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Six months later...

The "American Taxpayer Relief Act of 2012" (ATRA, Pub. L. 112-240) was enacted just over six months ago.

It made the 2001 and 2003 tax cuts permanent for most taxpayers, and brought stability to gift and estate

taxes and the generation-skipping transfer tax. Now that some time has elapsed, we wanted to discuss

selected planning points, particularly as they relate to the significant exclusion amount, state estate taxes

and "portability." We first note, however, the Supreme Court's June 26th decision in *United States v.*

*Windsor*, which held that the Defense of Marriage Act is unconstitutional in not recognizing same-sex

marriages. Thus, the remarks addressed here about married couples and the marital deduction assume that

this deduction is also available to same-sex married couples – although it is presently unclear if such

couples are eligible for the marital deduction if they live in a state that does not recognize their same-sex

marriage.

Before getting into these planning points, some background may be helpful: The basics – on the federal side. Transfer taxes used to be in a state of

flux: prior to major tax legislation

in 2001 (let's call it the "2001 Act"), the maximum exclusion against gift and estate taxes was going to reach

\$1 million in 2006; the top rate was 55%. The 2001 Act accelerated this \$1 million exclusion to 2002, and

gradually increased the estate tax exclusion and generation-skipping transfer tax (GST) exemption to \$3.5

million by 2009, while freezing the gift tax exclusion at \$1 million; by 2007, it dropped the top rate to 45%. It

repealed the estate tax and GST in 2010 – but just for that year – and replaced the estate tax with a

"modified carryover basis" regime, which passed most of a decedent's built-in capital gains to heirs; it

retained the gift tax, with its \$1 million exclusion, but dropped the rate to 35%.

These 2010 provisions were going to expire in 2011, when the estate tax and GST would return, along with

the \$1 million exclusion and 55% rate – unless Congress acted...which it did, by passing legislation at the

end of 2010 (let's call it the "2010 Act"). The 2010 Act kicked the can down the road for two years: it

reinstated the estate tax and GST, retroactive to the beginning of 2010, but with special rules to minimize

potential litigation about the retroactivity; for 2011 and 2012, it kept the 35% rate, and set forth the following provisions:

- The gift tax exclusion was reunified with the estate tax exclusion (and GST exemption)
- There was now a \$5 million gift and estate tax exclusion (and GST exemption), indexed for inflation as of 2012, when the number became \$5.12 million, and
- "Portability" was introduced, effectively allowing a surviving spouse to "inherit" any unused gift and estate tax exclusion from the deceased spouse.

At the beginning of this year, ATRA made these temporary provisions permanent, and raised the top rate

from 35% to 40%. For 2013, the exclusion amount and GST exemption have increased to \$5.25 million.

The basics – on the state side. Pre-ATRA, the 2001 Act helped pay for its transfer tax reductions by eliminating the "state death tax credit," a revenue-sharing arrangement between the states and Uncle Sam.

The credit didn't cost a decedent's estate more, but gave Uncle Sam less: "pick-up" tax states such as

Florida and California simply charged whatever amount Uncle Sam was willing to recognize as a credit for

state death taxes paid. When that credit disappeared, states lost those dollars unless they "decoupled" from

the federal system. To date, about 20 or so states have done so, and have their own estate tax. State

exclusion amounts range from \$675,000 (New Jersey) to \$5.25 million (Delaware), although most are well

under the current \$5.25 million exclusion.

We're getting there. Many people who were aware of this crazy-quilt of ins and outs and ups and downs

regarding transfer taxes might have done – nothing. About their planning documents, that is. Or if they

finally threw in the towel and updated their documents, those documents do not reflect the permanent (and

steadily increasing) \$5 million exclusion unless they were written after January 2, 2013, when ATRA was

enacted. Documents therefore may not work as intended, particularly if they contain what are known as

"formula provisions."

Formula provisions. Formula provisions are typically used to take advantage of various tax benefits, such

as the exclusion amount or the GST exemption. As these amounts increase, so do the amounts passing

under formula provisions, which might look like this:

- Credit shelter. Husband's will creates a "credit shelter trust" for Wife and Children that equals the maximum amount Husband can protect from estate tax, with the balance of his estate passing to Wife, either outright or in trust; at Wife's death, the credit shelter trust will

pass estate-tax free to Children (Wife's will has a similar provision). The credit shelter trust ensures that Husband's exclusion amount isn't wasted, which it would be if everything passed to Wife (the marital deduction overrides the exclusion amount, and could mean that unnecessary estate tax is payable at Wife's death). In another case, Remarried Husband might leave his "credit shelter amount" – or maximum amount he can protect from federal estate tax – to his adult children, with the balance of his property passing to New Wife.

- GST exemption. Wealthy Grandma's will creates a trust for descendants that will last as long as the law permits (generally about 100 years); it will be funded with her available GST exemption so that she can protect as much as possible from the GST.

What's wrong with this picture? If those formulas were written when the maximum exclusion was going to be, say, \$1 million, along with a maximum GST exemption of \$1 million, indexed for inflation, "too much" property may now pass under these formula provisions. In other words, "vintage" documents with formula provisions can have unexpected (and undesirable) consequences in light of the ever-increasing \$5.25 million exclusion and GST exemption.

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Decoupled states – uh-oh. Now toss in a decoupled state: if Husband dies a New Yorker, for example, and his will uses a formula that creates a credit shelter trust equal to his maximum federal exclusion – currently \$5.25 million – he could trigger at least \$420,800 of New York estate tax, since New York's exclusion is only \$1 million. A similar problem can exist if Husband and Wife live in a state with no estate tax, but own property in a decoupled state, such as New York. Consider the following example:

Lance and Gwen are married and have retired to Florida, which has no state estate tax. They still own an \$800,000 condo in New York's Hamptons, where they like to summer. They own the condo jointly, and anticipate that it will automatically pass estate-tax free to the survivor. They're surprised when their nosy neighbor tells them they may have a New York estate tax problem since their condo is considered New York real property. Impossible, they think, it's under New York's \$1 million exclusion amount! As to their wills, Lance and Gwen take full advantage of their respective \$5.25 million exclusions to create a credit shelter trust for the survivor of them. Lance dies earlier this year. To Gwen's unhappy surprise, the Hamptons condo triggers New York estate tax: New York's estate tax calculation treats Lance as a New York resident for purposes of determining what the maximum New York tax would be if his entire taxable estate (the \$5.25 million credit shelter trust) were subject to New York tax. Because the condo represents 10% of Lance's total estate, Lance's New York tax is 10% of his hypothetical (full) New York tax (i.e., 10% of the New York tax on \$5.25 million). Could Lance and Gwen have prevented this? They could have put their condo into an LLC (limited liability company) of which they, and perhaps their children, were members... in the hope that this would convert the condo into intangible property that would not be subject to New York tax.

Here's the point: full use of the federal exclusion can trigger state estate tax, even if the deceased individual doesn't live in a decoupled state, but simply owns property in it. This is even more of an issue as the federal exclusion amount continually increases.

"Portability." Portability lets the surviving spouse effectively "inherit" the unused exclusion of the deceased spouse. It is designed to simplify planning for married couples, so that they don't need to bother with the "credit shelter trust" mentioned above. In other words, it is predicated on the notion that married couples would prefer to simply leave everything outright to the other, but for that

pesky marital deduction that trumps  
– and therefore wastes – the exclusion amount of the first spouse to die.  
Yet that is not necessarily the  
case. Nevertheless, when portability was temporary in 2011 and 2012, most  
people – both professional  
advisors and married couples who were being advised – didn't pay much  
attention to it. Now that portability  
is permanent, however, it is important to understand it, and recognize that  
portability may play a role for  
married couples and their wealth planning. But first, some portability  
basics:

- To claim portability, the deceased spouse's executor must file an estate tax return within nine months of that spouse's death, even if the estate is under the filing threshold (\$5.25 million in 2013), and a return is otherwise not required.
- The executor elects portability by merely filing a timely estate tax return; if portability is not desired, the executor can affirmatively opt out of it by checking a box on the estate tax return.
- The surviving spouse can use the portable exclusion for gift or estate tax purposes.
- The IRS has an unlimited amount of time to question the amount of the portable exclusion, even if it is too late to assess gift or estate tax against the deceased spouse's estate.
- Portability doesn't apply to any state exclusion amount (for states with their own estate tax) or to the generation-skipping transfer tax (GST) exemption. Thus, to ensure that these benefits are not wasted at the first spouse's death, planning is generally required, and typically involves trusts.

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- Even if a person has been widowed several times, he or she can only use the portable exclusion from the last deceased spouse (in other words, the surviving spouse cannot accumulate multiple portable exclusions).
- The portable exclusion can't be any larger than the indexed exclusion in effect at the deceased spouse's death.

So that is a brief overview of portability. How can a married couple use it? Here is a possible approach:

John and Abby are long-time New Yorkers who have been married for years. They have two children and three grandchildren to whom they've never made more than annual exclusion gifts (currently \$14,000 per year to as many people as they want, or \$28,000 if they agree to split the gift). They've tried to be smart with their planning, but have been nonplussed at the transfer tax uncertainty, wondering where the exclusion was going to land, and whether there would even be an estate tax when they died. Concerned that they weren't getting any younger, John and Abby finally redid their wills in 2009, and followed their lawyer's advice: let the survivor decide what makes the most sense, tax-wise, when the first of them dies.

John's will therefore gives everything to Abby. If she "disclaims," or refuses to accept some of this property, it will pass to a trust that acts like a credit shelter trust by providing for Abby, but passing estate-tax free at her death to their children (Abby's will has similar provisions). John dies at the beginning of 2013, and leaves his \$10 million estate to Abby. The problem: if Abby disclaims the entire amount of John's exclusion – \$5.25 million – she'll take full advantage of what John can protect from federal estate tax, but will trigger at least \$420,800 of New York estate tax. If Abby doesn't disclaim anything, there will be no tax at John's death, but she will have wasted John's \$1 million New York exclusion. This could mean that unnecessary New York tax will be payable at her death.

The solution: Abby disclaims \$1 million worth of property to take advantage of John's New York exclusion; this goes into the disclaimer trust for her. Abby accepts the rest of the property, and thanks to portability, receives the balance of John's unused exclusion: \$4.25 million. Between this and her own \$5.25 million exclusion amount, Abby can protect \$9.5 million from gift or estate tax.

Abby feels financially comfortable (she has a large IRA and assets of her own that help provide for her),

and decides to give her two children the balance of the \$4.25 million portable exclusion from John (\$2.125 million each). Portability has allowed Abby to take full advantage of John's exclusion amount, yet save the significant New York estate tax that a fully funded disclaimer trust otherwise would have incurred. This current gift also forces the IRS to look at the amount of John's leftover exclusion now, rather than waiting until Abby's death, when records about John's estate and hard-to-value property could have long since disappeared. In the meantime, Abby's remaining \$5.25 million exclusion will continue growing because of inflation-indexing. So that is an easy and highly simplified example of portability. But what if John and Abby weren't comfortable leaving everything outright to each other, and preferred leaving property in trust? After all, John was afraid that Abby would fall prey to her importuning siblings after his death, and Abby thought it possible that John might remarry after her death, and even start a new family! What would become of their children's inheritance then? Trusts offer control, which both of them desire. Let us therefore change the facts a bit:

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John's will creates a credit shelter trust that equals the \$1 million New York exclusion. He leaves the balance of his \$10 million estate – or \$9 million – to a trust for Abby that is eligible for the QTIP election (in other words, the qualified terminable interest trust is only for Abby, and she gets all the income; the election will postpone tax at John's death, and what remains of the trust at Abby's death will be taxable in her estate). John dies in 2013, and the New York credit shelter trust is created. His executor must decide whether to elect full, or only partial, QTIP treatment for Abby's \$9 million trust.

Issue 1: If John's executor elects QTIP treatment for the full \$9 million trust, no New York tax will be payable (a good thing)...but if he does so, he's wasting the remaining \$4.25 million of John's \$5.25 million exclusion AND he's choosing something that wasn't necessary to postpone federal estate tax.

Can John's executor still elect portability in this case?

Issue 2: If John's executor makes a partial QTIP election of \$4.75 million, he will shield the other part of the \$9 million trust from federal estate tax using John's remaining \$4.25 million of exclusion.

Unfortunately, this \$5.25 million taxable estate (John's \$1 million New York credit shelter trust plus the \$4.25 million non-QTIPPED portion of Abby's \$9 million trust) will trigger at least \$420,800 of New York tax, even though there's no federal estate tax. Not good.

If John's executor elects QTIP for the full \$9 million trust, and thereby doesn't incur New York tax, why might portability not be available? Several thoughts come to mind: when the IRS issued temporary regulations on portability on June 18, 2012 (T.D. 9596 77 FR 36150-36163), those regulations offered examples where portability was used when the deceased spouse's estate was under the exclusion amount. These examples showed both a full and partial QTIP election – elections that were unnecessary to reduce the decedent's estate tax to zero, since none would have been payable anyway. The regs had no examples dealing with an estate that exceeded the exclusion amount and more QTIP treatment was elected than was necessary to protect the estate from tax. What to make of that?

Revenue Procedure 2001-38. Let us now look at Revenue Procedure 2001-38, issued on June 11, 2001.

Here, the IRS addressed when it would allow an executor to "undo" an unnecessary QTIP election. The Service noted that taxpayers had previously requested relief when: 1) an executor elected QTIP treatment for a trust, but the estate wouldn't have been taxable anyway because it was under the exclusion amount;

and 2) the executor accidentally elected QTIP treatment for both a credit shelter trust and a QTIP trust. The Rev. Proc. said that the Service would ignore the QTIP election and treat it as "null and void" if the QTIP election "was not necessary to reduce the estate tax liability to zero"; the Service would not do this, however, if the executor elected more QTIP than was necessary to reduce the estate tax liability to zero, or if the QTIP election was phrased as a formula "designed to reduce the estate tax to zero." In other words, the Rev. Proc. seems to say, if you didn't know what you were doing, we'll help you out; if you did know what you were doing, we're not going to play along.

How does that apply in the portability example above, where John's estate exceeds the exclusion amount, and his executor must decide whether to elect "excess" QTIP treatment for Abby's trust to avoid triggering New York estate tax? If the rationale of Rev. Proc. 2001-38 is applied, portability might not be permitted. Here's a possible reason why: suppose that John and Abby live in Florida, and no state estate dollars are at stake. An excess QTIP election presumably would have no other goal than ensuring that the full amount of Abby's trust was includible in her estate, and therefore eligible for a potential basis step-up that would eliminate the trust's built-in capital gains. This could be a real boon for the trust's ultimate takers, namely, John and Abby's children. In this circumstance, portability would ensure that John's exclusion is not wasted AND that potential capital gains are minimized...probably not what Congress had in mind.

The bottom line. Unless and until the IRS issues guidance on this, it is not clear that portability applies if a deceased spouse's estate exceeds the exclusion amount and more QTIP treatment is elected than is necessary to reduce the spouse's estate tax to zero. Although portability can work in "simple" situations,

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where the deceased spouse's estate is under the exclusion amount or the disposition to the surviving spouse is outright, it still has nuances and unanswered questions. Also, if a married couple wants to do generation-skipping planning for their descendants, they must actively use the GST exemption of the first spouse to die, or that exemption will die with her. To sum up. The ever-increasing \$5.25 million exclusion and GST exemption are real game changers – along with portability – and will make transfer taxes far less of a concern for many people. But those who live in a decoupled state like New York, New Jersey or Connecticut, or who own property there, still have very real planning concerns, as do those whose wealth exceeds the exclusion amount.

July 7520 rate issued

The IRS has issued the July 2013 applicable federal rates: the 7520 rate is 1.4%, an increase of 0.20% (20 basis points) from June's 1.2% 7520 rate. The annual, semiannual, quarterly and monthly mid-term rates are all 1.22%, an increase of 0.27% (27 basis points!) from June's annual, semiannual, quarterly and monthly mid-terms rates, which were all 0.95% (95 basis points).

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