear given the uncertainties as to whether or not a state or federal estate tax will be incurred. The inflation adjustments of the surviving spouse's estate may well make an estate that was slightly above the exclusion amount non-taxable. However, for estates substantial enough to know that a 40 percent federal estate tax cost will be incurred on the second death such a decision, especially if the basis step-up on the second death can be planned around, may well be reasonable.

QTIP Trap and Rev. Proc. 2001-38 and IRS Letter Ruling 201131011

The ability to make a state-only QTIP election has been the subject of much discussion in the professional literature. While somewhat technical in nature, it is important for tax practitioners to understand the issues involved in order to properly advise their clients because the discussion may be more than just theoretical. In Rev. Proc. 2001-38,[5] the IRS provided guidance on whether the marital deduction is available for a QTIP trust if the marital deduction is not necessary to eliminate the imposition of the federal estate tax.[6] In the guidance, the IRS permitted the estate of a surviving spouse to reverse an unnecessary and unwanted QTIP election that had been made on the estate tax return of the first spouse to die. Many commentators view this ruling as providing leniency to the taxpayer because of the mistake made by the tax planner involved in that particular instance. Had that leniency not been provided, the surviving spouse would have had to unnecessarily include assets in his or her estate that, but for the unnecessary QTIP election, would have been avoided. Whatever the motivation behind the issuance of Rev. Proc. 2001-38, the interpretation of its implications is uncertain but important.

Some practitioners have raised the concern that due to Rev. Proc. 2001-38, if an estate valued at less than the federal estate tax exclusion amount files a federal estate tax return to elect portability, a marital deduction QTIP election is not available. This could be a significant issue in decoupled states with exclusion amounts lower than the federal exclusion.

> **Example:** Rita Smith lives in a state with an exclusion amount of $1 million. Her estate is valued at $4 million. Rita is married to her husband, Phil. Rita's executor might prefer a $1 million bypass trust and a $3 million QTIP trust, thereby avoiding state and federal tax on her death. However, if the state's law tracks federal law, as most do, will the $3 million excess over the $1 million state exclusion qualify for QTIP treatment based on the logic of Rev. Proc. 2001-38? According to some interpretations of the guidance, most notably IRS Letter Ruling 201131011,[7] QTIP marital deduction treatment would not be allowed.

There have been arguments made in the professional literature that this interpretation is not correct, and that Rev. Proc. 2001-38 will not be applied to prevent federal QTIP treatment if the taxpayer does not affirmatively wish to avoid QTIP treatment. Therefore, according to this line of reasoning, Rita's $3 million QTIP trust should qualify for a federal QTIP marital deduction, and therefore also qualify for a state estate tax marital deduction in any state that follows federal estate tax law. This perspective is based on the clear language of the statutory basis for a QTIP, namely that once the QTIP requirements are met a valid and irrevocable QTIP election exists.[8] The IRS has said, however, in the limited situation contained in the guidance, it is willing to disregard the law. A somewhat different line of reasoning is that if the QTIP treatment would suffice to save state estate taxes that should suffice to justify and support the QTIP election even in the absence of a federal estate tax.

Unfortunately, IRS Letter Ruling 201131011, with facts similar to the Example above, appears to hold to the contrary. The issue that requires resolution and is being examined by the Treasury is whether a QTIP election which is unnecessary to save federal estate taxes but nonetheless saves state estate taxes is valid if the taxpayer elects such treatment or if is it void and of no effect irrespective of the state estate tax savings.[9] But until resolution occurs, practitioners must determine how to handle this issue.

Alternatives to QTIP Treatment to Avoid the Rev. Proc. and Letter Ruling Issue

Although the interpretation of the law discussed in the Example, above, seems persuasive, many practitioners have preferred not to risk the possibility of a state disregarding the desired QTIP election. They have sought QTIP alternatives that avoid the entirety of the QTIP issues. One safe option is to use a general power of appointment trust to assure qualification for the marital deduction instead of relying on a QTIP election. Structuring the marital share outright, as an estate trust, or as a general power of appointment trust

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will meet the marital deduction requirements of Code Sec. 2056 regardless of the impact of Rev. Proc. 2001-38 and IRS Letter Ruling 201131011. But, as discussed above, this might open the door to undesired creditor issues.

The option of simply making an outright bequest, while clearly avoiding the QTIP dilemma, lacks any of the protections of a trust and while simple, will often not be the optimal solution. The general power of appointment trust is rather inflexible in that the surviving spouse must be entitled to all of the income for life and hold a general power of appointment over the corpus. The general power of appointment trust[10] provides some of the protections afforded by a trust, but may not be acceptable to clients in certain situations, for example a blended family. This is because the spouse's power of appointment must be exercisable by the spouse alone and in all events. The power could also be conditional, effective only if required to qualify for the state estate tax marital deduction.

> **Planning Tip:** A typical QTIP trust could be provided for in the client's will. In addition, a provision could give a general power of appointment to the surviving spouse. However, this general power of appointment would only be effective over the trust if, and only if, necessary to qualify the bequest for the state estate tax marital deduction. There is no assurance that this approach would be accepted by a state where it might be necessary.

Perhaps the most challenging impediment for practitioners will be a client with assets valued at less than the federal exclusion amount, persuaded by the general media that the high exclusion amount and portability have made planning unnecessary. These clients may be unwilling to tolerate the cost and complexity that the explanation and drafting of the bypass and QTIP trusts will entail.

Conclusion

The rules applicable in the particular state can greatly complicate the estate planning decision process. If the state provides a state-only QTIP, the gap trust might qualify for the state marital deduction and no tax may be incurred on the first death. In other states, conformity with federal filing positions is required, and those rules can further complicate state estate tax planning. The next article in this series will explore technical issues that further exacerbate the planning challenges in these instances.

ENDNOTES

1 P.L. 112-240
2 P.L. 111-312
3 See CCH's State Inheritance, Estate and Gift Tax Reporter, ¶12,090, Classification of State Inheritance, Estate, and Gift Tax Laws for up-to-date information on each state's laws and CCH's Multistate Transfer Tax Laws Smart Chart.
4 See Letter dated January 31, 2011, from Fred M. Wagner III, Assistant Chief, Individual Audit Branch, New Jersey Division of Taxation, to Robert D. Borteck, reprinted in *Practical Drafting* at 10462 (April 2011), outlining the state's position concerning QTIP elections for decedents who died in 2010; and for New York see TSB-M-11(9)M (N.Y. State Dept. of Taxation and Finance, July 29, 2011), http://www.tax.ny.gov/pdf/memos/estate_&_gift/m11_9m.pdf.
5 2001-1 CB 135
6 For one of many examples applying Rev. Proc. 2001-38, see IRS Letter Ruling 201131011. For a detailed discussion of Rev. Proc. 2001-38 and IRS Letter Ruling 201131011, see *Estate Planning in a Decoupled State Post-ATRA for Married Clients Under the Federal Exclusion Amount: Part 6--Alternative Planning Approaches Based on Bequests to Marital Trusts.* See also IRS Letter Ruling 201345006, August 5, 2013, where the surviving spouse was beneficiary of a trust for which a state, but not federal, QTIP election was made. The ruling held that a gift of the trust interest by the surviving spouse was not subject to Code Sec. 2519, which would have applied if a federal QTIP election had been in effect. Code Sec. 2519 would value the gift at the entire value of the trust.
7 April 20, 2011.
8 Code Sec. 2056(b)(7).
9 See Department of the Treasury, 2013-2014 Priority Guidance Plan, Nov. 20, 2013.
10 Code Sec. 2056(b)(5)

Part 4—Ancillary Issues That Affect Bypass and Portability Planning in a Decoupled State

By: Martin M. Shenkman, Esq., Richard H. Greenberg, Esq., Glenn A. Henkel, Esq., and Bruce D. Steiner, Esq.

Minimizing or avoiding state estate tax on the first spouse's death may hinge on qualifying for the state estate tax marital deduction. Decisions regarding which testamentary trusts to fund, or not, will be critical. What had once been viewed as a relatively simple and almost standard estate tax result has been complicated by technical issues that practitioners will have to grapple with, as discussed in Part 3 of this series of articles.[1] These have been further compounded by a host of ancillary issues, which are discussed in this part of the series, that may trump the more commonly discussed planning scenarios and considerations.

Much of the post-ATRA discussion has focused on a possible tradeoff between the benefits of a bypass trust compared to relying on portability of a deceased spousal unused exclusion (DSUE) amount. The client could fund a bypass trust on the first death equal to the estate exclusion amount, thereby avoiding any state estate tax on the first death, and saving state estate taxes on the second death. However, funding the bypass trust may result in forgoing a basis step-up on those assets on the second death. Which option is preferable? Instead, should the client use some type of marital bequest so that assets will be included in the surviving spouse's estate qualifying for a basis step-up on the second death? There are important qualitative considerations that should be factored into the analysis. In a significant number of client situations, these ancillary considerations may well determine the recommended approach.

State Tax Changes

Practitioners must bear in mind that integrating state estate tax considerations into the planning analysis is subject to uncertainty as states have changed, and may continue to change, their estate and inheritance tax laws.[2] For example, Delaware, Indiana, Maine, Ohio, and Tennessee have reduced the impact of their estate or inheritance taxes. Connecticut and Minnesota have recently bucked the trend by making their transfer tax systems harsher. The fact that the federal exclusion amount and portability are permanent (whatever that might mean in Washington) has no impact on state estate and inheritance tax laws. Some states may make their rules harsher to meet revenue needs, *e.g.*, by enacting a gift tax to backstop their estate tax. Others might view the continued administration of a state estate tax as too burdensome with so few taxpayers being subjected to the federal estate tax. However, the requirement to file a federal estate tax to secure portability might encourage yet other states to retain their estate taxes and to rely on the Forms 706 filed to secure portability as the backstop to their state estate taxes. As state tax laws change, the need to adapt planning recommendations for clients domiciled in those states will also have to evolve.

A potentially costly issue that wealthy clients should address, but few have, is the potential for decoupled states to add gift taxes to backstop their estate taxes, as Connecticut and Minnesota have done. Without a gift tax, wealthy domiciliaries may be able to simply give assets away before death and avoid state estate tax. State estate taxes,

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in states other than Minnesota and Connecticut, are optional. If a state enacted a gift tax, the opportunity to use inter vivos transfers to avoid that state's estate tax will be lost.

Will the Surviving Spouse Be Domiciled in a Decoupled State on the Second Death

About 40 million people move annually in the US. Nearly three-fourths of the U.S. population moves an average of once every five years, of whom 7,628,000 moved to a different state. For those over the age of 70, less than two percent move annually.[3]

A recent Forbes.com article explores the reasons people are moving and where they are going to.[4] "In fact, most of the top-10 states people are leaving are located in the Northeast and Great Lakes regions, including Illinois (60%), New York (58%), Michigan (58%), Maine (56%), Connecticut (56%) and Wisconsin (55%). According to Stoll,[5] this reflects a consistent trend of migration from the Frost Belt to the Sun Belt states based on a combination of causes. The Northeast and Midwest also feature a comparatively high concentration of residents over 65, says Stoll, who tend to retire to states that are warmer and less expensive. That's why southern and western states are some of the most popular places to move to. According to the study, North Carolina, South Carolina, Florida and Arizona feature some of the highest ratios of people moving in," says Goudreau.[6]

When evaluating the costs and possible benefits of a particular strategy (e.g., a bypass trust funded up to the state limit and some type of marital trust for the remainder, versus the entirety to a marital type trust to qualify for a basis step-up on the second death), the potential for the particular client moving prior to death to a no-estate tax state should be considered as part of the qualitative discussion. If the client has children and grandchildren living in a non-decoupled state perhaps the possibility of that as a draw should be discussed. Similarly, if the client has little or no family in the decoupled current home state, that may be a factor that might similarly indicate a greater likelihood of moving. The magnitude of the possible state estate tax, especially if coupled with a high income tax for the years prior to death, may be a factor conducive to a move. The bottom line, especially for clients hesitant to incur the cost and complexity of bypass trust funding and administration, is to discuss with the client the likelihood of relocation.

Moving to a new state alone, however, may not suffice to address the issues entirely. If a client has a reasonably likelihood of purchasing a residence in a new no-tax state, what might the client's plans be for his or her residence in the other state? Some clients may be quite adamant that, regardless of whether they purchase a house in a new state, they will never relinquish their residence in the initial home state. In some instances, the line of inquiry must extend beyond what the client might do with respect to "moving" but also what they might insist on retaining in their "former" domicile. Ties to the former home state may result in the client retaining enough ties to that state to be subject to its estate tax. Many high-tax states have become quite aggressive in their pursuit of former domiciliaries who claim to have moved.

How Relevant is the Basis Step-Up?

Most discussions of bypass trust versus portability presume maximizing the basis step-up available on the death of the second spouse is crucial and that assets inside the bypass trust will appreciate. But are these concerns or assumptions realistic? Consider the examples and discussions following.

Example 1: Assume that the combined estate of Tim and Nina Finley is worth $1,400,000 (none of which is held in retirement accounts) and that the assets are expected to rise in value by 150 percent between the death of the first spouse and the second spouse's death. Suppose further that the assets are balanced between the spouses and that a bypass trust is created under each spouse's will. Finally, assume a combined capital gains rate (state and federal) of 20 percent. Note that while the heirs' capital gains tax rates could be higher, this illustration assumes the income of the heirs is less than $400,000 (single) or $450,000 (joint), where the highest brackets begin. The state estate tax exclusion is $700,000 (this figure is used for ease of illustration rather than the $675,000 New Jersey exclusion). Tim dies on October 31, 2013. If everything passes to the survivor, the income tax would be avoided

at the second death. The $1,400,000 would grow to $2,100,000 (150%), and in New Jersey, the estate tax would be $106,800 (the Code Sec. 2011 credit amount). However, if a bypass trust was used, the New Jersey estate tax at the second death would be $36,000. The income tax (assuming everything was liquidated and the heirs had no capital losses to offset the gains) would be $70,000. Thus, the total tax cost would be $106,000. The use of the trust neither cost nor saved the heirs any funds.

Example 2: Assume the same facts as in Example 1, above, but assume that the asset values are larger, or assume that an IRA is included as part of the family estate which is expected to be rolled over to the surviving spouse in order to defer income tax to the surviving spouse. In these events, the higher figures cause the estate of the survivor to be in a higher state estate tax bracket, resulting in a more significant saving by using the bypass trust over the use of portability.

Example 3: Often, the assets that will fund the bypass trust are assets that will not be liquidated immediately at the death of the survivor. For example, many times the asset may be stock (or LLC membership interests) in a family business that will not be sold. Other legacy assets, such as the family vacation home, fund the trust and are expected to remain a family asset for the foreseeable future. In that event, the income tax savings of the step-up in income tax basis are not as pronounced. More specifically, if a sale will not likely occur for decades, the present value of that future capital gains tax cost may be insignificant. Thus, saving state estate tax may actually prove a preferable planning approach.

Financial advice typically recommends a reduction in the percentage allocation of a client's portfolio to equity investment in post-retirement years. Thus, if only 30 percent of the client's portfolio is invested in equities, how material is the appreciation in a state exclusion amount bypass trust likely to be? For example, "many financial professionals recommend a gradual reduction of equity allocations during retirement years; e.g., starting out with, perhaps 50% to 60% of assets in equities during the client's 60s and gradually declining to 20% to 30% by the client's 80s."[7] The reality is that many older clients face the opposite issue. They have such excessively low equity allocations in their investment portfolios that they lack reasonable inflation protection to their maximum life expectancy. Every practitioner has met many retired, and especially elderly, clients who view CDs, municipal bonds, and the like as the only appropriate investments. The more serious problem for many older clients is not the loss of basis step-up on the second death but outliving their money. While the current investment climate might favor higher allocations to equities and lower bond allocations in light of historically low interest rates and fears of future inflation and rate rises negatively impacting bonds, the point of the preceding discussion is that a significant portion of the client's asset allocation will likely be to assets that do not have a significant, or any, expectation of appreciation.

Finally, similar to the comment above, if there *is* a step-up in estate assets at the passing of the first spouse, would it be likely that the "bypass trust" assets would be managed under "modern portfolio theory" during the life of the survivor? If so, gains would be realized over the life of the survivor thereby minimizing the impact of a step-up at the passing of the survivor. Again, in that event, the known state estate tax savings could outweigh the possibly limited unrealized appreciation that heirs may face.

Can the Basis Step-Up Be Controlled in Other Ways

There are a number of mechanisms by which potential appreciation in a bypass trust can either be minimized or addressed.

Asset Location

"Asset allocation" concerns the broad investment categories to which a client's investment assets are divided, for example, 50 percent in equities, 40 percent in bonds (or "bond-like" assets or "substitutes") and 10 percent in cash. In contrast, "asset location" concerns the "buckets" into which the various assets comprising the cli-

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ent's asset allocation are held. For example, assume that the above allocation is used. The client might concentrate bonds in the bypass trust formed on the death of the first spouse, the remaining bonds and income-oriented stocks in his/her IRA, and the remaining assets in his/her personal name. In that manner, the income from income-generating assets will be sheltered inside the IRA and appreciation in the bypass trust will be largely eliminated because it holds only a bond portfolio. Many of the discussions concerning the basis on the second death presume that the assets held in the bypass trust will appreciate in value. Prior to ATRA, the normal estate administration convention had suggested concentrating equities, with greater potential for appreciation, inside the bypass trust. That tax paradigm has shifted for many moderate wealth clients (although likely not for ultra-high net worth clients). Asset location decisions can prove the mechanism of avoiding any significant gain inside the bypass trust thereby obviating the need for a second basis step-up.

Income Distribution and Defining Income to Include Capital Gains

Another approach that can be used to help control the appreciation inside a bypass trust is to distribute income annually. Because of the compressed income tax rates for trusts, distributing income currently can be tax advantageous. Achieving this benefit, however, will not always be feasible as a result of constraints in the governing instrument or state law. The language in many trust instruments will not permit the distribution of capital gains to the surviving spouse (or any other person) as a current income beneficiary. This is because most trusts, and most state laws, define capital gains as inuring to corpus. In these events, a distribution of the cash flow generated by a capital gain, even if permitted under the discretion afforded to the trustee, will not distribute the capital gain for tax purposes without more. For existing trusts, if the language cannot be modified by powers granted to a trust protector or other fiduciary, it may be feasible to decant the trust to a new trust with broader provisions permitting inclusion of capital gains in income. With this flexibility, it may be possible to plan gains and losses to be realized by the trust, surviving spouse, and perhaps other bypass trust beneficiaries, in order to minimize current tax costs by making the optimal distributions.

Tax Advantaged Investments

If the trust is appropriate to hold life insurance, the allocation of some of the trust assets to the purchase of a permanent life insurance policy on the life of the surviving spouse could provide a currently tax-advantaged investment opportunity (any gains being protected within the tax-favored envelope of the policy) and to provide a death benefit that will have no capital gain exposure; *i.e.*, the cash death benefit. Life insurance may be appropriate as an asset class that can also provide a means of mitigating the taxable appreciation inside the trust.

Power to Distribute Appreciated Assets

One option considered by some practitioners is to afford the trustee, or a special distribution trustee, the right to distribute appreciated assets from the bypass trust to the surviving spouse/beneficiary to cause the inclusion of those assets in the surviving spouse's estate. This will allow for a basis step-up on those assets. While this approach can mitigate the possible negative tax effects of holding appreciating assets inside the bypass trust, remember that the "power to appoint" is also the "power to *disappoint.*"

It presents obvious practical problems in many situations. Who would be willing to serve as the distribution trustee to make such a decision? What exposure would such a distribution trustee face? Is it practical in an extreme situation to actually distribute property? Is it practical to utilize such an approach in a blended family when the surviving spouse is not the parent of the children who are the remainder beneficiaries of the trust? How can such a decision be made, especially in blended family situations, without detriment to the remainder beneficiaries? If the trustee tries to mitigate that risk by contractually obligating the surviving spouse receiving a principal distribution of highly appreciated assets to make specified gifts or bequests to the bypass remainder beneficiaries, what ramifications might that have? To what extent must the advisor explain the creation of the power to the testator?

While these could be insurmountable concerns, there are certainly some families for which this flexibility could be integrated into the planning. Obviously, there is no assurance that a cohesive family at the time the planning will continue to be congenial after the death of the first parent/ spouse. It may also be advisable to include indemnification provisions in the trust to protect the distribution trustee. The distribution trustee might benefit from a provision to be held harmless from the remainder beneficiaries on the distribution. But, those indemnification provisions could prove to be a dangerous approach in that they might provide a trustee with ill motives the "cover" to make a decision that is known to be detrimental to the remainder beneficiaries.

Structure the Bypass Trust As a Grantor Trust

It has become popular and useful for many clients to create irrevocable trusts which are characterized as "grantor" trusts for income tax purposes. A grantor trust is a trust that, for income tax purposes, is the alter ego of the donor, causing the donor to report all income of the trust as his/her own. This occurs because of the application of Code Secs. 671 through 679 by retaining certain enumerated 'strings' over the trust. A particularly valuable benefit of a grantor trust post-ATRA is that if the trust holds *appreciated* assets, the donor can swap other non-appreciated assets, *e.g.*, cash, without triggering capital gains tax, and thereby include those appreciated assets in his or her estate. Thus, the client can achieve a step-up in basis by bringing appreciated assets back into his or her estate before he or she dies. However, these benefits have not gone unnoticed by the Obama Administration and Treasury Department. In fact, both the fiscal year 2013 and 2014 Greenbook proposals seek to restrict grantor trusts. The 2013 Greenbook sought to include grantor trust assets post-enactment in the grantor's estate.[8] The 2014 Greenbook attacked only sales to grantor trusts.[9] While the latter was a more surgical strike, it seems clear that there is movement to affect the use of grantor trusts (often referred to as intentionally defective grantor trusts (IDGTS)).

The substantial benefits of grantor trust status described above can be extended to what would otherwise be a more traditional "credit shelter" trust. Making a bypass or credit shelter trust a grantor trust as to the beneficiary/surviving spouse can provide substantial additional tax benefits. By creating a "grantor trust credit shelter trust," can the client preserve the ability to remove appreciated assets from the "credit shelter" without a current income tax cost so that those assets can be returned to the estate of the beneficiary/spouse in order to achieve a basis step-up? Some commentators refer to this as a "supercharged credit shelter trust."[10] The details of this technique may be too complex for smaller estate plans, but "smaller" is relative post-ATRA when a $10 million estate may be safely below the federal estate tax threshold for a family. This technique can be illustrated in simple terms as follows:

> **Example 4:** Wayne Strong creates an inter vivos qualified terminable interest property (QTIP) marital trust for his wife, Lulu. The QTIP trust provides for the creation of a bypass trust back to Wayne. Thus, when Lulu dies, if she is survived by Wayne, the QTIP funds a bypass trust for his benefit. That bypass trust will be a grantor trust as to Wayne following Lulu's death. In a more comprehensive plan, Lulu might establish a similar, but not reciprocal trust, for Wayne. This would enable whichever spouse is the surviving spouse to have a bypass trust that is characterized as a grantor trust. Some practitioners prefer to structure such trusts to have a situs and governing law of a state that permits self-settled trusts in order to mitigate the risk of the grantor spouse being a beneficiary of the bypass trust that he or she effectively established.

Alternative Approach to Transforming a Bypass Trust as a Grantor Trust

How else can a bypass trust be characterized as a grantor trust? The grantor trust rules make the *grantor* the owner for income tax purposes, and that *grantor,* for a credit shelter trust, would be the decedent, not the surviving spouse. Further, Code Sec. 677 makes the "spouse" of the donor the *grantor*. However, if the spouse is the *surviving* spouse, he or she is probably not the "spouse" pursuant to that provision. Thus, the authority,

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which makes someone "other" than the grantor the deemed "owner" for income tax reasons under the grantor trust rules, must be identified.

Under Code Sec. 678, a person is deemed the owner of a trust over which he or she has a power of withdrawal. This tax status remains as "grantor" even after that power lapses. Moreover, in some credit shelter trusts the surviving spouse is granted the power to withdraw the greater of five percent of the trust corpus, or $5,000, without adverse estate tax consequences. This is referred to as the "5-and-5 power." On the spouse's death, the corpus of the bypass trust with a 5-and-5 power is not included in her estate, only the amount of corpus she could have taken in the year of death, *e.g.*, $5,000 or five percent of the overall trust. Recall that Code Secs. 2041(b)(2) and 2514(e) statutorily protect the lapse of a withdrawal right from having estate or gift tax consequences to the surviving spouse. Thus, when a spouse is granted in the trust instrument a 5-and-5 power, the credit shelter trust will become a grantor trust as to the spouse over time at a rate of five percent per year on the portion not previously a grantor trust (*e.g.*, five percent after the first year, 9.75 percent after the second year, etc.).

If over time, the assets appreciate and the trust becomes largely a grantor trust as to the surviving spouse, the grantor trust planning opportunity, similar to that described in the inter vivos or super-charged credit shelter trust approach described in the preceding discussion, will be created as to the surviving spouse. This approach (the gradual creation of grantor trust status) has been recognized in a number of private rulings.[11] This has also been recognized in the context of a lapse of a *Crummey* withdrawal right.[12]

Charitable Distributions

Permitting charitable gifts from a bypass trust has not been conventional since the goal historically has been to maximize the assets outside the surviving spouse's estate. Instead, charitable bequests could be made by the surviving spouse or from the estate of the surviving spouse to garner an estate tax charitable deduction. However, the new tax paradigm might provide an incentive to rethink this traditional approach. If the family unit has charitable giving objectives, then selecting the optimal source from which to fund those charitable gifts could maximize the overall tax benefits of the contributions. The bypass trust might be in a higher income tax bracket than any family member so that distributions to charity may provide the most benefit to the trust.

Conclusion

The decision-making process as to whether a bypass trust should be used or whether the client should rely on a marital bequest to secure a basis step-up on the second death is far too simplistic for many real world applications. Practitioners guiding clients in achieving the optimal tax results overall must evaluate many different circumstances and planning options. The sheer number and variability of these options confirms that achieving the absolute optimal result is at most a theoretical goal. But with a broader perspective on planning, and consideration of more options, practitioners can help clients improve the likelihood of moving closer to the optimal result. With this foundation, a number of specific planning options can be explored in the next article in this series.

ENDNOTES

1 Estate Planning in a Decoupled State Post-ATRA for Married Clients Under the Federal Exclusion Amount: Part 3--State Bypass and QTIP Trusts

2 See CCH's State Inheritance, Estate and Gift Tax Reporter, ¶12,090, Classification of State Inheritance, Estate, and Gift Tax Laws for up-to-date information on each state's laws and CCH's Multistate Transfer Tax Laws Smart Chart.

3 U.S. Census Bureau data quoted in http://www.melissadata.com/enews/articles/0705b/1.htm)

4 *The States People Are Fleeing In 2013*, by Jenna Goudreau, Forbes, Feb. 7, 2013, http://www.forbes.com/sites/jennagoudreau/2013/02/07/the-states-people-are-fleeing-in-2013/..

5 Ms. Goudreau is referring to economist Michael Stoll, professor and chair of the Department of Public Policy at the University of California, Los Angeles.

6 *Supra* at 2.

7 http://njaes.rutgers.edu/money/pdfs/older-adults-money-advice.pdf 5/23/13

8 General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (commonly referred to as the Greenbook) at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf

9 General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf

10 See Blattmachr, Gans and Zeydel, *Super Charged Credit Shelter Trust*, 21 Probate and Property No. 4, 52 (July/August 2007).

11 See IRS Letter Rulings 200022035, March 3, 2000, and 200104005, September 11, 2000.

12 See IRS Letter Ruling 9541029, July 14, 1995.

Part 5—Alternative Planning Approaches Based on Outright Marital Bequests

By: Martin M. Shenkman, Esq., Richard H. Greenberg, Esq., Glenn A. Henkel, Esq., and Bruce D. Steiner, Esq.

This installment in this series of articles examining planning after the American Taxpayer Relief Act of 2012[1] (ATRA) in decoupled states will evaluate three planning options, each based on the use of an outright marital bequest. The next and final installment in this series will evaluate three additional planning options built on the use of a bequest to a marital trust.[2] The following discussion provides a framework for both parts.

Framework for Discussion of the Options

The "permanency" of portability and the manner in which it is applied, as promulgated by the Temporary Regulations under Code Secs. 2010 and 2505, when coupled with other factors suggests consideration of various estate planning techniques which may lessen, or even eliminate state estate taxes for married couples with little or no effect on federal transfer taxes – and in some cases produce a superior result at the federal level. These techniques will be applicable in states that (i) do not impose a gift tax (*i.e.*, states other than Connecticut and Minnesota, but planning can also be pursued in modified form by those domiciled in one of those states) and (ii) calculate the estate tax based on the application of the now defunct state death tax credit.

The factors that form the basis for the planning suggestions include: (i) portability is "permanent," (ii) the Basic Exclusion Amount ("BEA") of a spouse, which was previously wasted if not utilized upon the death of the first spouse to die, now "survives" via the deceased spousal unused exclusion (DSUE) amount, (iii) any gifts made by a surviving spouse are applied first to the DSUE and (iv) the application of the DSUE amount to a gift will not be subject to transfer tax even if the surviving spouse possesses a lower DSUE amount via a different DSUE from a subsequently deceased spouse.

The suggested planning techniques are similar to those utilized pre-portability, but with specific modifications to tailor them to the new rules. The suggestions are designed both with outright transfers, similar to disclaimer planning, and with transfers structured as marital trusts, which satisfy the requirements of Code Sec. 2056(b)(7) (qualified terminable interest property (QTIP) trusts).

The plans presented are as follows:

- **Plan A** – Outright Transfer and Reliance on Portability
- **Plan B** – Outright Transfer and Gift of the DSUE Amount
- **Plan C** – Outright Transfer and Non-Qualified Disclaimer of the DSUE Amount
- **Plan D** – Marital Trust Transfer and Use of Section 2519 to Impose Gift of the DSUE Amount
- **Plan E** – Marital Trust Transfer and Use of General Power of Appointment to Impose Gift of the DSUE Amount
- **Plan F** – Marital Transfer and Hybrid of Plans D and E to Impose Gift of DSUE Amount

Plans D through F are discussed in Part 6 of this series of articles.

The Fact Pattern

The following hypothetical fact pattern will be used with the analysis of each of the plans.

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Assume that Albert and Caroline Mann reside in New Jersey and are permanently domiciled in New Jersey (their grandchildren live in New Jersey, and they have no intent of moving). Albert has a net estate equal to $10,000,000, all of the assets of which are owned by him individually. Neither Albert nor Caroline has made any prior adjusted taxable gifts. Caroline has no independent assets. Albert dies in 2013 and has both a BEA and an applicable exclusion amount (AEA) in the identical amount of $5,250,000. Albert's estate elects portability. There is an inflationary increase in Caroline's BEA each year after 2013 through and including the year of her death.

Preliminary Structure

Irrespective of the ultimate plan adopted, the Will for each spouse contains a bypass trust that is funded with the maximum amount that can be transferred on the death of the first spouse to die without the imposition of a federal or state estate tax. Since New Jersey has an exclusion amount in 2013 of $675,000, the bypass trust will be funded with that amount. The assets transferred into the bypass trust, and the appreciation of those assets, will not be subject to federal or state estate tax on the death of either spouse.

Plan A – Outright Transfer and Reliance on Portability

The assets in excess of the amount transferred to the bypass trust of $675,000 are bequeathed to the surviving spouse, Caroline. The DSUE amount of Albert, equal to $4,575,000 [$5,250,000 (Albert's BEA) less $675,000 (the amount transferred to the state exclusion bypass trust)] is inherited by Caroline. Accordingly, Caroline has an AEA in an amount equal to $9,825,000 [$4,575,000 (Albert's DSUE) plus $5,250,000 (Caroline's BEA)]. Additionally, Caroline's BEA will increase each year that she survives beyond 2013 by that year's inflation adjustment.

No federal or state estate tax is due upon the death of Albert. The taxable estate of Albert is equal to $675,000, well below the exclusion amount for federal purposes and exactly the exclusion amount for New Jersey purposes.

In many cases, Caroline's estate will be insulated from federal estate tax, even if no further planning is implemented. The anticipated indexing of Caroline's BEA, and the reduction of Caroline's assets through consumption, may provide sufficient insulation from any federal estate tax on her later death for the vast majority of even wealthy clients.

There are, however, disadvantages associated with this plan if it is actually used with the structure presented.

- First, Caroline's assets could increase at a rate that exceeds the indexing of her BEA and thereby potentially subject Caroline's estate to federal estate tax.
- Second, Caroline may remarry and the second (or later) spouse may die and become the new last deceased spouse (Last Deceased Spouse). In the event that the DSUE of the Last Deceased Spouse is less than the DSUE obtained by Caroline as a result of Albert's death, Caroline's estate may become subject to federal estate tax.
- Third, a very substantial state estate tax will be due on the later death of Caroline whether or not a federal estate tax is due. For example, if Caroline dies with a taxable estate in an amount equal to $10,000,000, the state estate tax will be approximately $1,000,000.

Notwithstanding the above disadvantages, many taxpayers might nonetheless opt for an outright distribution with sole reliance on portability, Plan A, rather than use the disclaimer estate plan that was common prior to portability. This latter plan would have been an outright bequest to the surviving spouse followed by his or her disclaiming that amount necessary to fund a bypass trust without the imposition of a federal estate tax. Without portability, the only way to safeguard the federal exclusion amount, $5,250,000 in 2013, from the federal estate tax upon the death of the second spouse to die came with a price tag of a state estate tax of more than $400,000 on the death of the first spouse to die, Albert in our hypothetical.

With portability under an outright transfer, Plan A, there is no state estate tax due until the second spouse dies. This may be several years, or decades, later. Also, unless the Last Deceased Spouse changes (as a result of remarriage and death of the subsequent spouse) and thereby

causes the surviving spouse, Caroline, to obtain a lower DSUE amount, the BEA that was forfeited prior to the enactment of portability may now be utilized by Caroline along with Caroline's individual BEA, which is indexed for inflation and will accordingly increase further. The combination of these will shield an initial amount equal to $9,825,000 from federal estate tax. Even if Caroline were to die with a taxable estate in an amount equal to $10,000,000, and in that event a state estate tax in an amount equal to $1,000,000 were due, many taxpayers would prefer the deferral until the second death. Many taxpayers may be willing to take their chances that the surviving spouse will move to a non-decoupled state before death, or otherwise avoid that state estate tax, than endure the cost and complexity of additional planning.

Plans B Through F

Plan A delineated above provides a "no plan" strategy that defers the state estate tax that would otherwise be due on the death of the first spouse, Albert, until the death of the second spouse, Caroline. While Plan A offers the virtue of simplicity, that benefit is offset by significant risks:

- A large state estate tax could be due on the second death, approximately $1,000,000 in our example above.
- The potential payment of estate taxes with respect to the future growth in connection with assets initially protected by the DSUE amount inherited by the surviving spouse.
- A change of the Last Deceased Spouse with a lower DSUE amount available to the surviving spouse.
- There is no protection from divorce or claimants or the benefits of control that a trust would afford.

Plans B through F go further. If successful, not only is there no state estate tax on the first spouse's death, but there is no state estate tax on the death of the second spouse with respect to the amount of assets equal to the entire BEA of the first spouse to die - $5,250,000, plus the growth in those assets between the date of the first spouse's death and the date of the second spouse's death. Stated another way, Plans B through F may afford a married couple (which may, after the Supreme Court declared Section 3 of the Defense of Marriage Act (DOMA) unconstitutional in *E. Windsor*, 2013-2 USTC ¶60,667, encompass a larger group of clients) the ability to shield the full federal exclusion amount from *both* the federal estate tax, *and* the state estate tax *both* at the first death <u>and</u> the second death of the married couple. Furthermore, the potential disadvantages associated with Plan A, the outright bequest and total reliance on portability, can be avoided with further planning; *i.e.*, applying the approaches discussed in Plans B and C below, and D through F in Part 6 of this series.

Plan B – Outright Bequest Followed By Survivor's Gift of the DSUE Amount

Non-Self-Settled Outright Version of Plan B

Plan B mirrors Plan A at the death of the first spouse to die, in that an amount equal to $675,000, the state exclusion amount, is devised to the state exclusion bypass trust, and the $9,375,000 of remaining assets are bequeathed outright to the surviving spouse, Caroline. The DSUE of Albert, in an amount equal to $4,575,000, is ported to Caroline. But, Plan B improves on Plan A and provides a solution to the risks identified for Plan A. In this simpler version of Plan B, Caroline, soon after Albert's death, makes a gift in an amount equal to $4,575,000. The gift can be made to whomever Caroline may choose. While the simplest donees might be children and/or grandchildren of the couple, in trust or otherwise, that would limit Caroline's ability to access those assets. Recognizing the unwillingness of many surviving spouses to forgo any access to a large value of assets, this issue is addressed below. The tax results of Plan B are as follows:

- No federal or state estate tax is due on the death of Albert because the taxable estate of Albert is limited to the lower state exclusion amount, $675,000, in the hypothetical. Note that had Albert's will simply bequeathed the larger amount to the children, grandchildren, or a trust for them on his death, there would have been no federal estate tax, but a rather substantial state estate tax. Instead, by bequeathing the amount in excess of the state ex-

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clusion to the surviving spouse, Caroline, and having her make a gift, there is no state estate tax on Albert's death.

- No federal gift tax is due. Caroline, on the date of the gift, has an AEA in an amount equal to $9,825,000. This is comprised of the DSUE obtained from Albert equal to $4,575,000, plus the BEA of Caroline, equal to $5,250,000. Since the amount of the gift is less than Caroline's AEA, no federal gift tax is due.
- No state gift tax is due either as the examples are premised on a state that does not impose a gift tax, New Jersey in the hypothetical. This latter assumption will not apply in Connecticut and Minnesota, which do impose a gift tax. In those states, the gift may have to be limited to the amount of the state gift tax exclusion amount. A critical issue for this type of plan is whether or not other states may follow Minnesota's recent lead and enact gift taxes to backstop their estate tax systems.
- No state estate tax will be due with respect to the assets given by Caroline. Unlike the federal transfer tax system, states which utilize the state death tax credit regime do not require an "add back" and impose an estate tax in connection with adjusted taxable gifts.
- The DSUE ported to Caroline is first applied to the gift.[3] Therefore, Caroline does not use any of her BEA. This is significant in that her BEA will continue to be inflation adjusted, whereas the DSUE from her late husband was fixed at his death and would not thereafter be increased by annual inflation adjustments.

Accordingly, Caroline's "inheritance" of Albert's DSUE, followed soon thereafter by the gift of assets using some portion or all of that DSUE, produces effectively the same tax result at the federal level as if Albert had fully funded the bypass trust available to him. In either event, an amount equal to $5,250,000 of BEA, which Albert had possessed, is fully used. In the traditional pre-portability plan, Albert would have used his entire BEA to fund a bypass trust at a cost of a state estate tax of more than $400,000. With Plan B, only $675,000 of Albert's BEA is used to fund a bypass trust with the result of not incurring any state estate tax on his death. The remaining $4,575,000 is also utilized, but in two steps. First, it is transferred to Caroline as the DSUE amount of Albert. Second, it is transferred by Caroline to lower generations as a gift. The assets transferred in an amount equal to the DSUE via the two-step process, $4,575,000 in the example, will completely escape the state transfer tax system during the life and at death of both of Albert and Caroline, so long as the decoupled state does not impose a gift tax.

If the surviving spouse, Caroline in the above hypothetical, was to remarry and her second husband died before she did, her Last Deceased Spouse would change. The DSUE available to Caroline could then be less than the $4,575,000 DSUE of her first husband. There are, however, no adverse transfer tax consequences to Caroline of this occurring by virtue of the fact that she consummated the gift using up the DSUE from Albert prior to the remarriage. The Temporary Regulations impose neither a "toll charge" nor a "clawback."

If, as a result of a later marriage, Caroline obtains an additional DSUE from her second husband (*i.e.* Husband 2 had remaining exclusion when he died), Caroline could utilize that additional DSUE of her new Last Deceased Spouse by making a lifetime gift or at her death (or a combination of both) notwithstanding the fact that Caroline had already utilized the DSUE of Albert amounting to $4,575,000.

All of the future appreciation with respect to the assets given by Caroline to children or grandchildren, as with any gift, will not be subject to estate tax on the later death of Caroline. However, absent using a grantor trust with a swap power as donee, those assets will not qualify for a step-up in basis on Caroline's later death. This is precisely why all such gifts should ideally be made to an appropriately structured grantor trust and not outright. Realistically, however, many clients will avoid the complexity and costs of a trust in spite of the potentially dramatic tax benefits it can afford. Non-Self-Settled Trust Version of Plan B

If Caroline chooses to transfer, by gift, the assets involved to a trust for the benefit of her children or grandchildren, she could structure the trust as an intentionally defective grantor trust (IDGT), unlocking all of the tax benefits derived with respect to the utilization of IDGTs. One of the most prominent features of having the donee trust characterized as a grantor trust is that Caroline could

retain a swap power that she could use to swap highly appreciated assets back into her estate to obtain a basis step-up on her death. With the increased emphasis on income tax planning, and in particular maximizing basis step-up on the death of both spouses, using a grantor trust as donee should likely be the default option practitioners present to clients.

The Self-Settled Trust Version of Plan B

While the most basic version of Plan B produces the favorable results discussed above, and the simple trust version of Plan B enhances those benefits with the addition of grantor trust status and a swap power, most taxpayers will be reluctant to use that approach. Specifically, the basic version requires the complete relinquishment of the assets attributable to the DSUE, and many taxpayers will not be willing to complete gifts of such a substantial nature.

For many years, estate practitioners have explained to clients the tax advantages of the transfer of a certain amount of assets, typically the BEA or state exemption equivalent, not directly to a spouse, but instead to a bypass trust. The ability to assure that the spouse is adequately protected financially is almost universally derived from a basic premise that, although the assets are not received directly by the surviving spouse, the assets are transferred to a trust of which the surviving spouse is a beneficiary. Most bypass trusts are drafted to include provisions to reduce estate taxes and simultaneously provide for sufficient access to trust assets to satisfy the surviving spouse's financial needs and wants.

The non-self-settled trust version of Plan B provides no such security; the assets are irrevocably given. Although it should be noted that, if the trust version of Plan B (outright bequest from first spouse to die to the surviving spouse, followed by a gift to a trust for heirs) is implemented, that trust might lend money to the surviving spouse at a low interest rate to infuse cash if needed. However, suppose the surviving spouse would instead give the assets to a trust of which he or she was a discretionary beneficiary (in addition to the children and grandchildren). This could provide somewhat comparable results to the bypass trust with which practitioners and clients alike are familiar.

Most state laws provide that a transfer to such a trust would not be respected for asset protection purposes. Simply put, a gift by Caroline to a trust of which she is a beneficiary would be reachable by her creditors under most state laws. Since the tax laws use the ability of creditors to reach assets as a litmus test for estate inclusion, such a trust formed in most states would not succeed for estate tax purposes, as all trust assets would be included in Caroline's estate. If a creditor can attach the assets of the self-settled trust, then for tax purposes, those assets would be included in the estate of the donor under Code Sec. 2036 and the plan would fail.

However, there are currently fourteen states in which a donor can establish a "self-settled" trust, and if properly handled and with no fraudulent conveyance or bankruptcy issues, then that donor's/beneficiary's creditors should not be able to attach the trust's assets. Delaware, Nevada, Alaska and South Dakota are the most popular states for self-settled trusts. However, if a client lives in a different state whose laws permit a self-settled trust, there might be an advantage to having that client's self-settled trust formed under the client's qualifying home state statutes.

If creditors cannot attach the assets of the trust, Code Sec. 2036 does not automatically apply and the gift by the surviving spouse to the "asset protected" self-settled trust may be deemed complete with no inclusion of the assets in the estate of the surviving spouse, notwithstanding that the surviving spouse is a beneficiary. Thus, Caroline could inherit assets in excess of the state exclusion amount outright thereby avoiding state estate tax in the decoupled state on Albert's death. Thereafter, Caroline could give those assets, in an amount up to the DSUE of Albert, to a self-settled trust created in a state permitting such trusts. Caroline could then receive all of the tax and other advantages discussed above for the non-self-settled version of Plan B, with the added benefit that monies could be distributed to Caroline in the discretion of an independent trustee.

There are other issues to consider with respect to the self-settled trust option. Case law developments adversely affecting self-settled trusts have resulted in some practitioners structuring

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self-settled trusts with various mechanisms to reduce the risk of the transaction being subjected to the reach of creditors, and thereby undermining the tax results. One approach is not to name the grantor and intended beneficiary, Caroline in this illustration, as a beneficiary. Instead, an individual selected by Caroline is given the authority to act in a non-fiduciary capacity to add to the class of beneficiaries in a manner that could also include Caroline. Other practitioners have crafted such trusts with a delay prior to the grantor, again Caroline in this hypothetical, being a beneficiary. The ideal delay would be ten years and one day to take the transfers to the self-settled trust outside of the reach of the bankruptcy trustee to avoid the transfers. It should be noted, however, that not all developments concerning self-settled trusts have been negative.[4]

The self-settled trust described above is often referred to as a domestic asset protection trust (DAPT). This can, subject to the issues and drafting decisions noted above, be used in connection with Plan B (the "Plan B Trust").

Although the analogy of a bypass trust and the DAPT may be useful for introducing the planning concept to a client, it is important that practitioners differentiate the two trusts. Since Caroline is the grantor of the DAPT, the DAPT cannot include certain provisions that might ordinarily be included in many bypass trusts. These provisions must be avoided to prevent the DAPT assets from being included in Caroline's estate. Unlike the typical bypass trust, the surviving spouse is the grantor of the "Plan B Trust." Remember that the "grantor" of a typical bypass trust is the deceased spouse who is not a beneficiary. As such, the retention of certain rights by Caroline as the surviving spouse and grantor with respect to the assets transferred to the Plan B Trust will trigger Code Sec. 2036 and cause the transaction to fail in a manner similar to the creation of a self-settled trust in state that does not respect such trusts. Consider the following:

- If a donor transfers assets to a trust and retains the right to the income from the trust, Code Sec. 2036(a)(1) will cause the assets of the trust to be included in her estate.
- If a donor transfers assets to a trust and retains the right alone or in conjunction with anyone else to determine the distribution of the assets, Code Sec. 2036(a)(2) will cause the assets of the trust to be included in the estate of the grantor, Caroline in this example. Accordingly, the surviving spouse should not be the trustee or a co-trustee of the Plan B Trust, since Code Sec. 2036(a)(2) applies if the donor has *any* authority in connection with the distribution of the assets of the trust. Control with respect to such authority is not required to invoke Code Sec. 2036(a)(2). Accordingly, the surviving spouse should not serve as a co-trustee even if the surviving spouse can be outvoted by other co-trustees.
- If the donor spouse retains a power of appointment with respect to the assets transferred, Code Sec. 2036(a)(2) will cause the assets of the trust to be included in the estate of the donor. Accordingly, the surviving spouse should not retain a power of appointment with respect to the assets transferred to the Plan B Trust.

Code Sec. 2036 will also apply, and thereby undermine the plan, if there is an implicit understanding between the trustee and the surviving spouse that the assets will be utilized for the benefit of the surviving spouse at such times as the surviving spouse determines. Substantial case law has been developed in this area; results are often determined based on the facts and circumstances, which are beyond the scope of this article. Great care should be taken to ensure that any distributions to the surviving spouse are at the sole discretion of the trustees and that the surviving spouse is comfortable with such an arrangement.

If the surviving spouse is willing to sacrifice these rights, which often are provided in a traditional bypass trust, the Plan B Trust should approximate the benefits of a bypass trust, avoid state estate tax on the first spouse's death, and provide the other benefits discussed above.

Plan C – Outright Transfer Followed By Non-Qualified Disclaimer of the DSUE Amount

Plan C and Plan B are effectively the same – either in the non-self-settled trust or the self-settled trust version. However, in Plan C the donee trust, in whichever format desired, is drafted at the same time the clients' wills are drafted.

In order to invoke Plan B (outright bequest to the surviving spouse followed by a gift of the DSUE) in either version, the surviving spouse is required to engage in a transaction that in many instances will be considered by him or her as complex and overbearing. A grieving widow or widower is often unable to clearly comprehend a transaction that a layperson might have difficulty understanding under normal circumstances.

In order to avoid that potentially difficult hurdle at a difficult time, the estate planning practitioner may wish to consider drafting the donee trust to be used under Plan B at the same time the wills and other estate planning documents of the spouses are being drafted. The wills would be drafted in a manner similar to a traditional disclaimer will, i.e. all assets in excess of that which is transferred to the state bypass trust are left outright to the surviving spouse with the proviso that if the surviving spouse disclaims, the assets are devised to the desired donee trust. At the death of the first spouse, the surviving spouse need not proceed with the exercise that includes the drafting of the Plan B trust. The surviving spouse need only effectuate a disclaimer in order to fund the pre-existing trust. There is, however, one critical difference between this approach and that which occurs with a traditional disclaimer plan.

If the surviving spouse invokes the traditional qualified disclaimer, he or she will be deemed to have predeceased the deceased spouse with respect to the assets disclaimed. A qualified disclaimer, as every practitioner is well aware, means accepting no benefit from the assets to be disclaimed, and completing a disclaimer as required under state law, and in compliance with the provisions of Code Sec. 2518, including the requirement that the disclaimer be completed within nine months of death. If a qualified disclaimer is used, the result will be that the assets disclaimed will be included in the taxable estate of the deceased spouse because the disclaimer would void the estate tax marital deduction. This will result in the imposition of a state estate tax on the first death. This defeats the planning goals involved.

Example: Assume that Caroline desires to use the Plan B Trust that has already been drafted and executes a qualified disclaimer with respect to assets in an amount equal to $4,575,000, the amount of Albert's DSUE amount. Since the disclaimer is qualified, the assets will be deemed as if transferred directly from Albert to the Plan B donee/trust. That transfer, however, would then not qualify for the estate tax marital deduction. When coupled with the assets transferred to the state exclusion bypass trust, *i.e.*, $675,000 in the above example using New Jersey, the taxable estate of Albert will be in an amount equal to $5,250,000. Accordingly, although no federal estate tax will be due since the taxable estate is equal to the BEA of Albert, a state estate tax of more than $400,000 will be imposed. The result is identical to the traditional pre-portability disclaimer planning technique discussed above.

A different, less intuitive approach from what traditional planning has entailed, will solve this problem in a decoupled state without a gift tax. A disclaimer can be effectuated in many states without being qualified. A non-qualified disclaimer produces an ordinarily undesirable result, but, in this instance, a thoroughly desirable tax result. If a disclaimer is non-qualified, the transaction is treated for tax purposes as if the disclaimant, Caroline in these examples, made a gift of the assets disclaimed to the recipient, the donee/trust. Accordingly, if Caroline effectuates a non-qualified disclaimer, she will be treated for tax purposes as having first inherited the assets from Albert, which is precisely the desired result since the transfer from Albert's estate to Caroline will qualify for the federal and state estate tax marital deduction.

In order to effectuate a non-qualified disclaimer, a transaction rather counterintuitive to traditional estate planning, the disclaimer must fail one of the requirements delineated in Code Sec. 2518. One of the requirements is that the disclaimer must be effectuated within nine months of the date of death of the decedent. Notwithstanding this time period, many states allow a disclaimer to occur more than nine months following the date of death of the first spouse. New Jersey law, for example, provides that a disclaimer can be effectuated at any time.

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Accordingly, if Caroline affects a non-qualified disclaimer of assets in an amount equal to the DSUE of Albert, $4,575,000, more than nine months after the date of his death, the following results should be realized:

- The disclaimer will be non-qualified pursuant to Code Sec. 2518.
- If the disclaimer would nonetheless be valid under applicable state law the transfer of the property to the appropriate trust as a result of the non-qualified disclaimer would then be valid.
- The non-qualified, but otherwise valid disclaimer, should be treated for tax purposes as a bequest from Albert's estate to Caroline followed by a gift from Caroline to the donee/trust. There may, however, be some risk that this transaction could be attacked under a step-transaction theory.

All of the desired results delineated in Plan B above will be achieved, albeit by a different mechanism.

Conclusion

The preceding discussion presented three broad approaches to planning in a decoupled state post-ATRA relying on an outright marital bequest. The discussion in the next and final section will present three broad approaches based on bequests to a marital trust. That discussion will be based on the foundation established at the beginning of this article.

ENDNOTES

1 P.L. 112-240

2 See Estate Planning in a Decoupled State Post-ATRA for Married Clients Under the Federal Exclusion Amount: Part 6--Alternative Planning Approaches Based on Bequests to Marital Trusts.

3 Temp Reg. §25.2505-2T(b)

4 Dahl v. Marlette Enterprises, LC, C. Robert Dahl, Dahl Family Irrevocable Trust, and Charles F. Dahl, Fourth Judicial District Court, Utah County, State of Utah, Civil No. 090402989; Dahl v. Marlette Enterprises, LC, C. Robert Dahl, Dahl Family Irrevocable Trust, and Charles F. Dahl, Utah Court of Appeals, Appellate Case No. 20111077.

Part 6—Alternative Planning Approaches Based on Bequests to Marital Trusts

By: Martin M. Shenkman, Esq., Richard H. Greenberg, Esq., Glenn A. Henkel, Esq., and Bruce D. Steiner, Esq.

This final installment in this series of articles examining post-ATRA planning in decoupled states will evaluate three planning options, each based on the use of a bequest to a marital trust. The foundation and assumptions for this discussion are identical to those presented in the preceding installment in this series and are not repeated here.[1]

Plans D, E and F – Suggestions in Circumstances Where a Marital Trust Is the Recipient of the Assets in Excess of the Amounts Transferred to the State Bypass Trust

Practitioners and clients often prefer to transfer assets to trusts for the benefit of the surviving spouse in lieu of an outright transfer to that spouse. The qualified terminable interest property (QTIP) trust has become a mainstay in estate planning. It allows the estate tax on the amount in excess of the exclusion amount to be deferred until the surviving spouse's death.

Rev. Proc. 2001-38[2] and IRS Letter Ruling 201131011[3] have raised concerns with respect to whether an estate can elect the estate tax marital deduction in connection with a QTIP trust if the election does not save federal estate tax. The result of that issue, as discussed in a preceding installment in this series of articles,[4] remains the subject of debate.

- Plan D is designed for estate planning practitioners unconcerned with the qualification of a bequest for the state estate tax marital deduction in spite of Rev. Proc. 2001-38 and IRS Letter Ruling 201131011.
- Plan E is designed for estate planning practitioners who are concerned that Rev. Proc. 2001-38 and the letter ruling may prevent qualification for the state estate tax marital deduction.
- Plan F is a hybrid of Plans D and E.

The factual scenario below is used to illustrate the concepts of Plans A, B, and C in Part 5 of this series[5] and Plans D, E, and F, in this part.

> Assume that Albert and Caroline Mann reside in New Jersey and are permanently domiciled in New Jersey (their grandchildren live in New Jersey, and they have no intent of moving). Albert has a net estate equal to $10,000,000, all of the assets of which are owned by him individually. Neither Albert nor Caroline has made any prior adjusted taxable gifts. Caroline has no independent assets. Albert dies in 2013 and has both a BEA and an applicable exclusion amount (AEA) in the identical amount of $5,250,000. Albert's estate elects portability. There is an inflationary increase in Caroline's BEA each year after 2013 through and including the year of her death.

Plan D – Marital Trust Transfer and Use of Code Sec. 2519 to Effectuate Gift of the DSUE Amount

Overview of Plan D

Under Plan D, an amount equal to the state estate tax exclusion, $675,000 for New Jersey, is

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transferred to a state exclusion bypass trust. An amount in excess of $675,000, up to the basic exclusion amount (BEA) of the deceased Husband, Albert, is transferred to what is often referred to as a "gap trust," which meets all of the requirements necessary to elect the estate tax marital deduction. Accordingly, an amount equal to $4,575,000 ($5,250,000, Albert's BEA, less $675,000 which is the amount of BEA devised to the state exclusion bypass trust) is transferred to the gap trust. Any amounts in excess of Albert's BEA are transferred to his wife, Caroline, either outright, or to a QTIP trust.

Unlike traditional pre-portability planning where the executor would choose whether to elect the estate tax marital deduction in connection with the gap trust, Plan D anticipates that the marital deduction will be elected in all events. Clients who use Plan D assume that Rev. Proc. 2001-38 and IRS Letter Ruling 201131011 are of no concern, and that the marital deduction will be available with respect to the gap trust as well as the marital trust for the excess. The executor of Albert's estate also elects the marital deduction with respect to any amounts in excess of Albert's BEA, which could be a QTIP trust for the benefit of Caroline, or any other type of marital qualifying bequest (noting, however, that the gap trust must be structured as a separate QTIP for Plan D to succeed).

As a result of the marital deduction elections, Albert's taxable estate is equal to $675,000, no more than the state exclusion amount, so that both state and federal estate tax can be avoided on the first death. Accordingly, Albert's deceased spousal unused exclusion (DSUE) amount is equal to $4,575,000 [Albert's BEA of $5,250,000, less $675,000]. The concept underlying Plan D is to make a gift of the DSUE amount and produce the same results effectuated in Plans B and C but is applying a different type of mechanism than used in the preceding outright examples.

Code Sec. 2519 states that, if the surviving spouse who is the beneficiary of a QTIP trust with respect to which the marital deduction is elected disposes of all or part of the income interest in that QTIP trust, the disposition will be treated as if the entire interest in the QTIP trust, *i.e.*, its full value, is deemed given by the surviving spouse. Accordingly, a disposition by Caroline of all or a portion of her income interest in the gap QTIP trust will be deemed a gift of the entire value of that trust, namely $4,575,000, not merely the calculated value of the income interest disposed. This approach provides a similar result to what was achieved pursuant to Plan B (an outright bequest to Caroline followed by her gift of the DSUE amount). Several hurdles need to be cleared in order to achieve the Plan D Code Sec. 2519 results.

Technically, Code Sec. 2519 does not provide that the disposition of all or a portion of the income interest causes the entire value of the QTIP trust to be deemed a gift. Rather, the gift transfer under Code Sec. 2519 is equal to the value of the entire trust, less the value of the income interest relinquished. The income interest is treated as an ordinary transfer.[6] The combination of the two transfers results in a gift of all of the interests of the trust. No matter how derived, the net result of the disposition of all or a portion of the income interest will cause the full value of all of the assets of the QTIP trust to be treated as a gift by Caroline, the surviving spouse.

The Interrelationship Among Code Secs. 2036, 2044, and 2519

To understand and implement a Plan D approach, the interplay of several Code provisions needs to be considered. Code Sec. 2044 provides that the assets of a QTIP are required to be included in the gross estate of the surviving spouse at the value as of that spouse's date of death. The logic is intuitive: if a marital deduction is utilized to defer the estate tax with respect to the first spouse to die, the remaining assets should be included in the taxable estate of the surviving spouse in a manner identical to an outright transfer between spouses.

If a disposition pursuant to Code Sec. 2519 is invoked and the result is a deemed gift of the entire value of the QTIP trust, it seems unfair to include those assets in the estate of the surviving spouse. The taxable event occurred and a full "toll charge" was assessed as a result of the disposition and the application of Code Sec. 2519. Code Sec. 2044(b)(2) confirms this result.

It might appear that the disposition by Caroline of her income interest in the gap QTIP

trust, or in only a portion of it, would produce the desired result. Such a disposition is treated as a gift of the entire value of the gap trust and a transfer of Albert's full DSUE amount. No inclusion of the assets of the trust will occur as a result of the application of Code Sec. 2044. Thus, a trust for the benefit of the surviving spouse that originally provided for income and principal distributions to the surviving spouse would remain in place. However, since the income interest has been transferred by a gift, triggering Code Sec. 2519, what would remain in place would be the same trust with the right for the surviving spouse to receive discretionary principal distributions. This "principal-only" gap QTIP trust would not be included in the surviving spouse's estate – at least pursuant to Section 2044.[7]

All of the above would be achieved with a trust in place that could continue to provide principal distributions to Caroline. The advantages that this approach offers compared to the self-settled trust approach of Plan B can be substantial. The costs, complexity and risks of a self-settled trust might be avoided. Caroline could be an immediate and named principal beneficiary of the gap QTIP trust from inception and after the Code Sec. 2519 gift of the income interest. That might be more favorable in some respects than the manner in which certain practitioners might apply a self-settled trust option.

Unfortunately, although the assets of the trust may not be included pursuant to Code Sec. 2044, inclusion may occur pursuant to Code Sec. 2036. The barriers imposed by Code Sec. 2036 must also be overcome in order to render the Code Sec. 2519 Plan D successful.

Reg. §25.2519-1 indicates that Code Sec. 2036 may apply. In Reg. §25.2519-1(g), *Example 4*, the surviving spouse transferred a portion of the income interest, which, pursuant to the statute, forces all of the remainder interest to be treated as a gift. The *Example* states that the non-relinquished (retained) portion of the income is treated as a retained interest with respect to the same portion of the remainder interest that is deemed given. Accordingly, Code Sec. 2036 applies to that portion of the trust. However, there is no retained interest attributable to the portion over which the income is not retained. Therefore, if none of the income interest is retained, *i.e.*, if the entire income interest is transferred by the surviving spouse's gift, then Code Section 2036 should not apply. Unfortunately, there are additional hurdles addressed below.

Unstated in *Example 4* is whether or not the result would be different if the surviving spouse was the discretionary principal beneficiary of the QTIP trust. In that event, an argument could be made that the relinquishment of the income interest, when combined with a retained principal interest, causes Code Sec. 2036 to apply.

Reg. §25.2519-1(g), *Example 5*, implies a contrary and more favorable result. In *Example 5*, the surviving spouse is a discretionary beneficiary of the QTIP trust. Although the *Example* addresses prior principal distributions in a QTIP trust, for which a partial QTIP election was made and then followed by a partial disposition of the income interest, only the portion of the income interest, specifically the retained portion, is subject to Code Sec. 2036. By contrast, the existence of the discretionary principal distribution did not cause Code Sec. 2036 to apply to the portion of the income interest disposed. Accordingly, it would appear that the existence of discretionary distributions when coupled with a disposition of the entire income interest should not cause Code Sec. 2036 to apply.

For those not comfortable with the position espoused in *Example 5*, there could be a concern that the principal distributions available to the surviving spouse render the gap trust a "self-settled" trust. This means that the surviving spouse is effectively equivalent to the donor of the income interest while retaining an interest in the trust. To allay that concern, the gap trust could contain a provision that allows the situs of the trust to be changed to a state whose laws recognize self-settled trusts. Prior to the disposition of the income interest, the situs and governing law could be changed from the state of the decedent's domicile (where the gap trust presumably was formed) to that of a self-settled trust jurisdiction. The disposition would then occur at a point at which the trust could be a self-settled trust without jeopardizing the tax results. This approach might mitigate some of the concerns about possible estate inclusion of the post-gift, principal-only, gap QTIP trust under Code Sec. 2036.

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One situation that is not addressed in the Regulations is the surviving spouse serving as a trustee or co-trustee of the gap QTIP trust. If the surviving spouse was a trustee, it would appear that Code Sec. 2036 might be more readily advocated by the IRS. The surviving spouse would arguably, in her capacity as trustee, control the disposition of the principal of the gap trust. If the surviving spouse transfers an income interest in property while directly retaining, as a trustee, a discretionary interest in the principal in the identical property, Code Sec. 2036 might be more readily argued as applicable pursuant to the language of Code Sec. 2036(a)(2) – "alone or in conjunction with." The IRS might argue that Code Sec. 2036 is applicable in this setting even if the surviving spouse was only a co-trustee and has no control over the dispositions to himself or herself.

Accordingly, caution suggests that the surviving spouse not be a trustee of the gap trust. If he or she already possesses trustee or co-trustee status, he or she should consider resigning before the Code Sec. 2519 gift. After the resignation, and when a successor trustee is in place, the surviving spouse can then effectuate the disposition of the income interest in the gap trust in accordance with Plan D and Code Sec. 2519.

Another issue relates to the determination as to what is required to qualify as a disposition of the income interest in the gap trust. It is clear that the actual gift of the income interest to a third party, *e.g.*, children, grandchildren, or trusts for their benefit, would qualify as a disposition of the income interest under Code Sec. 2519. Since the trust provides for principal distributions to the surviving spouse, the gift of the income interest may not be problematic to some spouses. To others, it may not be acceptable.

A non-qualified disclaimer of the income interest should be treated as a disposition. IRS Letter Ruling 200022031[8] specifically treats a non-qualified disclaimer as a disposition. Other forms of dispositions that trigger Code Sec. 2519 may also be effective because the term "dispositions" is interpreted broadly under that section.

The surviving spouse should not use a qualified disclaimer of the income interest to accomplish the desired result. This is similar to the discussion related to Plan C. If Caroline executed a qualified disclaimer of the income interest in the gap trust, that would result in treating the funding of the gap trust as being effected by Albert, the first spouse to die. That would cause the gap trust to be ineligible for the state estate tax marital deduction and thereby in turn cause a state estate tax to be imposed in a decoupled jurisdiction with a lower exclusion amount, like New Jersey in the hypothetical example above.

Many wills and trust agreements include an anti-alienation clause. Depending on the language of that provision, it may arguably undermine a disposition of the income interest by the surviving spouse. Consideration could be given to modifying the standard spendthrift language to specifically permit the contemplated disposition of the income interest. If this is not done, it may be feasible to decant into a trust that has a more appropriately crafted provision, but that would add to the complexity of the transaction and may not be feasible depending on how state law views such a clause.

Accordingly, it would appear that if IRS Letter Ruling 201131011 does not prevent the election of the estate tax marital deduction in circumstances in which no federal estate tax is saved, the marital election applied to the gap trust should accomplish the following results:

- Assure that no federal or state estate tax is paid on the first death.
- The DSUE amount of the first spouse to die will pass to the surviving spouse, Caroline, in this example.
- The disposition of the income interest will trigger Code Sec. 2519 and cause a gift of the entire value of the gap QTIP trust, thereby using the DSUE amount of Albert, the first spouse to die.
- All of Caroline's BEA, as the surviving spouse, will remain intact.
- The gap trust, which is a QTIP trust, will not thereafter be includible in the estate of the surviving spouse pursuant to Code Sec. 2044, since the application of Code Sec. 2519 preempts the application of Code Sec. 2044.
- The plan, if properly structured and administered, should not cause Code Sec. 2036 to apply with respect to the surviving spouse provided that the surviving spouse disposes of all of the income interest, is not a trustee of the gap trust, and for those who question the

applicability of *Example 5* discussed above, the trust has a situs in a self-settled trust jurisdiction prior to the disposition of the income interest.

Plan E - Marital Trust Transfer and Use of General Power of Appointment to Make Gift of the DSUE Amount

Another approach can be used to accomplish similar planning objectives to those described in the preceding hypothetical plans. This approach, which uses a general power of appointment and is referred to as Plan E, endeavors to address some of the tax concerns of the preceding planning techniques. However, it should be remembered that every technique discussed has its own array of issues and complexities, and all discussions have assumed no state gift tax, which is not the case in Connecticut and Minnesota.

For those fearful that Rev. Proc. 2001-38 and IRS Letter Ruling 201131011 might prevent the estate tax marital deduction from being obtained with respect to the gap trust, the marital deduction could be secured using an alternative approach. Specifically, a marital deduction could be obtained by establishing a general power of appointment trust pursuant to Code Sec. 2056(b)(5). No election for the marital deduction is necessary (as it would be with a QTIP trust) as marital deduction treatment is automatic. The DSUE amount passes to the surviving spouse as if the assets were transferred outright. As more particularly addressed below, additional provisions will be necessary in order to successfully invoke this general power of appointment approach.

The general power of appointment trust provides part of the solution; it secures the estate tax marital deduction and achieves the transfer of the DSUE amount. However, it does not, without more, accomplish the goal of the gift that utilizes the recently acquired DSUE amount and the elimination of the trust assets from the reach of the decoupled state's estate tax. Also, more is needed to assure that the appreciation on trust assets is removed from both the federal and state estate tax.

If the general power of appointment is not exercised during the life of the surviving spouse, the assets of the gap trust will be included in the estate of the surviving spouse pursuant to Code Sec. 2041. If the power is exercised during the surviving spouse's lifetime, that exercise will be treated as a gift. The gift is treated as if the spouse owned the assets of the gap general power of appointment trust and then transferred those assets to the donee.[9] Since the relinquishment of the general power of appointment would simply leave the assets in the trust for the benefit of the surviving spouse, those assets would be included in the surviving spouse's estate under Code Sec. 2036.

One approach would be to provide the surviving spouse with the narrowest general power of appointment that could be affected during lifetime. That approach could be expanded to facilitate more advantageous planning by adding the right for the surviving spouse to appoint to a trust created for the benefit of the surviving spouse in a self-settled trust jurisdiction for which the surviving spouse does not possess a retained income interest and is not a trustee or co-trustee and over which the surviving spouse does not possess a power of appointment.

This is the same type of trust suggested if the gift of the property was first left outright to the surviving spouse pursuant to the self-settled trust version of Plan B.

The surviving spouse would then exercise the power of appointment in favor of the self-settled trust. Since the exercise is treated as a gift under Reg. §20.2041-3(d), that gift would be completed and escape estate taxation on the death of the surviving spouse. As stated above, the result should be identical to that achieved with the self-settled trust version of Plan B, subject to the same facts and circumstances scrutiny in connection with Code Sec. 2036.

Plan F – Marital Transfer and Hybrid of Plans D and E to Make Gift of DSUE Amount

If a practitioner is unsure whether Rev. Proc. 2001-38 and IRS Letter Ruling 201131011 could undermine the estate tax marital deduction and would prefer to utilize the general power of appointment trust only as a last resort, consider structuring the plan so that the gap trust is a QTIP trust and provide the surviving spouse with a general power of appointment and accompanying power to appoint to a self-settled trust described above only

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in the event_that the estate tax marital deduction is not available.

If the estate tax marital deduction as a QTIP election is honored, then the surviving spouse can invoke the Code Sec. 2519 gift approach described in Plan D. If not, the surviving spouse can exercise the general power of appointment in favor of the self-settled trust described in Plan E.

For those concerned that the surviving spouse might die prior to the determination of the acceptance or denial of the marital deduction as a QTIP election, consider the exercise of the general power of appointment before the determination. Since the power exists only in the event that the marital deduction as a QTIP election is not available, it will have no effect if a favorable QTIP marital deduction is achieved, but should be effective from the date of the exercise of the power if the QTIP marital deduction is denied.

Alternative Planning Suggestions in Light of Portability and Its Application

The "permanency" of portability and the manner in which it is applied as promulgated under Code Secs. 2010 and 2505 and the related temporary regulations, when coupled with planning in a decoupled state, require that consideration be given to more robust estate planning techniques that may lessen or eliminate state estate taxes for married couples with little or no negative effect on federal transfer tax consequences. In some instances, these more sophisticated approaches can produce a superior result at the federal level. These techniques will be applicable in states that do not impose a gift tax (all but Connecticut and Minnesota), and that calculate the estate tax based on the application of the now defunct state death tax credit. However, even in the two states that impose a gift tax, Minnesota and Connecticut, these planning concepts may be applied in some fashion.

Endeavoring to Develop Default Rules for Planning Post-ATRA

While there is clearly a myriad of possible planning scenarios and outcomes, each of which could influence the determination of the recommended planning approach, having a framework to guide practitioners, and perhaps several general default provisions, will make planning easier and more efficient. The following guidelines might be useful:

- Overarching considerations as to asset title dictate planning decisions. Until the permanence of portability, a standard planning recommendation was to divide assets approximately equally between spouses to facilitate funding a bypass trust on the first death. Clients had to weigh the benefits of retaining existing asset ownership arrangements or sacrificing estate tax planning benefits. Now, if the clients have an overarching personal reason not to change the title to assets, portability could mitigate the need to change. For example, if one spouse is a physician worried about potential malpractice claims, and the other spouse is unconcerned about such liability issues, retaining assets in that lower-risk spouse's name (rather than dividing ownership), may provide an alternate plan to rely on portability without funding a bypass trust if the physician-spouse dies first. Similarly, in a new marriage or second marriage where one spouse holds pre-marital assets, then perhaps reliance on portability rather than re-titling assets, may be a preferable approach.
- Using disclaimer bypass trusts. If a mandatory testamentary bypass trust is not acceptable to the family, consider including a bypass trust funded by a disclaimer in the clients' wills (or revocable living trusts). Retaining the flexibility of a disclaimer bypass trust might make sense because the flexibility that this will afford to recast the plan if circumstances or laws change prior to the first death can be invaluable. Incorporating a bypass trust funded by disclaimed assets can be a relatively ubiquitous clause that should not add appreciably to the cost of the documents. Finally, since the client has unfettered control over whether to exercise the disclaimer in the future, any concerns about perceived complexity can be addressed at the first death.
- Funding an inter vivos spousal lifetime access trust (SLAT). If the client's estate is sufficiently large (even if well below the federal exclusion levels), or if the client faces liability exposure that is significant, funding an inter

vivos bypass trust (other than in Connecticut/Minnesota, and in those states up to their exclusion amounts) may provide substantial current asset protection benefits, safeguard assets in the event of elder financial abuse and similar problems, and save greater state estate tax than a bypass trust funded to the state exclusion amount will permit at death. The lifetime SLAT approach may prove especially useful for growing assets outside the reach of a state estate tax in a state with a gift tax.

- Incorporating more flexible bypass trusts. Review with the client the possibility of including more flexible options in the governing instrument, such as the possible use of a "Clayton-QTIP" trust provision, the power to distribute substantially appreciated assets, the right to make charitable gifts from the bypass trust, inclusion of all heirs as beneficiaries with a sprinkle or spray power, the ability to have capital gains designated as included in "fiduciary accounting income" (not allocated to corpus), and perhaps other options. Flexibility in planning, drafting and implementation can provide options to mitigate the tax basis and state estate tax. Based on the preceding discussions, wills for clients who may be domiciled in, or own property in, decoupled states might include a state exclusion trust, which is a gap trust for the amount in excess of the state exclusion and up to the federal exclusion, and a marital trust for the excess over the gap trust. The gap trust might include a range of powers and modified spendthrift clause in order to create the flexibility necessary to take advantage of some of the planning options discussed above. For example, the gap trust might be structured as a QTIP trust with a standby general power of appointment if the QTIP will not qualify for the state estate tax marital deduction, and the spendthrift language in the trust might be modified.

The Likelihood of Appreciation Inside a Bypass Trust Generating Tax Detriment

While there are a myriad of factors to evaluate, in some instances, this decision may not be complex. The greater the likelihood of the loss of basis step-up on the second death the more important to use any one or more of the mitigation techniques discussed in an earlier article in this series. Whatever type of bypass trust might be utilized, careful post-funding management of the trust can reduce, or obviate, the basis and other tax issues.

Conclusion

Estate planning to reduce state estate taxes and/or state inheritance taxes will remain a concern for many clients. The challenges of coordinating state tax minimization, with maximizing basis step-up, preserving favorable trust benefits, and other goals will remain daunting. No good deed goes unpunished, the advent of the portability of the federal estate tax exclusion amount, together with increased income tax considerations, has raised the complexity of estate tax planning in decoupled states to a new level.

ENDNOTES

[1] See *Estate Planning in a Decoupled State Post-ATRA for Married Clients Under the Federal Exclusion Amount: Part 5-- Alternative Planning Approaches Based on Outright Marital Bequests.*

[2] 2001-1 CB 1335.

[3] August 5, 2011.

[4] *Estate Planning in a Decoupled State Post-ATRA for Married Clients Under the Federal Exclusion Amount: Part 3--State Bypass and QTIP Trusts.*

[5] *Estate Planning in a Decoupled State Post-ATRA for Married Clients Under the Federal Exclusion Amount: Part 5-- Alternative Planning Approaches Based on Outright Marital Bequests.*

[6] Code Sec. 2511

[7] Code Sec. 2044(b)(2)

[8] March 3, 2000.

[9] Reg. §§20.2041-1 and 20.2041-3

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