2005

Quadpartite Will Redux: Coping With the Effects of Decoupling

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The disparity between federal and state death tax exemptions presents additional challenges in planning for married persons. The authors suggest sample language that will be appropriate even if the state exemption exceeds the federal exemption.

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"Quadpartite Will: Decoupling and the Next Generation of Instruments," published in the April 2005 issue of ESTATE PLANNING,[1] suggested new will and revocable trust drafting techniques for married persons domiciled in "decoupled" states. In this context, the word "decoupled" refers to a state with a death tax exemption which is different from the federal estate tax exemption. The assumption for the April article was that the state death tax exemption would be smaller than the federal exemption.

Married taxpayers in decoupled states (with a smaller state exemption) face a dilemma in implementing a traditionally "optimal" estate plan—one that would fully use the federal estate tax exemption equivalent ("estate tax exemption") of the first spouse to die (i.e., "the first decedent") and leave the balance of the first decedent's estate in a manner qualifying for the federal estate tax marital deduction. Traditionally, such a structure has been used to fully postpone federal estate tax until the death of the surviving spouse.

In a decoupled state with a smaller exemption, full use of the federal estate tax exemption in the first decedent's estate will result in state death tax being due upon the first decedent's death (a result of the smaller state exemption). Conversely, if use of the federal estate tax exemption is limited in the first decedent's estate to the (smaller) state exemption, then more federal (if not state) estate tax will likely be due upon the death of the surviving spouse. Limiting use of the exemption in the first estate will increase the federal estate tax marital deduction for that decedent, and property qualifying for a marital deduction in the first decedent's estate will usually be included in the federal taxable estate of the surviving spouse.

The April article suggested creating a separate trust (called an "Excess Exemption QTIP Trust") that could qualify (by election) for the federal estate tax marital deduction as qualified terminable interest property ("QTIP") under IRC Section 2056(b)(7). Property passing to the Excess Exemption QTIP Trust would have a value equal to the amount by which the federal estate tax exemption exceeded the state death tax exemption.

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For states (such as Rhode Island) that permit an independent marital deduction election for state purposes, without regard to whether a federal marital deduction election has been made, the separate state election would be made for the Excess Exemption QTIP Trust. For other states (such as New York) that do not permit a state-only QTIP election, it was recommended that the first decedent's estate elect QTIP treatment for the Excess Exemption QTIP Trust for both federal and state death tax purposes, but have the estate of the surviving spouse seek relief from that election under Rev. Proc. 2001-38.[2] That Revenue Procedure appears to permit the estate of the surviving spouse to have the QTIP election made in the estate of the first decedent "undone" so that the Excess Exemption QTIP Trust would not be included in the estate of the surviving spouse. The April article included sample language for wills and revocable trusts to implement either strategy.

Further refinement for a very few states

The earlier article was based on the fact that, in most states which have a death tax exemption different from the federal estate tax exemption, the federal estate tax exemption is larger than the state death tax exemption. That disparity will grow as the federal exemption increases from $1.5 million this year to $2 million beginning in 2006 and then to $3.5 million for 2009. Although the federal exemption is scheduled to drop back to $1 million beginning in 2011, it will still exceed the exemption then scheduled to be permitted in some states. (There is no federal estate tax for those who die in 2010.)

However, in some states the opposite can occur: the state exemption can exceed the federal exemption. That would be the case in Connecticut, for example, where recent legislation establishes a state death tax exemption of $2 million.[3]

Another more common situation in which the state death tax exemption will be larger than the federal estate tax exemption occurs where the taxpayer makes lifetime gifts using the federal gift tax exemption.[4] For example, assume a married Tennessean made a taxable gift of $1 million in 2004, using up her entire federal gift tax exemption. The resulting adjusted taxable gift means that if she were to die in 2005, a credit-shelter bequest in excess of $500,000 would produce a federal estate tax.[5] In effect, the 2004 gift reduced her remaining federal exemption to $500,000. Yet her available state death tax exemption will be $950,000.[6] (Tennessee does not impose any gift tax; lifetime transfers do not have any effect on the amount of the optimal credit-shelter bequest in terms of the state tax.)

Instruments should be drafted using a formula that will 'work' regardless of which exemption is larger (or if they are the same).

No federal estate tax or state death tax will be due if our married donor is the first decedent and the credit-shelter bequest is limited to the effectively available federal exemption ($500,000). Moreover, no "unnecessary" federal estate tax will be due when the surviving spouse dies on account of "overuse" of the federal estate tax marital deduction (the federal estate tax marital deduction having been limited to the minimum amount necessary to reduce to the federal estate tax to zero). But when the surviving spouse dies, state death tax may be due on account of the "extra" use of the marital deduction in terms of the state death tax (the marital deduction having been in excess of the amount necessary to eliminate the state estate tax).

Applying numbers to the above example, assume that the wife dies in 2005, dividing her $4 million estate (after debts and expenses) into a marital portion and a credit-shelter portion based on a formula clause that is geared to her federal estate tax profile. The marital bequest would equal $3,500,000, and the credit-shelter bequest would equal the balance of $500,000.

However, her $4 million estate only needs a marital deduction equal to $3,050,000 in order to reduce her Tennessee estate tax to zero. Assuming her husband remains a Tennessean until his death, his Tennessee taxable estate likely will be larger than if the marital deduction had been so limited for state purposes. However, if only a $3,050,000 marital deduction were used for both state and federal purposes, federal estate tax would be due when the first spouse died because, as stated, the available federal exemption was only $500,000.

This "overuse" of the marital deduction for state purposes may be easily cured in those states that

[1] See Gans and Blattmachr, "Quadpartite Will: Decoupling and the Next Generation of Instruments," 32 ETPL 3 (Apr. 2005).

[2] 2001-1 CB 1335.

[3] Public Act 05-251, House Bill 6940.

[4] See Sections 2505 and 2010 (providing the federal unified credit for federal gift and estate tax purposes, respectively).

[5] As discussed in the April article, other factors (such as taxable gifts in excess of the federal gift tax exemption or use of the "old" lifetime gift tax exemption with respect to gifts made between 9/8/76 and 12/31/76) also may reduce the amount of allowable federal estate tax exemption equivalent.

permit an independent QTIP election (i.e., an election for state purposes that does not mirror the federal election). In such a state, the executor would make a federal but not state QTIP election for a separate Excess Exemption QTIP Trust.

That strategy will not work, however, in those states (such as New York) that do not permit an independent QTIP election.[7] In those states, the federal QTIP election is binding for state purposes as well.

Uncertain which exemption will be larger?

Unless the state and federal exemption amounts are equal and the estate tax effect of lifetime gifts is the same for federal and state purposes, difficulties will arise in determining the optimal marital and credit-shelter bequests. In most instances, it will not be possible to determine with any certainty whether the remaining federal exemption or the state exemption will be larger.

To deal effectively with this uncertainty, instruments should be drafted using a formula that will "work" regardless of which exemption is larger (or if they are the same). The following language, which creates an optimal Excess Exemption QTIP Trust, is offered to achieve that result:

Sample Disposition[8]

If my Wife survives me, I give a sum equal to my *Excess Exemption QTIP Gift* to the Trustee of the Marital Trust under this Will, to be disposed of under the terms of that trust and to be held as a separate trust. This separate trust shall be called the Excess Exemption QTIP Trust.

Accompanying Definitions

My "Excess Exemption QTIP Gift" means the amount, if any, by which what my Optimum Marital Deduction Gift would have been if that term meant the greater of (a) the minimum amount necessary as the federal estate tax marital deduction in my estate to reduce the federal estate tax due by reason of my death to the lowest possible amount (determined without regard to the Excess Exemption QTIP Gift) and (b) the minimum amount necessary as the marital deduction in my estate under the death tax laws of the state of my domicile to reduce such state death taxes due by reason of my death to the lowest possible amount (determined without regard to the Excess Exemption QTIP Gift), exceeds my Optimum Marital Deduction, calculated as provided below.

My "Optimum Marital Deduction" means the lesser of (a) the minimum amount necessary as the federal estate tax marital deduction in my estate to reduce the federal estate tax due by reason of my death to the lowest possible amount (determined without regard to the Excess Exemption QTIP Gift) and (b) the minimum amount necessary as the marital deduction in my estate under the death tax laws of the state of my domicile to reduce such state death tax due by reason of my death to the lowest possible amount (determined without regard to the Excess Exemption QTIP Gift).

Using the above formula requires an independent state QTIP election if the state exemption is larger than the federal exemption. Accordingly, if it is certain that the taxpayer will die domiciled in a state that does not permit an independent QTIP election, then the foregoing sample language need not be included in the instrument. Rather, the simpler language suggested in the April article may be used. But it seems that there is "no harm" in using the more complicated language. Additionally, because an independent QTIP election could become available in the future (through a change of domicile or change of state law), the more complicated language offers a potential upside:

Where lifetime gifts have effectively reduced the (remaining) federal estate tax exemption, the state exemption may exceed the federal exemption.

Coordination of distributions and management of the trusts

If an Excess Exemption QTIP Trust is created, there may be at least two, if not three, virtually identical QTIP trusts created under the decedent's will or revocable trust: The Excess Exemption QTIP Trust, a Reverse QTIP Trust (to use up an otherwise unused GST exemption of the first decedent), and another QTIP trust for the balance of the estate.[9] If there is, or may be, more than one QTIP trust, it may be appropriate to permit them to be managed

[6] Tenn. Code Ann. § 67-8-316.

[7] See, e.g., N.Y. Tax Law § 952.

[8] This language is derived from Wealth Transfer Planning℠ published by Interactive Legal Services (www.ilsdocs.com) and is reproduced here with its permission.

[9] See, e.g., Section 2056(b)(5). Such a trust, nevertheless, might have provisions during the surviving spouse's lifetime that are identical to those of a QTIP trust. Hence, providing for such a trust to be managed *in solido* with QTIP trusts under the same instrument may be appropriate to consider.

together (essentially, be managed *in solido*) although each should be treated as a separate trust. The fourth trust for the spouse, to hold the applicable estate tax exemption (taking into account both the federal and applicable state death tax exemptions) must also be coordinated with the (up to) three QTIP trusts.

In addition, coordination of distribution provisions should be addressed. For example, absent other factors, any invasion of corpus from the QTIP trusts should be made last from any QTIP trust with respect to which it is expected that relief will be requested under Rev. Proc. 2001-38, because it is anticipated that such trust will be excluded from the gross estate of the surviving spouse; and second to last from any QTIP trust that has a lower inclusion ratio under Section 2631 for generation-skipping transfer tax purposes (such as a reverse QTIP trust may) than any other QTIP trust.

Years after 2005

Beginning in 2006, the federal estate tax exemption is scheduled to reach $2 million. Since the federal gift tax exemption remains at $1 million, will it be possible for a state exemption to exceed the federal exemption? Certainly it seems that the minimum available federal estate tax exemption would always be at least $1 million. Thus, unless the applicable state exemption is greater than $1 million (as will be the case in Connecticut), one might conclude that the state exemption could not exceed the remaining federal estate tax exemption. But that is not necessarily so. As in the case of the earlier example involving a decedent who died in 2004, lifetime gifts made by a decedent dying after 2005 may cause the remaining estate tax exemption to be less than the state exemption (even where the state exemption is $1 million).

An example may be helpful. Assume that a taxpayer made a taxable gift in 1977 of $3 million, and thereafter made no other taxable gifts. Assume he dies in 2006, when the maximum federal estate tax exemption is $2 million, with a taxable estate of $2 million. Although his taxable estate is the same as the maximum federal estate tax exemption for the year of his death, federal estate tax will still be due. This taxpayer's federal estate tax is determined by adding the $3 million adjusted taxable gift to his $2 million taxable estate.[10]

The net federal estate tax, after the allowance of the credit under Section 2010 (and before any other credit that might be allowed) and the credit for the gift tax payable with respect to the adjusted taxable gift, is $485,000. Hence, he should not view his federal estate tax exemption as $2 million but rather as $945,652.[11] That is less than the exemption permitted by several states, including New York and Tennessee (as well as Connecticut).[12] Hence, for at least the years 2005 through 2008, the available state estate tax exemption may exceed the available federal exemption, suggesting that an Excess Exemption QTIP Gift should be based on the principles discussed above.

Practice Notes

Creating a separate QTIP trust, equal to the difference between the federal estate tax exemption and the state death tax exemption may be both appropriate and advantageous.

Conclusion

The disparity between federal and state death tax exemptions presents additional challenges in planning for married persons. In many cases, the federal exemption will exceed the state exemption. But in some situations, especially where lifetime gifts have effectively reduced the (remaining) federal estate tax exemption, the state exemption will exceed the federal exemption. Creating a separate QTIP trust, equal to the difference between the federal estate tax exemption and the state death tax exemption may be both appropriate and advantageous. The sample language set forth earlier in this article provides for both eventualities and should be considered. ■

[10] See Section 2001(b).

[11] The maximum credit allowed under Section 2505 for federal gift tax purposes is $345,800 (essentially, the tax computed on the first $1 million of taxable gifts). The maximum credit for the years 2006 to 2008 allowed under Section 2010 for federal estate tax purposes is $780,800 (essentially, the tax computed on a taxable estate of $2 million assuming no adjusted taxable gifts were made). The excess of the federal estate tax credit of $780,800 for 2006 over the federal gift tax credit of $345,800 is $435,000. Hence, adjusted taxable gifts may "use up" up to $345,800 of the federal estate tax credit. As a result, as little as $435,000 of the federal estate tax credit may be available to use against the taxable estate. In such a case, the federal estate exemption (or, in other words, the maximum taxable estate the decedent could have without paying any federal estate tax by reason of the credit under Section 2010) is, therefore, determined by multiplying the taxable estate (T) by 46% to produce a gross estate tax of $435,000, or .46T = $435,000; so T = $945,652. See Section 2001(b).

[12] It will not matter for New York estate tax purposes that the state exemption is greater than the federal exemption. To reduce his federal estate tax to its minimum, the taxpayer will limit the credit shelter amount to the lower federal exemption and have the balance of his or her estate pass under the protection of the marital deduction. Whatever qualifies for the federal marital deduction will automatically qualify for the state marital deduction, in effect. Therefore, there is no opportunity for a married New Yorker to use the strategy discussed in this article where the state exemption is larger than the federal exemption.