State Estate Tax Planning and Portability

By Sanford J. Schlesinger, Esq. and Martin R. Goodman, Esq.

Traditionally, married couples who want to avoid the payment of federal estate taxes on the death of the first of them to die and who want to provide for the support of the surviving spouse generally had two alternatives available to them to accomplish those goals.

First, the parties could provide in their testamentary documents that the first of them to die bequeaths his and her entire estate either to the surviving spouse, outright and free of trust, or to a trust for the lifetime benefit of the surviving spouse that qualifies for the federal estate tax marital deduction. Under this alternative, the estate of the first to die would not have to pay any federal estate taxes, and such a decedent would have made his or her entire estate available to support the surviving spouse. In addition, all of the assets that the decedent bequeaths to or in trust for the lifetime benefit of the surviving spouse would receive a so-called "stepped up" basis for income tax purposes at the surviving spouse's death, as all of such assets would be includible in the surviving spouse's estate for estate tax purposes. However, the first spouse to die would not be using his or her estate tax exclusion effectively, since, as stated above, all of the assets that the decedent bequeathed to or in trust for the benefit of the surviving spouse would be includible in the surviving spouse's gross estate for estate tax purposes.

Second, the parties could provide that the first of them to die would bequeath the portion of the decedent's estate that could pass free from the payment of federal estate taxes by reason of the unused portion of the decedent's basic exclusion amount (the credit shelter amount) to a trust for the lifetime benefit of the surviving spouse that would not qualify for the federal estate tax marital deduction (a so-called credit shelter trust). The balance of the decedent's estate would be bequeathed either to the surviving spouse, outright and free of trust, or to a trust for the lifetime benefit of the surviving spouse that would qualify for the federal estate tax marital deduction. This type of planning is commonly referred to as "credit shelter trust planning." In such event, there would be no federal estate tax payable by the estate of the first spouse to die, and all of the assets of the first spouse to die would be available to support the surviving spouse. In addition, the credit shelter trust would not be includible in the surviving spouse's estate for estate tax purposes on his or her subsequent death, thereby resulting in the first spouse to die having used his or her federal estate tax exclusion effectively. However, since the credit shelter trust would not be includible in the surviving spouse's gross estate for estate tax purposes on his or her subsequent death, the assets in that trust would not receive a stepped-up basis at that time.

The elimination of the federal estate tax credit for state death taxes paid caused many states to "de-couple" their state estate tax from the federal estate tax regime. As of this writing, these states include Connecticut, Illinois, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oregon, Rhode Island, Vermont, and Washington. In addition, the District of Columbia also has de-coupled its estate tax from the federal estate tax regime. As a result, married couples who reside in one of those states and who use credit shelter trust planning could have to pay a substantial state es-

Mr. Schlesinger is the Founding and Managing Partner and **Mr. Goodman** is a partner at Schlesinger Gannon & Lazetera LLP, New York, New York. Mr. Schlesinger is a member of the CCH Financial and Estate Planning Advisory Board.

tate tax on the death of the first spouse to die, even though no federal estate taxes would be payable as a result of such death. Thus, married couples who reside in a state that has de-coupled its estate tax from the federal estate tax regime would be required to choose between the first alternative described above, to avoid the payment of state estate taxes on the death of the first spouse to die, at the cost of not effectively using that decedent's federal estate tax exclusion, and credit shelter trust planning to effectively use the federal estate tax exclusion of the first spouse to die, at the cost of paying state estate taxes as a result of that death.

The elimination of the federal estate tax credit for state death taxes paid caused many states to "de-couple" their state estate tax from the federal estate tax regime.

However, the recent advent of portability for federal estate tax and gift tax (but not for generation-skipping transfer tax) purposes has created the possibility of a third alternative that would allow such couples to both (1) effectively use the federal estate tax exclusion of the first spouse to die and (2) avoid the payment of state estate taxes on such person's death. This column will discuss this third alternative and the benefits that may result from utilizing it.

Background

Prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) (EGTRRA), Section 2011 of the Internal Revenue Code of 1986, as amended (the Code), allowed a decedent's estate to claim a credit against the payment of federal estate taxes for state death taxes paid by the estate, based upon a graduated rate table. However, if the state in which the decedent resided at his or her death did not impose an estate tax (or an inheritance tax), then the decedent's estate generally would not be required to pay any state death taxes and there would be no such federal credit. As a result, most states had a state estate tax, commonly referred to as a "pick-up tax," that was equal to the maximum amount of such federal credit. Thus, in such a state a decedent's estate would pay the state estate tax and would have a credit for such payment against the amount of federal estate taxes that the estate was required to pay. The economic consequence to the estate was not to increase the combined amount of federal and state estate taxes that the estate would pay, but merely to shift the payment of a portion of the combined amount of such taxes from the federal government to the state.

EGTRRA phased out this federal credit over a three year period, starting in 2002 and ending in 2004, and replaced the credit for estates of decedents dying after 2004 with a federal estate tax deduction for state death taxes paid by the estate.[1] This phase out and eventual elimination of such credit caused states that had their estate tax based upon the amount of such credit to lose an important source of revenue. As a result, many of those states changed their estate tax regime by enacting estate tax, inheritance tax and/or succession tax regimes to make up for the loss of revenue due to the elimination of such credit; thus, these states de-coupled their estate tax from the federal estate tax regime. However, different states de-coupled based on different pre-EGTRRA exemptions, and different states therefore have different exemption amounts.

For example, the State of New York de-coupled its estate tax by basing the computation of the New York estate tax on the amount of such credit that was in effect of July 22, 1998. In addition, the unified credit for New York State estate tax purposes for the estates of persons dying after 2001 was fixed at $345,800, which is the amount of the federal estate tax that is due on a taxable estate of $1,000,000. Thus, the State of New York in effect created a $1,000,000 New York State estate tax exemption.

In addition, the amount of the federal estate tax exclusion, or the basic exclusion amount, which is adjusted for inflation, has increased to $5,250,000 for the estates of persons dying in 2013 and will increase to $5,340,000 for the estates of persons dying in 2014.

As a result of these tax law changes, if a person dies a resident of a state that has de-coupled its estate tax from the federal estate tax regime, and if the person utilizes traditional credit shelter trust planning, such person's estate could be required to pay a substantial state estate tax, even though the estate would not be required to pay any federal estate tax. For example, in the case of a New York State resident who uses credit shelter trust planning, the decedent's estate would be required to pay New York estate taxes of $420,800, if the person dies in 2013, or $431,600, if the person dies in 2014. In the case of a New York State resident who uses credit shelter trust planning and who directs that the New York State estate tax should be paid from the portion of his or her estate that qualifies for the federal estate tax marital deduction, rather than from the credit shelter trust, the estate would be required to pay New York estate taxes of $478,182, if the person dies in 2013, or $490,454, if the person dies in 2014.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) (the 2010 Tax Act) introduced the concept of portability, which applied in the case of married couples. With portability, the estate of the first spouse to die could elect to permit the surviving spouse to use the unused portion of the deceased spouse's federal estate tax exclusion for gift tax and/or estate tax purposes (but not for generation-skipping transfer tax purposes). Thus, if the first spouse to die bequeaths his or her entire estate to the surviving spouse in a manner that qualifies for the federal estate tax marital deduction, and the decedent's estate elects portability, the entire bequest would qualify for the federal estate tax marital deduction, the decedent's estate would not use any portion of his or her federal estate tax exclusion, and the surviving spouse could use the entire amount of the deceased spouse's exclusion for gift tax and/or estate tax purposes.[2]

A Third Alternative

The existence of portability creates a third planning alternative to the two types of estate planning that are described at the beginning of this column. Pursuant to this third alternative:

- The first spouse to die would bequeath an amount equal to the state estate tax exemption of the state in which the decedent is a resident to a traditional credit shelter trust, which would not qualify for the federal estate tax marital deduction (or to a trust which could qualify for such deduction, such as a trust receiving qualified terminable interest property (QTIP), but as to which the decedent's executor would not make a QTIP election) and which, therefore, would not be includible in the estate of the surviving spouse for federal estate tax purposes.
- The first spouse to die would bequeath the balance of his or her credit shelter amount remaining after the above-described bequest to a trust for the lifetime benefit of the surviving spouse that would qualify for the federal estate tax marital deduction, such as a trust receiving QTIP property.
- The first spouse to die would bequeath the balance of his or her estate to the surviving spouse, either outright and free of trust, or to a trust for the lifetime benefit of the surviving spouse that would also qualify for the federal estate tax marital deduction; again, such as a trust receiving QTIP property.
- The executor of the estate of the first spouse to die would make a QTIP election for the second bequest described above and for the third bequest described above (if such bequest is to a QTIP trust).
- The executor of the estate of the first spouse to die would elect portability.
- The surviving spouse would make lifetime gifts to the natural objects of her bounty, in an amount equal to the amount that is "ported" from the estate of the first spouse to die to the surviving spouse.

As a result of this planning, the estate of the first spouse to die would not pay any federal estate taxes, as the bequest to the credit shelter trust will be less than the amount of the decedent's basic exclusion amount, and the remaining bequests would qualify for the federal estate tax marital deduction. In addition, the parties would effectively use the federal estate tax exclusion of the first spouse to die as a result of the bequest to the credit shelter trust and the lifetime gifts that the surviving spouse would make. This result would ensue because, if a spouse dies and his or her estate elects portability and, if the surviving spouse thereafter makes lifetime gifts, the surviving spouse is deemed to have first used the amount that is ported from the estate of his or her last deceased spouse to the surviving spouse, before the surviving spouse uses his or her own exclusion.[3] Further, the estate of the first spouse to die would not pay any state estate taxes, even if he or she dies a resident of a state that de-coupled from the federal estate tax regime, and the parties would effectively use the state estate tax exemption of the first spouse to die by the bequest to the credit shelter trust.

... if a person dies a resident of a state that has de-coupled its estate tax from the federal estate tax regime, and if the person utilizes traditional credit shelter trust planning, such person's estate could be required to pay a substantial state estate tax, even though the estate would not be required to pay any federal estate tax.

As a variation to this third planning alternative, the first spouse to die could dispense with the above-described bequest to a credit shelter trust of an amount equal to the state estate tax exemption, and instead bequeath an amount equal to his or her entire credit shelter amount to a QTIP trust, in which event the amount that would be ported from the estate of the first spouse to die to the surviving spouse would be the decedent's entire credit shelter amount, and the surviving spouse would then make gifts equal to such amount. In such event, the estate of the first spouse to die would not pay any federal estate taxes, and the parties would effectively use the federal and state estate tax exemptions of the deceased spouse as a result of the lifetime gifts that the surviving spouse would make.

It is noted that the surviving spouse usually would not incur any state gift taxes by making such gifts, since, as of this writing, the only states that impose a gift tax are Connecticut and Minnesota.

It is important to note that a surviving spouse can use the amount that is ported to him or her only by the estate of the person who is the surviving spouse's last deceased spouse. For example, if H-1 and W are married, H-1 dies and his estate elects portability, W then marries H-2, and H-2 thereafter dies before the death of W, then H-2, not H-1, is thereafter W's last deceased spouse. Thus, from and after the death of H-2, W could no longer use any amount that had been ported to her by the estate of H-1. Consequently, if H-1 dies and his estate elects portability, it would be important for W to make such lifetime gifts, using the amount ported to her from the estate of H-1 to avoid the payment of gift taxes with respect to such gifts, before W marries H-2, to avoid the possibility that H-2 would predecease W before W makes such gifts.

This planning technique does not require the surviving spouse to own independent assets that would be sufficient to make such gifts. For example, either or both of the QTIP trusts that would be created under the decedent's will for the benefit of the surviving spouse, in addition to requiring that the net income of those trusts must be distributed currently to the surviving spouse, could also give the trustee the discretion to distribute trust principal to the surviving spouse. If the surviving spouse does not have sufficient independent wealth to make such gifts, then the trustee could distribute trust principal to the surviving spouse to enable him or her to make such gifts.

In addition, the income that would be earned with respect to, and the future appreciation on, the assets that the surviving spouse would use to make such gifts would be excluded from the surviving spouse's transfer tax base (since such income and appreciation would be received by the donees of such gifts rather than by the surviving spouse), as would similarly occur with the use of a credit shelter trust. Further, if the surviving spouse is the beneficiary of the credit shelter trust, the future appreciation on the assets bequeathed to such trust would also be excluded from the surviving spouse's transfer tax base, as the trust would not be includible in his or her gross estate for federal estate tax purposes. Moreover, if the surviving spouse is the beneficiary of the credit shelter trust, even the income that such trust earns could be excluded from the surviving spouse's transfer tax base by making the distribution of such income discretionary, rather than mandatory, and by providing that the trustee could only distribute such income to the surviving spouse if his or her other available resources are insufficient to provide for his or her support.

It is noted that even though the trusts that qualify for the federal estate tax marital deduction would be includible in the gross estate of the surviving spouse for federal estate tax purposes, the amount of income that either or both of such trusts would earn during the surviving spouse's life, and that would therefore be currently distributable to the surviving spouse and includible in the surviving spouse's transfer tax base (to the extent not consumed by the surviving spouse) can, in effect, be "controlled" by the trustee by investing in low-yield, high-growth assets.

Obviously, before making such gifts, the surviving spouse would have to be comfortable in the belief that the remaining assets that are owned by him or her individually, and that are owned by such trusts, after he or she makes such gifts, and the income from such assets, will be sufficient to provide for the support of the surviving spouse for the rest of his or her life. However, if this comfort level is reached, then this technique would enable the parties to effectively use the estate tax exclusion of the first spouse to die and to also avoid the payment of state estate taxes on the death of such spouse even in the case of a de-coupled state.

It is important to note that this planning technique involves the surviving spouse making substantial lifetime gifts and, therefore, that the deceased spouse would want the donees of such gifts to be the natural objects of the bounty of the deceased spouse. Thus, this planning technique is suitable for married couples who have a long-term marriage and who do not have any children from a prior marriage, so that the deceased spouse would have a reasonable degree of certainty that the surviving spouse would make the gifts to the children of their marriage. However, in the case of married couples who do not yet have a long-term marriage, or who have children from a prior marriage of either or both of them, this planning technique may not be suitable, as the first spouse to die would be less likely to assume that the surviving spouse would make the gifts to persons who are the natural objects of the decedent's bounty.

Conclusion

This new alternative technique combines many of the best features of the two techniques that are described at the beginning of this column and has the substantial additional benefit of avoiding the payment of state estate taxes in states that have de-coupled from the federal estate tax regime.

ENDNOTES

1 Code Sec. 2058.

2 Portability, as enacted by the 2010 Tax Act, was applicable only if both spouses died after 2010 but before 2013. However, the American Taxpayer Relief Act of 2012 (P.L. 112-240) made portability "permanent," so that portability can be elected if both spouses die at any time after 2010. It is noted that as of this writing no state has specifically enacted portability.

3 Temporary Reg. §25.2505-2T.