A Penton Publication
Trusts & Estates
The Journal of Wealth Management for Estate-Planning Professionals—Since 1904

Deathbed Opportunities

In decoupled states, there are some last-minute planning strategies that can significantly help heirs

By **Robert C. Pomeroy**, of counsel, and **Susan L. Abbott**, associate, Goodwin Procter LLP, Boston

Estate planners have new opportunities to save taxes for their clients using deathbed planning techniques in states that have decoupled their estate taxes from the federal estate tax.

Before the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), a credit was allowed in the computation of the federal estate tax for death taxes paid to any state, subject to the limitations set forth in Internal Revenue Code Section 2011. (See "The Past.".) Many states limited their estate taxes to the amount of that state death tax credit, which meant that the federal government shared a portion of its estate tax revenue with the state in question at no cost to the estate of the deceased client.

Then EGTRRA phased out the state death tax credit over a three-year period beginning in 2002. As a result, the credit was eliminated by 2005. However, simultaneous with the disappearance of the state death tax credit, a new deduction became available. For the estates of those dying after Dec. 31, 2004, new IRC Section 2058 provides for a deduction from the value of the gross estate for the amount of any estate, inheritance, legacy or succession taxes actually paid to any state or the District of Columbia with respect to any property included in the federal gross estate of the decedent. Unlike the former state death tax credit, there is no limit on the amount of the deduction other than the amount of state taxes actually paid.

After EGTRRA, many states "decoupled" their state estate taxes from the amount of the state death tax credit so as to avoid having their estate taxes phased out along with the credit. (See "Where the Opportunities Lie.") Most of these states provided that their estate taxes would continue to be based upon the amount of the pre-EGTRRA state death tax credit. There are many variations in how the amount of the "exemption" from the tax is to be computed. Also, a few states allow taxpayers to elect qualified terminal interest property (QTIP) treatment for state estate tax purposes even when none was elected for federal estate tax purposes.

We focus here on the state estate tax advantages of lifetime taxable gifts by the terminally ill client who is domiciled in a state that has an estate tax based upon the amount of the former federal state death tax credit and the accompanying income tax considerations. The strategies considered include lifetime taxable gifts that do not incur a federal gift tax; the funding of a credit-shelter trust for the benefit of one's spouse and issue; and the making of taxable gifts which incur a gift tax. We also consider steps to be taken while a client is in good health that, if he should later become ill, facilitate pursuing these strategies.

LIFETIME GIFTS

The gross amount of the federal estate tax is based upon both the amount of a decedent's adjusted taxable gifts (which in most cases means the decedent's taxable gifts made after 1976) and the decedent's taxable estate. Hence, although making a taxable gift a short time before a taxpayer's death removes the gift from the taxable estate, it adds the gift to the amount of the adjusted taxable gifts and likely won't reduce the federal estate tax. However, the gross amount of the state death tax credit was based only upon the size of the taxable estate. A taxable gift made just before death removes the value of the gift from the calculation of a state death tax that is based solely upon the former federal state death tax credit. (See "State Death Tax Calculus.") Assuming that the state has no gift tax, such a transaction can produce a very significant savings at no current tax cost.

The federal state death tax credit reached its highest marginal bracket of 16 percent for taxable estates in excess of $10.1 million. At that level of taxable estate, the marginal federal estate tax bracket for the years 2007 through 2009 (and perhaps beyond) is 45 percent. The deduction of the state death tax in computing the federal estate tax produces an effective marginal state death tax rate of 8.8 percent for individuals with taxable estates in excess of $10.1 million. (See "Savings.")

CREDIT-SHELTER TRUST

Making an immediate pre-mortem taxable gift that exhausts the unified credit available to be used against lifetime gifts can produce significant savings. When no spouse is involved, such gifts presumably would be made to, or for the benefit of a client's descendants or other objects of his bounty. If time is short, an outright gift could be made with a minimum of time and effort.

When there is a spouse, though, the client's first priority might be that the financial

WHERE THE OPPORTUNITIES LIE

Look at both the 15 decoupled states and, possibly, other states where an estate/inheritance tax doesn't consider lifetime gifts

Fifteen jurisdictions have a "decoupled" estate tax based on the federal state death tax credit in effect prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and no gift tax. The planning techniques we suggest will generally be useful to clients domiciled in these jurisdictions: District of Columbia, Illinois, Kansas, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, North Carolina, Oregon, Rhode Island, Vermont and Wisconsin. Note that Wisconsin's estate tax will be "recoupled" with the federal state death tax credit for decedents dying after Dec. 31, 2007. (Wisconsin will have no estate tax until and unless the state death tax credit is reinstated under federal law.)

The techniques also may be useful in other states where there is an estate or inheritance tax that does not take lifetime gifts into consideration in the calculation of the tax.

The threshold of combined taxable estate and adjusted taxable gifts that must be reached before a tax is incurred varies from state to state. For example, in New Jersey the threshold is $675,000, while in Vermont it is $2 million.

Maine, Maryland, Massachusetts, Oregon and Rhode Island all allow a separate qualified terminable interest property (QTIP) election to be made for estate tax for property qualifying for QTIP treatment under federal law as to which no federal QTIP election was made.

— Robert C. Pomeroy and Susan L. Abbott

security of the spouse not be compromised. It does no good to make the gift directly to the spouse, as that will only increase the size of the spouse's taxable estate when she dies.

In such a situation, the client should consider funding a credit-shelter trust for the benefit of the spouse and perhaps other heirs, presumably with terms simiilar to the credit-shelter trust provided for in the client's estate plan. This will ensure that the spouse will have the same economic benefit from the assets used to fund the trust as she would have had in the absence of a gift. Should the client's health improve, as long as the spouse survives and is on good terms with the client, the assets transferred to the trust are likely to be indirectly available to provide for the client's own financial needs.

In many states with a decoupled state death tax, the "exemption" amount for state death tax purposes is fixed at a level that already is lower than the current federal applicable exclusion of $2 million and will be even more so when (and if) the scheduled increase to $3.5 million takes place in 2009. For married couples with modest-sized estates, a decision will have to be made when the first spouse dies as to whether to fully fund the federal credit-shelter amount, thereby incurring a state death tax, or to fund the credit-shelter gift only up to the amount that can avoid both federal and state estate taxes.

In states with a separate QTIP election, it will be possible to fully fund the federal credit-shelter without incurring a state death tax. But

SAVINGS

A $1 million immediate pre-mortem taxable gift can spare beneficiaries a considerable amount in state estate taxes

Assume that a terminally ill client who has made no prior taxable gifts is living in a decoupled state. He makes a taxable gift of $1 million, then dies one month later in calendar year 2007. The estate tax savings in estates of various sizes are:

Savings Generated by $1 Million Immediate Pre-Mortem Taxable Gift

Total Pre-gift assets	$2,000,000		$6,000,000		$12,000,000	
	No Gift	Gift	No Gift	Gift	No Gift	Gift
Gift	$0	$1,000,000	$0	$1,000,000	$0	$1,000,000
Taxable estate*	2,000,000	1,000,000	6,000,000	5,000,000	12,000,000	11,000,000
State death tax	99,600	33,200	510,800	391,600	1,386,800	1,226,800
Federal estate tax	0	0	1,570,140	1,623,780	3,875,940	3,947,940
Total taxes	99,600	33,200	2,080,940	2,015,380	5,262,740	5,174,740
Savings		$66,400		$65,560		$88,000

* Before deduction for state death taxes

—Robert C. Pomeroy and Susan L. Abbott

CREDIT-SHELTER TRUST

Pre-death funding of federal gift tax credit-shelter amount can reduce the cost of funding the estate tax credit-shelter amount

	No Lifetime Taxable Gifts				Lifetime Taxable Gift of $1,000,000 to Credit-Shelter Trust				
Year of Death	Credit-Shelter Funding	State Death Tax Due*	State Applicable Exclusion Amount	Marginal Cost of Funding Credit-Shelter With More Than State Exclusion	Credit-Shelter Funding	State Death Tax Due	Remaining State Applicable Exclusion Amount	Marginal Cost of Funding Credit-Shelter Amount	Savings Realized Over No Gift Scenario
2007	$2,000,000	$107,391	$1,000,000	10.7%	$1,000,000	$35,169	$0	3.5%	$72,222
2008	2,000,000	107,391	1,000,000	10.7	1,000,000	35,169	0	3.5	72,222
2009	3,500,000	254,911	1,000,000	10.2	2,500,000	151,316	0	6.1	103,595

* State death tax due is a circular calculation based on taxable estate equal to credit-shelter funding plus amount of state death tax

—Robert C. Pomeroy and Susan L. Abbott

STATE DEATH TAX CALCULUS

How to do the math underlying the deathbed strategies

To understand deathbed planning techniques, it's important to master the arithmetic involved in computing an estate tax based upon the former state death tax credit.

Unlike the calculation of the federal estate tax, the calculation of the gross amount of the state death tax credit was based solely upon the amount of the federal taxable estate, with no reference to the amount of a decedent's adjusted taxable gifts. The only role that the amount of adjusted taxable gifts played in calculating the state death tax credit arose from the fact that the state death credit could not exceed the amount of the federal estate tax, which is affected by the amount of adjusted taxable gifts, after reduction by the amount of the unified credit.

To illustrate, take an example involving a decedent who dies in 2007 domiciled in our home state of Massachusetts. The Massachusetts estate tax is now based upon the amount of the state death tax credit that would have been due under federal law in effect on Dec. 31, 2000, including the then-scheduled increases in the amount of the unified credit. Under prior federal law, the amount of the unified credit in 2007 would have been $345,800, which would have sheltered an aggregate of $1 million of taxable estate and adjusted taxable gifts from tax.

In scenario 1, our decedent makes no taxable gifts during lifetime and at his death leaves $2 million to a credit-shelter trust for the benefit of his spouse and issue. In scenario 2, the facts are altered in that he makes a taxable gift of $1 million to an irrevocable credit-shelter trust for his spouse and issue just before he dies, then leaves another $1 million to that same trust upon his death. In both scenarios, he leaves the balance of his $5 million estate outright to his spouse, who is a U.S. citizen.

No federal estate tax is due in either scenario, yet the Massachusetts estate tax will be considerably different.

	Scenario #1	Scenario #2
Federal taxable estate	$2,000,000	$1,000,000
Adjusted taxable gifts	0	1,000,000
Total	2,000,000	2,000,000
Federal estate tax	0	0
Mass. taxable estate*	2,107,391	1,035,169
Mass. estate tax (based on former state death tax credit)	107,391	35,169

Under current federal law, a deduction can be claimed for state estate taxes. However, as this was not the case under federal law in effect on Dec. 31, 2000, the Massachusetts estate tax must be added to the amount in the federal taxable estate in computing the Massachusetts estate tax.

Note also that while Massachusetts is said to have an "exemption" of $1 million, a tax will be due even though the federal taxable estate is only equal to $1 million. Massachusetts is one of a very few states with a decoupled tax that allows a separate qualified terminable interest property (QTIP) election. If in these scenarios the federal credit-shelter trust qualified for QTIP treatment (but for which no federal QTIP election was made), a Massachusetts QTIP election for $1 million would eliminate any tax.

In the first scenario, such an election would reduce the Massachusetts taxable estate to $1 million, which at first blush generates a tax of $33,200 per the state death tax credit tax table. However, under the federal system that would have been in effect had the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) not been enacted, the federal estate tax for a person dying in 2007 with a taxable estate of $1 million would have been completely eliminated by the $345,800 unified credit that was to have been in effect for years 2006 and later. Because there would have been no federal estate tax due after application of the unified credit, there would have been no state death tax.

In the second scenario, a QTIP election for $1 million would eliminate any taxable estate and there would be no state death tax in any event.

— Robert C. Pomeroy and Susan L. Abbott

THE PAST

Before 2002, there was a huge break on federal estate taxes

Before the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), one could credit against federal estate taxes those amounts paid in state death taxes up to specified limits—the so-called "state death tax credit." By 2005, this credit was phased out, replaced by a deduction for state death taxes.

State Death Tax Credit Rate Table

If the taxable estate* is at least . . .	But less than . . .	The tax credit is . . . *Plus*	This percent . . .	Of excess over . . .
-	$100,000	-	0.0	-
$100,000	150,000	-	0.8	$100,000
150,000	200,000	$400	1.6	150,000
200,000	300,000	1,200	2.4	200,000
300,000	500,000	3,600	3.2	300,000
500,000	700,000	10,000	4.0	500,000
700,000	900,000	18,000	4.8	700,000
900,000	1,100,000	27,600	5.6	900,000
1,100,000	1,600,000	38,800	6.4	1,100,000
1,600,000	2,100,000	70,800	7.2	1,600,000
2,100,000	2,600,000	106,800	8.0	2,100,000
2,600,000	3,100,000	146,800	8.8	2,600,000
3,100,000	3,600,000	190,800	9.6	3,100,000
3,600,000	4,100,000	238,800	10.4	3,600,000
4,100,000	5,100,000	290,800	11.2	4,100,000
5,100,000	6,100,000	402,800	12.0	5,100,000
6,100,000	7,100,000	522,800	12.8	6,100,000
7,100,000	8,100,000	650,800	13.6	7,100,000
8,100,000	9,100,000	786,800	14.4	8,100,000
9,100,000	10,100,000	930,800	15.2	9,100,000
10,100,000		1,082,800	16.0	10,100,000

* Note that, for ease of use, this table has been revised from that which appeared in the Internal Revenue Code so that it is based on the size of the taxable estate and not the adjusted taxable estate (which was determined by allowing a $60,000 deduction.)

—Internal Revenue Code Section 2011(b) before EGTRRA

this will be done at the cost of requiring the surviving spouse to receive the income from the trust for which a state QTIP election is made, thereby increasing the size of that spouse's estate when she dies.

The funding of a credit-shelter trust with the client's $1 million federal gift-tax exemption equivalent can dramatically reduce the state death tax cost of fully funding the balance of the client's federal credit-shelter amount upon his death. It also is likely to lead to a decision to forego a separate state QTIP election where one is available, as the tax savings will not be justified when compared to the potential future state death tax cost when the surviving spouse dies. (See "Credit-Shelter Trust.")

INCURRING GIFT TAX

We have assumed the client did not want to make taxable gifts that would incur an actual federal gift tax liability. This is generally a sound strategy, because the current federal transfer tax system is likely to be revised substantially in the near future. But for a client who has a very short life expectancy (or who wishes to hedge his bets about the probability of an elimination of the tax or a drop in rates), making a taxable gift that incurs a current gift tax liability can produce even greater savings in state death taxes. For example, assume a taxable gift of $10 million out of what will otherwise be an estate of $50 million. A total of $880,000 can be saved. (See "Gifts That Incur Tax.")

BASIS CONSIDERATIONS

There is one potential tax downside to lifetime gifts made for the purpose of avoiding state estate taxes: the loss of the basis adjustment for assets that are includible in the client's gross estate at death. If a gift is made with low basis assets, the potential increase in the income taxes due when it's sold could more than offset savings in state estate taxes. For example, the gift of an asset worth $100,000 might save as much as

$8,800 in state estate taxes. But if that asset has a cost basis of $10,000 in the hands of the donor and the gift generates no gift tax liability, the basis in the hands of the donee will remain $10,000. When the donee sells the property, at current rates the federal capital gains tax is likely to be $13,500 and a state capital gains tax also may be incurred. Depending how long the donee plans to hold the property, he might have been better off had the asset passed through the donor's taxable estate.

The solution is to try to gift only cash and high-basis assets. Particularly when a client has little time to live, an effective strategy could be to borrow funds (low-basis assets could be pledged as security) and give away the cash. Assuming that the low-basis assets are liquid, they can be sold shortly after the client dies at no gain and the loan can be repaid.

GIFTS THAT INCUR TAX

A pre-mortem gift that incurs federal gift tax can produce even more savings

Savings generated by $10 million immediate pre-mortem taxable gift

Total Pre-Gift Assets	$50 million	
	No gift	Gift
Gift	$0	$10,000,000
Taxable estate*	50,000,000	40,000,000
Federal gift tax	-	3,600,000
State death tax	7,466,800	5,866,800
Federal estate tax	18,239,940	18,959,940
Total taxes	25,706,740	24,826,740
Savings		$880,000

* Before deduction for state death taxes

— Robert C. Pomeroy and Susan L. Abbott

IN GOOD HEALTH

To enhance the possibility that deathbed gifts can be made, a client should consider executing a durable power of attorney that allows a disinterested attorney-in-fact to make sizeable gifts of the client's property to named parties or to trusts for their benefit. The power of attorney could give the attorney-in-fact the ability to borrow money in the client's name and pledge the client's assets as security for the loans. If the client has a funded revocable trust, the trust document also could give a disinterested trustee the power to make distributions to the client's named parties and the power to borrow funds in the trust's name and pledge assets as security for the loan. (The use of a funded trust might accelerate the speed with which the loan can be repaid after the client's death.) If the client has an established banking or brokerage relationship, it would be a good idea to ask that the bank or broker review the documents to ensure the institution will make the loans with a minimum of red tape when the time comes.

For a married client who is terminally ill, there may be a considerable advantage if he were to fund a credit-shelter trust for the benefit of his spouse and other beneficiaries while still living. The typical client's estate planning is likely to already contain such a trust, but since its terms will be set forth in the client's will or revocable trust, it will not be possible for the client to irrevocably fund that trust while living. A client domiciled in state with a decoupled estate tax who wishes to incorporate a credit-shelter trust into his estate plan should consider creating that trust under a separate trust instrument. The provisions of the trust document could provide that it would become irrevocable at the earlier of its funding with more than a nominal amount or the client's death. The client's will or revocable trust instrument would be written so as to send the client's remaining credit-shelter amount to this trust at the time of his death. The client's estate plan also would include a durable power of attorney authorizing his attorney-in-fact to fund the stand-by credit-shelter trust during the client's life with property up to the amount that could be sheltered by the client's applicable exclusion amount available for gift tax purposes. If the client became terminally ill, the client or the client's attorney-in-fact then would be in a position to fund the trust before the client died. ▮