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Exemption Portability May Be a Remedy for Decoupling Problem

Portability can ease an estate planning concern for married couples whose state and federal estate tax exemptions differ, reducing the reliance on Rev. Proc. 2001-38 as a solution.

MITCHELL M. GANS AND JONATHAN G. BLATTMACHR, ATTORNEYS

With the increase of the federal estate tax exemption and the phase out of the state death credit (which most states took as their estate tax) effected by provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("2001 Tax Act"), the death tax systems of several states became "decoupled" from the federal estate tax system. That has caused problems for many married persons residing in or owning property in these decoupled states. Under current federal legislation, these problems are scheduled to end at the beginning of next year because all of the estate tax changes made by 2001 Tax Act and the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "2010 Tax Act") then terminate—including having the federal estate tax exemption drop back to $1 million and the state death tax credit restored. Yet, the problems are present for those who die before this year's end. Also, some disparity between the estate tax exemptions permitted by federal and state law seems likely to continue, especially in light of President Obama's proposal for a $3.5 million estate tax exemption.

Although prior articles in this publication[1] have pointed out that Rev. Proc. 2001-38[2] appears to provide married people in such states with a solution to these problems, "portability" of the unused exemption of the spouse dying first (enacted as part of the 2010 Tax Act) may provide another one. Therefore, even without regard to the Revenue Procedure, overfunding the marital bequest, to avoid a state death tax in a decoupled state, is no longer terribly problematic under a portability regime. If, for example, a QTIP marital deduction election is made with respect to a trust and the election results in overfunding the marital deduction (in that less than the fully allowable federal estate tax exemption is used in the estate of the first spouse to die), the effect is to increase the exemption that is ported over to the surviving spouse.

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Background

Certain of the federal estate tax changes made in the 2001 Tax Act caused a lack of parallelism between the federal estate tax exemption and the estate tax exemption of several states. That law increased the federal exemption over time to $3.5 million while exemptions allowed under some states remained at $1 million or became less the federal exemption.[3] The difference in exemptions could place a married person who was

domiciled in a state that had a different estate tax exemption from the federal exemption (a "decoupled" state) and did not permit a separate QTIP election (Section 2056(b)(7) permits a marital deduction for property placed in a QTIP trust) on the horns of a dilemma:

- If the estate of the spouse dying first used the fully available federal estate tax exemption, which was greater than the state exemption, by conveying the entire federal exemption amount to a credit shelter trust (discussed below), state death tax would be payable when that spouse died.
- If instead the estate of the spouse dying first used only that portion of the federal exemption that equaled the lower state death tax exemption (i.e., conveying only the lower state exemption amount to a credit shelter trust), no state (or federal) estate tax would be due when that first spouse died; but more would be included in the gross estate for federal (and possibly state) death tax purposes of the surviving spouse than if the fully available federal exemption had been placed in the credit shelter trust.

Rev. Proc. 2001-38, published guidance issued by the IRS, seems to enable such a married couple to deal effectively with this dilemma. Currently, on account of the enactment of the 2010 Tax Act, the difference in the exemptions is even greater: $5.12 million for the federal exemption but still only $1 million in, for example, New York (in some states, the disparity is even greater). While this greater difference could exacerbate the dilemma, the 2010 Tax Act also created a new concept, called "portability," that may also be used to eliminate or minimize the problem of disparity in the federal and state exemptions.[4]

Typical division of the estate of the first spouse to die. Since the adoption of the "unlimited" marital deduction in 1981 legislation, it has been common practice for a married person to direct that, if his or her spouse survives, the estate be divided into two components or parts. One component is made equal to the estate tax exemption. That part is exempted from estate tax when that spouse dies on account of the unified or applicable estate tax credit defined in Section 2010. That part may be placed into a credit shelter trust, with the surviving spouse as a beneficiary; if properly designed, it will not be included in the gross estate of the survivor. The trust is commonly referred to as a "credit shelter trust" because it is protected from tax by reason of the unified credit; it may also be referred to as an "estate tax exemption trust" (because it is protected from tax by reason of the translated estate tax exemption), or a "bypass trust" (because it "passes by" the estate of the surviving spouse for estate tax purposes).

The second component usually passes to the surviving spouse outright or to a marital deduction trust for the surviving spouse; the second component does not generate tax when the first spouse dies by reason of the marital deduction.[5] The property that passes to or in trust for the surviving spouse under the protection of the estate tax marital deduction is included in the gross estate of the survivor (unless consumed, given away, or dissipated before the survivor dies).[6]

Dilemma for those in decoupled states. If an amount equal to the federal estate exemption is transferred in a form that does not qualify for the estate tax marital deduction, then "unnecessary" state estate tax may have to be paid when the first spouse dies in decoupled states. For example, if a New Yorker dies this year with an estate of $5.12 million and without having used any portion of his or her federal estate tax exemption before death and the entire federal exemption amount is placed into a credit shelter trust, no federal estate tax would be due, but New York estate tax would be payable.[7] If, however, the amount conveyed to the credit shelter trust

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1 See Gans and. Blattmachr, "Quadpartite Will: Decoupling and the Next Generation of Instruments," 32 Estate Planning 3 (April 2005); and Gans and Blattmachr, "Quadpartite Will Redux: Coping With the Effects of Decoupling," 32 Estate Planning 15 (October 2005).

2 2001-1 CB 1335.

3 For a complete list of the state death tax rules, see the McGuire Woods State Death Tax Chart (revised 5/7/2012) which can be accessed at http://www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf.

4 See note 3, *supra*.

5 See Section 2056(a).

6 See discussion in Estate of Turner, 138 TC No. 14 (2012), in which the Tax Court refused to change its conclusions made in Estate of Turner, TCM 2011-209. In some cases, this second part of the estate is also divided by directing an amount equal to the otherwise unused generation-skipping transfer (GST) exemption under Section 2031 of the first spouse to die to pass into a separate qualified terminable interest property (QTIP) trust described in Section 2056(b)(7), sometimes called the "reverse QTIP trust." A QTIP trust qualifies for the estate tax marital deduction only by affirmative election by the estate of the spouse dying first.

7 The calculation of the New York estate tax requires a double computation. For a description, see Radigan and Radigan, "Analyzing New York Estate Tax Law as Federal Proposals Loom," N.Y. Law J., 5/14/2012.

8 See note 3, *supra*.

9 Under Section 2044, any property in a QTIP trust that has qualified for the gift or estate tax marital deduction for the spouse of the person creating the trust is included in that spouse's gross estate at death.

10 As detailed in the articles referred to in note 1, *supra*, the Excess Exemption QTIP Trust is a separate trust equal to the amount by which the larger of the state death tax exemption and the federal estate tax exemption exceeds the smaller of the two exemptions.

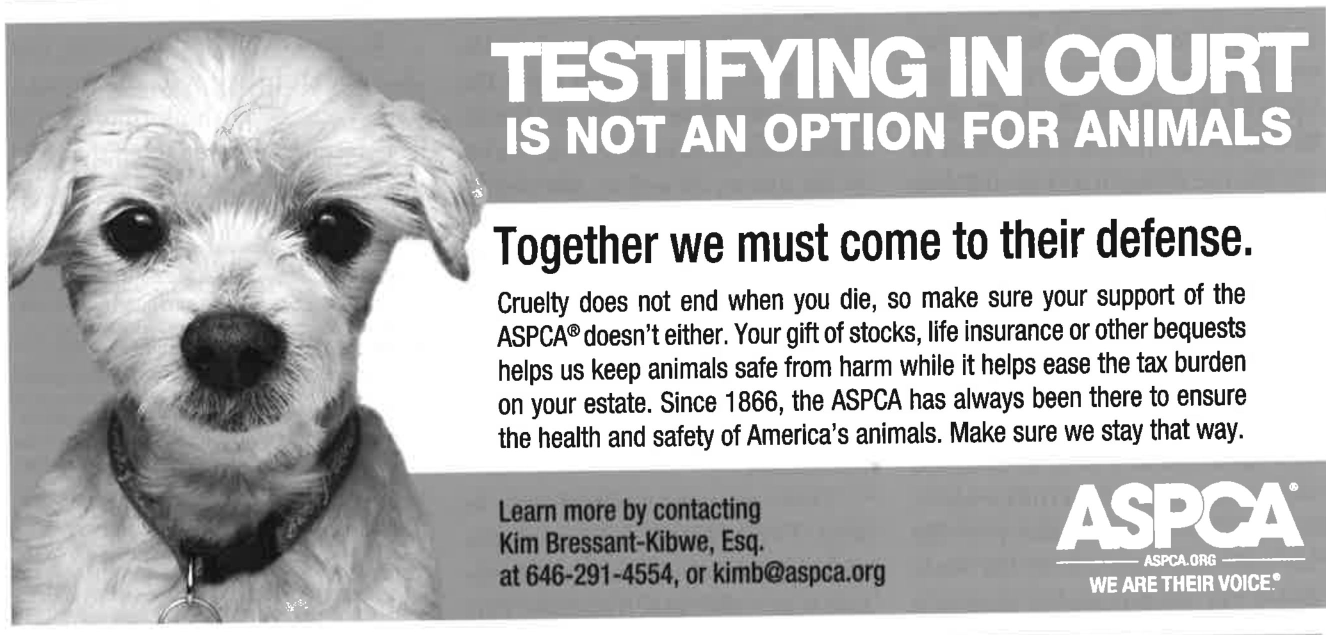
11 As explained in Gans and Blattmachr, "Quadpartite Will: Decoupling and the Next Generation of Instruments," note 1, *supra*, the Revenue Procedure has requirements that must be met in order to reverse the QTIP election made in the estate of the spouse dying first.

were limited to $1 million (i.e., the amount of the New York estate tax exemption), neither federal nor New York estate tax would be due at the first spouse's death. However, $4.12 million of the exemption of the spouse dying first would be wasted: whereas $5.12 million could have been placed in the credit shelter trust without causing any federal tax in the first spouse's estate and none of the assets in the trust would be taxable at the surviving spouse's death, placing only $1 million in the credit shelter trust results in $4.12 million being taxable at the surviving spouse's death.

In effect, placing only $1 million in the credit shelter trust eliminates the state estate tax at the first spouse's death but at a cost: An additional $4.12 million must now be included in the surviving spouse's gross estate (with any appreciation or depreciation in the assets up to the death of the surviving spouse being taken into account). If, in this example, the extra $4.12 million were placed in a QTIP trust, the same results would obtain as long as the state did not permit a state-only QTIP election.[8] In other words, in the absence of a state-only QTIP election, decoupling means either state death tax payable when the first spouse dies or more federal (and possibly state) death tax when the surviving spouse dies. (If the state permitted a state-only QTIP election, assets conveyed to the credit shelter trust could, if the trust were drafted in the form of a trust described in Section 2056(b)(7), qualify for the marital deduction for state purposes and thereby eliminate the state estate tax; at the same time, the assets in the credit shelter trust, assuming no federal QTIP election, would be excluded from the surviving spouse's gross estate for federal estate tax purposes).

Revenue Procedure to the rescue. In Rev. Proc. 2001-38, the IRS ruled that, for purposes of applying Section 2044[9] in the surviving spouse's estate, any QTIP election made in the estate of the first spouse to die that was unnecessary to eliminate the federal estate tax can be "undone" or "reversed." For example, if the first spouse died in 2012 with an estate of $5.12 million and placed the entire amount into a QTIP trust and the QTIP election were made, relief could be sought under this Revenue Procedure in order to eliminate the application of Section 2044 in the surviving spouse's estate—in other words, to eliminate the inclusion of the assets in this trust in the surviving spouse's estate because the QTIP election was unnecessary in the first spouse's estate.

Thus, if the spouse dying first directed the amount by which his or her federal estate tax exemption exceeded the state exemption to pass into a separate QTIP trust (called an "excess exemption QTIP trust")[10] and the executor made the QTIP election on the federal return, it would also qualify for the New York estate tax purposes. In that case, neither federal nor New York estate tax would be due on the death of the first spouse to die. Although that would seem to cause the excess federal exemption to be included in the gross estate of the surviving spouse under Section 2044, the Revenue Procedure, as indicated, allows a reversal of the QTIP election made in the estate of the spouse dying first so that no part of the Excess Exemption QTIP Trust would be included in the gross estate of the surviving spouse either for federal or state estate tax purposes.[11]



If this planning structure is used, the Excess Exemption QTIP Trust is treated as a credit shelter trust for federal and state purposes: All appreciation accruing in the trust's assets until the death of the surviving spouse is excluded from the surviving spouse's estate. At the same time, because of the QTIP election at the death of the first spouse, the assets conveyed to the trust qualify for the marital deduction, eliminating state, as well as federal, estate tax at the death of the first spouse. And this result obtains even in a state like New York, where the QTIP election is respected for state purposes only if made on the federal return. In short, this structure makes it possible to negate the effects of a state rule that denies the marital deduction for a QTIP in the absence of a federal election.

Now portability has entered the picture

As mentioned above, the 2010 Tax Act, in addition to increasing the federal exemption to $5.12 million for this year, also created a "portability" system under which the surviving spouse may "inherit" any unused estate tax exemption of the first spouse to die. In order to qualify for portability, an affirmative election is required to be made on the U.S. estate tax return of the spouse dying first. If this election is made, the unused exemption of the spouse dying first is ported over to the surviving spouse, making it available to the surviving spouse not only for estate tax purposes but also for gift tax purposes.[12]

Portability provides another way to avoid the horns of the dilemma discussed above. A married domiciliary of a decoupled state that does not permit a state-only QTIP election may provide for only the amount of the state death tax exemption to pass to a credit shelter trust.[13] For example, a married New Yorker with an estate of $5.12 million provides for only $1 million to be conveyed to a credit shelter trust and for the balance to pass to the spouse. As mentioned above, in such a case, no state or federal estate tax will be due at the first spouse's death. However, the entire $4.12 million will be included (plus growth or minus any decline in value) in the gross estate of the surviving spouse. Also, the survivor will inherit, under portability, the unused federal estate tax exemption amount of $4.12 million.

Overfunding the marital bequest, to avoid a state death tax in a decoupled state, is no longer terribly problematic under a portability regime.

Portability is not the same as a credit shelter trust. It is important to note that portability does not produce the same results that flow from using a credit shelter trust. First, where a credit shelter trust is used, the entire amount placed in trust would be excluded from the gross estate of the surviving spouse. Thus, all appreciation in the value of the assets, as well as any depreciation, is not taken into account in the surviving spouse's estate. Under portability, this is not true. Thus, if there is appreciation in the value of the assets qualifying for the marital deduction, a credit shelter trust will produce better results than portability.

There are other differences, as well. For example, although the unused federal estate tax exemption is portable and, therefore, may be inherited by the surviving spouse, the unused GST exemption of the first spouse to die is not. Because, in many cases, what would be the unused GST exemption is allocated to the credit shelter trust, it is not likely that all of the GST exemption of the spouse dying first will be used if the credit shelter trust amount is limited to the state estate tax exemption amount. Also, the basis for income tax purposes of the assets after the death of the surviving spouse is different depending on whether a credit shelter trust is used. (Under portability, basis is adjusted under Section 1014 with respect to assets owned by the surviving spouse at the time of death, whereas no such adjustment is permitted with respect to assets in a credit shelter trust.)

The end of portability? Of course, under the 2010 Tax Act, the federal estate tax exemption is scheduled to return to $1 million at the end of this year, making it the same as the exemption of New York and certain other states. More important, perhaps, is that the state death tax credit allowed under Section 2011 would be restored and virtually all states take that amount as their state death tax.[14]

Moreover, under the 2010 Tax Act, portability will disappear. However, many think that federal legislation will be enacted that will increase the federal exemption to

[12] See, generally, Blattmachr, Gans, Zaritsky, and Zeydel, "Estate Planning After the 2010 Tax Relief Act: Big Changes, But Still No Certainty," 114 J. Tax'n 68 (February 2011).

[13] As explained in Gans and Blattmachr, "Quadpartite Will Redux: Coping With the Effects of Decoupling," note 1, *supra*, it might be possible in some states for the state death tax exemption to be larger than the available federal exemption.

[14] All state death tax systems had provided, before the enactment of the 2001 Tax Act, for their estate tax to be equal to the maximum credit allowed under Section 2011, although a few states had exceptions in some cases. See note 3, *supra*.

at least $3.5 million, make portability permanent, and permanently eliminate the state death tax credit. Indeed, President Obama's proposals call for such an approach.[15] That suggests practitioners in states with a disparity between the federal and state estate tax exemptions probably should continue to plan for some disparity to remain in effect. If the estate plan is structured to include an Excess Exemption QTIP Trust, those administering the estate will have two options:

1. Rely on Rev. Proc. 2001-38.
2. Rely on portability.

Structuring the estate plan to include an Excess Exemption QTIP Trust seems to make both options available by electing for that trust to qualify for the marital deduction and then (1) invoking Rev. Proc. 2001-38, if appropriate, when the surviving spouse dies or (2) using portability to capture for the use of the surviving spouse the unused federal estate tax exemption of the spouse dying first. Under either option, no state tax will be due at the death of the first spouse even if the state will only respect the QTIP election if made on the federal estate tax return.

Double tax benefit? In fact, it would seem that the taxpayers could capture both benefits: the inheritance of the unused federal estate tax exemption and the ability of the surviving spouse's estate to invoke Rev. Proc. 2001-38 and thereby be able to exclude the assets in the Excess Exemption QTIP Trust from the survivor's gross estate. Hence, there would a double estate tax benefit by structuring the estate plan of the first spouse to die to have an Excess Exemption QTIP Trust. However, it is likely, if not certain, that the IRS will rule either that (1) the Revenue Procedure may not be used if portability has been elected or (2) the "inheritance" of the exemption will be disallowed if the Revenue Procedure is invoked. Of course, if the surviving spouse used the inherited exemption during lifetime, its use could not be effectively disallowed at the survivor's death unless there was a "recapture" for estate tax purposes of the exemption so used during lifetime.

In the absence of a state-only QTIP election, decoupling means either state death tax payable when the first spouse dies or more federal death tax when the surviving spouse dies.

At a minimum, it seems that the IRS will simply deny the use of the Revenue Procedure if portability has been applied during life. After all, a change in the portability rules may require congressional action; the Revenue Procedure can be revoked or modified by the IRS itself.

Is portability preferable? As a practical matter, it seems practitioners will rely on portability, if made permanent, instead of relying exclusively on Rev. Proc. 2001-38. As mentioned above, portability applies only if an affirmative election is made on the U.S. estate tax return of the spouse first to die. Because the provisions of the Revenue Procedure might be changed at any time by the IRS, the safer route may prove to be portability.

How does the Revenue Procedure produce a better outcome? As indicated, the Excess Exemption QTIP Trust creates an effect very similar to using a credit shelter trust (assuming relief is obtained under the Revenue Procedure). Thus, as explained, if assets appreciate during the lifetime of the surviving spouse, it produces a better outcome than portability. The opportunity it creates to exclude such appreciation suggests that this type of trust be included in the estate plan where the state, like New York, will not recognize a state-only QTIP election. Simply put, in a state like New York, whether the Revenue Procedure approach or portability is used will make no difference at the death of the first spouse. In either case, no state tax will be due at that time. But, as suggested, the Revenue Procedure approach offers the potential to exclude appreciation from the survivor's estate, whereas portability does not offer this opportunity.

New York State position. Another interesting point relates to a rule developed by the New York State Tax Commission. Although New York law suggests that a QTIP trust will qualify for the New York marital deduction only if an election was made pursuant to Section 2057(b)(7) to have it qualify for the federal estate tax marital deduction, the State Tax Commission has ruled that a separate QTIP election may be made for New York estate tax purposes if the decedent's estate was not required to file a U.S. estate tax return (such as where a decedent died in 2010 and his or her estate elected out of the federal estate tax regime or the estate falls under the filing threshold for filing a return under Section 6018).[16] Nonetheless, it has also ruled that

[15] See, generally, Blattmachr, Graham, and Blattmachr, "A Look at the Obama Estate Tax Proposals: What They Mean for Planners and Clients," Alaska Trust Company Newsletter (March 2012).

[16] See TSB-M-11(9)M.

if the estate files a U.S. estate tax return, even if only to elect portability, no separate New York QTIP election will be permitted.[17]

Although it might seem that this again puts the estate of a New York married person on the horns of a dilemma, there does not seem to be a problem: The married New Yorker's U.S. estate tax return would contain a federal QTIP election, thereby eliminating the New York estate tax, as well as a portability election. Hence, no estate tax would be due for either federal or New York purposes, and the unused federal exemption would be inherited for use by the surviving spouse. However, although portability tends to protect the estate of the surviving spouse from additional federal estate tax on the federal estate tax exemption not used by the first spouse to die, it does not protect that amount from New York estate tax when the survivor dies (assuming the estate of the surviving spouse is subject to New York estate tax when he or she later dies).

In contrast, it seems that invoking Rev. Proc. 2001-38 does protect it from New York estate tax on the unused federal estate tax exemption of the spouse dying first. The Revenue Procedure prevents the property with respect to which the Revenue Procedure applies from being included in the gross estate of the surviving spouse for federal estate tax purposes. Only property included in a decedent's gross estate for federal estate tax purposes may be subjected to New York estate tax.[18]

Portability may end soon. Of course, for married persons domiciled in a decoupled state who die this year, there is no assurance that portability will continue. After all, under current legislation, it disappears at the end of this year. So what should a practitioner do in light of this uncertainty? The estate plan of a married person domiciled in a decoupled state should provide for the creation of an Excess Exemption QTIP Trust. This creates maximum flexibility.

It seems likely that, in most cases, the estate of the first spouse to die will elect for it to qualify for the federal estate tax marital deduction (or elect for it to qualify for state death tax purposes if the state permits a state-only QTIP). If portability has been made permanent, the estate also can elect for it to apply—the QTIP election has the effect of porting over, by affirmative election, the federal estate tax exemption amount not used by making that amount qualify for the marital deduction. If portability has not been made permanent, the estate of the surviving spouse can reverse the QTIP election with respect to the Excess Exemption QTIP Trust created by the first spouse to die by invoking Rev. Prov. 2001-38, thereby retroactively using the federal estate tax exemption of the spouse dying first.

More on portability vs. Rev. Proc. 2001-38. If both portability and Rev. Proc. 2001-38 are available, at least two additional considerations need to be taken into account. The first is that, under the Revenue Procedure, all appreciation occurring in the trust's assets held in the Excess Exemption QTIP Trust after the death of the first spouse to die and up to the death of the survivor would be excluded from the gross estate of the survivor. In contrast, in the case of portability, all such appreciation would be taxable in the survivor's gross estate.

The second is that, in the case of portability, the property inherited by the surviving spouse will receive an automatic change in income tax basis pursuant to Section 1014. On the other hand, if the Revenue Procedure is invoked, the basis of that property will not be adjusted at the survivor's death as it will not be included in the survivor's gross estate.

Conclusion

The disparity in the state and federal estate tax exemptions for those married persons who are domiciled in decoupled states has been aggravated by the 2010 Tax Act, which increased the federal estate tax exemption to $5.12 million for this year. Married persons in such a state face a Morton's fork[19]: Pay more state death tax when the first spouse dies or pay more federal (and, perhaps, state) estate tax when the survivor dies. Those who live in a state that permits a state-only QTIP trust can avoid that problem by creating a trust described in Section 2056(b)(7) equal to the amount by which the federal exemption exceeds the state exemption (an Excess Exemption QTIP Trust) and making a QTIP election to qualify the trust for the marital deduction only for state death tax purposes.

For those living in a decoupled state that does not permit a state-only QTIP election, using Rev. Proc. 2001-38 seems a way to avoid the problem. Now with portability there is another choice: Make the QTIP election for federal (as well as state) estate tax purposes but also elect for the unused federal exemption to be ported over to the surviving spouse.

Whether invoking the Revenue Procedure or using portability is better may be a difficult decision. However, the key to ensuring maximum flexibility for a married person domiciled in a decoupled state is to ensure the estate plan includes the creation of an Excess Exemption QTIP Trust. ■

[17] *Id.*

[18] See New York Tax Law § 954.

[19] Some might refer to it as a "Hobson's choice" but as explained in en.wikipedia.org/wiki/Hobson's_choice it is more properly viewed as a Morton's fork.