

Flexibility and Simplicity—The Drafting Keys After EGTRRA 2001

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Careful drafting and flexibility have always been important tools for solid estate planning. Since the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), however, an estate planner's need for precision drafting has never been greater. In the age of the upward spiraling applicable exclusion amount and its unification with the generation-skipping transfer (GST) exemption, replacement of stepped-up basis with carryover basis, repeal of the estate and GST taxes for one year (2010), reversion to pre-EGTRRA rates in 2011, phasing out of the state death tax credit and decoupling of New York State's estate tax in 2004, the days of merely providing a credit shelter trust in the will of the "wealthier spouse" with a taxable estate are over. In addition to each of the above ramifications, the estate planner must also consider the uncertainty of EGTRRA's survival. Given that the Republican-led Congress tried both in 2002 and 2003, as yet unsuccessfully, to make the one year estate and GST tax repeal permanent and that the Democrats continue to insist that we can no longer afford the tax cuts provided in EGTRRA, predictability in the law is eliminated from our planning process. The upshot is that, over the next eight years, our clients may finally understand the importance of reviewing their estate plans frequently.

This article will highlight certain aspects of estate planning that we must revisit with our clients in light of the changes contained in EGTRRA and the impact of New York State's decoupling estate tax. In addition, to help you plan for these uncertain times, we will discuss specific techniques that will add the power of flexibility and simplicity to your drafting.

I. Nuts and Bolts of EGTRRA

While the rhetoric that followed the debates and the enactment of EGTRRA focused on the supposed repeal of the estate and GST taxes, these taxes appear to remain alive and well. In fact, EGTRRA merely provides a temporary reprieve from the burdens (unjust or not) of the federal estate and GST tax system that comes in three forms. First, the applicable exclusion amount, which had been \$675,000 in 2001 and slated to increase gradually to \$1 million in 2006, was accelerated to that amount in 2002 and placed on a new time line, increasing to \$3.5 million in 2009.¹ Second, pursuant to § 2010(c) of the Internal Revenue Code,² the applicable exclusion amount and

the GST exemption will be unified on January 1, 2004,³ and remain as such until the year 2011.

Finally, EGTRRA provides for repeal of the estate and GST taxes⁴ *only* for the year 2010. In fact, P.L. 107-16 § 901(a)-(b) provides, in relevant part, as follows:

Sec. 901. SUNSET OF PROVISIONS OF ACT.

(a) IN GENERAL. All provisions of, and amendments made by, this Act shall not apply—

(1) to taxable, plan, or limitation years beginning after December 31, 2010, or

(2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010.

(b) APPLICATION OF CERTAIN LAWS. The Internal Revenue Code of 1986 and the Employee Retirement Income Security Act of 1974 shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) *as if the provisions and amendments described in subsection (a) had never been enacted.*⁵

It is clear that the federal estate and GST taxes are not dead. Instead, despite an easing of the tax burden over the next seven years due to the rising exemption amounts and the one year repeal, the federal estate and GST taxes will re-emerge in 2011 in full force and effect under the pre-EGTRRA laws.

A. The price we pay for EGTRRA

The temporary relief under EGTRRA does not come without a hefty price: the demise of the state death tax credit and the replacement of stepped-up basis with carryover basis.

1. Phase-out of the state death tax credit

Prior to 2001, many states imposed a state estate tax that was equal to the state death tax credit allowed on the federal estate tax return.⁶ Such states were often referred to as "pickup tax" states, since

they would receive estate tax revenue to the extent that the federal government shared such revenue by means of a credit. As a result of EGTRRA, however, the state death tax credit is being phased out through 2005. In particular, EGTRRA has reduced the state death tax credit by 25% in 2002, by 50% this year, and by 75% in 2004, and will repeal the state death tax credit for estates of decedents dying after December 31, 2004, replacing it with a deduction for state death taxes paid.⁷ Many “pickup tax” states, however, have enacted legislation “decoupling” their estate taxes from the federal tax changes, thereby allowing them to retain estate tax revenue. New York, for example, applies a state exemption amount of \$1 million, and calculates the estate tax on estates over this amount using Table B—Computation of Maximum Credit for State Death Tax, based on rates in effect in 2001,⁸ despite the fact that that credit is being phased out. As a result, a taxable estate in New York and other such “pickup tax” jurisdictions that have decoupled will pay more in combined federal and state estate taxes due to the reduction in the state death tax credit.

Example 1: The estate of an unmarried New York decedent who died in 2001 with a taxable estate of \$2.5 million would have paid federal estate tax of \$664,450 (after taking into account the applicable federal estate tax exemption of \$675,000 available in 2001 and a credit of \$138,800 for death taxes paid to New York State).

Example 2: Given the same facts as in Example 1, except that death occurs in 2004, the estate would owe federal estate tax of \$435,300 (after taking into account the federal estate tax exemption of \$1.5 million then available and a state death tax credit of \$34,700 (state death tax credit of \$138,800 reduced by 75%). The estate would also owe New York State estate tax in the amount of \$138,800, despite the fact that the allowable credit for federal estate tax purposes would only be \$34,700.⁹

Unlike the examples above for New York, the cost of EGTRRA is significant for certain “pickup tax” states that calculate and collect the state estate tax based *solely* upon the federal credit allowable in the year of the decedent’s death. While New York State will collect the full amount of its tax based upon pre-EGTRRA tables, those states that merely impose a tax based upon the post-EGTRRA federal

credit for state death taxes will continue to lose tax revenues of 25% per year through 2004. In 2005, the estate tax in those states will be effectively repealed by EGTRRA if they are constitutionally prohibited from imposing an estate tax (e.g., Florida) or otherwise fail to adopt alternative legislation.

2. The loss of a step-up in basis in favor of carryover basis

For the year 2010, the one year the estate and GST taxes are repealed, EGTRRA terminates the step-up in basis for property acquired from a decedent and replaces it with a carryover basis.¹⁰ Carryover basis is defined as the lesser of (i) the decedent’s adjusted basis or (ii) the fair market value of the property at the decedent’s date of death.¹¹ The decedent’s executor can allocate a \$1.3 million basis increase to any one or more assets for which carryover basis applies.¹² In addition to the \$1.3 million basis increase, a spousal property basis increase of \$3 million can be allocated to property transferred outright or in a qualified terminable interest property trust (QTIP).¹³ Note, however, that the basis increase for any asset cannot exceed the fair market value of the asset at the decedent’s date of death.

While at first blush this may not appear significant, consideration must be given to the potential income tax consequence to the beneficiaries of the decedent’s estate when (i) the net appreciation of the decedent’s assets is greater than \$1.3 million and there is no surviving spouse and (ii) the net appreciation is more than \$4.3 million and there is a surviving spouse.

Example 3: A widower dies in 2010 with the following assets in his name alone:

	Adjusted Basis	Fair Market Value
House	\$200,000	\$1,500,000
Stock	100,000	500,000

His will leaves his entire estate to his only child. If the decedent’s executor allocates the \$1.3 million basis increase entirely to the house (\$1.3 million + \$200,000 = \$1.5 million), and if the child later sells the stock, the child will incur a long term capital gain of \$400,000 and a capital gains tax of \$80,000. (\$500,000 - \$100,000 = \$400,000; \$400,000 x 20% = \$80,000).¹⁴ Note that the one-year repeal of estate and GST taxes under EGTRRA comes with an attached

income tax liability. In addition, New York State will impose a state estate tax in the amount of \$99,600.

Example 4: Compare the results in Example 3 to those that would occur if the same decedent were to die in 2006 when the federal applicable exclusion amount increases to \$2 million. There would be no federal estate tax although New York would still collect its pickup estate tax of \$99,600 and, since the child would receive an aggregate step-up in basis to \$2 million in the house and the stock to their fair market value on date of death (or alternate valuation date), there would be no income tax liability.

Another drawback to the carryover basis system is the potential for fiduciary issues to arise when administering the estate of a decedent who dies in 2010. In particular, unless detailed and complete records regarding basis are maintained during the decedent's lifetime, the decedent's executor will have the overwhelming task of attempting to reconstruct the basis in order to satisfy the reporting requirements. Not only will this effort involve additional time and fees, but it will also expose the executor to an enhanced risk of being surcharged.¹⁵ The executor may also be subject to claims by beneficiaries in different tax brackets that the allocation of the basis increase is neither fair nor reasonable.¹⁶

Many of these issues were previously addressed following the Tax Reform Act of 1976 when carryover basis was initially introduced. Plagued with problems then, it could not pass muster and, within a few years, was repealed retroactively. Given that the 1976 carryover provisions failed despite the fact that they provided a "fresh start" date for determining basis (rather than requiring one to make that determination from old and/or incomplete records), as well as the fact that carryover basis under EGTRRA is staged for only a one-year comeback, it is particularly difficult to expect clients to pay legal fees for provisions that may never take effect. Nonetheless, as we get closer to the year 2010, we must assess with our clients—particularly those who are frail or who may not remain competent over the next few years to draw a new will—the appropriateness of including provisions to take advantage of the \$1.3 million basis increase and the \$3 million spousal property basis increase. For those circumstances where a provision is advisable, suggested language follows:

Basis Increase. (A) If my Spouse survives me and if at the time of my death § 1022 of the Code is in effect, it is my wish that both the aggregate basis increase and the spousal property basis increase will be utilized to the extent available. To this end:

(1) I direct my Executors to give to my Trustees, to hold in the Family Trust, those assets to which my aggregate basis increase can be allocated.

(2) I further direct my Executors to give to my Trustees, to hold in the Marital Trust, as a minimum, such property as my Independent Executors, in their absolute discretion, shall provide for the aggregate spousal property basis increase after taking into account any other property to which spousal property basis increase has been allocated by my Executors. My Executors shall fund the Marital Trust with assets having the lowest aggregate fair market value to utilize such basis increase, unless my Independent Executors, in their absolute discretion, determine not to do so (because, for example, it appears that another asset is more likely to be sold sooner), in which event my Executors may fund the Marital Trust with such other asset.

(B) For purposes of this Article:

(1) My Independent Executors, in their absolute discretion, shall determine which property shall receive basis increases pursuant to § 1022(b) and (c) of the Code as well as the amount of such increases and shall make such determinations without regard to any duty of impartiality among the beneficiaries.

(2) My Independent Executors shall not be liable to any beneficiary of my estate for the selection of any assets made in accordance with the provisions in this Article, unless such selection is made in bad faith.

(3) The terms "aggregate basis increase," "aggregate spousal property basis increase," and "spousal property basis increase" shall have

the same meanings as those ascribed to them in § 1022(b) and (c) of the Code.

(4) The term “my Independent Executors” shall mean my Executors other than (i) the beneficiaries of the Family Trust as to distributions to that Trust and (ii) my Spouse as to distributions to the Marital Trust.

B. Decoupling of New York’s exemption amount

As is noted above, the exemption amount in New York for the years 2002-2003 has been interpreted as matching the federal estate tax applicable exclusion amount of \$1 million.¹⁷ While New York’s exemption amount will remain at \$1 million, beginning in January 2004, the federal exemption amount will increase to \$1.5 million.¹⁸ Thus, New York will again be in a situation similar to that which existed prior to January 1, 2000 when the amount exempt from the state estate tax was less than the federal estate tax exemption. Now, as then, the executor may well be required to file a New York State estate tax return and even pay a New York State estate tax, although no federal estate tax is due and, perhaps, no federal estate tax return must be filed.

Likewise, in 2004, New York State’s GST amount will decouple from the GST exemption under § 2631(c)¹⁹; however, New York State will continue to “pick up” its GST tax for New York property passing to a skip person based upon the federal GST credit of five percent (5%) as it existed under the 1986 Code, as amended on July 22, 1998.²⁰ In New York, this mirrors the phase-out of the state death tax credit.

Note, however, that while the state death tax credit will be replaced with a deduction, there will not be a corresponding deduction for state GST taxes when the credit for those taxes terminates.

Example 5: In 2006, father created a Trust for child with remainder to grandchild on child’s death. Prior to creating the Trust, father had already used his GST exemption. Child dies several years later, at which time there is a taxable termination. The Trust consists solely of New York property having a value of \$3 million dollars at child’s death. Based upon the federal law in effect prior to EGTRRA, the GST tax due New York State would be \$82,500, computed as follows:

Federal tax imposed under § 2601 of the Code based on rate in effect prior EGTRRA:

\$3,000,000 at 55% = \$1,650,000

Credit for certain state taxes under § 2604 of the Code in effect prior to EGTRRA:

5% of \$1,650,000 = \$82,500

For illustration, the chart below depicts the state of the applicable exclusions where the federal applicable exclusion increases and unifies with the federal GST exemption while the New York State applicable exclusion and GST exemption remain static and tied to the law pre-EGTRRA.

Year	Federal Applicable Exclusion	NYS Applicable Exclusion	Federal GST Exemption	NYS GST Exemption
2003	\$1,000,000	\$1,000,000	\$1,100,000	\$1,100,000
2004–2005	\$1,500,000	\$1,000,000	\$1,500,000	\$1,100,000 indexed for inflation
2006–2008	\$2,000,000	\$1,000,000	\$2,000,000	\$1,100,000 indexed for inflation
2009	\$3,500,000	\$1,000,000	\$3,500,000	\$1,100,000 indexed for inflation
2010	N/A–No Tax	\$1,000,000	N/A–No Tax	\$1,100,000 indexed for inflation
2011	\$1,000,000	\$1,000,000	\$1,100,000 indexed for inflation	\$1,100,000 indexed for inflation

The table above clearly demonstrates the dilemma facing estate planning attorneys in New York. As you will note below, the estate planning techniques routinely selected under prior law may no longer be appropriate for your clients.

II. Estate Planning—What Must Be Considered for Each Estate

In light of the vast, yet temporary, changes that EGTRRA makes to the estate, GST and gift taxes, it is imperative that attorneys reevaluate their clients' estate plans. For instance, if a client's will was executed prior to 2001, when the federal applicable exclusion amount was \$675,000, the planning choice reflected in that will may no longer be appropriate or produce the desired result for the client. Thus, the threshold question under EGTRRA is what type of clients need sophisticated tax planning in their wills?

A. Which clients need tax planning for their wills?

We are all too cognizant of the planning difficulties due to the sunset provision of EGTRRA and the uncertainty of whether Congress will permanently repeal the estate and GST taxes. We also have many concerns regarding carryover basis (despite the fact that it was introduced in a slightly different form in 1976 and failed within a few years) and the phase-out of the state death tax credit (which is creating revenue problems for the states). In addition, we cannot ignore the fact that many of our clients currently face estate, GST and gift taxes at substantial rates. Therefore, estate planning remains a necessary consideration for these clients. For other clients, however, the focus may shift from tax planning to other planning concerns such as spendthrift, long-term care or other disabilities, minor children, education, and small business succession. Whether you are advising a client whose estate requires tax planning or a client whose estate does not, it is imperative that both plans are capable of adapting to unforeseen changes in the tax laws.

1. An estate under \$1 million no longer needs tax planning

In the face of uncertainty therein lies a scintilla of predictability. Assuming the availability of the full federal and New York applicable exclusion amounts (even after the sunset of EGTRRA), an unmarried person or a married couple, in either case with an estate value of under \$1 million (and no taxable gifts), does not need tax planning. This is because New York's applicable exclusion amount is \$1 million and the federal applicable exclusion amount will not be less than \$1 million after EGTRRA's scheduled sunset.²¹

Of course, this does not mean that a simple "I love you" will is the most prudent approach. Although an estate under \$1 million will not need sophisticated tax planning, your clients may have concerns that should be addressed in their estate plans. For example, an outright disposition could jeopardize children should the surviving spouse remarry without entering into a prenuptial agreement. Other issues, such as long-term care or a spendthrift beneficiary, may also require specific provisions. It is important to note, however, that if a surviving spouse is the sole beneficiary and is intending to invest aggressively the assets acquired under the marital deduction, then the need for advanced tax planning may be necessary to shelter any amount that is expected to appreciate above the surviving spouse's applicable exclusion amount.

For those clients whose assets exceed \$1 million in value, tax planning options should be considered. The authors suggest that such planning strive for flexibility and simplicity to provide a mechanism that can adapt to the various changes under EGTRRA as well as the effect of New York State's decoupling estate tax.

2. Estates over \$1 million must have flexible plans

For those estates over the \$1 million threshold, we urge estate planners to review your clients' existing wills to determine the impact, if any, of the disparity between the federal and state applicable exclusion amounts. In particular, careful attention must be paid to the formula clauses that determine the amount of assets passing under the marital deduction and those directed into a credit shelter (or "bypass") trust. Without such analysis, an unintended consequence may occur such as an overfunded credit shelter trust that may result in either the effective disinheritance of the surviving spouse (i.e., where the spouse is not a beneficiary of the credit shelter trust) and/or the triggering of a state estate tax.

For example, a standard "reduce to zero" formula may provide as follows:

If my Spouse survives me, I give [to my Spouse absolutely] [to my Trustees to hold in trust for my Spouse] the minimum amount necessary to reduce the federal estate tax on my estate to the smallest possible amount (including zero) after taking into account the credit allowable against such tax under § 2010 of the Code and the credit allowable under § 2011 of the Code (provided use of this credit does not require an

increase in the state death taxes paid), but no other credit. I recognize that this amount may be affected by the action of my Executors in exercising certain tax elections, and that it may be zero. In determining this amount, property shall be valued as finally determined for federal estate tax purposes in my estate.

Such a commonly used formula is intended to reduce the aggregate estate taxes by minimizing assets passing to the surviving spouse, and thereby maximizing the credit shelter trust. From an estate tax savings perspective, the formula also ensures that any appreciation during the period of administration is allocated to the credit shelter trust.²²

With the increasing federal applicable exclusion amounts under EGTRRA, however, such a “reduce to zero” approach may have the unintended consequence of either binding the surviving spouse to the terms of a credit shelter trust where one may not have been necessary for estate tax savings purposes or, in some cases, effectively disinheriting the surviving spouse.

Example 6: Assume a decedent in 2003 who has a taxable estate of \$1.5 million, all passing under the terms of her will. Use of the above formula will cause \$500,000 to be set aside for the surviving spouse (outright or in a marital trust), and the remaining \$1 million to be allocated to a credit shelter trust.

Example 7: If, given the facts in Example 6, that same decedent were to die in 2004 (when the federal applicable exclusion amount increases to \$1.5 million), the entire \$1.5

million estate would be allocated to the credit shelter trust and nothing would pass outright to or in a marital trust for the surviving spouse.

This may not be a major concern if the surviving spouse is the sole beneficiary of the credit shelter trust during his lifetime since the surviving spouse may enjoy the income and certain distributions of principal. On the other hand, if the surviving spouse is a discretionary beneficiary, and particularly if one of several discretionary beneficiaries (the others being the decedent’s children from a prior marriage), disputes may arise regarding the proper distributions from the credit shelter trust.

Consider also the testator who is concerned that distributions to her surviving spouse from the credit shelter trust might be accumulated, thereby causing her surviving spouse’s estate to be taxable at his death. If, as a result, the credit shelter trust has several discretionary beneficiaries with no priority stated for the spouse, or if the surviving spouse is not included in the class of beneficiaries, then, under Example 6, the surviving spouse would be effectively disinherited.²³

An additional concern regarding the commonly used “reduce to zero” formula is that it fails to accomplish a reduction of the combined federal and state estate tax to zero when the applicable exclusion amount for a state decouples with the federal amount. The applicable exclusion amount in New York, for example, is capped at \$1 million. Therefore, if the credit shelter bequest at the first spouse’s death is maximized based upon EGTRRA’s increasing exemption, a tax will be imposed on the estate of a decedent who dies after 2003, a resident of New York State. The significance of this point is highlighted by the following chart:

Year	Federal Applicable Exclusion	NYS Applicable Exclusion	Maximizing Credit Shelter Trust to Federal Exclusion	NYS Tax on Maximized Credit Shelter
2003	\$1,000,000	\$1,000,000	\$1,000,000	\$0
2004–2005	\$1,500,000	\$1,000,000	\$1,500,000	\$64,400
2006–2008	\$2,000,000	\$1,000,000	\$2,000,000	\$99,600
2009	\$3,500,000	\$1,000,000	\$3,500,000	\$229,200
2010	N/A—No Tax & No Marital Deduction	\$1,000,000	Unlimited	Based on Unlimited Credit Shelter Amount
2011	\$1,000,000	\$1,000,000	\$1,000,000	\$0

This chart lends firm support to the need to incorporate more flexibility into an estate plan. The commonly used “reduce to zero” approach limits a fiduciary’s ability to engage in post-mortem tax planning because the formula is inherently inflexible.

It is therefore important that we help our clients avoid the harsh imposition of the New York State estate tax by modifying the formula language to impose a limit on the size of the credit shelter. Such a modification might include the sentence: “In no event shall this amount be more than the largest amount necessary to eliminate any New York estate taxes.”²⁴ While this approach may eliminate the imposition of New York State estate tax, it may very well subject the surviving spouse’s estate to federal and state estate taxes since more assets will be held in a marital trust or distributed to the surviving spouse. Therefore, it is also important that we draft for more flexibility utilizing post-mortem planning so that an estate will more readily adjust to the tax laws at the date of death.

B. Planning for flexibility

Given the evolution that EGTRRA will bring over the next eight years, it seems prudent to empower the surviving spouse and/or executor to engage in post-mortem tax planning by adopting a formula clause that incorporates a “wait and see” approach. We often hear investment advisors claim that someone cannot time the market. In our planning process, an analogous thought applies—we cannot plan on the year of death (and the year of death can bring different consequences under EGTRRA). Thus, in light of the current tax laws, it is sound reasoning to permit the executor to look at the applicable exclusion amount and the tax rates in effect at the death of the first spouse, and to determine *at that point in time* the extent to which assets will pass under the marital deduction rather than the credit shelter trust. In addition, at the death of the first spouse, the executor might be better able to forecast the tax laws that may be in effect in the anticipated year of the surviving spouse’s death.

Estate planners might consider a variety of alternatives to the inflexible standard “reduce to zero” formula. Three examples of flexible planning include (i) the disclaimer trust, (ii) the divisible QTIP trust, and (iii) the contingent QTIP trust (or “Clayton QTIP”).²⁵ The selection will depend, among other things, upon the size of the marital estate, intricacies of the family relationships, money management skills, and whether the surviving spouse may be susceptible to long-term illness. Each of these scenarios will provide a mechanism for the surviving spouse and/or the executor to engage in post-mortem tax

planning utilizing a sliding scale approach when making allocations to the marital and non-marital shares. It is also important to note that each of these methods will qualify for the \$3 million spousal carry-over basis increase in 2010.²⁶

1. The disclaimer trust

When planning for a client with a small or modest estate, disclaimer planning may be a viable option. In essence, such a plan leaves the testator’s entire estate outright to the surviving spouse with a further provision for any property disclaimed by the spouse to funnel into a non-marital trust. For example, a disclaimer provision may provide in relevant part:

If my Spouse renounces any interest in property otherwise passing to my Spouse under this will, I give the property so renounced to my Trustee, to hold in trust (hereinafter, the “Disclaimer Trust”) [*add provisions for non-marital trust for the benefit of spouse or spouse and others, making sure not to give spouse a power of appointment other than a \$5,000 x 5% withdrawal power*].

This approach provides flexibility and gives the surviving spouse maximum control of the decedent’s assets. From the control standpoint, the initial provision for outright distribution to the surviving spouse is similar to the simple “I love you” will; however, the disclaimer provision adds post-mortem tax planning flexibility by enabling the surviving spouse to shelter, in a non-marital trust, assets having a value equal to the exemption equivalent amount (or a lesser amount). Although, the surviving spouse makes this decision when more facts are known, it is based upon his willingness to forgo outright distribution of assets in favor of sheltering them from inclusion in his taxable estate.

Disclaimer planning, however, may not be appropriate in every small or modest sized estate. The federal disclaimer statute defines a “qualified disclaimer” as an irrevocable and unqualified refusal to accept an interest in property if (i) the refusal is in writing; (ii) it is given to the executor within nine months of the date of death; (iii) the person has not accepted the interest or any of its benefits; and (iv) the disclaimed interest passes without any direction on the part of the person making the disclaimer and passes to the decedent’s spouse or a person other than the person making the disclaimer.²⁷ Herein lie two pitfalls for the surviving spouse who may not be guided by counsel.

First, if after the death of a decedent, the surviving spouse accepts any benefit of the decedent's property (i.e., house, money, etc.), then with but a few exceptions, a subsequent disclaimer will not be a "qualified disclaimer" under § 2518(b) of the Code, thereby frustrating the testator's intent to provide post-mortem tax planning flexibility with respect to those assets. For example, although an asset is titled solely in the name of a decedent, the surviving spouse may view it as belonging to both of them, and continue to benefit from the asset as a matter of "entitlement" after the decedent's death. Such an act would disallow the benefits of the disclaimer under § 2518(b) of the Code, causing the asset to pass as marital property in the decedent's estate and ultimately be included for estate tax purposes in the estate of the surviving spouse. Second, even if the surviving spouse does not accept the benefits of the decedent's property, a disclaimer would not be "qualified" if not executed by the surviving spouse and delivered within nine months of the decedent's death.

In addition, disclaimer planning may not be appropriate where the client has children from a prior marriage. Assuming that the decedent's children are sole beneficiaries, discretionary beneficiaries with the surviving spouse or even just the remainder beneficiaries of the disclaimer trust, irrespective of subsequent tax implications, the surviving spouse may not have the incentive to disclaim any interest that will ultimately benefit the decedent's children. Rather, preferring to control the ultimate disposition of such property, the surviving spouse may accept it outright at the decedent's death. Finally, the surviving spouse may simply refuse (i.e., due to fear of losing control, vulnerability, or no reason at all) to disclaim an interest. These examples demonstrate certain instances where the flexibility and control given by disclaimer planning may create an intolerable risk, thereby rendering this post-mortem tax planning vehicle inappropriate.

Nonetheless, in the appropriate situation, a disclaimer trust can be a particularly effective tool for the estate planner to utilize since EGTRRA.

2. The divisible QTIP

In those situations where the disclaimer trust is not appropriate, but the testator still wants the surviving spouse to benefit from the entire estate, a divisible QTIP trust may be the solution.²⁸ Under this concept, an executor can divide a QTIP trust into three shares, namely, (i) an estate tax exemption share, (ii) a marital share,²⁹ and, to the extent the decedent's GST exemption has not been fully used, (iii) a GST exempt marital share, making a QTIP election for the latter two shares and a reverse GST elec-

tion for the last share. The Treasury Regulations demonstrate clearly the power and administration of the divisible QTIP:

Example 8. Severance of QTIP trust.

D's will established a trust funded with the residue of D's estate. Trust income is to be paid annually to S for life, and the principal is to be distributed to D's children upon S's death. S has the power to require that all of the trust property be made productive. There is no power to distribute trust property during S's lifetime to any person other than S. D's will authorizes the executor to make the election under § 2056(b)(7) only with respect to the minimum amount of property necessary to reduce estate taxes on D's estate to zero, authorizes the executor to divide the residuary estate into two separate trusts to reflect the election, and authorizes the executor to charge any payment of principal to S to the qualified terminable interest trust. S is the sole beneficiary of both trusts during S's lifetime. The authorizations in the will do not adversely affect the allowance of the marital deduction. Only the property remaining in the marital deduction trust, after payment of principal to S, is subject to inclusion in S's gross estate under § 2044 or subject to gift tax under § 2519.³⁰

Most importantly from the standpoint of flexibility, unlike disclaimer planning where the surviving spouse is given only nine months to disclaim, with a QTIP trust the executor has up to fifteen months after the decedent's date of death to make a full or partial QTIP election.³¹ With an additional six months,³² the executor can more readily determine what portion of the trust should qualify for the marital deduction and what portion should be held as a non-marital trust, minimizing the impact of taxes at the surviving spouse's death.³³ Although the executor on the estate tax return must express intent to divide the trust, the actual division of assets need not be accomplished until the end of the estate's administration. If a partial election is made, it must be with respect to a fractional or percentage share of the property so that the elective portion reflects its proportionate share of the increase or decrease in applying code §§ 2044 and 2519.³⁴

In addition, under the divisible QTIP, the executor can create a second marital trust (a GST exempt marital trust), and make a reverse QTIP election to take advantage of the decedent's GST exemption to the extent (if at all) that such exemption has not been used. A sample provision follows:

If my Spouse survives me, I give my residuary estate to my Trustee to hold in as many separate Trusts, each for the benefit of my Spouse, as my Executors, in their absolute discretion, shall determine. In the event my Executors make an election under § 2056(b)(7)(B)(v) of the Code to treat a portion of my residuary estate as qualified terminable interest property, such portion shall be referred to as the "Marital Share," and the remaining portion of my residuary estate shall be referred to as the "Nonmarital Share." In the event that my Executors make a further election under § 2652(a)(3) of the Code to allocate my unused GST exemption, if any, to a portion of the Marital Share, my Marital Share shall be divided into two separate parts, one to which my unused GST exemption is allocated (the "Reverse Marital Share"), and the other being the remaining part of the Marital Share. The Nonmarital Share shall be held by my Trustees under Article [Article setting forth terms of Family Trust], and shall be known as the "[testator's surname] Family Trust." The Marital Share shall be held by my Trustees under Article [Article setting forth terms of Marital Trust], and shall be known as the "[Spouse's name] Marital Trust." The Reverse Marital Share, if any, shall be held by my Trustees under Article [Article setting forth terms of GST Exempt Marital Trust], and shall be known as the "[Spouse's name] GST Exempt Marital Trust."

With the unification of the estate tax applicable exclusion amount and the GST exemption in 2004, there will not be too many situations where the unused GST exemption will exceed the amount applied to the non-marital trust. One such situation, however, will occur where a testator who is a resident of a state that has decoupled (e.g., New York),

limits the non-marital trust to the state's applicable exclusion amount.

Example 9: Decedent, a resident of New York State, dies in 2004 when the federal applicable exclusion amount is \$1.5 million and New York State's exemption is only \$1 million. Decedent's taxable estate is \$2 million. Decedent's will provides for a formula credit shelter trust, as limited to New York State's exemption amount. Decedent's residuary estate is to be held in one or more QTIP trusts for her husband. The executors will fund the credit shelter trust with \$1 million. In order to take advantage of decedent's \$1.1 million GST exemption (none of which was used during decedent's lifetime), the executors will allocate \$1 million to the credit shelter trust. In addition, they will divide the QTIP trust into two separate trusts: one shall be determined by a fraction, the numerator of which will be \$100,000 (decedent's remaining unused GST exemption) and the denominator of which shall be the value of the residuary estate (the "GST Exempt Marital Trust"), and the other shall be the remaining fractional share. Decedent's executor will make an election under § 2652(a)(3) of the Code to allocate her remaining \$100,000 GST exemption to the GST Exempt Marital Trust. These provisions and transactions will (i) avoid payment of New York State estate tax in the amount of \$64,400 at the decedent's death (though it risks the possibility of increased estate tax at her husband's death), (ii) take advantage of decedent's full GST exemption, and, if death were to occur in 2010, take advantage of both aggregate basis increase and spousal property basis increase.

Another such situation would occur where a client has made gifts during life which did not require allocation of the GST exemption, but used a portion of her applicable exclusion amount. As a result, the reverse QTIP election at death would be a viable planning tool since there would be a spread between the GST exemption and the applicable exclusion amount.

Example 10: Decedent dies in 2003 with a taxable estate of \$2 million. Decedent made lifetime gifts of \$100,000, leaving up to \$900,000 (her remaining applicable exclusion amount) to fund a credit shelter trust. Decedent's will calls for a pecuniary credit shelter trust, with the residuary estate to be held in one or more QTIP trusts for the surviving spouse. Since decedent has not used any of her \$1.1 million GST exemption, decedent's executor will allocate \$900,000 to the credit shelter trust, causing it to be fully exempt, and will create two QTIP trusts, one being a fractional share of the residuary estate (the numerator of which is \$200,000, and the denominator of which is the value of the residuary estate), for which a reverse QTIP election will be made.

Another potential feature of the divisible QTIP is that if the executor makes a partial QTIP election (which may trigger the payment of some tax at the first spouse's death) and the surviving spouse dies within ten years of the first spouse's death, the surviving spouse's estate may be entitled to a credit for taxes paid on prior transfers ("TPT Credit").³⁵ This trust may be an attractive planning tool for the estates of more mature couples where it is anticipated that both spouses will pass away within a relatively short time of each other.

Although the divisible QTIP may provide a powerful tool for post-mortem planning flexibility, it may not be appropriate when the value of the surviving spouse's estate exceeds the federal and/or state applicable exclusion amount and the surviving spouse is or will be in a high income tax bracket with adequate independent monthly cash flow to maintain an accustomed standard of living. The influx of required income distributions from the non-marital share of the divisible QTIP may further inflate the surviving spouse's estate, running the risk of increasing estate taxes at his subsequent death. In addition, should the surviving spouse require long-term nursing care, the divisible QTIP does not take advantage of key asset protection strategies that might otherwise allow one to qualify for Medicaid. In these circumstances, the "Clayton QTIP" may be a better option.

3. The "Clayton QTIP"

While the "Clayton QTIP" derived its name from the U.S. Court of Appeals, Fifth Circuit case *Estate of*

Clayton v. Commissioner,³⁶ a review of the Treasury Regulations reveals that it may be more aptly named the "contingent QTIP."³⁷ The Treasury Regulations state, in pertinent part:

Contingent income interests.—(i) An income interest for a term of years, or a life estate subject to termination upon the occurrence of a specified event (e.g. remarriage), is not a qualifying income interest for life. However, a qualifying income interest for life that is contingent upon the executor's election under § 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 . . .³⁸

As the Treasury Regulations explain, the contingent income interest provides a powerful addition to the divisible QTIP approach. The contingent QTIP permits the executor to make a partial QTIP election and allocate the non-elected property to a non-marital trust that does not necessarily provide a lifetime income interest to the surviving spouse. By utilizing this approach, the testator is hedging against increasing the size of the surviving spouse's taxable estate since the surviving spouse will not necessarily be the recipient of income distributions from the non-marital trust.³⁹ This approach may also take advantage of the disparity in income tax rates between the surviving spouse and the testator's children. For instance, if the surviving spouse is in the 35% income tax bracket, income distributions to him from the non-marital trust would be taxed at that rate. If, however, the surviving spouse does not need part or all of the income from the non-marital trust, use of a contingent QTIP would allow the trustees to distribute such income to the testator's children whose income tax bracket is presumably lower (i.e., 28%) than that of the surviving spouse. Thus, the contingent QTIP plan also has an income tax savings component.

The contingent QTIP might be carved out of the residuary estate as follows:

If my wife survives me, my residuary estate shall be disposed of as follows:

a) I authorize my Independent Executors to make an election under § 2056(b)(7)(B)(v) of the Code to treat

a portion of my residuary estate as qualified terminable interest property. In the event such an election is made, such elected portion shall be referred to as the "Marital Share," and the remaining portion shall be referred to as the "Nonmarital Share."

b) My Trustees shall hold the Marital Share in as many separate Trusts as my Executors, in their absolute discretion, shall determine, each for the benefit of my Spouse, the dispositive terms of which are set forth in Article [Article setting forth provisions for QTIP Trust]. My Trustees shall hold the Nonmarital Share in as many separate Trusts as my Executors, in their absolute discretion, shall determine, the dispositive terms of which are set forth in Article [Article setting forth provisions for Contingent QTIP Trust: a discretionary trust for issue or for surviving spouse and issue].

Equally important, if the surviving spouse requires long-term skilled nursing care but does not have private long-term care insurance, the contingent QTIP may provide a superior means for protecting assets and therefore maximizing the trust remainder for the testator's children. For example, the executor might be directed to funnel the QTIP trust assets, to the extent QTIP treatment is not elected, into a contingent QTIP that is in the form of a supplemental needs trust (SNT) for the surviving spouse. This action may prevent the trust assets from being exhausted due to the surviving spouse's long-term illness. Note, however, that the contingent QTIP does not come without potential challenges. The surviving spouse's interest (if one exists at all) in a contingent QTIP (whether an SNT or otherwise) cannot compare to the interest he would have had in the non-marital share of a divisible QTIP, and certainly does not compare to the outright disposition he would have received (but for a disclaimer) in an "I love you" will. It is not surprising then that an estate plan relying upon a contingent QTIP may face a spousal elective share problem. In fact, unlike a disclaimer based plan, the New York elective share statute is not satisfied by any form of QTIP trust distributions.⁴⁰ Thus, in cases where a waiver of the elective share is not obtained, the surviving spouse may defeat a flexible estate tax savings plan by taking the elective share. This right of election may be exercised for emotional or financial reasons (i.e., the surviving spouse's feeling that he is being disinherited or his refusal to per-

mit the decedent's children by a prior marriage to inherit the entire non-marital trust). Another disadvantage to the contingent QTIP plan is that the surviving spouse does not have a fixed and ascertainable interest in that trust as he would in a divisible non-marital QTIP trust. Therefore, if he dies within ten years after the decedent, the benefit to his estate of the TPT credit will be considerably less (if at all) than it would otherwise be if he were the beneficiary of a divisible non-marital QTIP trust.

Finally, when selecting fiduciaries for a contingent QTIP plan, it is essential that there be an independent executor. Neither the surviving spouse nor any of the beneficiaries of the non-marital trust should serve as the sole executor. Since the surviving spouse is the only person entitled to benefit from the marital share, there is an inherent conflict of interests between the surviving spouse and the beneficiaries of the non-marital share (whether or not the surviving spouse is one of the beneficiaries). This conflict is an invitation for litigation if the beneficiaries of the non-marital share believe that the surviving spouse is acting only in the best interest of the marital share rather than of both shares. On the other hand, if the surviving spouse is the sole executor, and makes the QTIP election over only a small portion of the Trust, the surviving spouse can be deemed to have made a taxable gift to the beneficiaries of the contingent QTIP Trust. Similarly, if one of the other beneficiaries is sole executor and makes the QTIP election over a significant portion of the Trust, he could be deemed to have made a gift to the surviving spouse by virtue of the fact that his interest in the contingent QTIP Trust has been reduced. Given this issue, it is prudent for the testator to appoint an independent executor for purposes of making the partial QTIP election.

C. Do not forget simplicity

When planning for flexibility to deal with the temporary effects of EGTRRA it is important not to lose sight of simplicity. Clients often come to an attorney's office with previously drafted estate planning documents and no understanding as to how the estate plan works. Sometimes, as we strive zealously to represent our clients and reduce the impact of estate taxes, simplicity is overlooked. When choosing a flexible plan to address the temporal nature of the current tax laws, a simple plan along with other techniques may produce a superior and more understandable result for the client.

1. Maximize each client's state applicable exclusion amount

The drafting concepts discussed above are important, but if the clients' assets are not properly

allocated and titled, the plan will not work. Since each New York resident can transfer up to \$1 million at death, it is also necessary to maximize the assets of *each* spouse to the extent possible so that each will have at least \$1 million in his or her name alone. This can be accomplished by transferring assets between spouses (which are tax-free transfers) while both spouses are living.

Example 11: Wife has assets valued at \$1.8 million in her name and husband has \$200,000 in his name. They have reciprocal wills with credit shelter trusts benefiting the other. Husband dies in 2000. Since wife had not transferred any of her assets to husband, only \$200,000 can be sheltered in the trust under his will, with \$800,000 of husband's exemption having been wasted. When wife dies in 2005, her assets remain valued at \$1.8 million and the federal exemption is then \$1.5 million. Wife's estate will pay \$198,900 in taxes (federal: \$113,700; NYS: \$85,200).

Example 12: Same facts as in Example 10, except that wife transfers \$800,000 to husband in conjunction with their new wills. When husband dies in 2000, \$1 million can be placed in the credit shelter trust under his will. When wife dies in 2005, her assets are now reduced to a value of \$1 million, and neither Federal nor New York State estate taxes are required.

2. Don't forget the power of lifetime gifting

For those estates that are on the borderline for tax planning, lifetime gifting may be the prescription (assuming the client has liquidity to carry out such a plan). In 2003, each individual can give up to \$11,000 annually, free of federal gift taxes, to an unlimited number of people (and they *do not* have to be related to the donor). If one spouse has the lion's share of the assets, both spouses can elect to utilize gift splitting, and make gifts of \$22,000 annually. For clients who have a high net worth and are not "fearful" of becoming "impoverished," this is a powerful estate reduction technique.

Example 13: A married couple with two children can make gifts (federal gift tax free) of up to \$44,000 a year, in aggregate, to their children. Making such annual exclusion gifts over

a five-year period would remove \$220,000 from the couple's estate. If each child were married and had four children, annual exclusion gifts to each child, in-law, and grandchild, using split-gifts over a five-year period would remove \$1,320,000 from the couple's estate.

3. The irrevocable life insurance trust still has value

To some, the increasing federal exemption amounts over the next eight years may alter their willingness to create an irrevocable life insurance trust. In contrast, the irrevocable life insurance trust may remain an excellent source of liquidity for those who live in states, like New York, that have decoupled from the federal exemption levels. Planning with life insurance may be a mechanism to complement a marital deduction formula that maximizes the credit shelter trust to the federal exemption level since it provides the necessary liquidity to pay the state estate tax cost for that increase. Alternatively, if the credit shelter trust is limited to the state exemption amount, thereby increasing the value of the surviving spouse's estate, liquidity will be needed at that spouse's subsequent death. In addition, if carry-over basis is not repealed, additional funds may well be needed to replace funds used to pay capital gains taxes. Of course, the estate planner must crunch the numbers for each client by comparing the cost of premiums that will sustain the insurance with the potential savings that should result from the instant liquidity that will be obtained.

4. Moving may be an option

There are certain states, like Florida, where the state constitution prohibits the imposition of an estate tax. So long as the federal statute provides credit for death taxes paid to a state, Florida can "pick up" this credit as a state death tax. Once the federal statute phases out this credit, however, Florida will no longer be able to impose a death tax. Clearly, for certain clients, it may be worth considering a change in domicile to a state like Florida.

III. Conclusion

The federal estate and GST taxes are not permanently repealed by EGTRRA. In fact, EGTRRA raises important challenges for estate planners to address over the next eight years. When facing these challenges, simple techniques should be analyzed first to solve a potential tax problem. At the same time, where tax planning must be accomplished, estate planners should consider the power of flexibility to address the evolving effects of EGTRRA. A combina-

tion of both simplicity and flexibility will provide your clients with the tools needed to contend with the uncertain state of our current federal and state estate and GST tax laws.

Endnotes

1. I.R.C. § 2010(c). In addition, EGTRRA provides that the top marginal estate and gift tax rate will decrease from 55% in 2001 to 45% in 2009, but the top marginal estate and gift tax rate will return to 55% in 2011. In the year 2010, when the estate tax is repealed, the gift tax will be retained at the top income tax rate.
2. Unless otherwise indicated, references to “§” and “§§” are to sections of the Internal Revenue Code of 1986, as amended (the “Code”), and references to “Treas. Reg. §” are to the Regulations under the Code.
3. § 2631(c). It is at this point in time that the estate tax and gift tax will be “de-unified” (although they will share a common tax rate from 2002-2009).
4. It is important to note that this repeal does *not* include the federal gift tax. The federal gift tax applicable exclusion amount will remain at \$1,000,000 with a maximum tax rate in 2010 of 35%.
5. P.L. 107-16, § 901(a)-(b) (emphasis added).
6. § 2011(a).
7. §§ 2011(b)(2)(B), 2058.
8. Technical Services Bulletin Memorandum, TSB-M-02(2)M (Mar. 21, 2002), which allows New York to take advantage of the federal estate tax exemption of \$1 million for decedents dying in 2002 and 2003, despite the fact that § 951 of the New York Tax Law might otherwise be interpreted as limiting the exemption to \$700,000 for the years 2002 and 2003; *see also* NYS Estate Tax Return, Form ET-706 (3/02).
9. For an excellent discussion of the effect of EGTRRA on New York estate tax calculations, *see* NYSBA Trusts and Estates Law Section Newsletter: Philip L. Burke, *The Effect of Recent Federal Estate Tax Legislation on the New York Estate Tax: Part II*, Winter 2002, vol. 35, no. 4, at 40.
10. § 1014(a), (f).
11. § 1022(a)(2).
12. § 1022(b)(2)(B). In addition, § 1022(b)(2)(C) provides that the basis increase shall be further increased by unused built-in losses and capital loss carryovers.
13. § 1022(c)(2)(B).
14. This example does not take into account the recent decrease in the capital gains tax rates before the new carryover basis rules under EGTRRA take effect.
15. Frank S. Berall, Ellen K. Harrison, Jonathan G. Blattmachr & Lauren V. Detzel, *Planning for Carryover Basis That Can Be/Should Be/Must be Done Now*, WG&L Estate Planning Journal (Mar. 2002).
16. *Id.*
17. *See supra* note 8.
18. N.Y. Tax Law § 951(a).
19. The federal exemption unifies with the I.R.C. § 2010(c) amount.
20. N.Y. Tax Law § 1020(a). *See also* § 2604(a), (b).
21. This assumes that neither Congress nor the New York State Legislature will act aggressively to reduce the applicable exclusion amount to an amount below \$1 million.
22. It should be mentioned that if the assets depreciate in value during the period of administration, the credit shelter will bear the burden of the decrease in value.
23. Surely, in this scenario, the surviving spouse would exercise the right of election under EPTL 5-1.1-A if a waiver of said right had not been executed.
24. Harold D. Klipstein & Ira Mark Bloom, *Drafting New York Wills, Law and Forms*, § 7.26 Form 3, at 7-278 (Matthew Bender & Co. 2003).
25. For an excellent synopsis of the advantages and disadvantages of each of these techniques, *see* Howard M. Zaritsky, *Practical Estate Planning and Drafting after the Economic Growth and Tax Relief Act of 2001*, ¶ 2.02[6] (Warren Gorham & Lamont 2001).
26. § 1022(c)(2)(B).
27. § 2518(b).
28. Zaritsky, *supra* note 25, at ¶ 2.02[6][b].
29. § 2056(b)(7); Treas. Reg. §§ 20.2056(b)-7(b)(2)-(4),-7(h), Ex. 9; *see also* EPTL 7-1.13(a)(1) (which permits the division of a QTIP trust).
30. Treas. Reg. § 20.2056(b)-7(h), Ex. 9.
31. § 6081(a); Treas. Reg. § 20.6081-1(b) (granting an automatic extension of time to file if an executor requests it within nine months of the decedent’s date of death).
32. When a determination has to be made regarding a QTIP election, it is prudent post-mortem tax planning to obtain a six-month extension of time to file.
33. Treas. Reg. § 20.2056(b)-7(b)(2)(i)-(ii).
34. Treas. Reg. § 20.2056(b)-7(b)(2)(i). The separate trusts, however, do not have to be funded with a pro rata portion of each asset held by the individual trust. Treas. Reg. § 20.2056(b)-7(b)(2)(ii)(B).
35. § 2013.
36. 976 F.2d 1486 (5th Cir. 1992).
37. Treas. Reg. § 20.2056(b)-7(d)(3)(i).
38. *Id.*
39. If, however, the surviving spouse is a discretionary beneficiary of the non-marital trust, distributions can be made to him should he need additional funds. On the other hand, if he enters into a long-term care facility, funds from the trust can be used to supplement any governmental benefits to which he may be entitled.
40. Klipstein & Bloom, *supra* note 24, § 7.27[2], at 7-303.

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