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Quadpartite Will: Decoupling and the Next Generation of Instruments

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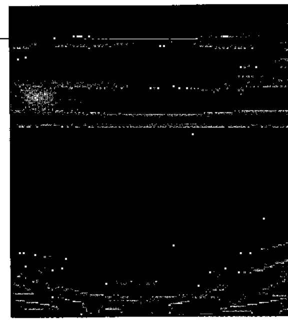

Quadpartite Will: Decoupling and the Next Generation of Instruments

The authors suggest a number of innovative planning strategies (such as an additional QTIP trust) for married individuals domiciled in a state that has an estate tax exemption which is less than the federal exemption.

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As a result of the reduction beginning in 2002 and complete elimination, effective beginning in 2005, of the state death tax credit allowed under IRC Section 2011, the cost of estate or inheritance tax imposed by many states has increased. In fact, some states, such as New York, that had not imposed any effective estate tax because the state tax was made equal to the amount that was allowed as such a credit, now impose an additional estate tax because the state system imposes a tax equal to the amount that would be allowed as a credit if the credit had not been reduced or eliminated. In other words, the state system is no longer coupled exactly to the amount of the credit actually allowable but rather, to what was allowable before the state death tax credit began to be phased out under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA").[1]

That means the cost of dying domiciled in such a state has increased. In some cases, the additional state death tax may more than offset the reduction in federal tax attributable to the lowering of the federal estate tax rates which have dropped from a top rate of 55% in 2000 to 47% now, and the top rate is scheduled to drop to 45% beginning in 2007. Some other states that had not limited their estate or inheritance taxes to the state death tax credit amount under IRC Section 2011 continue to impose additional tax burdens on the estates of certain of their domiciliaries.

Furthermore, several states now have a smaller estate tax exemption than that allowed under federal law,[2] which has now risen to $1.5 million[3] and is scheduled to rise to $2 million in 2006 and to $3.5 million for 2009.[4] That may also increase the cost of dying domiciled in such a state (as compared to dying domiciled in a state that allows the same level of exemption). It may mean, for example, that the estate of an individual who dies with a taxable estate no greater than the amount of his or her federal estate tax exemption may owe state death tax.

The smaller state exemption presents new challenges in planning for a married person who otherwise would be inclined to divide his or her estate between a so-called optimum credit shelter (or federal estate tax exemption) share and a

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marital deduction share. It even presents problems for individuals who die domiciled in a state that imposes no state death tax or allows a exemption equal to the federal exemption if that individual owns real or tangible personal property situated in a state with a state death tax and/or a smaller exemption than that allowed under the federal estate tax system.

This article will explore some planning steps that may be considered for married individuals domiciled in a state having an exemption that is less than the federal exemption. This problem may "disappear" (or be reduced) in 2011, when the changes to the Internal Revenue Code made by EGTRRA "sunset" (i.e., at that time, pre-EGTRRA provisions become effective, resulting in the restoration of the state death tax credit and the reduction in the federal estate tax exemption to $1 million). In other words, in many cases, the problems attributable to the smaller state estate tax exemption relative to the federal exemption are only temporary.

Married persons in states with smaller exemptions

As a result of EGTRRA, in many states, the federal and state estate tax exemptions are no longer in lockstep.[5] For example, in New York, the exemption remains $1 million even though the federal exemption is currently $1.5 million and is scheduled to increase over the next five years.

The resulting lack of parallelism between the two systems has complicated estate planning for many married couples. For instance, in New York (or any state providing an exemption that is less than the federal exemption), a couple adopting an estate plan designed to minimize their federal estate tax liability must in effect agree voluntarily to pay a toll charge in the form of a state estate tax at the death of the first spouse. And, as the federal exemption increases, the toll charge will increase.

As a matter of conventional planning, a married person typically divides her estate into two portions (more accurately, three portions in order to fully use the generation-skipping transfer ("GST") tax exemption). One portion, consisting of the estate-tax exemption amount, is placed in a credit shelter trust. The second portion, the balance of the estate, is gifted to the spouse, either outright or in trust, in order to qualify for the marital deduction.

Assume, for example, that a wife has $2.5 million in assets and dies in 2005. If the will divides her estate in this typical manner, the husband will receive a bequest of $1 million, and the other $1.5 million in assets will be placed in a credit shelter trust. The plan accomplishes two objectives. It prevents the $1.5 million in assets contributed to the credit shelter trust from being taxed in the husband's estate on his later death, and it defers the estate tax through the use of the marital deduction on the remaining $1 million until the husband's subsequent death. Most significantly, both these objectives are accomplished without paying any estate tax at the death of the wife.

In a state with an exemption that is less than the federal exemption, this plan would produce a state tax at the wife's death. If $1.5 million of the wife's assets is bequeathed to the credit shelter trust and the remaining $1 million is bequeathed to the husband, in New York, a tax of $64,400 would be payable at the wife's death. The tax is produced by the disparity in state and federal exemptions ($1.5 million for federal purposes and $1 million for New York state purposes). In other words, to achieve the optimal outcome for federal tax purposes, the wife's exemption of $1.5 million should be placed in the credit shelter trust. But this produces a suboptimal outcome for state purposes. Given that the state exemption is only $1 million and given that assets bequeathed to the credit shelter trust will not qualify for the marital deduction, placing $1.5 million in a credit shelter trust constitutes an "underutilization" of the marital deduction for New York purposes and results in the New York tax of $64,400. In effect, the New York tax is a toll

1 See, generally, Blattmachr and Detzel, "Estate Planning Changes in the 2001 Tax Act—More Than You Can Count," 95 J. Tax'n 74 (Aug. 2001). For a further discussion of these issues, see Fox, Pomeroy, and Abbott, "Ramification for Estate Planners of the Phase-Out of the Federal State Death Tax Credit: Boom, Bust or Unknown?," ACTEC J. (Summer 2003).

2 There is no federal estate tax exemption. There is a unified credit (a/k/a applicable credit) under Section 2010. The credit can be viewed, in some ways, as an exemption equivalent. However, it does not function as an exemption. For example, if the decedent had made certain taxable gifts after 1976, the credit will not protect as much property from tax as the exemption equivalent would indicate. The reason is that the exemption equivalent represents the amount that could be protected from tax if no such taxable gift had been made. Also, the unified (or applicable) credit itself is reduced if the decedent made a gift between 9/8/76 and 12/31/76, and used part or all of the specified gift tax exclusion then allowable under Section 2511. Section 2010(b).

3 It is possible that the exemption equivalent could, in fact, be greater if credits other than the unified (applicable) credit were allowed. See, e.g., Section 2013 relating to a credit for estate tax paid on property previously included in the gross estate of another person from whom the decedent has inherited property.

4 Under current law, the federal estate tax is repealed for 2010. It is to be restored beginning in 2011 as it was prior to EGTRRA, but with a $1 million exemption equivalent.

5 At least the following states are or appear to be "decoupled": Maine, Massachusetts, Maryland, Rhode Island, New Jersey, New York, Oregon, Tennessee, Minnesota (through 2007), Ohio, Wisconsin, Illinois (only in 2009) and the District of Columbia (Washington). Oregon, Ohio, Tennessee, Massachusetts, and Rhode Island permit a "state-only" QTIP election. The Supreme Court of Washington State has held that that state's estate tax is "coupled." Estate of Hemphill v. State, 2005 Wash. LEXIS 89 (Wash., 2005), Docket 74974-4 (2/3/05). Legislation to allow a state-only QTIP election has been introduced in at least Maine and New York.

charge imposed on couples seeking an optimal federal outcome.

The wife's will could be drafted to defeat the toll charge, but only at the cost of a greater federal tax at the husband's death. To illustrate, the wife's will could place only $1 million in the credit shelter trust, with the remaining assets of $1.5 million bequeathed to the husband in a form that would qualify for the marital deduction. While this would defeat the toll charge, the additional $500,000 bequest to the husband would increase his gross estate. Because the federal and state tax attributable to the inclusion of this additional amount (together with any return it produces in his hands) in the husband's estate will in all likelihood significantly outweigh the estate toll charge, many advisors will recommend against this approach—or will, more likely, draft the wife's will to permit the decision about paying the toll charge to be made after her death.

Some options to eliminate tax when the first spouse dies

Change of domicile before death. Probably, the most certain way to reduce the extra state death tax burden is for the individual to change domicile to another jurisdiction that has a lower or no state death tax or has a state death tax exemption equal to the federal exemption.[6] Changing domicile, of course, may have other far-reaching effects, including those relating to income tax, intangible property tax, spousal and possibly other family rights both during lifetime (e.g., in the event of divorce) or at death, appointment of fiduciaries, and many others. But the most important change typically caused by a switch in domicile is one of lifestyle. Almost certainly, the individual will have to spend more time in the newly established domicile than in the old one. Other steps, although perhaps not as life altering, also should be taken to establish that domicile has been changed.[7] Moreover, there is a danger that the decedent will have been found domiciled in the "old" state as well as the "new" one for state death tax purposes.[8]

Change in domicile may produce other benefits. For example, moving from a jurisdiction with state and, perhaps, local income tax to one with no income tax probably would be viewed by most individuals as beneficial. Cost-of-living charges may also be reduced. Even if such beneficial changes occur, the individual presumably would have already changed domicile if, in the aggregate, circumstances compelled such a change. Perhaps, for some individuals, the additional state death tax their estates will face will constitute the proverbial "straw that broke the camel's back" and cause them to effect a change in domicile. Nevertheless, changing domicile is so life altering that probably few individuals will voluntarily make such a change just because of the additional state death tax, especially if it is temporary; as indicated above, in many states, the extra state death tax burden will be eliminated or substantially reduced in 2011 when the state death tax credit is restored and the federal exemption drops back to $1 million.

One case where the change of domicile might be effected only on account of the additional state estate tax the individual's estate would face is where the individual is incompetent and institutionalized and will not understand that a life alternating change has occurred. Although an incompetent individual may not be able to form the requisite intent to change domicile, the guardian of the incompetent or a court having jurisdiction over the individual may order a change in domicile, which probably will be binding on the state tax authority within that state.[9]

Pre-death gift. In some states, a pre-death gift may eliminate the difficult choice a married person faces of paying state death tax by using the full federal estate tax exemption or avoiding both state and federal estate taxes at the death of the first spouse to die but exposing considerably more property to estate tax when the surviving spouse dies. For instance, suppose that a married New Yorker who has never used any of her federal exemption makes a $500,000 gift to an inter vivos credit-shelter-type trust, leaving her estate in effect with a $1 million federal estate tax exemption. It might seem that, because the remaining federal exemption is now equal to the state exemption, she

6 Also, any real or tangible personal property located in the "old" domicile state should be "removed" before death as a state may impose its death tax on real and tangible personal property located there. See Curry v. McCanless, 307 U.S. 357, 31 AFTR 937 (S.Ct., 1939).

7 Among other factors that may be considered in determining an individual's domicile are where the individual spends most of her time, where her more substantial home is situated, whether a home is owned or rented, where the individual is registered to vote and whether she actually votes there in person, whether the individual has executed and/or revoked a declaration of domicile (if available), what location the individual has declared to a census taker to be her principal residence, what IRS service center the individual has used to file her U.S. income and gift tax returns, where she has filed resident and nonresident income tax returns (if any), where her automobiles and other vehicles (e.g., boats) are registered, in what state(s) she holds resident driving, fishing and other licenses, where the individual has made plans to be buried, where her principal place of business is located, the states in which she holds any professional licenses (e.g., medicine or law), where her immediate family members (e.g., spouse and minor children) spend most of their time, where any minor children go to school, and what address is used in her passport and similar documents. See, generally, Restatement of Conflict of Laws § 11.

8 See In re Dorrance's Estate, 115 N.J. Eq. 268, 170 Atl. 601 (1934); *aff'd* 116 N.J.L. 362, 184 Atl. 743 (1935), *cert. den.*; In re Dorrance's Estate, 309 Pa. 151, 163 Atl. 303 (1932).

9 See, e.g., In re Seyse, 353 N.J. Super. 580, 803 A.2d 694 (2002); N.Y. State Tax Comm'n Advisory Opinion TSB-A-86(13)I, 1986 WL 31399 (N.Y. Dept. Tax. Fin., 1986); First Trust and Deposit Co. v. State Tax Comm'n, 3 N.Y. 2d 410 (1957).

could divide her estate into the "classic" two portions (a credit shelter trust, equal to her remaining $1 million federal exemption, and a marital deduction portion equal to the balance of her estate) without paying any federal or New York estate tax. But New York estate tax will still be due. The reason is that New York's estate tax is equal to the lesser of: (1) the pre-EGTRRA state death tax credit, and (2) the federal estate tax that would be due based on an assumed (contrary-to-fact) federal estate tax exemption of $1 million (computed based on the sum of the taxable estate and adjusted taxable gifts).

The state death tax credit on a taxable estate of $1 million (the amount passing to the credit shelter trust at death given the $500,000 lifetime gift) under pre-EGTRRA Section 2011 is equal to $33,200.[10] The actual federal estate tax due will be zero even though the federal estate tax will be calculated by imposing the tax on the sum of the decedent's $1 million taxable estate (the amount passing into the credit shelter trust at death) and the $500,000 adjusted taxable gift that passed into the lifetime credit shelter trust.[11] No tax is due because the federal exemption is $1.5 million.

But, as indicated, New York requires that, *for purposes of computing the New York estate tax,* the federal tax on the $1.5 taxable amount is computed on the assumption that the federal exemption is only $1 million. Under this assumed calculation, the federal estate tax would be $210,000. Because the pre-EGTRRA Section 2011 credit is only $33,200, that smaller amount is paid to New York. Thus, although counterintuitive, the estate must pay New York tax even though the taxable estate is only $1 million; New York permits an exemption of $1 million; and, under pre-EGTRRA Section 2011, adjusted taxable gifts are not considered in determining the credit.

To eliminate the New York tax, the taxable estate would have to be reduced to $100,000 (i.e., under Section 2011, the credit on a taxable estate of this amount would be zero). Given the current federal exemption of $1.5 million, a gift of $1.4 million would be necessary to reduce the taxable estate to $100,000 (assuming no prior adjusted taxable gifts).[12] And as the scheduled increases in the federal exemption become effective, reducing the taxable estate to $100,000 would require even greater inter vivos gifts (e.g., in 2009, when the federal exemption will be $3.5, an inter vivos credit-shelter gift of $3.4 would be necessary to optimally fund the credit shelter trust for federal purposes while not permitting the taxable estate to exceed $100,000). The difficulty, however, with making gifts in excess of $1 million is that they will generate federal (and, in some states, state) gift tax. Consequently, the value of using inter vivos gifts in order to reduce state tax liability is limited: gifts that generate federal gift tax liability should not be made for this purpose.[13]

It is important to note that any inter vivos gift designed to reduce the taxable estate could create an adverse income tax consequence. The basis of property included in a decedent's estate generally is equal to its estate tax value.[14] The basis of property given away during lifetime is the donor's basis adjusted for federal gift tax paid on inherent appreciation.[15] Hence, unless the individual has assets with which the gift could be made that have no inherent appreciation that would be eliminated on death on account of the change in basis to the estate tax

10 The credit under Section 2011 is computed on the "adjusted taxable estate," which is the taxable estate less $60,000.

11 See Section 2001(b).

12 For example, if the taxpayer had previously made adjusted taxable gifts of $600,000, she would need to make an additional taxable gift of $800,000 in order to reduce her taxable estate to $100,000. As an alternative, she could increase the amount passing under the protection of the marital deduction, but that would "overuse" the marital deduction by underutilizing the federal exemption.

13 To illustrate, assume that a gift of $1.4 million is made shortly before death in order to reduce the taxable estate to $100,000. Such a gift would generate a federal gift tax liability of $167,000. Because the federal gift tax liability exceeds the state toll charge of $33,200 were a gift of $1 million made instead (which would generate no gift tax liability), a gift in excess of $1 million makes no sense. And reducing the marital bequest to avoid wasting the gift tax payment would not be effective inasmuch as this would cause an increase in the taxable estate and therefore an increase in the New York tax. Moreover, any federal gift payment would then be included in the gross estate under Section 2035 if death occurs within three years, thereby causing an increase in the taxable estate and an increase in the New York estate tax. Parenthetically, it is worth noting that a taxpayer who has not made any prior adjusted taxable gifts could generate a federal gift tax by making a gift of only $1 million. If the taxpayer had made a taxable gift prior to 1976, a current gift of $1 million would generate a federal gift tax liability because the applicable tax bracket on the current gift is determined by taking into account the prior gift.

14 See Section 1014.

15 See Section 1015.

value rule, there may be an income tax cost of such a gift that probably should be considered in determining if avoiding the problem of the smaller state death tax exemption is worthwhile. It may turn out that the individual holds property that has an income tax basis greater than its current fair market value. Lifetime gifts of such property may preserve such higher basis (at least for purposes of measuring gain).

If inherent gain that would be eliminated for income tax purposes by death is imbedded in the only assets that are realistic gift candidates, the married person could borrow. But typically that will result in additional cost for interest, advice, and other expenses. Such borrowing, unless it is from a family member or entity, may not be cost-efficient.

Waiting until death. Whether it would be preferable to limit the credit shelter disposition to the lesser of the federal and state estate tax exemptions and pay a larger tax when the survivor dies, or to use the full federal estate tax exemption even though a state toll charge would be due when the first spouse dies, may depend on factors that will not be known until that spouse dies. For example, if the surviving spouse has an extremely short life expectancy, it may be better to use the full federal estate tax exemption in the estate of the spouse dying first because that may reduce overall taxes on the estates of both spouses.[16] Generally, it may be preferable to wait until the first spouse dies to make a decision as to how much of the federal exemption to use. Several options are available that may accomplish this.

First, the credit shelter disposition could be limited to the lesser of the federal or state estate tax exemption, with the balance passing in a form that qualifies for the marital deduction. The surviving spouse could make a qualified disclaimer,[17] within nine months of the death of the spouse dying first, of a sufficient amount of the portion of the estate qualifying for the marital deduction to make fuller or complete use of the federal exemption. One limitation in using such a strategy may be the reluctance of the surviving spouse to disclaim because of the reduction in economic benefits the surviving spouse would otherwise enjoy.[18]

An alternative is to use a so-called Clayton QTIP.[19] This is a disposition that passes into a QTIP trust to the extent—but only to the extent—that the executor elects QTIP treatment under Section 2056(b)(7), but passes otherwise (such as to a credit-shelter-type trust) to the extent QTIP is not elected. The executor, by controlling how much qualifies for the marital deduction, controls how much estate tax exemption (federal and state) is used.

Although a similar result can be achieved by merely making a partial QTIP election, the Clayton QTIP offers the "advantage" that the portion with respect to which the QTIP election is not made may pass into a trust that may authorize distributions to descendants as well as the surviving spouse, which may provide opportunities to reduce income taxes (such as by making distributions of trust income to descendants) and to avoid gift tax (as distributions from such a trust are not subject to gift tax but distributions to the surviving spouse, followed by gifts of such distributions by the survivor to his or her descendants, may be subject to such tax). A disadvantage of the Clayton QTIP, however, is that, if the property not elected for QTIP treatment passes in a form over which the surviving spouse does not have an income interest, the effective use of the prior transfer credit under Section 2013 may be diminished or eliminated.[20]

Alternative: Separate QTIP trust equal to excess federal exemption

In any event, many married individuals who reside in states that have smaller state death exemptions than permitted for federal estate tax purposes will not be willing to change domicile or make such large gifts for a variety of reasons. But the creation of a special QTIP trust by them under their estate planning documents may provide another way to avoid the problems of the smaller state death tax exemption. In other words, they could create a QTIP trust equal (subject to refinements discussed below) to the excess of the federal estate tax exemption available to the decedent's estate over the amount that may pass free of both federal and state death taxes by reason of the federal and state death tax exemptions. Examples will help illustrate the effect of this special QTIP equal to the "excess" federal estate tax exemption.

Assume that a married New Yorker dies in 2005 with an adjusted gross estate[21] of $2.5 million, never hav-

16 In fact, if it is anticipated that the surviving spouse may die soon after the other spouse, it may be preferable to make the taxable estate of the spouse dying first even greater than the federal estate tax exemption on account of the allowance of the prior transfer credit under Section 2013.

17 See Section 2518. If the surviving spouse is under age 21, the nine-month period within which he or she may disclaim commences upon his or her 21st birthday.

18 Professor Jeffrey Pennell lists "Darling, I promise I will disclaim if it will save taxes" as one of the three "great" lies. Pennell, 843-2nd T.M. (BNA), *Estate Tax Marital Deduction*, p. A-12, n. 55.

19 Reg. 20.2056(b)-7(d(3).

20 See Rev. Rul. 67-53, 1967-1 CB 265.

21 The adjusted gross estate was defined under Section 2056(c)(2), before the effective date of the Economic Recovery Tax Act of 1981 which made the marital deduction "unlimited," as the gross estate reduced by debts and administration expenses that are deducted under Section 2053. A slightly different definition is still contained in Section 6166(b)(6). The adjusted gross estate as used in this article refers to its meaning under now repealed Section 2056(c)(2).

ing used any of her federal estate tax exemption of $1.5 million. All estate administration expenses are deducted for federal estate tax purposes.[22] Her adjusted gross estate is divided into three portions: a credit shelter trust equal to the maximum amount that can pass free of tax without generating any federal or state estate tax, a QTIP trust equal to the excess of the federal exemption over the state exemption, and a disposition of the balance in a form so that it will qualify for the federal and state marital deduction.

The amount passing to the QTIP is the excess of the federal exemption of $1.5 million over the state exemption of $1 million, or $500,000. Assuming her executor elects for the QTIP trust to qualify for the marital deduction under IRC Section 2056(b)(7), her taxable estate will equal the amount of the state exemption, which is assumed to be $1 million and which is the amount passing to the credit shelter trust. In other words, the marital deduction will be $1.5 million, consisting of the $500,000 QTIP and the balance of her estate (that is, that part of her adjusted gross estate not passing into the $1 million credit shelter trust or into the $500,000 QTIP) of $1 million. Thus, with a marital deduction of $1.5 million and a taxable estate of $1 million, no federal tax is due.

Nor is any New York estate tax due. The amount of state death tax credit under IRC Section 2011 is $33,200. But the federal estate tax due on the $1 million taxable estate, based on an assumed federal exemption of $1 million, is zero. Because the estate is required to pay New York estate tax equal to the lesser of the state death tax credit amount under Section 2011 ($33,200) or the amount of federal tax due using only a $1 million exemption (zero), no New York estate tax is due.

The problem, at least from a federal estate tax perspective, is the underutilization of the federal exemption or, conversely, the overutilization of the marital deduction. That, as explained above, may have two adverse consequences. First, if the full federal estate tax exemption had been used, an additional $500,000 could have been added to the credit shelter trust (which may permit distributions to beneficiaries other than, or in addition to, the spouse). That could possibly reduce income taxes (if such other beneficiaries are in lower income tax brackets than the surviving spouse or the trust) and may reduce the level of taxable gifts the surviving spouse makes: distributions from the credit shelter trust to beneficiaries other than the spouse are not subject to gift tax. If the $500,000 is in a QTIP trust, the trustee may not make distributions to anyone other than the surviving spouse. Although the trustee may be permitted, under the terms of the deceased spouse's will, to distribute property to the spouse who, in turn, could give it to the beneficiaries of the credit shelter trust, the surviving spouse would be making gifts in doing so.

The second problem, mentioned above, likely will arise when the surviving spouse dies. Because property that qualifies for the marital deduction in the estate of the first spouse to die is included in the gross estate of the survivor, the survivor's gross (and, perhaps, taxable) estate will be increased by the amount now passing to the QTIP rather than the credit shelter trust, unless it is consumed or dissipated by the survivor. This tax could be significant. At a 55% tax rate (the top bracket that is to be restored beginning in 2011), an additional $275,000 of tax would be due.[23]

The additional marital deduction transfer of $500,000 in the foregoing example need not have passed into a QTIP trust. The same result could be achieved by making a transfer of that amount in any other form that would qualify for the marital deduction, such as an outright bequest. But the use of a QTIP trust may have ameliorated the problem of having to pay additional estate tax on this marital deduction amount when the surviving spouse dies. At least some states (such as Massachusetts and Oregon) permit an executor to make a state-only QTIP election. In other words, the executor would not elect for the $500,000 QTIP trust to qualify for the federal estate tax marital deduction under IRC Section 2056(b)(7). The executor would elect for the trust to qualify for the marital deduction only for state death tax purposes. Under this approach, the QTIP trust should not be included in the surviving spouse's estate for federal purposes, but only for state purposes.[24]

22 If the expenses are not deducted for estate tax purposes under Section 2053, they will "use up" part of the federal estate tax exemption unless they constitute certain "management" expenses within the meaning of Reg. 20.2056(b)-4(d). See, generally, Gans, Blattmachr, and McCaffrey, "The Anti-Hubert Regulations," 87 Tax Notes 969 (5/15/00). Also, beginning this year, state death tax paid is deductible for federal estate tax purposes under Section 2058. This tax may not be deducted for certain state death tax purposes.

23 Of course, the QTIP trust will not likely remain at $500,000 for the balance of the survivor's lifetime. It may decline or grow in value. Although the additional $275,000 in estate tax will not be due until the survivor dies, one may view this as the present value cost (above the state death tax that would be due if the enhanced marital deduction transfer were not made) if one assumes that the QTIP trust will grow at the same rate as the discount rate that would be used to determine the present value cost of the additional tax that will be due when the survivor dies.

24 Property that has qualified for the marital deduction by the QTIP election under Section 2056(b)(7) is included in the gross estate of the surviving spouse under Section 2044. If the QTIP election under the former section is not made, there will be no gross estate inclusion under the latter section, although it is conceivable that the trust might be included in the survivor's estate by reason of the survivor having been granted a general power of appointment described in Section 2041.

Unfortunately, most states that have limited the state death tax exemption do not permit a state-only QTIP election. But an opportunity to effect such a state-only election may be achieved under Rev. Proc. 2001-38.[25] In fact, the use of this Revenue Procedure may produce a better result for the estate of the surviving spouse than would a state-only QTIP election.

Not infrequently, apparently, the executor of a decedent's will elects for more property to qualify for the estate tax marital deduction than is necessary to reduce the federal estate tax to zero. For example, assume a married man died in 2004 with a federal adjusted gross estate of $2.5 million, and gave all his property to a trust that would qualify as a QTIP. His executor makes the QTIP election with respect to the entire trust, even though a partial election would have eliminated the federal tax because of the $1.5 million federal exemption.

As to his estate's federal estate tax, the QTIP election for the entire trust, as opposed to only the minimum amount necessary to reduce his federal estate tax to zero, is unimportant. But it may have a dramatic estate tax consequence in the wife's estate. The entire trust will be included in her estate under IRC Section 2044. His executor needed to make the QTIP election for only 40% (that is, $1 million) to reduce his federal estate tax to zero; and if such a partial election had been made, only 40% of the trust would be included in the wife's gross estate under Section 2044.

In Rev. Proc. 2001-38, the IRS granted relief where the executor of the first spouse to die "over-elected" QTIP treatment and thereby failed to use the available federal estate tax exemption of that spouse. Specifically, the Revenue Procedure allows the executor of the surviving spouse to request that the QTIP election made in the estate of the first spouse to die be "undone" to the extent the estate would have been able to avoid paying any federal estate tax by reason of the unused federal estate tax exemption of the first spouse to die. But that relief may not be requested if the QTIP election was a partial election, should have been a partial election, was made pursuant to a word formula (e.g., "the executor hereby elects for that portion of the trust equal to the decedent's remaining GST exemption to qualify for the estate tax marital deduction pursuant to Section 2056(b)(7) of the Internal Revenue Code"), or was a protective election (for example, the executor says the election is being made if—but only if—the property is included in the decedent's gross estate).

Consequently, in the example just considered, where the executor elected to have the entire $2.5 million trust qualify for the marital deduction, the relief would not be granted because a partial election should have been made and relief is not made available in this context. Suppose, instead, that the husband had divided his estate into two shares, one (the marital bequest) equal to the minimum amount necessary to reduce the federal estate tax to its minimum, and the other share equal to the balance of his estate, both shares passing into a trust described in Section 2056(b)(7). Also assume that his executor had elected for both shares to qualify for the marital deduction as QTIP trusts. In that case, relief would be granted under Rev. Proc. 2001-38 in the surviving spouse's estate to "undo" the election with respect to the second share as it was equal to the remaining federal estate exemption and, therefore, its election for QTIP treatment was unnecessary to reduce the federal estate tax to zero.

The Revenue Procedure seems to provide an opportunity to divide the federal estate tax exemption into two parts—one equal to the state death tax exemption, which will pass as the credit shelter portion, and the balance of which will pass into a QTIP trust. This second part is the excess of the federal estate tax exemption over the state exemption. A QTIP election may be made for this second part (equal to the excess federal estate tax exemption) to qualify for the marital deduction under Section 2056(b)(7). Even though the QTIP election for this second part was unnecessary to reduce the federal estate tax to zero, it was necessary to reduce the state estate tax to zero. When the surviving spouse dies, the executor of that spouse's will may request relief under Rev. Proc. 2001-38 (which should be granted) to exclude the trust equal to the excess federal exemption from the survivor's gross estate for federal estate tax purposes because its election for QTIP purposes in the estate of the first spouse to die was entirely unnecessary to reduce the federal estate tax to zero (and it was not a partial, protective, or word formula election).[26]

[25] 2001-1 CB 1335.

[26] Some might question whether taxpayers may rely on the Revenue Procedure. If, for example, the QTIP election were made at the death of the first spouse, could the Service refuse to grant relief at the death of the second spouse and thereby include the QTIP in the second spouse's gross estate for federal purposes? Revenue Procedures that set forth procedural rules, rather than substantive interpretations of the Code, are not binding on the Service. See, e.g., Estate of Shapiro, 111 F.3d 1010, 79 AFTR2d 97-2152 (CA-2, 1997). Where, however, the refusal to follow such a Revenue Procedure constitutes an abuse of discretion, the courts will not permit the Service to disavow it. See *id.* In a series of recent cases, the courts have been unwilling to permit the Service to disavow taxpayer-friendly published guidance, holding the government bound without making an abuse-of-discretion inquiry. See Rauenhorst, 119 TC 157 (2002); Dover Corp. and Subsidiaries, 122 TC 324 (2004); Baker, 122 TC 143 (2004). Whether this line of cases could be invoked in the context of a taxpayer-friendly Revenue Procedure setting forth procedural rules remains unclear. In other words, further clarification is required regarding the extent to which the distinction between procedural rules and substantive interpretations made in earlier cases such as *Shapiro* has been overtaken by these more recent cases. In any event, it would seem that, even if the Revenue Procedure is not binding, there is no reason to believe that the Service would withhold the relief the Revenue Procedure contemplates.

It also seems, at least in some states, that relief granted to exclude the trust from the federal gross estate of the surviving spouse may also result in its exclusion for state death tax purposes. In New York, for example, Tax Law section 961 provides that a final federal determination as to the inclusion of property in the gross estate controls for state purposes unless it is shown to be erroneous by a preponderance of the evidence. Certainly, the allowance of the marital deduction for federal estate tax purposes in the estate of the spouse dying first for the amount equal to the excess federal estate tax deduction is not incorrect. In fact, it is binding on the estate of both the spouse who dies first as well as the estate of the surviving spouse unless the survivor's estate qualifies for and requests relief under Rev. Proc. 2001-38. Similarly, its exclusion from the federal gross estate with respect to the surviving spouse, if that relief is requested and granted under the Revenue Procedure, is correct. Therefore, it would seem controlling for New York estate tax purposes as well.[27]

How the excess federal estate tax exemption should be described

Suppose that a married person, who is domiciled in a state with a smaller estate tax exemption than allowed for federal estate tax purposes, wishes to avoid all estate tax if his or her spouse survives and also wishes to minimize tax when the survivor dies. In this situation, the estate planning documents could take one of two approaches. One approach would provide for the credit shelter disposition to be a preresiduary bequest of a fixed sum of money: (1) a credit shelter disposition (such as a trust for the spouse and descendants) equal to the largest sum that can pass as such disposition without causing any federal or state estate tax to be due, (2) a QTIP equal to the excess of the federal estate tax exemption over the sum so passing as the credit shelter disposition, and (3) a marital deduction disposition (such as a second QTIP or an outright bequest to the spouse) of the balance of the estate.

The alternative would provide for the marital deduction shares to be a preresiduary bequest of a fixed sum of money: (1) a disposition in a form (such as outright) to or for the surviving spouse that will qualify for the marital deduction equal to the minimum sum necessary as the marital deduction to reduce the federal (but not necessarily the state) estate tax to its minimum, (2) a QTIP equal to the sum necessary as the marital deduction to reduce both the federal and the state death taxes to their minimums (taking into account the first marital deduction disposition), and (3) a credit shelter disposition of the balance of the estate. Another option would be to make each of the three dispositions fractional shares of the decedent's estate.

In fact, it may be that there should be a quadpartite will or revocable trust: (1) to the credit shelter disposition, the sum (or fractional share) equal to the maximum that may pass as the credit shelter disposition without increasing the federal or the state death taxes, (2) to the first QTIP, the sum (or fractional share) equal to the excess of the federal estate tax exemption over the amount of the credit shelter disposition, (3) to a second QTIP,[28] a sum (or fractional share) equal to the excess of the decedent's unused GST exemption under IRC Section 2652 over the sum of the amounts disposed of under "(1)" and "(2)," and (4) to the spouse or to a trust in a form qualifying for the estate tax marital deduction, the balance of the estate.

[27] As indicated, once the Service grants relief under the Revenue Procedure, it is controlling for New York purposes unless the federal determination is shown to be incorrect by a preponderance of the evidence. This standard implies that only questions of fact can be challenged once a federal determination is made. See Matter of Weaver's Estate, 410 N.Y.S.2d 777, 410 N.Y.S.2d 777 (Surr. Rensselaer County, 1978), *aff'd* 74 A.D.2d 678, 424 N.Y.S.2d 789 (3rd Dept., 1980) (requiring the state to present factual evidence, not legal argument, in order to satisfy the preponderance standard in New York Tax Law section 961). Thus, it would seem that, if the Service concedes a legal issue, New York is precluded from taking a contrary view. See Marx v. Bragalini, 6 N.Y.2d 322 (1959) (precluding a challenge by the state after emphasizing that the Service had conceded the legal issue in a Revenue Ruling—with this decision forming the basis for later enactment of New York Tax Law section 961). Since the question of whether an unnecessary QTIP election should be treated as valid at the death of the second spouse is legal, not factual, the Service's concession should control. Thus, as long as the statute of limitations in New York is closed with respect to the first estate at the time of the second spouse's death, making the QTIP election and then seeking relief under the Revenue Procedure should be effective. And while New York might argue that the second spouse's estate should be estopped under a duty-of-consistency theory from treating as a nullity a QTIP election the state had accepted in the first spouse's estate, the controlling nature of the Service's resolution under the Revenue Procedure should be determinative. In terms of the statute of limitations, to be sure, New York does permit an assessment even if the limitations period is otherwise closed where a federal change occurs. See N.Y. Tax Law § § 979, 990, and 683. Where, however, relief is sought under the Revenue Procedure, no federal change occurs in connection with the marital deduction claimed on the earlier return. If, in other words, the federal statute of limitations is closed with respect to the earlier return, New York could not maintain that a federal change had occurred. Thus, the federal-change provisions in New York law would appear to be irrelevant with respect to the earlier return.

[28] As a general rule, the last individual who is treated as transferring property for estate or gift tax purposes (that is, the last person who has made a gift for federal gift tax purposes or in whose gross estate the property is included) is the "transferor" for federal GST tax purposes. That is the person whose GST exemption under IRC Section 2652 may be allocated to the property. Although the spouse who creates a QTIP trust is the initial transferor of the property in that trust, the other spouse will become the transferor when that spouse makes a gift of the property during lifetime or at death when it is included in his or her estate under Section 2044. However, Section 2652(a)(3) allows the spouse who creates the QTIP trust that is made to qualify for the marital deduction by election under Section 2523(f) or 2056(b)(7) to be treated as the transferor of the property for GST tax purposes by "reversing" that election for such tax purposes. That permits that spouse's GST exemption to be allocated to the QTIP trust. See, generally, J. Blattmachr, D. Hastings, and D. Blattmachr, "The Tripartite Will: A New Form of Marital Deduction," 127 Tr. & Est. 47 (Apr. 1988).

For example, assume a married New Yorker dies in 2005 with an estate of $4 million, having made $300,000 of taxable gifts after 1976 and having used no part of her GST exemption. Her remaining federal estate tax exemption is $1.2 million. Her New York estate tax exemption is $1 million. Now it might seem that, if the credit shelter disposition were $1 million, with a resulting taxable estate of $1 million, there could be no federal or state tax. But, because of the prior taxable gift, a taxable estate of $1 million would produce a New York tax.

The reason, as explained above, is that the federal estate tax is imposed under IRC Section 2001 on the sum of the taxable estate plus the decedent's adjusted taxable gifts, here, $1.3 million. Although no federal estate tax would be due (because the federal exemption is $1.5 million), a state death tax would be due. The reason is that New York imposes a tax equal to the lesser of: (1) the state death tax credit amount determined under IRC Section 2011 (in this case, $33,200, which is the amount on a taxable estate of $1 million); and (2) the federal estate tax on $1.3 million but on the assumption that the federal exemption is only $1 million (which, in this case, is $124,000). Accordingly, the estate would owe $33,200 of New York estate tax.

To avoid the New York tax, the credit shelter amount (which will equal the taxable estate) must be reduced so that, when it is added to the adjusted taxable gifts, no federal estate tax would be due even if the federal exemption were limited to the New York exemption of $1 million. In this case, that would be a credit shelter amount (or taxable estate) of $700,000. When that amount is added to the $300,000 of adjusted taxable gifts, the tax base for federal estate tax calculation purposes is $1 million, which is offset by the assumed $1 million federal exemption.

Therefore, her $4 million adjusted gross estate would be divided into the following four parts: (1) a credit shelter trust of $700,000; (2) a first QTIP equal to the excess of the remaining federal exemption of $1.2 million allowable to the estate over the credit shelter amount (that is, the smallest amount that could pass to the credit shelter trust without increasing the federal or the state death tax) of $700,000, or $500,000 [i.e., $1.2 million minus $700,000]; (3) a second or so-called reverse QTIP equal to the excess of the decedent's unused GST exemption of $1.5 million over the sum of the credit shelter trust and the first QTIP of $1.2 million, or $300,000; and (4) a disposition (such as another QTIP trust) of the balance of the adjusted gross estate, or $2.5 million. Her taxable estate, assuming her executor makes the appropriate QTIP elections, would be $700,000, the amount of the credit shelter disposition.

To which QTIP does the Rev. Proc. apply?

As in the foregoing example, an estate may have more than one QTIP, raising the question which QTIP is entitled to the relief of Rev. Proc. 2001-38. In a sense, it seems that each QTIP may have wasted use of the federal estate tax exemption of the spouse first to die. Fortunately, the Revenue Procedure seems to allow the relief to be granted to that QTIP which is equal to the otherwise unused federal estate

Practice Notes

When the surviving spouse dies, the executor of that spouse's will may request relief under Rev. Proc. 2001-38 (which should be granted) to exclude the separate QTIP trust equal to the excess federal exemption from the survivor's gross estate for federal estate tax purposes.

tax exemption even if there is more than one QTIP.

Rev. Proc. 2001-38 states that, in order to qualify for relief, it must be established that: "the election was not necessary to reduce the estate tax liability to zero." In the above example, that would be the election for the first QTIP. That conclusion is supported by a series of private letter rulings.[29] For example, in Ltr. Rul. 200243030, the first spouse to die created a credit shelter trust that was in the form of a QTIP trust equal to his unused federal estate tax exemption, and placed the balance of his estate also in a QTIP trust. His executor elected under Section 2056(b)(7) for both trusts to qualify for the marital deduction. Relief under Rev. Proc. 2001-38 was granted to the surviving spouse's estate to exclude the credit shelter trust from her gross estate.

Why the survivor's estate may not request the Rev. Proc. relief

It might seem that the estate of the surviving spouse would always want the "unnecessary" QTIP not to be included in his or her estate under Section 2044. But that may not be the case in circumstances where the change in basis under Section 1014 is more "valuable" than estate tax exclusion from the survivor's estate. For example, the assets in the unnecessary QTIP may have inherent gain in them at the time of the survivor's death but the survivor's estate, even including that QTIP, may be less than the survivor's estate tax exemption. In such a case, the relief granted to the survivor's estate by Rev. Proc. 2001-38 presumably would be adverse.

Specific language

As mentioned above, specific language to "deal" effectively with the smaller state exemption, and to place the estate of the surviving spouse in a position to request relief under the Rev. Proc., is necessary. First, the "credit shelter" or "estate tax exemption" must be limited to no more than the maximum that will result in neither federal nor state death tax. Second, the excess federal exemption special QTIP must equal no more than the unused federal exemption after taking into account the credit shelter or estate tax exemption gift and all other factors, including adjusted taxable gifts or other transfers that reduced the available federal exemption.[30] Here are some sample provisions[31]:

> *Estate Tax Exemption Gift.* If my Husband/Wife survives me, I give a sum/fractional share[32] of my estate, as determined after payment of transfer taxes, expenses and other preresiduary bequests made before this bequest, equal to my Estate Tax Exemption to the Trustee/s of the trust under Article [*put in number of the Article that contains the "Credit Shelter" Trust*] of this document to be disposed of under the terms of that trust.
>
> My "Estate Tax Exemption" means the largest amount that can pass to the Trustee/s of the trust under Article [*put in number of the Article that contains the "Credit Shelter" Trust*] without increasing the Federal estate tax and without increasing the state death tax due under the law of the state of my domicile by reason of my death.
>
> *Excess Federal Exemption QTIP Gift.* If my Husband/Wife survives me, I give a sum/fractional share[33] of my estate equal to the excess, if any, of (i) my Unused Federal Estate Tax Exemption over (ii) the Estate Tax Exemption Gift to the Trustee/s of the QTIP Marital Trust under Article [*put in number of the Article that contains the QTIP Trust*] of this document, to be disposed of under the terms of that trust and held as a separate trust. "My Unused Federal Estate Tax Exemption" means the largest amount that could pass to the Trustee/s of the trust under Article [*put in number of the Article that contains the "Credit Shelter" Trust*] of this document without increasing the Federal estate tax due by reason of my death. ■

29 Under Section 6110(k)(3), neither a private letter ruling nor a National Office technical advice memorandum may be cited or used as precedent.

30 Because both federal and state death taxes are reduced to zero, the deductibility of state death taxes under IRC Section 2058 seems academic. But state death tax may be due on account of real or tangible property located in another state. The sample provisions have been crafted to take even that possibility into account.

31 These are derived from *Wealth Transfer Planning* and are published here with the permission of Interactive Legal System. See www.ilsdocs.com.

32 Some practitioners may wish to provide for a specific numerator and denominator of the fraction if a fractional share bequest is made.

33 *Id.*