The Federal Government Giveth and the State Government Taketh: Drafting for Decoupled State Death Taxes

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, in the majority of states the state death tax was purely a function of the federal estate tax. For example, Illinois abolished its inheritance tax for decedents dying after December 31, 1982. In these so-called “pick-up” tax states, the state death tax was simply whatever credit was allowed pursuant to the federal calculation. If there was no federal estate tax, there would be no state death tax. This course of action not only simplified the administration of estates (many older clients continue to be concerned about bank accounts being “frozen” at death and the need to obtain inheritance tax waivers to transfer assets), but also reduced the incentive of some wealthier clients to change domicile for tax-motivated reasons.

As the federal government reduced the highest marginal estate tax rate to under 50 % (currently at _%), it started tinkering with other provisions of Chapter 11 of the Code to make sure the federal estate taxes were not reduced. One such change was with the state death tax credit.

Currently, the state death tax credit is no longer; it is merely a deduction against federal estate taxes. As a result, this has created havoc with state inheritance tax regimes.

The basic result for states has been to decrease the state revenues that states used to receive as a result of the state death tax credit. And the states have not been passive in this decrease. The majority of states have amended their own estate tax structures, often by increasing state estate (or inheritance) tax rates.

States have also moved away from linking their own estate taxes with those of the federal government. This has often been referred to by practitioners as “decoupling.” Essentially, an estate tax is calculated independent of the federal estate tax.

One result of decoupling is that though there may be no federal estate tax at the first spouse’s because of a combination of the applicable exclusion amount and the marital deduction, there could be a state death tax under what once were “properly” drafted estate planning documents.

Example of the Problem.

Under certain state statutes, the applicable exclusion amount (that amount that is free of estate tax independent of the marital deduction) is frozen, such as say at 2,000,000 (Illinois for example). In that situation, the typical marital deduction clause that reduces federal taxes to zero without reference to state taxes will result in a state death tax at the death of the first spouse. For example, assume that in 2009 a married person dies with a typical “reduce to zero” estate plan, bequeathing the applicable exclusion amount to the Family Trust and the balance of the estate to the surviving spouse or to a marital deduction trust for the surviving spouse. A gift of the largest amount necessary to reduce federal estate taxes to zero would produce a Family Trust of $3,500,000 but would incur an Illinois tax of $229,200.

The only way to avoid this tax would be to limit the size of the Family Trust to $2,000,000, but doing this forgoes the use of the deceased spouse's full exclusion amount, thus exposing an additional $1,500,000 of potential tax at the surviving spouse's death, if there is such an estate tax. Most traditional marital formula clauses do not address this problem because they direct the fiduciary to consider the federal *credit* for state death taxes, not state death taxes themselves.

If the choice is between paying a tax in 2009 to increase the size of the Family Trust or avoiding a tax but increasing the size of the surviving spouse's estate, then one must compare relative tax rates. This seemingly simple comparison is compounded, however, because (a) under current law there is no tax at all if the surviving spouse dies in 2010 and (b) most planners believe that the current system is so unworkable that Congress is sure to make some major change, perhaps making repeal permanent. And making that decision while drafting the documents now – that is, choosing between maximizing the property free of federal estate tax or incurring a state death tax prematurely –is not practical.

Therefore, for the practitioner, the goal is to draft documents in the way that will allow the client to "wait and see," and decide the answer to the above question after the first spouse passes away.

One Way to Do This

First, in a typical "reduce to zero" situation, if the Family Trust is a net income trust for the benefit of the spouse, the client generally may not need to make any further revisions to the plan. If the first spouse's death might produce a tax (such as an Illinois resident's death in 2009), the executor or trustee can manage the state death tax situation by making a partial QTIP election with respect to the Family Trust, choosing to limit it in order to avoid or minimize the state death tax. For example, if an Illinois spouse dies in 2009, a partial QTIP election with respect to a net income Family Trust could limit the taxable estate to $2,000,000, thus avoiding the Illinois tax.

Example: Wife dies in 2009 and her estate plan provides that the first 3.5 million of her estate passes to a credit shelter trust. The remaining balance, say, 2 million, passes outright to the spouse. As to the credit shelter trust, her husband is a mandatory income beneficiary and the sole discretionary principal beneficiary. The State of Illinois imposes an estate tax on all non-marital dispositions in excess of 2 million. The husband does not want to incur Illinois estate tax at that time. Therefore, as to the 3.5 million credit shelter trust, the executor elects to have 1.5 million of that (1.5 million/3.5 million) treated as qtip, thereby qualifying it for the marital deduction. The remaining 2 million is a credit shelter trust. The credit shelter into two trusts pursuant to the terms of the document. There is no State estate tax, though the new 1.5 million qtip trust will be included in the husband's gross estate.

Drafting Example: Make sure that the CST will qualify for qtip. Two requirements to keep in mind here: the trust must provide income; and there can be no discretionary beneficiary of the trust during the spouse's lifetime other than the spouse. The following, for example, would qualify.

Article 5
Family Trust

The trustee shall administer the Family Trust as follows:

Mandatory Payment of Income. Beginning with my death, the trustee shall pay all the income to my spouse.

Discretionary Payment of Principal. The trustee may pay to my spouse as much of the principal as the trustee from time to time considers necessary for the health or maintenance in reasonable comfort of my spouse. I recommend that the trustee make no payment of principal to my spouse if any part of the principal of the Marital Trust is reasonably available for those purposes.

<u>Iteration to Solution: Another Way</u>

The net income Family Trust, however, may not be desirable for a number of reasons. First, the client may not wish to have all of the income payable to the surviving spouse. In larger estates, the ability of the trustee to accumulate income, or to pay it among descendants pursuant to discretionary authority, helps to minimize the surviving spouse's estate and can result in a lower over-all income tax rate, to the extent children or grandchildren are in lower tax brackets than the surviving spouse. A second disadvantage of the net income Family Trust is that a partial QTIP election will require future principal invasions for the benefit of the surviving spouse to be made on a pro-rata basis from assets some of which will be, and some of which will not be, taxable in the surviving spouse's estate.

Another way to address the state estate tax issue is to provide in the federal credit/marital deduction formula that the credit shelter trust is to be funded with the largest amount that will result in no Death Taxes (defined to include State and federal estate and inheritance taxes). This formula could underfund the credit shelter trust for federal estate tax purposes. But in this setting, the "wait and see" approach will rely on disclaimers to increase the credit shelter trust (at the expense of incurring state estate taxes).

In that instance, the spouse will have the right to disclaim a portion of the marital share, with that portion then being distributed (after the payment of state estate taxes caused by the disclaimer) to the credit shelter trust.

Drafting Example: The disclaimer provision in the document would recognize that it is the marital share that could be disclaimed, and specifically provide that the disclaimed share is being held in a special trust.

1.1 ***"Effect of Disclaimer of Marital Trust.*** *To the extent the Marital Trust is disclaimed by or on behalf of my spouse, the disclaimed portion shall be held as a disclaimer trust and administered under the same terms as the Family Trust, except that my spouse shall have no power of appointment over the disclaimer trust."*

In the above example, it will be critical that the document allocates any increased taxes to the disclaimed portion, as follows:

1.2 " Notwithstanding the preceding two sentences:

(a) The trustee shall pay from the disclaimed assets the amount by which my Death Taxes are increased by reason of a disclaimer of any portion of the Marital Trust."

Conclusion

As the federal estate tax continues to be uncertain and ever-evolving, the complexity to the estate planner increases. Estate planners must now be very careful with their traditional marital deduction/credit shelter formula in order to prevent the unintentional incurrence of state inheritance or estate taxes at the passing of the first spouse.