2009 Illinois Planning: Decoupling Revelations

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Susan T. Bart
Sidley Austin LLP
One South Dearborn Street
Chicago, Illinois 60603
(312) 853-2075
sbart@sidley.com

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Susan T. Bart
Sidley Austin LLP
Chicago, Illinois
Phone: (312) 853-2075
Email: sbart@sidley.com

Susan T. Bart is a partner in the Private Clients, Trusts & Estates Group of the Chicago office of Sidley Austin LLP. She was named as one of the top 100 attorneys by *Worth* magazine. She is a Fellow of the American College of Trust and Estate Counsel (ACTEC) and former editor of the ACTEC *Journal*. She authored the book *Education Planning and Gifts to Minors* (Illinois Institute for Continuing Legal Education ("IICLE") 2004), coauthored the award-winning book *Illinois Estate Planning Forms and Commentary* (IICLE 3rd Edition 2005), and has written numerous articles. She also writes a monthly Q & A column for MorningstarAdvisor.com on their website entitled "529 Advisor." She is a member of the Board of Directors and Chair of the Illinois Institute for Continuing Legal Education. She is also a member of the Board of Trustees of Roosevelt University, a member of the Board of Directors of the Domestic Violence Legal Clinic, which provides legal services to victims of domestic violence, and a member of the Board of Directors and Secretary for The Next Theatre in Evanston, Illinois. Ms. Bart earned a Juris Doctor degree, *magna cum laude* (Order of the Coif), in 1985 from the University of Michigan Law School where she was Articles Editor of the *Michigan Law Review*.

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1. September 1, 1989 – December 31, 2004

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STATE DEATH TAX CREDIT TABLE

Taxable Estate/ Bracket Amount	Tax on Bracket Amount	Tax Rate on Excess Over Bracket Amount
900,000	27,600	5.6%
1,100,000	38,800	6.4%
1,600,000	70,800	7.2%
2,100,000	106,800	8.0%
2,600,000	146,800	8.8%
3,100,000	190,800	9.6%
3,600,000	238,800	10.4%
4,100,000	290,800	11.2%
5,100,000	402,800	12.0%
6,100,000	522,800	12.8%
7,100,000	650,800	13.6%
8,100,000	786,800	14.4%
9,100,000	930,800	15.2%
10,100,000	1,082,800	16.0%

3. "Pick-Up" states predominate by 2001.

B. **Phase Out of Credit**. 2001 legislation phases out state death tax credit by 2005. As of 2005, the state death tax credit was fully phased out.

C. **Deduction**. As of 2005, Code Section 2058 provides an unlimited deduction for state death taxes paid.

D. **Resurrection of the State Death Tax Credit: 2011?**

II. **Lamentations by the States**

A. **To Decouple or Not to Decouple**

1. Half the states have not decoupled and currently have no estate tax.

2. About one-third of the states decoupled (e.g., Illinois) or had taxes tied to state death tax credit as in effect in an earlier year (e.g., New York and D.C.).

3. Some states had both a pick up tax and inheritance tax, and now have only an inheritance tax (e.g., Indiana).

4. Some states created a separate state death tax (Connecticut and Washington).

B. **Repeal**. Under current law, in 2010 there will be no federal estate tax. Also in 2010, Illinois returns to its old rules and becomes, once again, a "pick-up tax" state. Thus in 2010, without a change in federal or Illinois law, there would be no Illinois estate tax.

C. **2001 Estate Tax System Revived in 2011**. Absent a change in federal tax laws, in 2011 we return to the federal estate and gift tax rules as they existed in 2001, including a revival of the state death tax credit. States that did not decouple, but that still have a pick-up tax, would again begin collecting estate tax revenues.

III. **Revelation 1: The 2001 Tax Act tax rate changes were not a sacrifice by the federal government.**

A. **Little Reduction in Federal Rates with State Death Tax**. Federal marginal rates were reduced only slightly if there is a state death tax.

2008 MARGINAL FEDERAL ESTATE TAX RATES			
	2001 Federal Rate With Pick Up Tax	**Federal Rate with Decoupling**	**Federal Rate with No State Tax**
$3,000,000	46.2%	42.0%	45.0%
$5,000,000	43.8%	40.5%	45.0%
$10,000,000	44.8%	39.3%	45.0%

B. **Increase in Federal Rates if No State Death Tax**. Federal marginal rates increase slightly if a state no longer has a state death tax.

C. **Fifty Percent Tax**. Combined rates are still 50% or higher.

2009 COMBINED MARGINAL ESTATE TAX BRACKETS		
Taxable Estate	**Prior to Decoupling**	**After Decoupling**
$5,000,000	55%	50.5%
$10,000,000	60%	51.9%
$20,000,000	55%	52.6%

IV. Revelation 2: The states are not willing to be as generous as the federal government in raising the exclusion.

A. "Exclusions" for Decoupled States

1. Few states recognize all the scheduled increases in the federal exclusion under the 2001 Tax Act. However, North Carolina, Vermont and Virginia do.

2. Illinois recognizes the 2001 Tax Act increases only up to $2,000,000.

3. Some states recognize a $1,000,000 exclusion (Maine, Maryland, Massachusetts, Minnesota, Nebraska, New York, Oregon).

4. Some states recognize a $675,000 exclusion (D.C., New Jersey, Rhode Island, Wisconsin).

B. What Does It Mean to Say that the State Only Recognizes the Exclusion up to Certain Amount?

1. There is no deduction of the exclusion amount before applying the state death tax credit table.

2. There is no credit against the state tax calculated using the state death tax credit table.

3. The estate tax exclusion matters only for purposes of applying Code Section 2011(e), which says that the state death tax credit cannot exceed the federal tax. This limitation was necessary when there was a federal credit for state death taxes, to avoid giving a credit greater than the taxes owed.

4. The 2011(e) limitation is no longer a logical necessity. However, it ensures that if the state recognizes the federal exclusion, an estate plan that funds the Family Trust with the federal exclusion will not result in estate tax.

a. The state death tax credit table produces a tax even for estates under the exclusion amount. For example, the tax on an estate of $2,000,000 is $99,600.

b. If the state recognizes the federal exclusion, Code Section 2011(e) prevents a state death tax credit for a Family Trust funded with the exclusion amount.

c. However, if the state recognizes a lower exclusion amount for purposes of applying the 2011(e) limitation, funding the Family Trust with more than the state exclusion amount imposes state taxes on the full amount in the Family Trust, not just the amount above the state exclusion.

V. **Revelation 3: Taxable gifts can push an estate into state taxation.**

A. **State Death Tax Table**. The state death tax credit table is applied against the taxable estate less $60,000. The taxable estate does not include lifetime taxable gifts.

B. **2011(e)**. It is the limit in 2011(e) that would prevent a tax on an estate of less than the state exclusion amount. Code Section 2011(e) calculated the federal tax on the estate, reduced by the unified credit, and limited the state death tax credit to no more than the federal tax. However, in calculating the federal tax, lifetime gifts are taken into account.

C. **Impact of Lifetime Gifts**. Thus if lifetime taxable gifts plus the taxable estate exceed the state exclusion amount, state estate tax will be imposed in a decoupled state.

D. **Examples**. Examples (assuming $2,000,000 state exclusion in 2008).

1.

Lifetime Gifts	$ 100,000
Taxable Estate	$2,000,000
State Estate Tax	$ 31,507

2.

Lifetime Gifts	$1,000,000
Taxable Estate	$1,500,000
State Estate Tax	$ 60,526

VI. **Revelation 4: When the state death tax applies, it starts taxing every dollar over $60,000.** In Illinois, the tax on different size estates in 2008:

A. **Example 1**. $2,000,000

Federal	0
State	0
Total	0

B. **Example 2.** $2,001,000

Federal	308
State	308
Total	616

C. **Example 3.** $2,387,190

Federal	120,162
State	120,163
Total	240,325

D. **Example 4.** $2,500,000

Federal	167,167
State	128,519
Total	295,685

VII. **Revelation 5: In Illinois, you may need to know your algebra to calculate the estate tax.**

The state death tax credit table is applied against the taxable estate less $60,000. One of the deductions taken in determining the taxable estate is the 2058 deduction for state death taxes. This requires an interrelated calculation. Some states disallow the 2058 deduction in computing state death taxes.

VIII. **Revelation 6: Land in a state of nonresidency can be taxed even if its value is less than the state's exclusion.**

A. **Assumptions:**

1. $1,000,000 total estate passing outright to children.

2. $250,000 Wisconsin vacation home.

3. Death in 2008. No lifetime taxable gifts.

B. **Step 1**: Calculate state death tax credit on $1,000,000, which is $33,200.

C. **Step 2**: Apply 2011(e) test, using $675,000 estate tax exclusion under Wisconsin law.

Federal tax on $1,000,000	=	$345,800
Unified Credit on $675,000	=	(220,550)
		$125,250

Section 2011(e) limitation does not apply.

D. **Step 3**: Pro rate state death tax credit.

$$\frac{\$250{,}000}{\$1{,}000{,}000} \quad \times \ \$33{,}200 = \$8{,}300$$

E. **Tax**. Wisconsin tax = $8,300.

IX. **Revelation 7: Lifetime, even deathbed, gifts can reduce tax.**

A. **State Gift Tax**

1. **Gift Tax**. Some states, such as Connecticut, Louisiana, North Carolina and Tennessee, have a gift tax.

2. **Estate Tax**. Even if a state does not have a gift tax, it may include in the taxable estate for estate or inheritance tax purposes certain gifts made prior to death. For example, Maryland imposes inheritance tax on (a) transfers made in contemplation of death and (b) transfers not made in contemplation of death, but made within two years of death and which are of a material part of the property of the decedent in the nature of a final disposition or distribution.

B. **Tax-Free Gifts**. If a client lives in a state with an exclusion less than $1,000,000 (or owns out-of-state assets in such a state) but no state gift tax, the client could make lifetime gifts of the federal exclusion amount ($1,000,000), to ensure that at least $1,000,000 of the first spouse's exclusion can be used without incurring state estate tax at the first spouse's death.

1. The gift must be complete and must remove the assets from the donor's estate. Therefore the donor cannot retain any interest in, or power over, the gifted assets.

2. However, if the donor is married, the donor could make a gift of the donor's lifetime exclusion to a Family Trust of which donor's spouse could be a discretionary beneficiary.

   a. Donor's spouse cannot split this gift.

   b. If donor's spouse attempts to create a mirror image trust, the reciprocal trust doctrine may apply.

3. If the client is reluctant to make the gift immediately, but wants to facilitate making the gift in the future, perhaps when the client's health takes a turn for the worse, the client could create a standby Family Trust in a separate document. The trust would be revocable until funded with more than a nominal amount.

C. **Taxable Gifts**. If a client lives in a state with a state estate tax, but no state gift tax, lifetime gifts, even if made within three years of death, will reduce the overall tax bill by eliminating state estate tax on the gifted assets.

1. **Calculation of State Estate Tax**. The state death tax credit is calculated on the taxable estate, and does not include lifetime taxable gifts.

2. **Gift Tax**. If gift tax is paid on a lifetime gift made within three years of death, the tax is included in the taxable estate, thus producing no federal tax advantage to lifetime gifts within three years of death except to the extent such gifts remove the future income or appreciation on the gifted assets from the estate. However, estate inclusion of the gift tax does not affect the state tax savings.

3. **Don't Bankrupt Estate**. Care should be taken to leave sufficient assets in the estate to pay debts, gift taxes, estate taxes and specific bequests.

4. **Reluctance to Pay Gift Tax**. Clients may be reluctant to incur a current gift tax, especially if they believe that the estate tax may be repealed or significantly reduced by the time of their deaths. However, deathbed gifts may still be attractive.

5. **Example**:

a. $10,000,000 estate.

b. Impact of $6,000,000 lifetime gift with death within three years.

	No Gift	Gift
	$10,000,000	$10,000,000
Gift Tax	0	(2,235,000)
Federal Estate Tax	(3,182,885)	(1,250,707)
Illinois Estate Tax	(926,923)	(253,986)
Remainder	$ 5,890,192	$ 6,260,307

Savings: $370,115 (about 6% of gift)

c. Impact of $6,000,000 lifetime gift with survival by three years (ignoring changes in rates and exclusions).

	No Gift	Gift
	$10,000,000	$10,000,000
Gift Tax	0	(2,235,000)
Federal Estate Tax	(3,182,885)	(324,543)
Illinois Estate Tax	(926,923)	(77,127)
Remainder	$ 5,890,192	$ 7,363,330

Savings: $1,473,138 (about 25% of gift)

D. **Basis**. However, assets given away during life have a carryover basis, whereas assets included in the estate receive a stepped up basis. Therefore, generally only high basis assets should be given away during life to avoid state estate taxes.

1. **Gift Tax**. However, if gift tax is paid, the gift tax is added to basis.

2. **Loan**. A loan from a third party lender can provide cash with which to make deathbed gifts without selling low basis assets. A line of credit could facilitate lifetime gifts.

3. **Depreciated Assets**. If the donor makes a gift of an asset with basis greater than its value, under Code Section 1015(a) the donee's basis for purposes of determining loss will equal the fair market value at the time of the gift. In other words, the donee cannot take advantage of the donor's accrued loss.

a. Thus if the donor can use the loss, the donor should sell the asset and gift the proceeds.

b. However, if the donor cannot use the loss, gifting the asset can have an advantage if the asset subsequently appreciates. The donee's basis for gain would be the donor's carryover basis. However, if the asset passes through a decedent's estate, the beneficiary's basis would be limited to fair market value at the time of death.

E. **Deathbed Gifts**

1. **Lessons from King Lear**. Most parents think their children are all Cordelias. But when your client discovers they are Reagans and Gonerils, who will the client blame?

2. **Gifting Mechanism.**

a. Transfer by donor.

b. By agent under power of attorney.

c. By trustee under revocable trust.

d. By special gift trust.

3. **Problems of Completing Gifts Prior to Death**

F. **Gifting Mechanism.**

1. **Donor**. The donor may not have the capacity to make a gift. Even if the donor has the mental capacity, practical obstacles arise if the donor cannot sign the donor's signature. Further, advisors and family members may be reluctant to raise tax planning issues at such time.

2. **Agent Under Power of Attorney**. Generally, the agent does not have the authority to make gifts unless explicitly granted such power in the instrument. When gift making power is routinely granted, often it is limited in amount (e.g., to the annual exclusion) and to a particular class of donees (e.g., descendants). Further, the power of attorney may leave open questions such as whether gifts can be made to a trust.

3. **Trustee Under a Revocable Trust**. A trustee under a revocable trust may be explicitly granted a power to make gifts from trust assets. All of the concerns discussed above with respect to powers of attorney apply. In addition, if the grantor is acting as sole trustee and is unable to make the gifts himself, there may be a delay while the necessary steps are taken to have the grantor resign or be removed and for the successor trustee to accept the office.

X. **Exodus: Clients are now asking not only when they should die, but where they should die.**

A. **Stay and Pay**. Certain clients may consider changing domicile in order to reduce or eliminate state death taxes.

B. **Domicile vs. Residency**. However, the concept of "domicile" is different than the concept of "residency." Further, if the individual maintains any contacts with his or her prior domicile, one should expect that the state of prior domicile may look carefully at various factors to determine whether domicile was in fact changed.

1. **Domicile**. "Every person has a domicile at all times and, at least for the same purpose, no person has more than one domicile at a time." Restatement Conflict of Laws (the "Restatement") § 11(2). Domicile is usually a person's home. Restatement § 11(1). Home is the place where a person dwells and which is the center of his domestic, social and civic life. Restatement § 12. In determining whether a dwelling place is a person's home, consideration should be given to (1) its physical characteristics; (2) the time the person spends there; (3) the things the person does there; (4)

the persons and things there; (5) the person's mental attitude toward the place; (6) the person's intention when absent to return to the place; (7) other dwelling places of the person, and similar factors concerning them. Restatement § 12(c).

2. **Capacity to Change Domicile**. However, under certain circumstances a person's domicile may not be where the person's home is located, because certain persons may lack capacity to acquire a domicile of choice. Restatement § 11, comment *a*. A person's domicile may be changed by a person who is legally capable of changing his domicile. In addition to legal capacity, acquisition of a new domicile requires a physical presence and an attitude of mind. Restatement § 15.

A person does not acquire a domicile by his presence in a place under physical or legal compulsion. Restatement § 17. Further, the requisite intent may not be present if the change of abode is for health reasons. Restatement § 18, comment *f*.

The Restatement contains special domicile rules for persons who are mentally deficient:

a. A person who is mentally deficient may acquire a domicile of choice if he has sufficient mental capacity to choose a home.

b. Special rules are applied to determine the domicile of a person who lacks the requisite mental capacity.

Restatement § 23. Comments *a* and *b* to this section of the Restatement are instructive:

> *a.* The crucial question is whether the person has sufficient mental capacity to choose a home. That he may be incapable of managing his own affairs is not conclusive; nor is the fact that he has been adjudged incompetent and a guardian appointed over his person or property.
>
> *b.* If a person after coming of age becomes mentally incapable of acquiring a domicile of choice and no legal guardian of his person is appointed, his domicile continues to be in the place where he had his domicile before he became incompetent. Except as stated in Comment *c* [dealing with incompetents living with a parent], a person, who is mentally incapable of acquiring a domicile of choice and for whose person no legal guardian has been appointed, does not acquire a new domicile in a place where he lives.

C. **Tax Savings from Change of Domicile.**

TAX SAVINGS FROM RELOCATING TO STATE WITH NO ESTATE TAX FROM DECOUPLED STATE	
Size of Estate	**Tax Savings**
$5,000,000	$193,700
$10,000,000	$509,800
$25,000,000	$1,643,700
$50,000,000	$3,540,300

XI. Lamentations for Married Couples

A. **Formulas.** Estate planning documents commonly use a funding formula upon the first death of a married couple to allocate assets between the Family Trust (aka the Credit Shelter Trust), which will not be subject to estate taxes at the surviving spouse's death, and the Marital Trust (or, alternatively, an outright gift to the surviving spouse), which will be subject to estate taxes at the surviving spouse's death. Traditionally, these funding clauses allocated an amount equal to the decedent's remaining estate tax exclusion (or a fraction of the residue defined by reference to such amount) to the Family Trust and the residue to the Marital Trust. Alternatively, the Marital Trust could be funded with a pecuniary amount and the Family Trust with the residue, but in either case the goal was to fund the Family Trust with the maximum amount that produced no federal estate tax at the first spouse's death. Before decoupling, in a pick-up tax state, this funding also produced no state death tax at the first spouse's death. However, in a decoupled state where the state estate tax exclusion is less than the federal estate tax exclusion, the precise wording of the funding clause will either result in the Family Trust being underfunded (funded with less than the federal exclusion, thus increasing estate taxes at the surviving spouse's death) or fully funded with the amount of the federal exclusion, resulting in some state estate taxes at the first death. Because there is no longer a federal credit for state death taxes, now funding clauses generally come in two varieties.

B. **Full Funding: Maximum Amount that Reduces Federal Taxes to Zero.** A funding clause that funds the Family Trust with the maximum amount that does not produce federal estate taxes, fully funds the Family Trust, but may incur some state estate taxes at the first spouse's death if the state estate tax exclusion is less than the federal estate tax exclusion. However, assuming that the surviving spouse dies with a taxable estate and that estate tax rates remain the same, this funding clause likely will produce lower aggregate estate taxes.

1. In a decoupled state with a state estate tax exclusion equal to the federal estate tax exclusion, no state death tax will result from fully funding the Family Trust with the federal estate tax exclusion amount upon the first death of a married couple because of Code Section 2011(e). Code Section 2011(e) provides that the state death tax credit shall not exceed the amount of tax imposed by Section 2001, reduced by the amount of unified credit provided by Section 2010. Although Code Section 2011(e) is irrelevant for *federal* purposes, because there is no longer a state death tax credit, it remains relevant for decoupled states that impose state estate tax in an amount equal to the state death tax credit that would have been allowed under prior law. Because no federal estate tax is imposed on the federal exclusion amount, no state estate tax would be imposed in a decoupled state provided that the state recognizes the federal exclusion for purposes of applying the 2011(e) limitation.

2. Until 2009, Illinois recognizes the increases in the federal exclusions. However, for 2009, Illinois recognizes only the $2,000,000 exclusion even though the federal exclusion will be $3,500,000. Illinois law takes into account the Code Section 2058 deduction in calculating Illinois estate taxes. For 2009, Illinois estate taxes of $229,200 will be imposed to fund the Family Trust with $3,500,000. See Exhibit 1.

3. If the state exclusion is less than the federal exclusion, and if for purposes of calculating the state estate tax, state law takes into account Code Section 2058, which allows a deduction for state death taxes, then in general:

    a. In 2008, state estate taxes of $99,600 will be imposed to fund the Family Trust with $2,000,000.

    b. In 2009, state estate taxes of $229,200 will be imposed to fund the Family Trust with $3,500,000.

4. If the state exclusion is less than the federal exclusion, and if for purposes of calculating the state estate tax state law ignores the Code Section 2058 deduction, then in general:

    a. In 2008, state estate taxes of $107,391 will be imposed to fund the Family Trust with $2,000,000.

    b. In 2009, state estate taxes of $254,910 will be imposed to fund the Family Trust with $3,500,000. See Exhibit 2.

5. The tax savings at the second death from fully funding the Family Trust at the first death depends upon the additional amount sheltered in the Family Trust by full funding, the size of the estate, and the estate tax rates then in effect.

C. **No Tax Funding: Maximum Amount that Reduces All Taxes to Zero.** A funding clause that funds the Family Trust with the maximum amount that does not produce any federal or state estate taxes avoids state estate tax on the first spouse's death. However, in a state with a lower exclusion amount than the federal amount, the Family Trust will be funded with less than the federal exclusion amount, thus increasing estate taxes at the survivor's death if the survivor has a taxable estate.

D. **Funding Variations**

1. **Ignore Inheritance Taxes.** The funding clause might minimize federal estate tax and all state estate taxes *computed by reference to a version of the Internal Revenue Code*, so that any inheritance tax would be ignored to avoid reducing the Family Trust funding if the inheritance tax begins to be assessed as relatively small amounts of property.

2. **Consider Only State of Domicile.** The funding clause might minimize federal estate tax and estate tax in the state of domicile. Thus estate tax would be paid on out-of-state property in states with a lower exclusion amount than the state of domicile.

XII. Drafting Tools

A. **Drafting Goal.** The goal of drafting for decoupling is generally not to decide when drafting the documents the extent to which to fund the Family Trust. Rather, the goal is to postpone until the first death the decision, at which time a more informed decision can be made based on the following factors:

1. Can the Family Trust be fully funded without paying state estate tax?

2. If state estate tax must be paid to fully fund the Family Trust, how much state estate tax must be paid?

3. Would paying the state estate tax to fully fund the Family Trust impose a hardship on the surviving spouse?

4. To what extent is the surviving spouse likely to consume the surviving spouse's assets and any marital trust or marital gift assets?

5. What will the estate tax rules likely be at the surviving spouse's death?

6. Will there likely be estate taxes imposed at the surviving spouse's death if the Family Trust is not fully funded? If so, what is the expected estate tax savings from fully funding the Family Trust?

B. **Available Drafting Tools.** A number of drafting tools are available to provide the flexibility to decide at the time of the first spouse's death whether to fully fund the Family Trust, thus possibly incurring state death tax at the first death, or whether to avoid (or limit) state death tax at the first death.

1. Partial QTIP elections.

2. Disclaimers.

3. Clayton QTIP provisions.

C. **Partial QTIP Elections**

1. To the extent the Family Trust is not fully funded at the first spouse's death, if a QTIP marital trust is created the executor can make a partial QTIP election to cause a portion of the QTIP to be subject to estate tax at the first spouse's death and exempt from estate tax at the surviving spouse's death. However, a partial QTIP election is not tax efficient. First, net income must be paid to the surviving spouse from both the QTIP and nonQTIP portion of the Marital Trust. To the extent income is paid from the nonQTIP portion, that depletes the portion of the trust that will be exempt from estate taxes at the surviving spouse's death and adds assets to the surviving spouse's estate. Second, if discretionary principal distributions are made from the Marital Trust, they are essentially made pro rata from the QTIP portion and the nonQTIP portion. To the extent they are made from the nonQTIP portion, that depletes the portion of the trust that will be exempt from estate taxes at the surviving spouse's death and adds assets to the surviving spouse's estate.

2. If the Family Trust is fully funded at the first spouse's death, but it is desirable not to pay state estate taxes, if the Family Trust qualifies as a QTIP, a partial QTIP election could be made over the Family Trust. However, to qualify as a QTIP, the Family Trust must distribute all net income to the surviving spouse, which is not tax efficient, as discussed above. Second, to qualify as a QTIP, the Family Trust cannot permit distributions to anyone other than the surviving spouse during the surviving spouse's life.

3. Partial QTIP elections are made by the executor, who may be better able to make the planning decisions than the surviving spouse. On the other hand, the surviving spouse often is the executor. Even if a third party is executor, the executor may be unwilling to make an election that results in state estate tax if the surviving spouse opposes such an election.

4. The executor must recognize the tax issue and actually make the election.

D. **Disclaimers**

1. **Disclaimer of Marital Trust**. To the extent the Family Trust is not fully funded, the trust could provide that if the surviving spouse disclaims the

Marital Trust or marital gift, the disclaimed portion passes to the Family Trust.

2. **Disclaimer of Family Trust**. To the extent the Family Trust is fully funded, if the Family Trust is solely for the benefit of the surviving spouse, the trust could provide that if the surviving spouse disclaims the Family Trust, the disclaimed portion passes to the Marital Trust or as a marital gift.

3. **Qualified Disclaimer**. In order to avoid gift tax consequences, a disclaimer must be a qualified disclaimer. Code Section 2518. Among other requirements, the disclaimer must be made within nine months of death and the surviving spouse must not have accepted any benefits from the disclaimed property.

4. **Power of Appointment**. Further, the surviving spouse cannot retain a power of appointment over the disclaimed assets. This could eliminate important flexibility in the estate plan.

5. **Spouse Acting as Trustee**. Attorneys disagree on whether the spouse may disclaim and still act as Trustee of the trust into which the disclaimed assets pass if the spouse's powers are limited by ascertainable standards. The Treasury Regulations on "acceptance of benefits" under Code Section 2518 provide:

> A fiduciary, however, cannot retain a wholly discretionary power to direct the enjoyment of the disclaimed interest. For example, a fiduciary's disclaimer of a beneficial interest does not meet the requirements of a qualified disclaimer if the fiduciary exercised or retains a discretionary power to allocate enjoyment of that interest among members of a designated class. See paragraph (e) of this section for rules relating to the effect of directing the redistribution of disclaimed property.

Treas. Reg. § 25.2518-2(d)(2). Thus this portion of the regulations suggests that the retention of a discretionary power, even one limited to an ascertainable standard, would disqualify the disclaimer. However, Treasury Regulations Section 25.2518-2(e)(1) states that the requirements for a qualified disclaimer are not met if the disclaimant, either alone or in conjunction with another, has the power to direct the redistribution or transfer of the property to another person unless the power is limited by an ascertainable standard. Note that the completed gift regulations seem to suggest that a power may be discretionary but subject to a reasonably definite standard. Treasury Regulations Section 25.2511-1(g)(2) provides that "the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no such standard exists."

6. **Surviving Spouse Must Act**. The decision to disclaim must be made by the surviving spouse and it can be difficult for the surviving spouse to understand the concept and the advantages of disclaiming, especially if one consequence of disclaiming is to produce immediate state estate taxes.

7. **Issue Spotting**. The surviving spouse's attorney must recognize the tax issue and advise the surviving spouse to disclaim if it would be advantageous.

E. **Clayton QTIP Provisions**

1. Under *Clayton v. Commissioner*, 976 F.2d 1486 (5th Circuit 1992) and Treasury Regulation § 20.2056(b)-7(d)(3) and -7(h) (ex. 6), the marital deduction is allowed for a QTIP trust that is funded only to the extent that a QTIP election is made. Treas. Reg. § 20.2056(b)-7(h). Thus an estate plan could provide for the residue to pass to a QTIP trust, but provide that to the extent the executor does not make a QTIP election, the assets pass to the Family Trust. The executor would decide whether to fully fund the Family Trust. Previously, the Service had taken the position that the executor's power to divert assets from the Marital Trust by failing to make a QTIP election was an impermissible power of appointment such that the Marital Trust could not qualify as a QTIP. The Fifth Circuit overruled this position (which had been upheld by the Tax Court), in *Clayton*. The Sixth Circuit, Eighth Circuit and finally the Tax Court followed *Clayton*. *Estate of Spencer v. Comm'r*, 43 F.3d 226 (6th Cir. 1995); *Estate of Robertson v. Comm'r*, 15 F.3d 779 (8th Cir. 1994); *Estate of Clack v. Comm'r*, 106 T.C. 131 (1996).

2. Treasury Regulation Section 20.2056(b)-7(d)(3) provides that for estates of decedents whose estate tax returns are due after February 18, 1997, "a qualifying income interest for life that is contingent upon the executor's election under Section 2056(b)(7)(B)(v) will not fail to be a qualifying income 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." Example 6 in the regulations provides:

> *Example 6. Spouse's qualifying income interest for life contingent on executor's election.* D's will established a trust providing that S is entitled to receive the income, payable at least annually, from that portion of the trust that the executor elects to treat as qualified terminable interest property. The portion of the trust which the executor does not elect to treat as qualified terminable interest property passes as of D's date of death to a trust for the benefit of C, D's child. Under these facts, the executor is not considered to have a power to appoint any part of the trust property to any person other than S during S's life.

Treas. Reg. § 20.2056(b)-7(h).

3. To the extent the Family Trust is not fully funded, if the Marital Trust is a QTIP trust, the trust could contain a Clayton provision that provides that to the extent no QTIP election is made over the Marital Trust, the assets will be added to the Family Trust.

4. A Clayton QTIP is better than an ordinary partial QTIP election, because the nonQTIPed assets can pass to the Family Trust and the Family Trust need not require the payment of net income to the surviving spouse. Further, discretionary principal distributions to the surviving spouse can be made from the Marital Trust rather than the Family Trust, which is more tax efficient. (In fact, the spouse need not even be a beneficiary of the Family Trust.) Further, the Family Trust can also permit distributions to other family members.

5. A Clayton QTIP is better than a disclaimer because the spouse does not have to disclaim any power of appointment over the Family Trust.

6. However, until further guidance is provided, the cautious will permit a Clayton QTIP election to be made only by an independent executor (and not by the surviving spouse or a potential beneficiary of the Family Trust) in order to avoid the argument that the surviving spouse made a gift with a retained interest by making the QTIP election.

XIII. **No-Tax Family Trust with Disclaimer Option** (Exhibit 3)

A. **Description**. With this disclaimer-based plan, the trust initially funds the Family Trust with the amount that produces no federal or state estate taxes, and provides that to the extent the surviving spouse disclaims the Marital Trust, the disclaimed assets will be added to the Family Trust.

1. Generally the trust would provide that the Family Trust would be funded with the largest amount permitted without incurring any federal or state death tax. If the surviving spouse wished to incur some state death tax at the first spouse's death in order to fully fund the Family Trust with the federal exclusion amount, the spouse would disclaim the appropriate amount from the Marital Trust. Of course the spouse would have the flexibility to disclaim a lesser amount if the spouse was willing to incur some state estate tax, but not the full amount of state death taxes that would be incurred if the Family Trust was fully funded with the federal exclusion amount.

2. To the extent the spouse does not disclaim, if the Marital Trust is a QTIP trust, the executor could make a partial QTIP election over the Marital Trust to incur some state estate tax at the first spouse's death.

3. In addition, the trust could contain a Clayton QTIP provision if the Marital Trust is a QTIP Trust. The Clayton provision would provide that if an independent executor is acting, to the extent no QTIP election is made, the assets pass to the Family Trust.

4. This disclaimer option could be drafted with an outright marital gift or a general power of appointment marital trust.

B. **Advantages**

1. Disclaimer-based planning leaves the decision of whether or not to incur state death taxes primarily with the surviving spouse, who would be most directly affected by the diminution of assets from paying estate taxes.

2. To the extent that assets are initially allocated to the Family Trust or disclaimed to the Family Trust, the net income of the Family Trust need not be distributed to the surviving spouse.

3. Discretionary distributions can be made from the Family Trust to descendants or other individuals.

C. **Disadvantages**

1. It is often difficult for surviving spouses to understand the concept of a disclaimer and to make decisions on complicated tax issues.

2. If the spouse disclaims a portion of the Marital Trust, the spouse cannot retain a power of appointment over the Family Trust. Although the trust could provide that any disclaimed portion of a Marital Trust passed to a separate disclaimer trust rather than to the Family Trust, so that the surviving spouse could retain a power of appointment over the Family Trust and only sacrifice a power of appointment with respect to the disclaimed assets, this approach complicates the planning by creating an additional trust.

3. A qualified disclaimer cannot be made if the surviving spouse has accepted any benefits from the disclaimed assets. This can create a need to postpone taking certain actions with respect to assets that might be disclaimed until the surviving spouse has made a decision about the disclaimer. In addition, it is possible that a surviving spouse may take some action that constitutes an acceptance of benefits of the disclaimed assets without understanding the tax implications of such action.

D. **When to Consider**. The No-Tax Family Trust with Disclaimer Option is appropriate when it is likely that at least a portion of the first spouse's exclusion amount must be used to minimize estate taxes.

XIV. **Three-Trust Structure** (Exhibit 4)

A. **Description**. The estate plan can direct the creation of three trusts upon the first spouse's death. The Family Trust would be funded with the greatest amount that does not result in any federal or state death taxes. The State Marital Trust would be funded with the federal exclusion amount, less the amount passing to the Family Trust. The remainder of the assets would be held in a Marital Trust or distributed outright to the surviving spouse. If the surviving spouse wished to incur some state death tax at the first spouse's death in order to fully fund the Family Trust with the federal exclusion amount, the spouse would disclaim the State Marital Trust, in which case its assets would be added to the Family Trust. The State Marital Trust would be designed to be eligible for QTIP treatment, so that to the extent the surviving spouse did not disclaim, the executor could decide whether to make a QTIP election, thereby avoiding state estate taxes at the first death, or whether not to elect QTIP treatment, thereby fully using the first spouse's federal estate tax exclusion but incurring state estate taxes. If the executor makes the QTIP election over the State Marital Trust, and if the residue also passes to a QTIP trust with similar terms, the two QTIP trusts could be merged. If the residue passes to a QTIP trust, this is functionally the equivalent of the No-Tax Family Trust with Disclaimer Option. However, this option may be simpler to explain to clients. Further, this option can be used, with slight modifications, if the client prefers that the residue pass to a general power of appointment trust or outright to the surviving spouse.

B. **Advantages**

1. Either the spouse, through disclaimer, or the executor, by not making a QTIP election over the State Marital Trust, can cause the first spouse's federal estate tax exclusion to be fully used.

2. If the document is drafted correctly, and the appropriate amount passes to the State Marital Trust, if the spouse chooses to disclaim the spouse can disclaim the entire State Marital Trust rather than having to define in the disclaimer by a formula the appropriate amount. In other words, the hard work is done in the document, making it less likely that an error will be made in the disclaimer. Similarly, the executor does not have to carefully define the amount over which to make a QTIP election, but can simply either make or not make the election over the State Marital Trust.

3. If the spouse disclaims the State Marital Trust, the income of the Family Trust need not be distributed to the surviving spouse, thus preventing an unnecessary increase in the value of the spouse's taxable estate.

4. Discretionary principal distributions to the surviving spouse can be made out of the Marital Trust, thus reducing the amount subject to estate taxes at the surviving spouse's death.

5. The Family Trust may permit discretionary income and principal distributions to descendants, as well as to the surviving spouse.

C. **Disadvantages**

1. If the spouse disclaims a portion of the State Marital Trust, the spouse cannot retain a power of appointment over the Family Trust. Although the trust could provide that any disclaimed portion of a State Marital Trust passed to a separate disclaimer trust rather than to the Family Trust, so that the surviving spouse could retain a power of appointment over the Family Trust and only sacrifice a power of appointment with respect to the disclaimed assets, this approach complicates the planning by creating an additional trust.

2. A qualified disclaimer cannot be made if the surviving spouse has accepted any benefits from the disclaimed assets. This can create a need to postpone taking certain actions with respect to assets that might be disclaimed until the surviving spouse has made a decision about the disclaimer. In addition, it is possible that a surviving spouse may take some action that constitutes an acceptance of benefits of the disclaimed assets without understanding the tax implications of such action.

D. **State QTIP Election**. If the state permits a QTIP election to be made for state estate tax purposes even if an election is not made for federal estate tax purposes, a state QTIP election can be made over the State Marital Trust. Upon the survivor's death, the State Marital Trust would be subject to state, but not federal, estate taxes.

E. **Revenue Procedure 2001-38**. This Revenue Procedure allows a surviving spouse's estate to disregard a previously made QTIP election if the election was unnecessary to eliminate federal estate taxes at the first spouse's death. Therefore it may be possible to make a federal QTIP election over the State Marital Trust, thereby avoiding all estate tax at the first spouse's death, and then to disregard the election for federal estate tax purposes at the surviving spouse's death, thereby avoiding federal estate taxes on the State Marital Trust at the survivor's death.

1. Rev. Proc. 2001-38 is not available for a partial QTIP election.

2. The IRS may not permit Rev. Proc. 2001-38 to be used where the QTIP election was necessary to avoid state estate taxes at the first spouse's death.

3. This technique may not work if state law does not permit inconsistent elections for estate tax purposes.

XV. **Three-Trust Structure with Clayton Provision** (Exhibit 5)

A. **Description.** The Three-Trust Structure with Clayton Provision is similar to the Three-Trust Structure, except that if an independent executor is acting, to the extent the independent executor does not elect QTIP treatment for the State Marital Trust, the assets are added to the Family Trust.

B. **Advantages**

1. Either the spouse, through disclaimer, or the executor, by not making a QTIP election over the State Marital Trust, can cause the first spouse's federal estate tax exclusion to be fully used.

2. If an independent executor is acting, the failure to make a QTIP election over the State Marital Trust causes its assets to be added to the Family Trust, which need not require the distribution of income to the spouse and which may permit distributions to descendants.

3. If the document is drafted correctly, and the appropriate amount passes to the State Marital Trust, if the spouse chooses to disclaim the spouse can disclaim the entire State Marital Trust rather than having to define in the disclaimer by a formula the appropriate amount. In other words, the hard work is done in the document, making it less likely that an error will be made in the disclaimer. Similarly, the executor does not have to carefully define the amount over which to make a QTIP election, but can simply either make or not make the election over the State Marital Trust.

4. The income of the Family Trust need not be distributed to the surviving spouse, thus preventing an unnecessary increase in the value of the spouse's taxable estate.

5. Discretionary principal distributions to the surviving spouse can be made from the Marital Trust, thus reducing the amount subject to estate taxes at the surviving spouse's death.

6. The Family Trust may permit discretionary income and principal distributions to descendants, as well as to the surviving spouse.

C. **Disadvantages.** The executor should be independent and should not be the spouse or any beneficiary of the Family Trust, because the executor, by making a partial QTIP election, has the power to shift beneficial interests between the spouse and the beneficiaries of the Family Trust.

XVI. **State QTIP Election.** Some states permit a QTIP election to be made for state estate tax purposes even if no QTIP election is made for federal estate tax purposes. Thus in Exhibit 6 a state QTIP election would be made over the State Marital Trust, but no federal QTIP election would be made. Thus no state or federal estate tax would be due at the first spouse's death. Upon the surviving spouse's death, the State Marital Trust will be subject to state estate tax, but not federal estate tax.

At least thirteen states permit a state QTIP election, Connecticut, Indiana, Kansas, Kentucky, Maine, Maryland, Massachusetts, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee and Washington. (New Jersey permits a state QTIP election if no federal estate tax return is filed.) Other states are likely to follow suit as they become aware of the tax planning problems created by decoupling. Therefore one may wish to draft estate plans in anticipation that a state QTIP election may be permitted at the first spouse's death.

XVII. **Generation-Skipping Transfer Tax Planning.** When generation-skipping transfer tax planning is involved, the drafting gets even more complex. Nevertheless, the same techniques of disclaimers, partial QTIP elections and Clayton provisions can be used. In most cases, you will ultimately only fund three trusts, making the trust administration manageable.

A. **GST No-Tax Family Trust with Disclaimer Option** (Exhibit 7)

B. **GST No-Tax Family Trust with Disclaimer Option and Clayton Provision** (Exhibit 8)

ALTERNATIVE DISPOSITIONS IN 2009
STATE EXCLUSION LIMITED TO $2,000,000
IF STATE ALLOWS DEDUCTION FOR STATE ESTATE TAX

REDUCE FEDERAL TAXES TO ZERO | **REDUCE ALL TAXES TO ZERO**

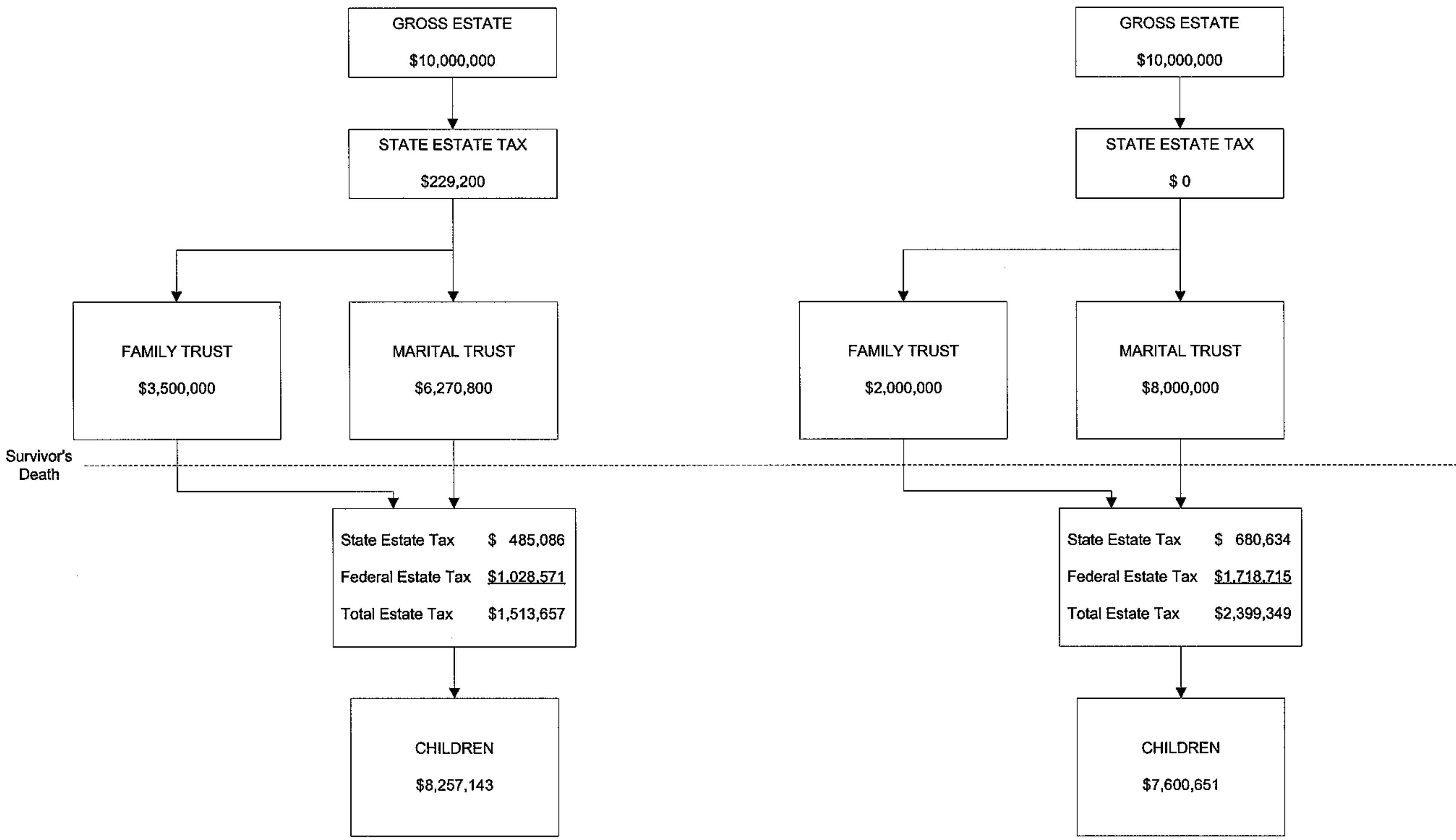

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EXHIBIT 1

ALTERNATIVE DISPOSITIONS IN 2009
STATE EXCLUSION LIMITED TO $2,000,000
IF STATE IGNORES DEDUCTION FOR STATE ESTATE TAX

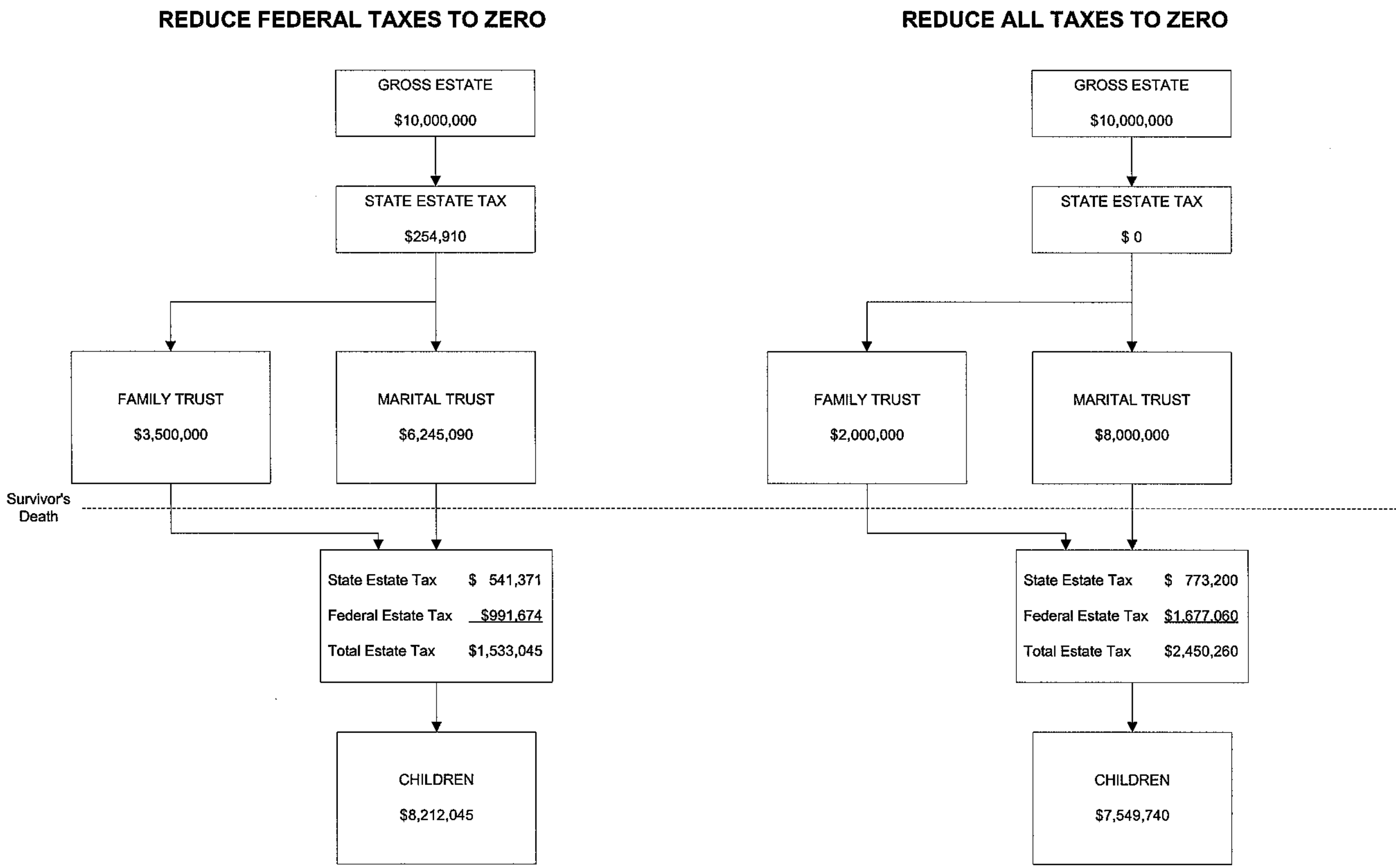

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EXHIBIT 2

NO-TAX FAMILY TRUST
WITH DISCLAIMER OPTION

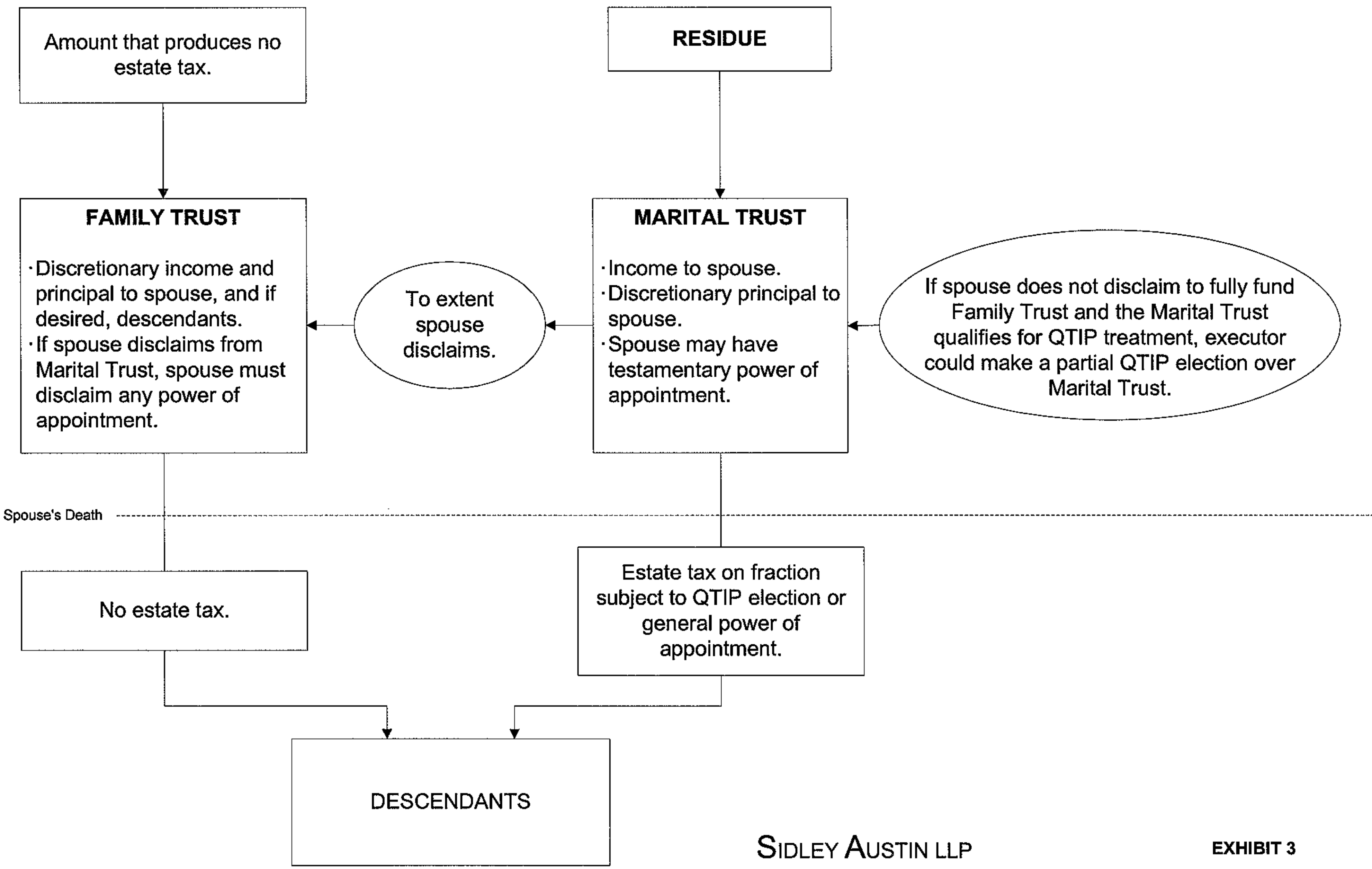

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EXHIBIT 3

THREE-TRUST STRUCTURE

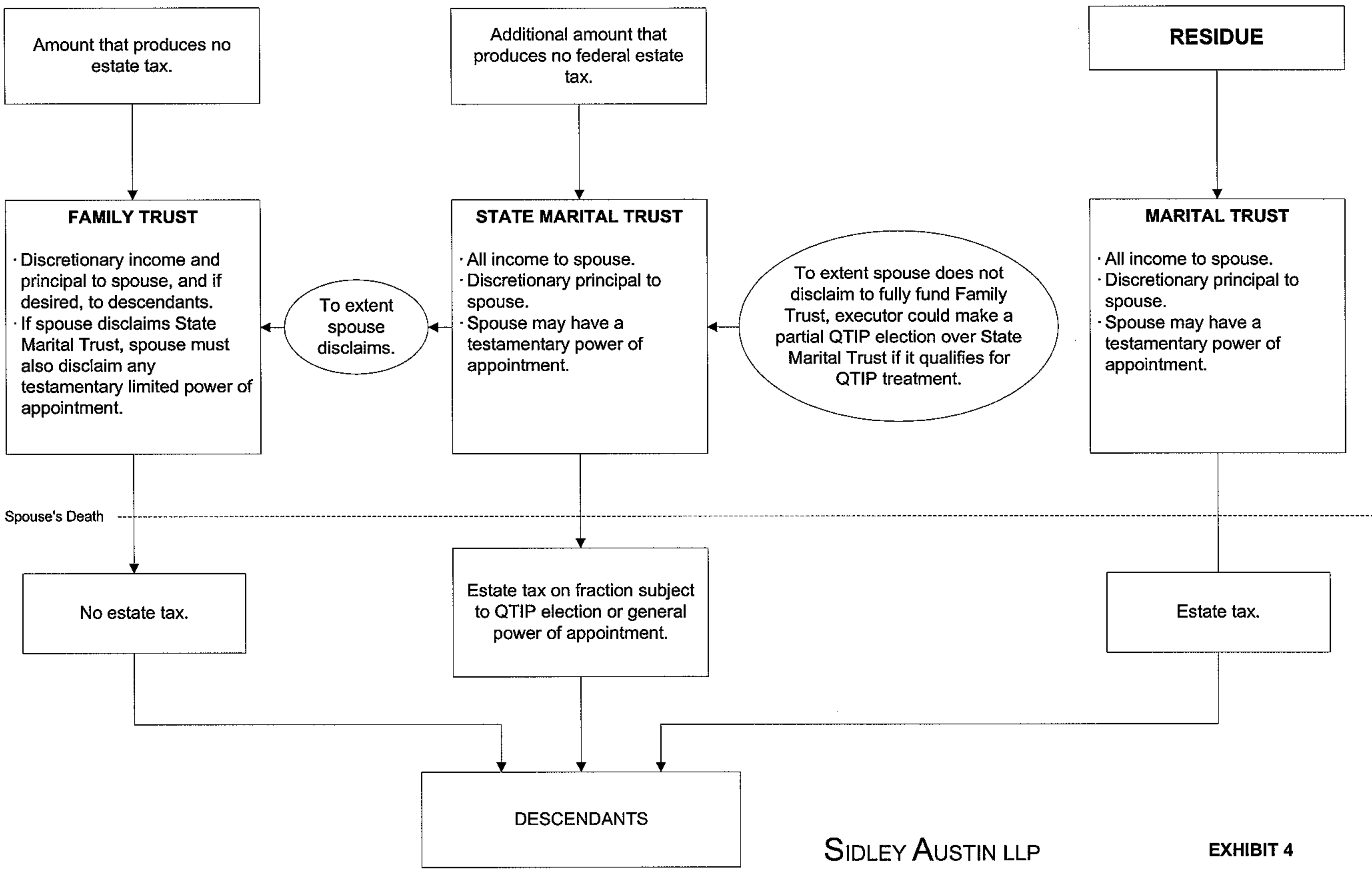

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EXHIBIT 4

THREE-TRUST STRUCTURE WITH CLAYTON PROVISION

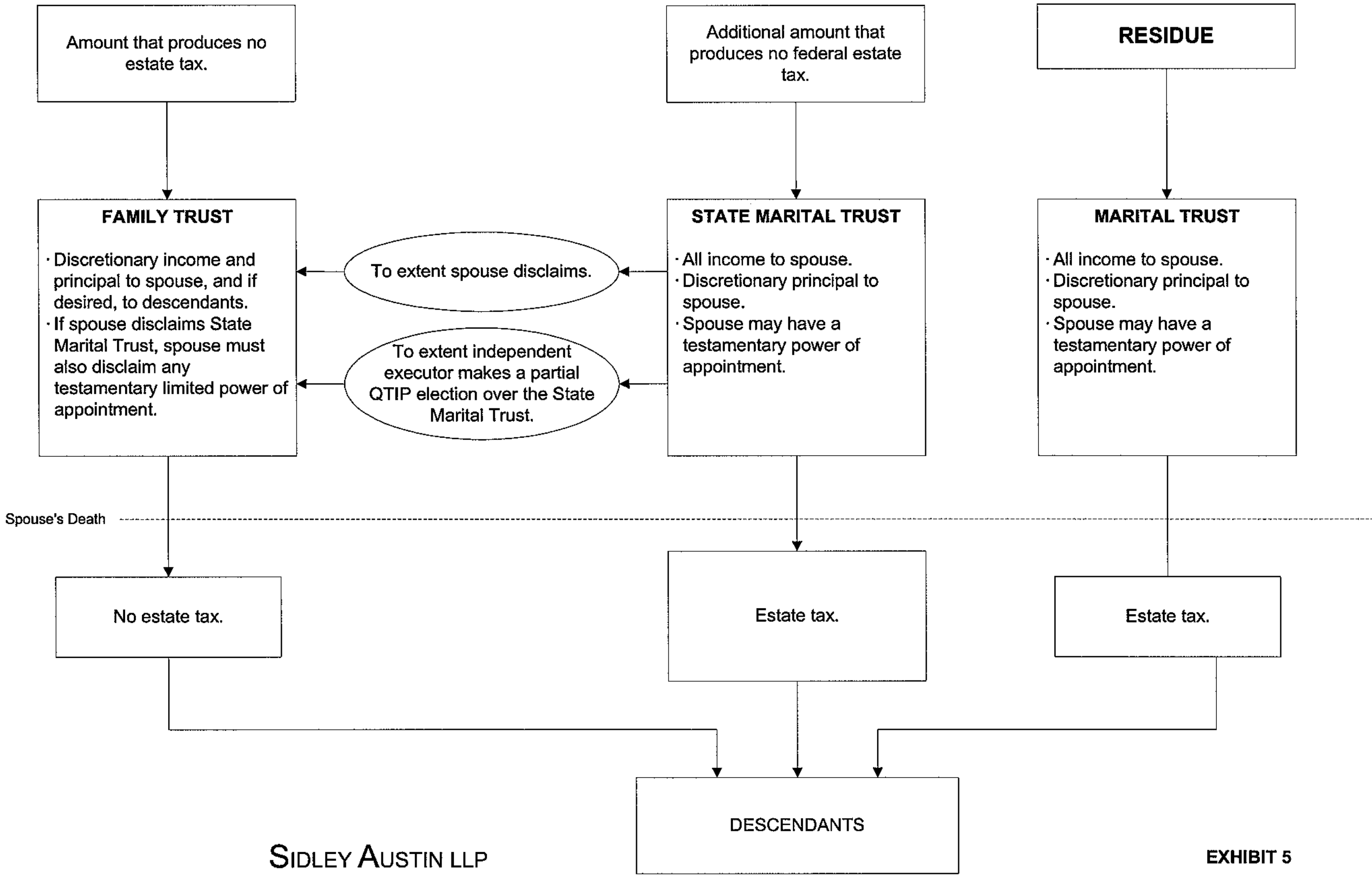

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EXHIBIT 5

STATE QTIP ELECTION

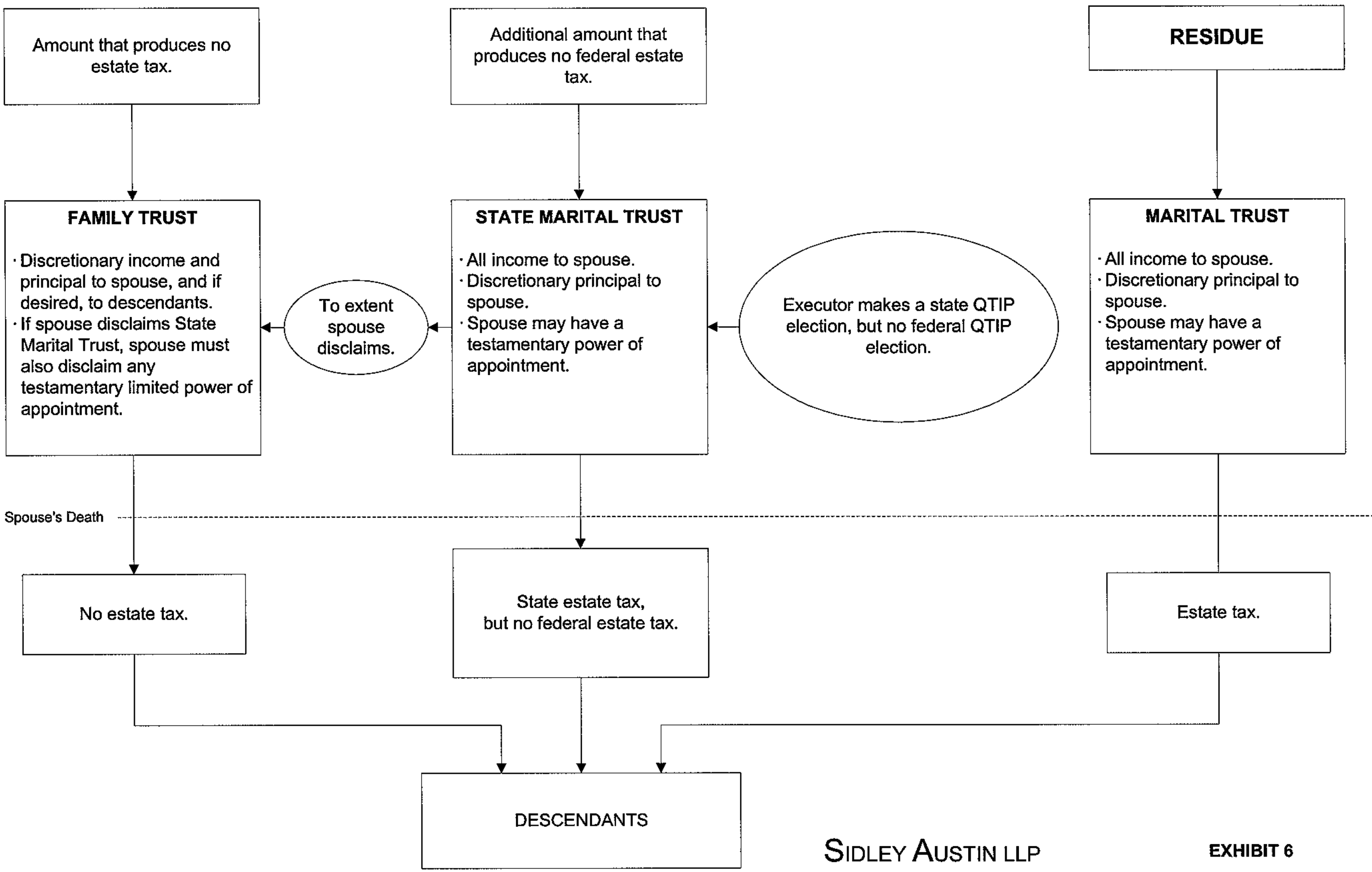

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EXHIBIT 6

GST NO-TAX FAMILY TRUST WITH DISCLAIMER OPTION

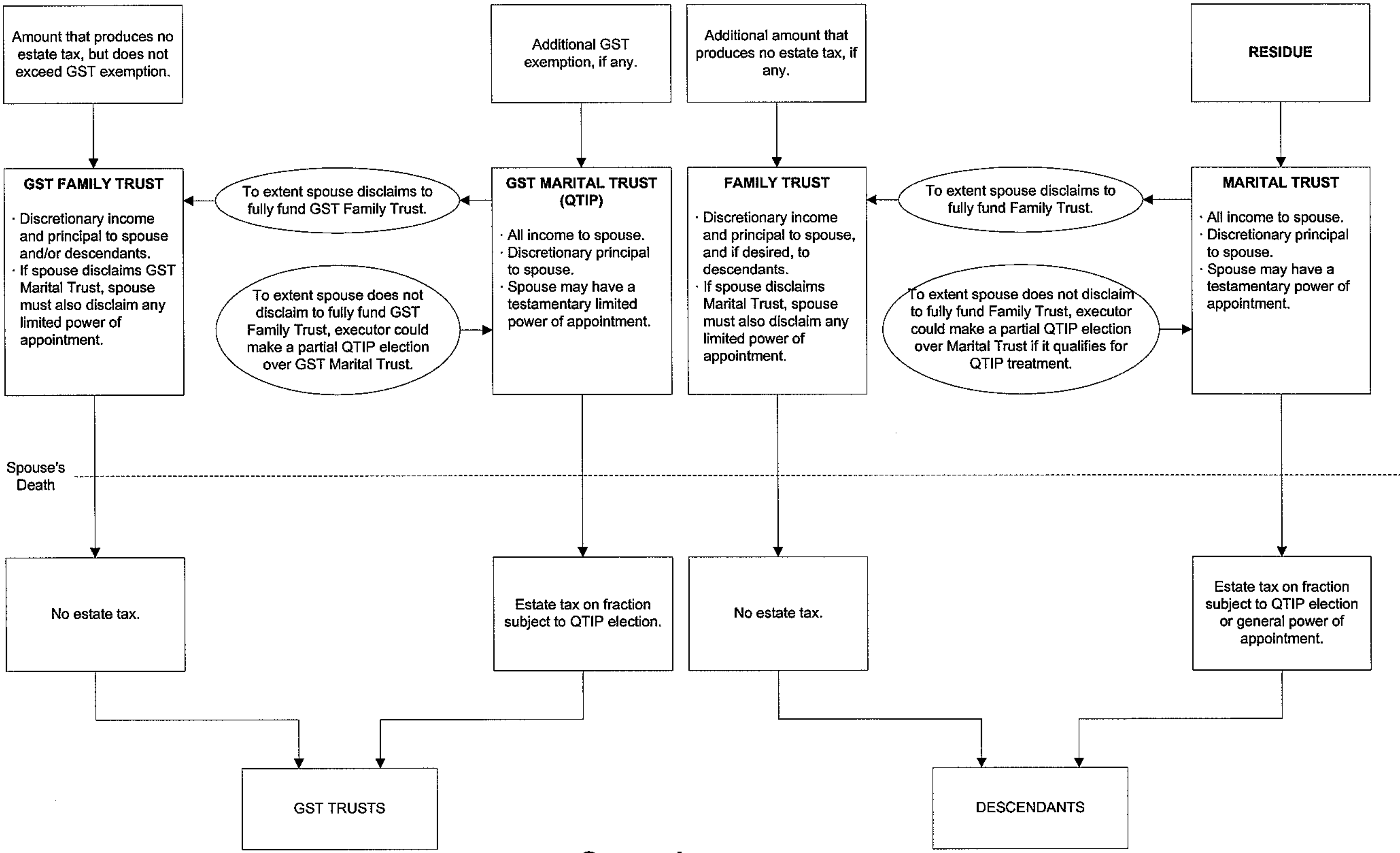

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EXHIBIT 7

GST NO-TAX FAMILY TRUST
WITH DISCLAIMER OPTION AND CLAYTON PROVISION

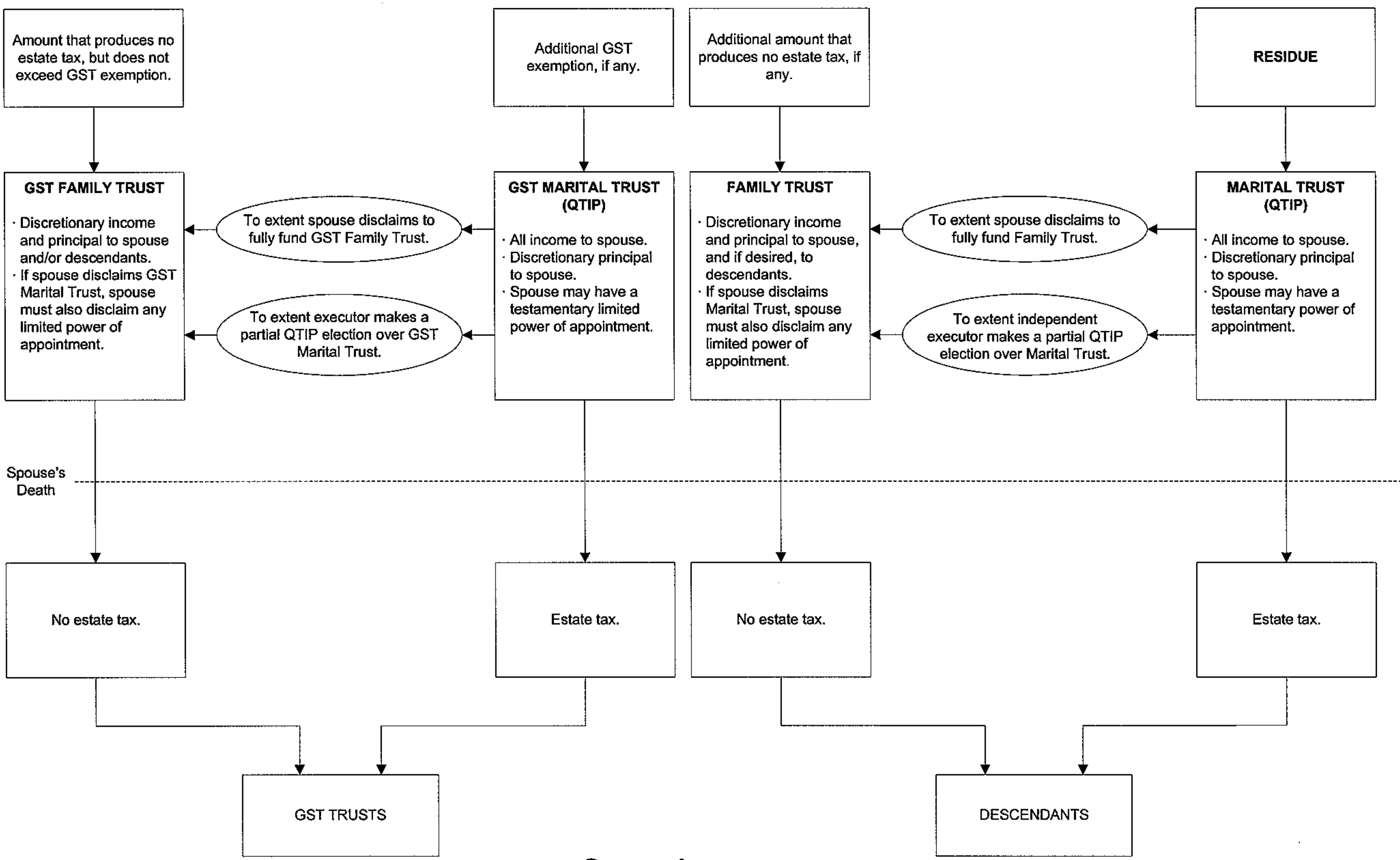

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EXHIBIT 8