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Mind the Gap: Coping Strategies for Federal and New York Estate Tax Exclusions

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Introduction

The recent changes in the federal estate tax laws were supposed to make estate planning easier. The "permanent" increase in the federal estate tax exclusion, combined with the "portability" of that exclusion between spouses, ideally should have eliminated tax considerations for all but the very richest American taxpayers. However, for many New York residents, the substantial—and growing—gap between the federal and state estate tax exclusions (presently $5.25 million and $1 million respectively) involves multifaceted choices and necessitates careful planning.

No one strategy will optimize the use of federal and New York estate tax exclusions in all circumstances. For some married couples, it may make more sense to pay New York estate taxes at the death of the first spouse, minimizing federal and New York taxes at the death of the survivor. In other cases, it may make more sense to minimize or eliminate New York taxes at the first spouse's death and risk exposure to higher federal and New York taxes at the survivor's death.

Neither my colleagues nor I have access to a fully functional crystal ball—if we did, our billing rates would be substantially higher. Consequently, in designing wills and revocable trusts to address the federal/New York estate tax "exclusion gap," it makes sense to keep one's options open for as long as possible. To accomplish that goal, some practitioners rely on disclaimers by the surviving spouse; others rely on partial qualified terminable interest property (QTIP) elections. However, the "Clayton" technique—allowing the deceased spouse's executor to direct assets either to a "credit shelter" trust or a QTIP trust—provides the most flexibility in achieving optimal tax consequences without interfering with the testator's substantive goals.

Federal Estate Tax

While a complete discussion of the federal estate tax is far beyond the scope of this chapter, it is helpful to review several basic elements of the tax.

The federal estate tax applies to the taxable estate of every decedent who is either a citizen or a resident of the United States.[1] The estate tax is

[1] 26 I.R.C. §2001(a) (West).

integrated with the gift tax, so that an individual's lifetime taxable gifts are factored into the tax base (and adjusted to avoid double taxation).[2]

The federal estate tax rates have ranged widely, from a maximum of 70 percent from 1977–1981 to 35 percent from 2011–2012; presently, the maximum rate is 40 percent.[3] Several credits and deductions ameliorate the bite of the federal estate tax, three of which are particularly relevant to this discussion.

First, the "unified credit" is available to all taxpayers. The credit is computed based on an "applicable exclusion amount," which represents the amount of a decedent's assets to be sheltered by the credit. The applicable exclusion amount has increased significantly over time. In 1977, the exclusion amount was $120,667. From 1987–1997, the exclusion amount was $600,000. In 2002, the exclusion amount was $1 million. For decedents dying in 2013, the basic exclusion amount is $5.25 million and is scheduled to be indexed annually for inflation.[4]

Until 2011, the federal estate tax exclusion was personal to each decedent: if a decedent failed to use the entire exclusion (e.g., because the decedent's taxable estate was less than the exclusion amount), the unused exclusion was wasted. However, thanks to a statutory change originally adopted in 2010 and made permanent on January 1, 2013, the exclusion amount is now "portable." Any portion of an individual's exclusion amount left unused at that individual's death may be used by that individual's surviving spouse.[5] For example, if a married individual dies in 2013 leaving a taxable estate of $3 million (and having made no taxable lifetime gifts), the individual's surviving spouse will have a deceased spousal unused exclusion (DSUE) of $2.25 million (i.e., the excess of the decedent's $5.25 million basic exclusion amount over the $3 million taxable estate). If the surviving spouse has not made any taxable gifts, his or her applicable exclusion amount will be $7.5 million: the sum of his or her own basic exclusion amount of $5.25 million and the $2.25 million DSUE.

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[2] 26 I.R.C. §2001(b).
[3] 26 I.R.C. §2001(c). During 2010, the federal estate tax was repealed and retroactively reinstated with a 35 percent maximum rate; however, the estates of decedents dying during that year were permitted to elect not to be subject to federal estate tax. *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312, 124 Stat. 3296, §301(a)).
[4] 26 I.R.C. § 2010(c) (West).
[5] 26 I.R.C. § 2010(c)(4).

Second, the marital deduction permits a decedent to bequeath an unlimited amount of value to his or her surviving spouse free of estate taxes, as long as that surviving spouse is a US citizen.[6] If such a bequest is made in trust, the trust must satisfy certain requirements to enable the bequest to qualify for the marital deduction. One popular vehicle for satisfying those requirements is the QTIP trust. A trust may qualify as a QTIP trust if (i) the surviving spouse is entitled to receive all of the trust's income (payable at least annually) or has a usufruct interest, for his or her life; (ii) no person (including the surviving spouse) may appoint any part of the trust's assets to anyone other than the surviving spouse during the surviving spouse's life; and (iii) the decedent's executor elects to treat the trust as a QTIP trust on the decedent's federal estate tax return (Form 709), which ensures that any balance of the trust remaining at the surviving spouse's death will be included in the surviving spouse's gross estate.[7] One potential benefit of such inclusion is that upon the surviving spouse's death, the income tax basis of the QTIP trust's assets will be adjusted ("stepped up," in the case of any appreciated asset) to equal the fair market value of those assets.[8]

Third, the decedent's federal estate tax is reduced by reason of death taxes paid to any state (or the District of Columbia) with respect to property included in the decedent's gross estate for federal estate tax purposes. Until 2002, that federal estate tax benefit was structured as a credit, so that every dollar of state death tax paid resulted in a corresponding dollar reduction in federal estate tax. The credit was based on a sliding scale, permitting a maximum credit of $1,082,800 plus 16 percent of a decedent's adjusted taxable estate over $10,040,000.[9] Many states, including New York, calibrated their estate taxes to "soak up" the credit. This "sponge tax" approach necessitated no separate state estate tax planning; the ultimate tax burden was the same as if there had been no state estate tax.

However, beginning in 2002, Congress phased out that credit, ultimately replacing it with a deduction.[10] Meanwhile, New York (among other states) maintained its estate tax as if the credit were still in place, as discussed below. As the federal estate tax exclusion has increased and the federal

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[6] 26 I.R.C. § 2056 (1997).
[7] 26 I.R.C. §§ 2056(b)(7)(B) & 2044.
[8] 26 I.R.C. § 1014(b)(10) (2010).
[9] 26 I.R.C. § 2011 (West).
[10] 26 I.R.C. § 2057 (West).

estate tax rate has decreased, state death taxes have become a more significant cost for many estates.

New York Estate Tax

New York State imposes estate tax on decedents domiciled in New York, as well as non-domiciliary decedents owning real or tangible personal property having a New York *situs*.[11] The tax is a "sponge tax," computed based on the federal death tax credit in effect on July 22, 1998. As a result, the subsequent repeal of that credit is disregarded. The tax is reduced by a "unified credit," generally determined in the same manner as the federal unified credit but based on a $1 million exclusion amount (i.e., disregarding post-2001 federal estate tax law changes).[12] Unlike the federal exclusion amount, the New York exclusion amount is not indexed for inflation. Thus, based on current law, the gap between the federal and New York exclusions—presently $4.25 million per taxpayer—is scheduled to increase over time.

Since New York's estate tax law remains thus "frozen in time" and exclusion amount portability is a creature of 2010 federal estate tax law, New York does not allow portability. Consequently, the $1 million exclusion amount remains personal to each taxpayer/decedent.

"The Gap" Problem

For very wealthy couples, there is a straightforward way to handle the disparity between the federal and New York exclusions. If an individual makes full use of his or her federal exclusion through lifetime gifting, there will be no estate tax exclusion for either federal or New York purposes—and thus no gap. (New York does not impose a state gift tax, so there is no exclusion gap applicable to gifts.) However, many couples are either unable or unwilling to make lifetime gifts of that magnitude. For moderately wealthy couples in that position, the federal-state exclusion gap creates an estate planning dilemma.

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[11] N.Y. Tax. Law §§ 952 & 960 (2004 McKinney). For New York domiciliaries, the gross estate is reduced by the value of any real or tangible personal property with a situs outside New York. N.Y. Tax. Law § 954.

[12] N.Y. Tax. Law § 951 (2010 McKinney).

For example, assume that a husband intends to provide solely for his wife upon his death (assuming the wife survives the husband), with provisions for their children only after the wife's death. Assume further that neither the husband nor the wife has made any taxable lifetime gifts. The husband's estate plan creates a "credit shelter" (a.k.a "bypass") trust for the benefit of the wife, bequeathing to that trust the maximum amount that can pass free of federal estate tax (i.e., $5.25 million if the husband dies during 2013). The husband bequeaths any balance of his estate to a QTIP trust for his wife's benefit. The credit shelter trust is intended not to qualify for the federal or state estate tax marital deduction, so that any bequest to that trust will utilize the husband's remaining estate tax exclusions. Since the credit shelter trust is not subject to the rules governing QTIP trusts, it can be designed more flexibly. For example, the trust can provide for discretionary rather than mandatory income distributions, so that if the wife does not need to spend the credit shelter trust's assets, income may be accumulated and ultimately sheltered from federal and state estate taxes at the wife's death. Moreover, unlike in the QTIP trust, the wife can be granted a lifetime power of appointment, permitting her to make gifts of the credit shelter trust's assets.

This credit shelter/QTIP trust structure fully utilizes the husband's federal estate tax exclusion at his death. However, if the husband is (and remains) a New York domiciliary, that federal exclusion use comes at a state tax cost. If the husband bequeaths the full $5.25 million exclusion to the credit shelter trust, the New York State estate tax will be $420,800.[13] To the extent the federal exclusion continues to increase and the New York exclusion remains fixed at $1 million, that first-death New York estate tax will increase.

Alternatively, the husband may avoid (or at least postpone) the first-death New York estate tax by leaving only $1 million to the credit shelter trust and the balance of his assets to the QTIP trust. In that case, the husband's estate may avoid both federal and New York tax. Moreover, the husband's estate may elect portability so that his wife receives his $4.250 million DSUE.

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[13] For ease of illustration, assume that all of the husband's assets are New York *situs* property.

Potentially, the first-death tax is a good investment for the husband and wife's family. To the extent the credit shelter trust appreciates between the date of the husband's death and the date of the wife's death, the incremental growth will escape both federal and New York estate taxes at the wife's death. Moreover, since the credit shelter trust permits income accumulation and lifetime gifts, maximizing the funding in that vehicle may afford the wife greater flexibility to accomplish her substantive lifetime planning goals.

On the other hand, the wife may expect that her own federal estate tax exclusion, combined with the DSUE she would inherit from her husband if her husband were only to utilize a portion of the credit shelter trust, may be sufficient to eliminate federal estate tax on her own gross estate. The wife may wish to re-domicile from New York to a state that does not impose an estate tax, in which case paying New York estate tax at her husband's death may be more than a mere timing issue. Depending on the family's ultimate plan to retain or sell the trust assets, the basis step-up available to QTIP trust assets at the wife's death may provide significant capital gains tax savings. Finally, the wife may regard a tax bill payable during her life more burdensome than a tax bill payable after her death.

Given the number of variable factors (including the possibility of future law changes), at the time the husband executes his will and revocable trust, it may not then be clear whether it is more advantageous (i) to fund the credit shelter trust with the husband's entire federal exclusion and trigger New York estate tax at his death or (ii) to fund the credit shelter trust only with the New York exclusion, avoiding the New York tax and relying on the DSUE and basis step-up to ameliorate the ultimate federal tax consequences at the wife's death.

In the face of such uncertainty, it is best to postpone the choice of how best to address the federal-state exclusion gap—and the related question of whether to use or "port" the federal exclusion – for as long as possible. Three common approaches accomplish that timing goal: disclaimer planning, partial QTIP elections, and the "Clayton" technique.

Disclaimer Planning

One means of deferring the exclusion gap decision is to permit a "qualified disclaimer" by the surviving spouse. Going back to our example, the husband could create a credit shelter trust only for the $1 million New York exclusion amount. The "gap" amount (or, if less, the balance of the husband's estate) would pass to a QTIP trust (or, if the husband prefers, outright to his wife). However, if the wife were to disclaim some or all of that bequest, the disclaimed portion would pass to a credit shelter trust.

To accomplish a qualified disclaimer, the wife must execute a written instrument by which she irrevocably and without qualification refuses the specified portion of the gap amount bequest. The instrument must be executed within nine months after the husband's death. Before executing the instrument, the wife must not have accepted the interest or any of its benefits. Because of the wife's refusal, the interest must pass without any direction on the wife's part (although a special rule permits the interest thus to pass to a trust for the wife's benefit, such as the credit shelter trust).[14] Under New York law, the instrument would need to be filed with the office of the clerk of the court having jurisdiction over the husband's will and notice would need to be served on the fiduciary and possibly other parties.[15]

These requirements present both risks and limitations. In some cases, the wife may be unable to make a valid disclaimer—e.g., she may be incapacitated at the time of her husband's death and may not have a durable power of attorney that specifically permits her attorney-in-fact to disclaim on her behalf. Alternatively, the wife may inadvertently accept the benefits of some portion of the interest (e.g., by withdrawing funds from a brokerage account before making the disclaimer). If the disclaimer fails to satisfy the statutory requirements, the wife will be deemed to have made a taxable gift of the disclaimed portion, potentially obviating the purpose of the plan.

Finally, to make any disclaimer to the credit shelter trust effective, the disclaimed assets must pass without any direction by the wife. Thus, the wife will be required to relinquish any power of appointment—lifetime or testamentary—in the credit shelter trust. Since one of the principal benefits of the credit shelter trust is the flexibility it affords the wife in tailoring future interests of family members (and possibly others) during her life or

[14] 26 I.R.C. § 2518(b) (West).
[15] N.Y. Est. Powers & Trusts Law § 2-1.11(c)(2) (2011 McKinney).

upon her death, the elimination of that flexibility as a result of a disclaimer is a significant drawback.

Partial QTIP Elections

Another means of addressing the exclusion gap is for the husband to bequeath the gap amount to a single trust that qualifies for QTIP treatment. Following the husband's death, the husband's executor may decide whether to elect QTIP treatment for all, some, or none of the trust.[16] Following a partial election, the trust may be divided into separate trusts on a fractional or percentage basis.[17] After the division, the trust for which the QTIP election is not made will function as a credit shelter trust, so that any balance of that non-QTIP trust remaining at the wife's death will pass free of federal and state estate taxes.

The partial QTIP election has three advantages relative to the disclaimer approach. First, it is simpler to accomplish, involving only an election on a federal estate tax return. Second, the federal estate tax return's due date can be extended (by six months) until fifteen months after the date of the husband's death, while no such extension is available for a qualified disclaimer.[18] Finally, the wife may retain her testamentary power of appointment in both portions of the trust.

On the other hand, the non-QTIP trust will be structured with the same limitations as the QTIP trust, so that the wife must receive all of each trust's net income (whether or not she needs it) and the wife may not have a lifetime power of appointment over either trust. Thus, the "QTIP-able" non-QTIP trust offers less second death tax savings potential and less flexibility of the traditional credit shelter trust.

Clayton Technique

A third approach permits the husband to create a credit shelter trust and a QTIP trust and empower his executor to apportion the gap amount between those two trusts. Under that approach, the husband's will and

[16] The QTIP election applies with respect to property, not with respect to a trust, so a partial election is possible. *See* 26 I.R.C. §2056(b)(7)(v).
[17] 26 C.F.R. §20.2056(b)-7(b)(2)(ii) (West).
[18] 26 I.R.C. §6075(a) (West); 26 C.F.R. §20.6081-1(b) (West).

revocable trust specify that any portion of the gap amount with respect to which the husband's executor elects QTIP treatment will pass to the QTIP trust, while any remaining portion of the gap amount will be added to the credit shelter trust.

In *Estate of Clayton v. Comm'r*,[19] the decedent's will created both a non-QTIP trust (Trust A) and a QTIP trust (Trust B) for the benefit of his surviving spouse. The decedent bequeathed to Trust A the amount exempt from federal estate tax by virtue of the unified credit and bequeathed the residue of his estate to Trust B, with the following proviso:

> In the event my executors fail or refuse to make the election under Section 2056(b)(7)(B)(II)(v) of the Internal Revenue Code of 1954, as amended [QTIP election], with respect to my Trust "B" property on the return of tax imposed by Section 2001 of the Internal Revenue Code of 1954, as amended, then the property with respect to which such election was not made shall pass to and become a part of the corpus of Trust "A" for the benefit of my Trust "A" beneficiaries.

After the decedent died, his widow (in her capacity as executrix) filed the estate tax return, electing QTIP treatment for a percentage of specified assets of the estate. The Internal Revenue Service disallowed the marital deduction for the property subject to the QTIP election. The estate filed a petition for redetermination in the United States Tax Court, which ruled in the Service's favor.[20]

On appeal, the Fifth Circuit reversed the Tax Court, ruling that the marital deduction was available. The court reasoned that the executor's ability to elect QTIP treatment (or not) and thus direct assets to one of two trusts was not tantamount to a power of appointment (which would invalidate QTIP status), but instead was analogous to a qualified disclaimer with retroactive effect.[21]

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[19] 976 F.2d 1486 (5th Cir. 1992).
[20] *Estate of Clayton v. C.I.R.*, 97 T.C. 327 (1991).
[21] *See Clayton*, 976 F.2d at 1498-1500.

Shortly after the Fifth Circuit decided *Clayton*, the Eighth Circuit faced the same issue in *Estate of Robertson v. Comm'r*;[22] the Sixth Circuit followed suit in *Estate of Spencer v. Comm'r*.[23] In both cases, the court reversed the Tax Court, upholding the marital deduction. After that third loss, the Treasury Department threw in the towel, adopting estate tax regulations confirming the validity of the Clayton technique: "A qualifying income interest for life that is contingent on the executor's election under section 2056(b)(7)(B)(v) will not fail to be a qualifying interest for life because of such contingency or because the portion of the property for which the election is not made passes to or for the benefit of persons other than the surviving spouse."[24]

Gap Decision Making

Armed with the husband's properly drawn testamentary instruments adopting a Clayton plan, the husband's executor in the above example can wait until after the husband's death to determine the optimal strategy for the wife and her family. At that time, the executor can assess the relevant factors in a somewhat clearer context.

If the wife is likely to outlive the husband by a substantial period, then there may be greater opportunity for appreciation in the assets of the credit shelter trust. If the wife's assets (plus any assets earmarked for the QTIP trust in all events) likely will be sufficient to provide for her lifetime needs, then the opportunity for estate tax-exempt growth in the credit shelter trust's assets may be more attractive, especially if the assets are deemed likely to grow at a rate greater than the inflation rate at which the wife's own estate tax exclusion is scheduled to increase. Finally, the flexibility of making tax-free lifetime gifts from the credit shelter trust may prove attractive to the wife.

On the other hand, the executor must weigh the immediate cost of the New York estate tax triggered by a credit shelter trust bequest, particularly if there is a possibility that the wife may become domiciled in a state that does not impose death taxes. Depending on the composition of the credit shelter trust assets and the family's ultimate plan for those assets, the eventual

22 15 F.3d 779 (8th Cir. 1994).
23 43 F.3d 226 (6th Cir. 1995).
24 26 C.F.R. §20.2056(b)-7(d)(3).

capital gains tax cost (due to the lack of a second basis step-up at the wife's death) may obviate a significant portion of the estate tax benefits afforded by the credit shelter trust. Finally, the executor must consider the possibility that the trust assets may be depleted through depreciation or consumption—in which case shifting assets to the QTIP trust and relying on portability may provide the greatest federal estate tax benefit. Especially as the federal estate tax exclusion (and thus the federal/state exclusion gap) grows, reliance on portability is likely to increase, especially in taxable estates at the lower end of the wealth spectrum.

Given the variables involved, it is essential that executors consult with skilled legal and investment advisors, as well as the beneficiaries they serve, to gather and analyze the key facts in applying the Clayton technique.

Conclusion

Since the "decoupling" of federal and New York estate taxes, married couples have been faced with a multifaceted dilemma in addressing the estate tax exclusion gap. Although the adoption of federal exclusion portability has added a new, helpful wrinkle, the decision-making process remains complex. While the Clayton technique does not provide the ultimate solution to the problem, it does create flexibility and buy time, so that executors can select the appropriate credit shelter and QTIP trust funding levels with as much relevant information as possible—and then implement that decision with a simple entry on the federal estate tax return.

Key Takeaways

- In planning for married couples, consider utilizing both a credit shelter trust and a QTIP trust and permit the executor to select how to allocate the federal/state "exclusion gap" amount.
- In some circumstances, maximizing the funding of the credit shelter trust and paying state tax at the first spouse's death may be a good investment, since appreciation in the credit shelter trust's assets will pass free of federal and state estate tax at the surviving spouse's death.
- On the other hand, the portability of the federal exclusion, the possibility of depletion of trust assets during the surviving

spouse's life, and the potential to avoid state estate taxes following a domicile change may cut in favor of limiting credit shelter trust funding.

- During the planning process, it is best to preserve flexibility, defer the decision, and gather and analyze the relevant facts as part of the administration of the first spouse's estate.

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