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Elaine Hightower Gagliardi on Flipping the Lens of Estate Planning: An Examination of the Effectiveness of Lifetime Transfers to Achieve Federal and State Tax Savings

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By Elaine Hightower Gagliardi[*]

§ 2.01 Introduction

Estate planners are recalibrating their planning focus in response to recent tax modifications at the federal and state levels. The need to refocus planning emanates from changes wrought by recent federal tax acts, beginning in 2001[1] and ending in 2013[2] with enactment of "permanent" provisions which increase the basic exclusion amount for federal estate and gift tax and generation skipping transfer tax exemption to an inflation adjusted $5,340,000 as of 2014,[3] institute the portability election for federal estate tax purposes,[4] alter the transfer tax rate to essentially a flat 40 percent,[5] and eliminate the state death tax credit in favor of a state death tax deduction for federal estate tax purposes.[6] The impacts of these changes on estate planning techniques and estate planners prove significant. The number of total federal estate tax returns filed decreased from about 122,000 in 2001 to about 32,000 in 2013[7] indicating substantially fewer estates find it necessary to file and suggesting the need for planners to assess the possibilities for continued tax planning. An examination of the wealth transfer tax landscape as it has emerged requires planners to consider the impacts and planning opportunities remaining from many different angles and to flip the lens to consider federal wealth transfer tax, state estate and inheritance tax, and income tax burdens and opportunities. This article primarily explores the impacts of these recent changes on the continued effectiveness and use of lifetime transfers as a tax planning tool.

Among the many questions raised by these recently legislated changes is the question of whether and when lifetime transfers make sense for clients from a federal and state tax law perspective. In answering this question planners must take into account the impact of lifetime transfers on both federal and state estate taxes, and the associated impact of those transfers for purposes of federal and state income taxation. Statistics indicate that lifetime transfers remain a viable planning technique. The most recent statistics show federal gift tax returns filings decreasing from about 304,000 in 2001 to about 249,000 in 2012, with a jump in 2013 to about 313,00,

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[1] The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub L No 107-16 (June 7, 2001).

[2] American Taxpayer Relief Act of 2012, Pub L No 112-240 (Jan. 3, 2013), and the preceding Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub L No 111-312 (Dec 17, 2010).

[3] IRC §§ 2010, 2505, 2631. See Rev Proc 2013-35, 2013-47 IRB 537 (providing 2014 inflation adjusted amounts).

[4] IRC § 2010.

[5] IRC § 2001.

[6] IRC § 2058 (state death tax deduction); IRC § 2011 (now repealed state death tax credit).

[7] Internal Revenue Statistics of Income, Tax Stats, http://www.irs.gov/uac/SOI-Tax-Stats-Numbers-of-Returns-Filed-by-Type-of-Return-IRS-Data-Book-Table-2; *See also* Internal Revenue Service Statistics of Income Bulletin, SOI Tax Stats < http://www.irs.gov/uac/SOI-Tax-Stats-Estate-Tax-Statistics-Filing-Year-Table-1> (accessed May 26, 2014)(Indicates estimated number of taxable estates decreased from 51,736 in 2001 to 3,738 in 2012, and also indicates estimated number of estate tax returns filed decreased from 101,871 in 2001 to 9,412 in 2012).

likely a result of the uncertainty as to whether the increases in the applicable credit amount would in fact sunset.[8] The following analysis repeatedly flips the lens to recalibrate understanding of the relative advantages and disadvantages of lifetime transfers in light of the new estate planning landscape.

This article begins by focusing on the continued viability of lifetime transfers in light of changing federal tax rates and exemption amounts, it then eyes the influence of state transfer taxation on lifetime planning opportunities. It analyzes the various opportunities and justifications for making lifetime transfers in light of the increase in exemption and the increasing focus on obtaining a step-up in basis, and it addresses many of the estate planning strategies suggested. A view of the horizon reveals that the answer to the question of whether lifetime transfers remain a viable planning tool depends in large part on the client's overall wealth and state of domicile. What becomes clear from the analysis is that lifetime transfers remain an important planning tool in the quest to minimize wealth transfer taxation and obtain a step-up in basis.

§ 2.02 Federal Wealth Transfer Tax Considerations in Making Lifetime Transfers

The federal tax benefits and costs resulting from a completed lifetime gift remain familiar despite the recent changes in the federal transfer tax. Changes of significance, however, include the increased threshold for determining when a completed gift yields tax savings and the use of gifts to preserve ported applicable exclusion amounts.

[1] Impact of the Increased Federal Threshold on Lifetime Transfers

From a federal transfer tax perspective, those clients whose assets likely will never exceed the basic exclusion amount, and if married twice that amount, generally do not obtain any federal transfer tax benefit from making lifetime gifts because those clients do not face the prospect of paying federal estate or gift tax.[9] The recent changes in the federal tax code increase the threshold amount for payment of wealth transfer tax in 2014 to $5,340,000 for individuals and up to $10,680,000 for married couples who elect portability.[10] This wealth transfer tax basic exclusion amount applies to aggregate transfers occurring during life and at death. The variance between taxation of transfers during life and at death for income tax purposes stems from the difference in basis.

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[8] The most recently published statistics for fiscal year 2012-2013 indicate gift tax return filings in fact increased to 313,000, http://www.irs.gov/uac/SOI-Tax-Stats-Numbers-of-Returns-Filed-by-Type-of-Return-IRS-Data-Book-Table-2 (accessed June 23, 2014). *See also* Internal Revenue Service Statistics of Income Bulletin, SOI Tax Stats – Total Gifts of Donor, Total Gifts, Deductions, Credits, and Net Gift Tax, http://www.irs.gov/uac/SOI-Tax-Stats---Total-Gifts-of-Donor,-Total-Gifts,-Deductions,-Credits,-and-Net-Gift-Tax (accessed May 26, 2014)(indicates estimated federal gift tax returns filings increasing to 258,393 in 2012 from 235,782 in 2003, although taxable returns decreased by about one-third during that time period to only 2,469 from 6,049). It will be interesting to see if the trend continues beyond 2013 because, during 2011 and 2012 the years for which 2012 and 2013 returns were filed, many transfers anecdotally were made in light of the uncertainty surrounding anticipated Congressional action dealing with sunset provisions.

[9] IRC § 2010.

[10] Rev Proc 2013-35, 2013-47 IRB 537.

Lifetime transfers of property by gift lose the ability to obtain a step-up in basis, assuming overall appreciation, thus, clients whose assets do not exceed the basic exclusion amount typically should refrain from gifts to avoid the disadvantage of a gift tax carry-over income tax basis from the donor to the beneficiary.[11] The one tax that can be avoided by death is the tax on the gain inherent in a decedent's assets, and this avoidance possibility can prove to be a substantial amount. In sum, the overall federal tax cost of making a gift by a client whose assets do not trigger a federal estate tax derives from the gift tax carry-over basis rule and is the amount of income tax on the gain inherent in the gifted property, and its subsequent appreciation, which will be owed on any future sale by the donee beneficiary that in fact triggers gain recognition.[12] For depreciable assets the tax cost of a lifetime gift increases to include the lost benefit of higher "stepped-up basis" depreciation deductions available to offset ordinary income.

[2] Impact of Relative Tax Rates on Benefits of Lifetime Transfers

Clients, whose assets exceed the basic exclusion amount, or if married twice that amount, may pay a federal transfer tax at the rate of 40 cents on every dollar in excess of the applicable exclusion amount.[13] In considering the effectiveness of making a completed gift in a manner that precludes subsequent estate taxation, the aggregate estate tax savings should be compared to any potential income tax that will be paid by the beneficiary on a subsequent sale of the asset due to the Section 1015 carry-over basis rules. Assuming the donee pays tax on inherent gain at long term capital gain rates, an overall tax savings on the lifetime transfer may result, but not always.[14] For high income earners the comparison in 2014 is the spread between the transfer tax at 40 cents on the dollar of date of death fair market value and, in most cases, a long term capital gains tax of 20 cents on each dollar of inherent gain at date of death.[15] The simplicity of this comparison, however, does not take into account the impact of any state capital gains tax that would also be imposed and that would narrow the benefits of making a completed gift. The calculus of making a gift that triggers payment of gift tax should also take into account the lost use of the money paid towards gift tax, if any, as offset by the tax exclusive nature of the gift tax assuming the donor survives for three years following the gift. Planners are all too well aware that clients hesitate to make any transfers triggering immediate payment of gift tax especially with the difficulty of being able to see clearly when looking into a crystal ball of the future. In general, the client preference is to avoid immediate payment of gift tax.

Consider the following examples yielding markedly different tax results depending on the amount of built-in gain inherent in the asset at the time of the gift. Each comparison assumes annual growth first at the rate of about 10 percent, and alternatively at about five percent, and total client assets sufficient to trigger an estate tax absent lifetime transfers.

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[11] Compare IRC § 1015 to IRC § 1014 assuming appreciation in value.
[12] The investment tax that could be imposed on the recognition of capital gain under IRC § 1411(c)(1)(iii) can also be avoided.
[13] IRC § 2001.
[14] IRC § 1 (the 2014 top long term capital gains rate generally is 20 percent, with 25 percent on depreciation recapture and a 28 percent rate on specific types of gain, as compared to 39.6 percent for short term capital gains and ordinary income). The rate indicated also does not take into account the net investment tax of 3.8 percent that may also be imposed at the time the beneficiary recognizes gain under IRC § 1411(c)(1)(iii).
[15] *Id.*

Situation A. In Situation "A" Adele owns $1 million of stock with essentially a very low basis, let's assume zero for ease of calculation. If Adele makes a lifetime transfer of the stock, and the stock appreciates in value at the rate of 10 percent over a four year period to $1,500,000, Adele will have saved estate tax on the appreciated amount to the tune of $200,000 (the amount of a 40 percent tax on the $500,000 of appreciation), but will have forgone a step up in basis of $1,500,000 leaving the donee to face a potential income tax cost of $300,000 (the amount of 20 percent long term capital gains tax on the inherent gain and appreciation of $1,500,000). Situation "A" indicates that in comparison to an outright gift, Adele would likely have been better off to the tune of $100,000 by holding the appreciated stock until death to obtain the step-up in basis, although this calculation does not factor in a discount for the fact that income tax may not be incurred by the beneficiary for several years to come.[16] A lower rate of anticipated growth, say five percent would yield an even worse result with assets growing to about $1,225,000 creating an estate tax savings of about $90,000 and a potential income tax liability in the hands of the donee of $245,000 yielding an overall greater tax cost from the lifetime transfer of $155,000.

Situation B. In Situation "B" Bruce makes a lifetime transfer of cash which the donee prudently invests and it grows at a ten percent rate over a four year period to $1,500,000. The outright gift likewise yields an estate tax savings of $200,000 but in the donee's hands a potential income tax cost of only $100,000 (the amount of 20 percent long term capital gains tax on the appreciation of $500,000). In this instance the lifetime transfer yields an overall tax savings of $100,000. Appreciation at a lower five percent rate of growth would continue to yield overall tax savings on the gift, but a smaller amount of about $45,000.

In Situation "B" the lifetime transfer yields an overall tax benefit, whereas in Situation "A" based on a similar transfer but with a low basis asset the lifetime transfer proves tax disadvantageous. These hypotheticals demonstrate the importance of putting pen to paper to determining if tax savings are likely to result from the lifetime transfer and the importance of making a realistic estimate as to anticipated growth. In advising clients on gifts, the estate planner needs to obtain information about the cost and depreciated basis of assets. As the spread between the transfer tax rate and the income tax rate becomes thinner, tax savings with low basis assets becomes harder to achieve and requires more optimistic projections in appreciation if it is assumed that the donee will sell the transferred asset in a manner triggering recognition of income.

The lesson from these examples is that the increase in the applicable exclusion amount and the decrease in the federal estate tax rate require a recalibration of the planning lens to carefully consider the income tax consequences of making a completed gift. Not all assets are the same and the client should carefully weigh whether a gift of a particular asset after balancing estate tax savings as against the income tax costs and the likelihood of triggering a recognition of gain yields the best tax result. In fact, the answer in the current tax landscape may be that it is better for an asset to be retained by the client and subject to a 40 percent estate tax for the purpose of

[16] Although parents may wish that their children not sell, it is often the case that children do not accede to their parents' wishes and they in fact do sell.

obtaining a step-up in basis at the client's death, assuming steady appreciation. This is especially true for depreciable assets in the hands of the beneficiaries who will obtain immediate tax benefit from a step-up in basis even if the beneficiary decides to hold the asset in the long term. If in Situation "A" the asset at issue were a fully depreciated rental unit instead of stock, the tax disadvantages of the gift would be exacerbated because the gift and consequent carry-over income tax basis not only would result in a 25 percent tax rate on the gain reflective of Section 1250 recapture, but would also cause the beneficiary to lose the benefit of the present value of a stream of depreciation deductions that could be used to offset ordinary income subject to a 39.6 percent tax rate.

Flipping the planning lens causes one to observe a twist in planning strategies with planners now attempting to force estate tax inclusion for many client assets and to turn away from gifting strategies that result in estate tax exclusion. For many, planning for the possibility of a step-up in basis has become the fashion trend and the planning focus.

[3] Considerations in Choosing an Appropriate Lifetime Transfer Strategy

Overall tax savings are more likely to occur if the lifetime transfer employs planning techniques using "high" basis assets at the time of the gift, and those techniques creating the opportunity to increase the value of property that eventually passes from the donor to the donee without using applicable exclusion amount or triggering transfer tax and with distribution to the beneficiary free of built-in gain. These planning techniques range from the relatively simple to the complex and among them are the following:

> ***Life Insurance***. If a donor makes cash transfers, within the annual exclusion amount, to a donee or to a trustee of a properly structured irrevocable life insurance trust in the amount of the premium to purchase life insurance on the life of the donor, the planning strategy can yield estate tax savings of 40 percent on the full amount of the proceeds and do so without adverse potential income tax consequences to the beneficiary.[17] Life insurance can be combined with gift strategies to minimize the impact of taxes on gain in much the same manner as it has been used to minimize the impact of estate tax.
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> ***Transfers to Same or Older Generation Family Members with Excess Applicable Exclusion Amounts***. Donors who have parents or other relatives whom they trust to ultimately transfer the donor's assets to the donor's intended beneficiaries might consider making tax free lifetime gifts to a trust up to the amount of the parent's or relative's unused applicable exclusion amount and generation skipping transfer tax exemption, and provide the parent or relative a testamentary general power of appointment to trigger use of the parent's applicable exclusion amount and a step-up in basis at the parent's date of death.[18] In absence of the exercise of the power, the property could be designated to be held in further trust with provisions precluding inclusion in a beneficiary's gross estate absent a distribution to the beneficiary or the granting of a further general power of appointment to the beneficiary. This strategy would allow for an immediate step-up in basis on the donor's parent's death and yield tax benefits accruing from a step-up in basis

[17] IRC §§ 101, 2042; 26 CFR § 20.2042-1(c).
[18] IRC §§ 1014, 2041.

sooner. The safest strategy would be to name beneficiaries to receive the property other than the donor or donor's spouse on the death of donor's parent. The transfer needs to be structured to avoid triggering IRC Section 1014(e) which precludes a step-up in basis for appreciated property transferred by a donor to a decedent within one year of the decedent's death where the donor or donor's spouse receives an interest in the transferred property passing from the decedent.[19] The law with regard to application of Section 1014(e) is not well developed. Private letter rulings in the context of spousal joint revocable trusts imply that if the decedent's gross estate includes property as a result of a general power of appointment granted by donor to decedent, the Service treats the property subject to the general power of appointment as passing from the donor to the decedent within one year of death.[20]

Grantor Retained Annuity Trusts. More complicated are the use of near zeroed-out grantor retained annuity trusts which can be accomplished without substantially eating up available applicable exclusion amount and conceptually pass appreciation in excess of the assumed IRC Section 7520 rates to the beneficiary transfer tax free with an offsetting potential income tax cost in the hands of the donee in the event of built-in gain. This strategy remains viable for high wealth clients if the spread between the transfer tax savings and the potential income tax cost after considering basis yields a positive savings.[21] In addition, grantor retained annuity trusts during the term of the trust are treated, at least in part, for income tax purposes as grantor trusts, and as a result the donor is liable for the income tax effectively allowing the trust assets to grow income tax free and thereby essentially achieving a further transfer from the donor to the donee transfer tax free.

Sales to a Grantor Trust. An initial transfer by donor to a trust effectively structured as a grantor trust for income tax purposes, but which is not includible in the donor's gross estate in conjunction with a subsequent sale to the trust of assets likely to appreciate can yield substantial tax savings.[22] The sale to a properly structured grantor trust, including on an installment basis, should not trigger gain and should not use up applicable exclusion amount except to the extent of the initial gift to the trust so long as the trust remains for income tax purposes a grantor trust. Rulings find that a sale or exchange between the donor and the grantor trust will not trigger gain as the donor effectively stands on both sides of the transaction.[23] Grantor trusts also allow for effective tax free transfers by the donor to the trust in the amount of income tax owed on the earnings of

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[19] IRC § 1014(e). The law with regard to IRC § 1014(e) is not well developed. Legislative history indicates that transfers passing directly "or indirectly" back to the donor or donor's spouse, and arguably this precludes passage of the property in trust for the donor or the donor's spouse. The Service has issued private letter rulings indicating that where the donor transfers property to decedent retaining a general power of appointment. *See* Mark R. Siegel, *IRC Section 1014(e) and Gifted Property Reconveyed In Trust*, 27 Akron Tax J 33 (2012).

[20] PLR 200210051; PLR 200101021; PLR 9308002.

[21] IRC § 2702; 26 CFR § 25.2702-3(e), Examples 8 and 9.

[22] See L. Mezzullo, *Freezing Techniques: Installment Sales to Grantor Trusts*, Probate & Property (Jan/Feb 2000), http://www.americanbar.org/content/dam/aba/publications/probate_property_magazine/v14/01/2000_aba_rpte_pp_v14_1_jan_feb_mezzullo.authcheckdam.pdf; S. Donaldson, *Burning Questions (And Even Hotter Answers) About Grantor Trusts*, https://www.naepc.org/journal/issue07c.pdf.

[23] See Rev Rul 85-13, 1985-1 CB 184.

property held in the trust and legally required to be paid by the donor which essentially allows trust assets to grow income tax free.[24] The tax benefits of using a grantor trust with proper drafting and when appropriate can further allow the grantor to swap out low basis assets for high basis assets so that at death the donor owns the low basis assets and that ownership will trigger a step-up in basis. The ability to swap out low basis assets, of course, yields to the practicalities of the donor owning high basis assets or cash with which to perform the swap.

As demonstrated by the options listed above, intricate planning techniques have evolved to avoid the various tax disadvantages of lifetime transfers even at a time when it was still vogue to avoid estate tax. The more intricate the planning strategy used, typically the higher the administrative costs of the strategy and often the more uncertainty as to ultimate tax benefit. As has always been the case, the tax advantages to be obtained by pursuing a planning strategy should be balanced against the ongoing administrative burdens associated with the transfer and the constraints placed on the continued use of the transferred property by the client. For the wealthy client who is likely to pay wealth transfer tax, these strategies can yield a positive tax benefit and remain important and viable opportunities.

[4] Impact of the Portability Election on Spousal Lifetime Transfers for the Purpose of Fully Using Both Applicable Exclusion Amounts

With the advent of the portability election, in conjunction with employment of what is essentially a flat wealth transfer tax rate as opposed to a graduated rate, spouses no longer need to make lifetime transfers as between each other to equalize assets and to avoid inadvertent loss of applicable exclusion amount. Portability allows the estate of a predeceased spouse to port unused exclusion amount by the deceased spouse to the surviving spouse upon filing of an estate tax return and the making of a portability election on the death of the first of the spouses to die.[25] Use of the portability election has the added advantage of obtaining a step-up in basis on the entirety of the couple's assets at the survivor's death when the predeceased spouse devises property outright to the surviving spouse or to a qualified terminable interest property trust for the surviving spouse's benefit in conjunction with the portability election.[26]

[5] Considerations in Designing an Estate Plan to Effectively Use the Portability Election and the Benefits of Lifetime Transfer Strategies

The question of whether to rely on the portability election in conjunction with an outright testamentary transfer of assets to the surviving spouse, which admittedly is the simplest estate planning technique to achieve full use of the applicable exclusion amounts of both spouses and a step-up in basis to the date of death of the surviving spouse, or whether to opt for a different marital planning technique depends in large part on a client's goals and preferences. Available options include choosing a testamentary plan that uses a qualified terminable interest property (QTIP) trust or a classic credit shelter trust in place of an outright transfer to the surviving spouse. A more tax effective option may be to use a lifetime transfer by one spouse for the

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[24] Rev Rul 2004-64, 2004-2 CB 7.
[25] IRC § 2010.
[26] 26 CFR § 20.2010-2T(a)(7)(ii)(C), Example 2.

benefit of the other spouse by employing what has been trademarked as a "super-charged credit shelter trust"[27] or using a "joint estate step-up trust."[28] The potential tax benefits of these strategies eventually may lead to increased lifetime transfers as between spouses. The options available to couples include, among others, the following:

> *Testamentary QTIP Trust*. A QTIP trust, like an outright transfer, provides the surviving spouse income for life and can provide her use of the trust principal as well, but leaves control over the ultimate disposition of the assets, the remainder interest, within the purview of the predeceased spouse. Treasury regulations acknowledge use of the QTIP trust in conjunction with a portability election.[29] The QTIP trust also allows for use of the "non-portable" generation skipping transfer (GST) tax exemption by allowing for a "reverse QTIP election" allocating the GST exemption of the predeceased spouse to the QTIP trust even though trust assets are includible in the surviving spouse's gross estate. Use of a testamentary QTIP trust does not require the making of a lifetime gift, and provides the tax advantage of postponement of any estate tax until the survivor's death and of a step-up in basis to the date of the survivor's death. It also provides comfort to the predeceased spouse that in a second marriage or in anticipation of a subsequent marriage of the surviving spouse, the predeceased spouse's assets will ultimately benefit the predeceased spouse's relatives. The QTIP trust, thus, works best in the situation where the couple has sufficient applicable exclusion amounts to fully protect the couple's assets from wealth transfer taxation so that the primary tax objective is to obtain the benefit of the step-up in basis on the appreciation occurring between deaths.
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> *Testamentary Classic Credit Shelter Trust.* A classic credit shelter trust typically provides benefits to the spouse and descendants of the trustor without a requirement that all income be paid to the surviving spouse. While it allows the trustor more flexibility as to design of dispository terms, the classic credit shelter trust is typically structured to avoid inclusion in the surviving spouse's gross estate and as a result loses the benefit of any step-up that could be achieved as to appreciation occurring between the death of the predeceased spouse and the survivor. (It would be important to build in flexibility to allow distributions to beneficiaries if it becomes beneficial to trigger a step-up in basis on the death of a beneficiary, including death of a spouse, after taking into account the tax landscape on the later death.) An allocation of the predeceased spouse's GST exemption may also be made to the classic credit shelter trust and thereby avoid its loss. Unlike the QTIP trust, the classic credit shelter trust is drafted in a manner that avoids inclusion of trust assets in the survivor's gross estate and thereby affects a valuation freeze of sorts for estate tax purposes as of the first death. As a consequence use of the classic credit shelter trust makes sense only if on the survivor's death it is anticipated that an estate tax will be owed that will yield a greater tax savings than the income tax cost of the loss of basis

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[27] Blattmachr, Gans, Zeydel, *Super-Charged Credit Shelter Trust(SM) versus Portability,* Probate & Property 10 (Mar/April 2014)(The authors' footnote indicates: "Super-Charged Credit Shelter Trust(SM) is a service mark of Ms. Zeydel, Mr. Blattmachr, and Mr. Gans who hereby grant permission for anyone to use it without charge provided appropriate attribution is given to them for its use." This parenthetical provides the attribution so requested as to the nomenclature.)

[28] This is a concept developed by Gassman Law Office as described on its website at http://gassmanlawassociates.com/the-joint-exempt-step-up-trust-jest/.

[29] 26 CFR § 20.2010-2T(a)(7)(C), Example 2.

step-up on appreciation that would occur from the time of the death of the first of the spouses to die to the time of the second death. Along the same lines as a QTIP trust, a classic credit shelter trust would not yield the best tax result for a couple whose assets do not exceed the anticipated available applicable exclusion amounts. It could, however, be structured to provide more creditor protection than may otherwise be had with a QTIP trust requiring income distributions outright to the surviving spouse.

Lifetime Transfer to Super-Charged Credit Shelter Trust.[30] Clients with large estates, as in the past, will continue to benefit from life time transfers and more aggressive estate and marital planning techniques. The super-charged credit shelter trust first written about and now trademarked by Jonathan Blattmachr, Mitch Gans and Diane Zeydel is a technique designed to achieve advantageous estate and income tax results for U.S. citizen spouses.[31] The goal is to complete transfers as between spouses using what some refer to as a defective grantor trust – a trust that avoids inclusion in the donor's estate, and that for income tax purposes is deemed owned by the donor. Under this strategy, ideally, each spouse would transfer assets to a trust that would initially qualify as a QTIP trust. Specifically, the donor transfers assets to a trust that qualifies for the QTIP election for the benefit of donor's spouse with provisions to cause the trust to be treated as a grantor trust for income tax purposes with respect to donor. On death of the beneficiary spouse the trust assets are included in the beneficiary spouse's estate, sheltered by the beneficiary spouse's applicable exclusion amount and, through exercise of a limited power of appointment by the beneficiary spouse, the assets of the QTIP trust are held in further trust for the original donor, but pursuant to terms such that the trust assets will not be included in the donor's gross estate and that result in the trust continuing to remain a grantor trust for income tax purposes as to the original donor.[32] The key is to ensure that the trust as it morphs from a QTIP to a credit shelter trust remains a grantor trust for income tax purposes which requires that neither spouse exercise a general power of appointment over the trust assets. Also key is that to the extent each spouse engages in this planning strategy the trusts created are sufficiently different to avoid the reciprocal trust doctrine.[33]

This planning strategy, if it works (and to date there are no definitive rulings as to its efficacy), produces very favorable tax results. The fact that the trust is drafted to avoid subsequent estate tax inclusion in the donor's estate effectively freezes the transfer tax cost to the couple and avoids imposition of transfer tax on the post-gift appreciation, a savings of 40 percent of the appreciation. Because it is designed as a grantor trust for income tax purposes, an additional transfer tax savings accrues to the tune of 40 percent of the amount of the income tax paid by the donor on the income earned by the trust assets, and this amount accumulates each year essentially serving as a stream of additional tax free transfers for purposes of the federal estate, gift and generation-skipping transfer taxes. The trust can permit the sale or exchange to the grantor of low basis assets held in the grantor trust for high basis assets to allow for the possibility of a

[30] *Supra,* at note 27.
[31] *Id.*
[32] *Id.*
[33] *Id.*

step-up in basis for the exchanged assets in the donor's hands without recognition of gain for income tax purposes during life. The grantor trust provides an extra boost to the transfer and income tax savings by allowing the trust assets to essentially grow income tax free.[34] The turbo, however, is provided by the fact that the couple, if the trust or trusts are properly drafted, can retain access and use of the trust assets during the beneficiary spouse's lifetime. An important advantage of this strategy is the ability to achieve tax savings while at the same time allow at least one of the spouse's to benefit from the trust assets.

Lifetime Transfers to a Joint Exempt Step-Up Trust. The joint exempt step-up trust or JEST first written and marketed by Gassman Law Associates also seeks to obtain advantages of a step-up in basis, specifically a step-up in basis on the death of the first spouse to die with respect to the assets of both spouses in an attempt to mirror for common law states the advantages of community property.[35] The planning technique involves transfer by both spouses of their assets to a joint trust, and the granting of a power of appointment over the entire trust to either spouse which triggers inclusion in the powerholder's gross estate. Following the first death, the assets are divided among a credit shelter trust or trusts and a QTIP trust as necessary to postpone any payment of transfer tax until the survivor's death. The technique aims to fully use the applicable exclusion amount of each spouse and obtain maximum use of the step-up in basis. Like with the super-charged credit shelter trust, uncertainty as to its effectiveness remain especially in light of earlier private letter rulings calling into question the ability to obtain a step up in basis if inclusion in the gross estate of the first spouse to die results from that spouse holding a general power of appointment.[36] While the technique is based on the issuance of several private letter rulings, none of the rulings have addressed all the issues raised by the technique in a manner favorable to clients. The JEST has the added benefit of allowing access to trust assets to both spouse's during their lifetimes, which is an important consideration for almost all clients.

As revealed by the portability planning alternatives discussed, unlike the tax world as it existed prior to the recent changes to the transfer tax landscape, a "default" estate plan similar to the family-marital or A-B trust plans of the past that meet the needs of most clients has yet to evolve. The best solution for the client depends in large part on the type of assets held by the client, the comfort level of the client with the decision making of the surviving spouse and the preferences for ultimate control over takers of the client's assets, and creditor protection issues. The goal is to minimize the overall taxes to be paid including federal and state transfer taxes, and federal and state income taxes. It is also becoming clear that lifetime transfers as between spouses may yield better overall tax results after taking into account income tax benefits of using techniques like the super-charged credit shelter trust or the JEST, assuming the Service and the courts eventually bless these techniques.

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[34] *Id.*

[35] See http://gassmanlawassociates.com/the-joint-exempt-step-up-trust-jest/ referencing Gassman, Ellwanger and Hohnadell, *It's Just a JEST, Joint Estate Step-Up Trust*, Steve Leimberg's Estate Planning Newsletter (April 3, 2013).
http://gassmanlawassociates.com/wp-content/uploads/2013/05/JEST-Article.pdf

[36] *Supra* at note 20.

[6] Lifetime Transfer to Avoid Application of the Last Deceased Spouse Rule

Consideration of lifetime transfers increase in importance when after a portability election has been made and assets are transferred to the surviving spouse, the surviving spouse chooses to remarry. In the event a portability election is made by the estate of the predeceased spouse and the surviving spouse remarries, the surviving spouse should consider using any ported deceased spousal unused exclusion (DSUE) amount prior to the death of any subsequent spouse on remarriage. The portability election limits use of a DSUE amount to that of the "last" deceased spouse.[37] The temporary treasury regulations on portability provide an ordering rule causing DSUE amount to be used first when the surviving spouse makes a gift,[38] and ensure that, once used, the benefit of the DSUE amount used will not thereafter be lost.[39] As a result, it is important for a surviving spouse's planning on remarriage to consider carefully whether a lifetime transfer is an appropriate tax planning strategy. The ported DSUE amount of the predeceased spouse is lost if not used prior to the death of any subsequent spouse on remarriage.

An example aptly demonstrates the impact of the last deceased spouse rule. For example, assume in each of the following situations that Bailey's predeceased spouse transfers $5,340,000 of assets and ports a corresponding DSUE amount of $5,340,000 to Bailey who also owns $5,340,000 in assets. In situation "A" assume Bailey later marries Chris who fully uses his applicable exclusion amount and dies prior to Bailey. On Bailey's later death in 2014, the DSUE amount from her predeceased spouse is lost and Bailey's estate may only use Bailey's basic exclusion amount of $5,340,000 resulting in an estate tax on Bailey's $10,680,000 in assets of $2,136,000. In situation "B" assume instead that prior to Chris's death Bailey makes a completed gift of $5,340,000 to children triggering use of the ported DSUE amount from the initial spouse. On Bailey's later death in Situation "B," Bailey's estate may shelter the adjusted taxable gift of $5,340,000 and Bailey's taxable estate of $5,340,000 with a $10,680,000 applicable exclusion amount consisting of Bailey's basic exclusion amount and the previously used DSUE amount ported from Bailey's first spouse. This example demonstrates where making a lifetime transfer achieves tax benefits in the context of a portability election.

§ 2.03 State Death Tax Considerations in Making Lifetime Transfers

Phasing out, and the eventual repeal, of the former state death tax credit in favor of a state death tax deduction has significantly impacted estate planning considerations for clients who now live in states that impose a state estate or inheritance tax. The elimination of the state death tax credit has also had a significant impact on state revenues. It is estimated that permanent repeal of the state death tax credit has cost states upwards of $3 billion in annual state revenues.[40]

[1] State Response to Repeal of the State Death Tax Credit

[37] IRC § 2010.
[38] Temp Treas Reg § 25.2505-2T(b) and (c).
[39] Temp Treas Reg § 25.2505-2T(c).
[40] See N. Francis, *Back from the Dead: State Estate Tax After the Fiscal* Cliff, Urban-Brookings Tax Policy Center (Nov. 14, 2012), http://www.urban.org/uploadedpdf/412694-back-from-the-dead.pdf; E. McNichol, I. Lay, D. Tenny, *Repeal of the Federal Estate Tax Would Cost State Governments Billions in Revenue*, Center on Budget and Policy Priorities (Dec. 12, 2000), http://www.cbpp.org/cms/index.cfm?fa=view&id=2128#Table%201.

The reduction in and eventual elimination of the state death tax credit as of 2005 as made permanent in 2013, has seen a varied response among states. Prior to 2005 all states imposed what was commonly referred to as a “pick up” or “soak up” tax, which essentially obtained for the state the maximum state death tax credit allowable under federal estate tax law without increasing the combined federal and state estate taxes owed on death. The state death tax credit allowable as part of the federal estate tax computation, thus, served as a revenue sharing measure with states, and allowed a credit against federal estate tax payable for state estate tax actually paid to a state up to the allowable credit amount based on a graduated rate topping out at 16 percent.[41] Prior to elimination of the state death tax credit in 2005, 38 states imposed only an estate tax keyed to the federal state death tax credit, with 12 states imposing an inheritance or an estate tax in addition to the pick-up tax.[42]

States reacted to the elimination of the state death tax credit in two different ways. Some states did not take any active steps and saw an elimination of the state estate tax, leaving the state either with no revenue from transfers on death or with revenue only from any previously separately enacted state estate or inheritance tax. Others responded by taking steps to enact a separately imposed estate tax. Annually Forbes.com updates its state map of states “where not to die” indicating those states imposing a state estate or inheritance tax. The map is changing as politicians respond to public sentiment. For example, in 2013 Indiana[43] and North Carolina[44] repealed state estate tax provisions, as did Kansas in 2009.

Currently 31 states no longer impose an estate or inheritance tax as of 2014. Those states include: Alabama,[45] Alaska,[46] Arizona,[47] Arkansas,[48] California,[49] Colorado,[50] Florida,[51] Georgia,[52] Idaho,[53] Indiana,[54] Kansas,[55] Louisiana,[56] Michigan,[57] Mississippi,[58] Missouri,[59]

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[41] IRC § 2011.
[42] J. Michael, *Survey of State Estate, Inheritance and Gift Taxes Information Brief*, Research Dept. Minnesota House of Representatives (Dec. 2013).
[43] Indiana House Bill 1001 (2013), http://www.ai.org/legislative/bills/2013/HB/HB1001.2.html.
[44] North Carolina Session Law 2013-316 (2013).
[45] Ala Code § 40-15-2 (2013)(tied to Federal state death tax credit).
[46] Alaska Stat § 43.31.011 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
[47] Arizona Laws Ch. 262 § 3 (2006)(repealed state estate tax tied to Federal state death tax credit effective Sept. 21, 2006).
[48] Ark Code Ann §§ 26-59-103, 26-59-106 (tied to Federal state death tax credit, effectively repealed for estate of decedents dying after 2004).
[49] Cal Rev & Tax Code § 13302 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
[50] Colo Rev Stat § 39-23.5-203(3) (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
[51] Fla Stat Ann § 198.02 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
[52] Ga Code Ann § 48-12-1.1 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
[53] Idaho Code § 14-403 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
[54] Ind Code § 6-4.1-2-2 (the Indiana inheritance tax was repealed as of 2013).
[55] Former Kan Stat Ann § 79-15,207 imposing estate tax repealed for estates of decedents dying after 2009.
[56] Inheritance tax repealed as of January 1, 2010, *see* former La Rev Stat § 47:2404(A).

Montana,[60] Nevada,[61] New Hampshire,[62] New Mexico,[63] North Carolina,[64] North Dakota,[65] Ohio,[66] Oklahoma,[67] South Carolina,[68] South Dakota,[69] Texas,[70] Utah,[71] Virginia,[72] West Virginia,[73] Wisconsin,[74] Wyoming.[75]

The remaining 19 states and the District of Columbia continue to impose or have subsequently enacted a state estate or inheritance tax. Many of those states have pegged imposition of the estate tax to the Federal applicable exclusion amount. Others have imposed a different exemption. Fourteen states and the District of Columbia impose an estate tax, and seven impose an inheritance tax with two of those imposing both taxes. States imposing an estate and/or inheritance tax include:

- Connecticut – imposes estate tax with an exemption amount of up to $2 million;[76]
- Delaware – imposes estate tax with an exemption equal to the Federal basic exclusion amount;[77]

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57 Mich Comp Laws § 205.232 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
58 Miss Code Ann § 27-9-5 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
59 Mo Rev Stat § 145.1000 (repeals estate tax).
60 Mont Code Ann § 72-16-903 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
61 Nev Rev Stat § 375A.100 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
62 NH Rev Stat Ann § 87:1 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
63 NM Stat Ann § 7-7-4(D) (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
64 NC Session Law 2013-316 (2013) repealed estate tax.
65 ND Cent Code § 57-37.1-01 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
66 Ohio HB 153 (2011), http://www.legislature.state.oh.us/analyses.cfm?ID=129_HB_153&ACT=As%20Passed%20by%20House.
67 Okla Stat tit 68, §802 (estate tax tied to state death tax credit effectively repealed; separate estate tax repealed effective January 1, 2010).
68 SC Code Ann § 12-16-510 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
69 South Dakota HB 1057 (2014) (repeals inheritance tax), http://legis.sd.gov/statutes/DisplayStatute.aspx?Type=Statute&Statute=10-40.
70 Tex Tax Code Ann § 211.051 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
71 Utah Code Ann § 59-11-103 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
72 Va Code Ann § 58.1.902 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
73 W Va Code § 11-11-2 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
74 Wis Stat § 72.01 (2001 Wisconsin Act 16 repealed estate tax for decedents dying after 2008).
75 Wyo Stat § 39-19-101 (tied to Federal state death tax credit, effectively repealed for estates of decedents dying after 2004).
76 Conn Gen Stat § 12-391(2014) (replaces the formerly imposed inheritance tax).
77 Del Code Ann Tit 30, §1501 (applies estate tax equal to maximum formerly allowable federal state death credit; the scheduled sunset of the estate tax was repealed per Delaware HB 51 (2013)

- District of Columbia − imposes estate tax with an exemption equal to $1 million;[78]
- Hawaii − imposes estate tax with an exemption equal to the Federal basic exclusion amount;[79]
- Illinois − imposes estate tax with an exemption equal to $4 million;[80]
- Iowa − imposes an inheritance tax;[81]
- Kentucky − imposes an inheritance tax;[82]
- Maine − imposes estate tax with an exemption amount equal to $1 million;[83]
- Maryland − imposes an estate tax with a $1 million exemption in 2014,[84] and an inheritance tax;[85]
- Massachusetts − imposes estate tax with an exemption of $1 million;[86]
- Minnesota − imposes estate tax with an exemption of $1,200,000 scheduled to increase;[87]
- Nebraska − imposes an inheritance tax,[88]
- New Jersey − imposes an estate tax with a $675,000 exemption,[89] and an inheritance tax,[90]
- New York − imposes estate tax with an exemption of $2,062,500 scheduled to increase;[91]
- Oregon − imposes estate tax with an exemption of $1 million;[92]
- Pennsylvania − imposes an inheritance tax;[93]
- Rhode Island − imposes estate tax with a 2014 inflation adjusted exemption of $921,655;[94]
- Tennessee − imposes an inheritance tax to be phased out by 2016;[95]
- Vermont − imposes estate tax with an exemption of $2,750,000;[96] and
- Washington − imposes estate tax with an inflation adjusted exemption of 2,012,000.[97]

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http://legis.delaware.gov/lis/lis147.nsf/vwlegislation/40F9090FBD42E4D485257B2E005096C6.

[78] DC Code Ann § 3702 (applies estate tax equal to maximum formerly allowable federal state death tax credit as allowable).

[79] Haw Rev Stat § 236D-2.

[80] Ill Comp Stat § 405/2(a)-(c)(applies estate tax equal to maximum formerly allowable federal state death tax credit as allowable).

[81] Iowa Code § 450.2 (inheritance tax applies to remote relatives and certain third parties); Iowa Code § 451 (reinstates the Iowa estate tax tied to the federal state death tax credit).

[82] Ky Rev Stat Ann § 140.010.

[83] Me Rev Stat Ann tit 36, §§ 4062, 4063.

[84] Md Code Ann, Tax-Gen § 7-302. Maryland HB 739 (2014), http://legiscan.com/MD/bill/HB739/2014.

[85] Md Code Ann, Tax-Gen § 7-202.

[86] Mass Ann Laws ch 65C § 2A.

[87] Minn Stat § 291.01.

[88] Neb Rev Stat § 77-2001.

[89] NJ Rev Stat § 54:38-1.

[90] NJ Rev Stat § 54:34-1.

[91] NY Tax Law § 952.

[92] ORS § 118.010(b).

[93] 72 Pa Cons Stat Ann § 9107.

[94] RI Gen Laws § 44-22-1.1 (estate tax tied to the 2001 federal state death tax credit).

[95] Tenn Code Ann § 67-8-301.

[96] Vt Stat Ann Tit 32, § 7401.

[97] Wash Rev Code § 83.100.040.

States continue to consider, revise, repeal and reenact state estate and inheritance tax rules. Recently, for example, some states like Tennessee[98] and Indiana[99] have chosen to phase out or repeal state death taxes, other states like Connecticut[100] and Maryland[101] have changed their exemption amounts, and yet other states like Washington[102] have taken steps to enact an estate tax or like Delaware chosen to repeal a scheduled sunset of estate tax provisions.[103] For many states that did not have a separately enacted estate or inheritances tax, the elimination of the state death tax credit effectively eliminated any state estate tax revenues for the state. The end result of the permanent repeal of the federal state death tax credit is a continued lack of uniformity among states as to the imposition of state death taxes. The variance among states means planners must be sensitive to the impact of other state's death taxes when clients own property outside the state of domicile and when clients intend on moving to or purchasing a residence in another state.

Given the impact of state estate tax, planners must keep one eye on opportunities to plan for avoiding state estate tax. (Avoiding state inheritance tax usually requires only avoiding gifts to non-family members or gifts to other beneficiaries that trigger inheritance tax.) To avoid state estate tax clients can change domicile and situs of assets to a state that does not impose such tax. This is a difficult decision for many clients given the often strong family ties to a particular state. Alternatively, clients can consider making lifetime gifts of property in order to avoid imposition of state death tax as no states, save Connecticut,[104] impose gift tax.

[2] Taking Domicile into Consideration as Part of an Estate Plan

Clients who live and own assets entirely within one of the 31 states that do not impose a state estate or inheritance tax need not concern themselves with state death tax issues. It is important for advisors in those states to remind clients who are planning to move to or purchase a residence in a state that does impose an estate or inheritance tax to make sure to revise their estate plan to take into account the state tax, and also to take steps to clearly establish the state of domicile.

Along the same lines, clients who live in a state that imposes an estate or inheritance tax but who own a second home in a state that does not impose such a tax should also clarify that they are domiciled in the state that would result in a lower overall tax burden. Domicile is important in determining both state estate or inheritance tax consequences and state income tax consequences.

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98 Tenn Pub. Act. Ch. 1057 (May 2, 2012), http://www.tn.gov/revenue/notices/inherit/12-13.pdf.
99 Indiana House Bill 1001 (May 11, 2013).
100 Conn Gen Stat § 12-391 (2010).
101 Maryland HB 739 (May 15, 2014), Md Code, Tax-Gen §§ 7-305, 7-309(a) and (b).
102 Wash Rev Code Chapter 83.100 (2014).
103 Delaware HB 51 (Mar. 28, 2013), http://legis.delaware.gov/lis/lis147.nsf/vwlegislation/40F9090FBD42E4D485257B2E005096C6 (accessed July 15, 2014) .
104 Minnesota enacted and then repealed its gift tax. Louisiana, North Carolina and Tennessee also repealed their gift tax in recent years. See, 2007 La Ac 371, http://www.revenue.louisiana.gov/forms/publications/tt%2810_07%29.pdf (accessed May 31, 2014), 2007 NC Sess Laws 2008-107 § 28.18(a), http://ncga.state.nc.us/gascripts/Statutes/StatutesTOC.pl?bPrintable=true&Chapter=0105 (accessed May 31, 2014); Tenn Pub Act Ch 1085, http://tn.gov/revenue/legsumm/2012legsumm.shtml#giftpc1085 (accessed May 31, 2014).

Both state taxes should be considered in choosing state of domicile assuming the client is willing to arrange the client's living arrangements and business and social affairs to change domicile.

The question of domicile is determined based on a number of factors and the taxpayer generally bears the burden to prove a change of domicile. The general common law test for domicile requires the establishment of a physical residence and the intent to permanently remain there.[105] It is a two part test requiring abandonment of the former domicile and intent not to return and to establish a new domicile.[106] A physical residence and time spent there is an important determinant of domicile.[107] When changing domicile from one state, it is key to establish by renting or purchasing a residence in another state.[108] In addition to establishing a physical residence, factors considered are the conduct of business by the taxpayer, the state where the taxpayer maintains a driver's license, car registrations, voting registration, social and religious memberships, and primary health care providers, and the state where holidays are primarily spent.[109] Courts also look to whether the taxpayer filed a declaration of domicile and a homestead exemption, and the place of taxpayer's primary bank and other accounts.[110] These factors establish the requisite intent.

In addition, the client should spend on an annual basis a majority of days in the state of domicile and take steps to calendar these days because while this test is important for a determination of residency, courts also take into account the number of days for purposes of showing intent as to domicile.[111] It proves more difficult to establish a change of domicile when the client continues to retain as a part-time home his or her original primary residence prior to the asserted change of domicile. It is important to carefully document and plan for a change of domicile so that in fact the taxpayer is subject to estate or inheritance tax in only one state, and so that both states do not claim the taxpayer as a domiciliary.

Even with a change in domicile, assets with a situs outside the state of domicile may be subject to tax in a decedent non-resident's hands in the state of situs. In establishing a change in domicile, the client should also work to change the situs of the client's assets to the new state of domicile to avoid estate tax as a non-resident based on situs.

[3] Impact of Lifetime Transfers to Minimize State Estate Tax

Clients who live or own property in states imposing a state inheritance or state estate tax must consider how to plan for such a tax. Even though the client may escape imposition of Federal estate tax because the client's gross estate and aggregate lifetime transfers do not exceed the federal applicable exclusion amount, the same client may face a state estate tax because the state

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[105] Evans v Comm'r of Revenue, 2013 Mass. Tax Lexis 3 (Mass App Tax Bd 2013).
[106] City of Warren v. Rebhan, 2011-Ohio-6340, 2011 Ohio App LEXIS 5205 (Ohio Ct App, Trumbull County Dec. 12, 2011)
[107] Bradison v Comm'r of Revenue, 2012 Minn. Tax LEXIS 12 (Minn TC Jan 31, 2012).
[108] Sanchez v Comm'r of Revenue, 770 NW2d 523, 2009 Minn LEXIS 544 (Minn 2009).
[109] *Id*. See also, Mauer v Comm'r of Revenue, 829 NW2d 59 (Minn 2013); Fowler v NC Dept of Rev, 2013 NC Tax Lexis 1 (NC Tax 2013).
[110] Mauer v Comm'r of Revenue, 829 NW2d 59 (Minn 2013).
[111] Fowler v NC Dept of Rev, 2013 NC Tax Lexis 1 (NC Tax 2013); Evans v Comm'r of Revenue, 2013 Mass Tax Lexis 3 (Mass App Tax Bd 2013).

imposes a lower exemption amount than the Federal exemption. States imposing a lower exemption amount include Connecticut, District of Columbia, Illinois, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oregon, Rhode Island, Vermont and Washington.[112] Clients may also pay a state estate or inheritance tax even though no federal tax is owed because the client's estate plan employs the use of a QTIP trust for which a marital deduction is allowed for federal estate tax purposes, but not for state estate tax purposes. States recognizing an exemption or deduction for QTIP property include Illinois,[113] Maine,[114] Massachusetts,[115] Minnesota,[116] New Jersey,[117] New York,[118] and Washington.[119]

In states where the exemption for state estate tax purposes is less than the federal applicable exclusion amounts, the planning choices for clients continue to require lifetime transfers as between spouses to ensure full use of the state exemption regardless of which spouse predeceases. Testamentary plans in those states should also typically employ a credit shelter trust in order to fully use the state exemption on the death of the first spouse to die and ensure the continued ability of the surviving spouse to benefit from the use of those assets if necessary. A formula clause would divide assets as between the credit shelter trust and those assets passing to or for the benefit of the surviving spouse in conjunction with a portability election.

State estate tax planning may also encourage a client to make life time transfers of the client's assets in excess of the state exemption amount in order to avoid payment of any state estate tax. The decision point, however, is whether the state estate tax saved offsets income tax implications of a carry-over basis for both state and federal income tax purposes. The vast majority of states impose state estate tax at the highest rate of 16 percent, and in comparing that rate to the federal long term capital gains tax rate of 20 percent supplemented by any incremental state capital gains rate, clients typically find that it is disadvantageous to use low basis assets to make any transfers for purposes of achieving state estate tax savings. With high basis assets, the ability to obtain a state estate tax savings in most states of up to 16 percent on the value of the assets subject to lifetime completed gift could prove advantageous. In states that do not have a provision subjecting lifetime transfers to inclusion for purposes of determining the state estate tax base, lifetime transfers of high basis assets in anticipation of death can result in a state tax savings without an offsetting federal estate or income tax cost except to the extent of a loss of the step up in basis on post-gift appreciation that could be obtained if the gift were not made. Some states do cause gifts within three years of a decedent's death or in contemplation of death to be subject to state estate tax. Among the states that include as part taxable estate for state estate tax purposes

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[112] See, *supra*, notes 76 through 97.
[113] 35 Ill Comp Stat 405/2(b).
[114] Me Rev Stat Ann Tit 36 § 4062.
[115] Mass Ann Laws ch 65C § 3A.
[116] Minnesota Dept of Rev Notice 12-05 (2012).
[117] See New Jersey Tax Handbook 7-3.
[118] TSB-M-10(1)M, New York State Department of Taxation and Finance (March 16, 2010).
[119] Wash Rev Code § 83.100.47.

certain transfers in contemplation of death are New Jersey,[120] Minnesota,[121] Maine,[122] and New York.[123]

Some commentators have indicated that it may be worthwhile to create a spousal lifetime access trust, also referred to as a SLAT, to achieve state estate tax savings.[124] This type of lifetime transfer would be especially important to consider in states that do not allow death bed gift planning because the state estate tax gathers deathbed gifts into the gross estate for state estate tax purposes. A SLAT allows a "couple" to retain use of assets in the trust for the spouse's lifetime and at the same time possibly achieve an overall tax savings depending on the asset used to make the gift. A SLAT is typically designed to work like a credit shelter trust avoiding inclusion in the beneficiary spouse's estate. To build in flexibility in the event the spouse for which the SLAT is created dies unexpectedly, it is important to include in the trust a broad lifetime and testamentary limited power of appointment to the beneficiary spouse to appoint property in further trust for the donor spouse if it becomes advisable to do so given future needs and the tax landscape in existence at the time of the beneficiary spouse's death. The point of concern, however, is to construct a plan such that it eliminates any implied agreement or the appearance of an implied agreement that could trigger inclusion in the donor spouse's estate or that could trigger the reciprocal trust doctrine. The SLAT, thus, faces some of the same issues and estate tax concerns as the super-charged credit shelter trust discussed above.

§ 2.04 Conclusion

In the face of the changing estate tax landscape, advisors and clients need to carefully weigh the impacts of a carry-over basis on the overall calculation of tax savings from a proposed lifetime transfer that amounts to a completed gift for transfer tax purposes. The assets used to make such lifetime transfers, if any, should be carefully chosen to minimize these impacts. In structuring trusts that will hold completed gifts special attention should be paid to whether the trust should be structured as a grantor trust for income tax purposes to allow for tax free growth and the possibility of swapping out low basis assets in the future to obtain a step-up in basis. Consideration should also be given to the use of including flexible limited powers of appointment to build in the ability to respond to future changes in the federal and state tax landscape. Completed lifetime gifts will continue to serve as important estate planning tools for clients who face imposition of the federal estate tax and for those clients who become subject to a state estate tax even if they do not own sufficient assets to trigger federal tax.

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[120] NJ Rev Stat § 54:34-1.
[121] Minn Stat § 291.005 (effective until Aug. 1, 2014).
[122] Me Rev Stat Ann Tit 36, § 4064-A.
[123] NY Tax Law § 954 (effective April 1, 2014 through January 1, 2019).
[124] M. Kitces, *The Rise of the Spousal Lifetime Access Trust (SLAT),* http://www.kitces.com/blog/the-rise-of-the-spousal-lifetime-access-trust-slat/.