A REPRINT FROM ESTATE PLANNING, JANUARY 1983

Avoiding the state death tax disadvantages of the unlimited marital deduction in large estates

The unlimited marital deduction, while delaying Federal taxes on one spouse's estate, can entail increased state death taxes and erosion of the unified credit trust. This article illustrates how substantial estates can avoid these undesirable results.

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ESTATE PLANNING for married persons with substantial assets naturally focuses on the marital deduction. ERTA removed the percentage limitations, for Federal estate and gift tax purposes, on the amount allowable as a marital deduction.

Making maximum use of the unlimited marital deduction, however, can result in the payment of substantially higher death taxes (both state and Federal) on the combined estates of both spouses. In large estates (*i.e.*, $5 million or more) subject to substantial state death taxes, its use can have a negative effect on the exemption equivalent (credit shelter) trust. Additionally, the intention to use the unlimited marital deduction requires a reassessment in the event of simultaneous death.

Essentially, there are four fundamentals of estate planning (for tax purposes) which must be balanced in determining the treatment of any issue.

Deferment. Deferral of tax payment affords the taxpayer tax-free use of money until the tax falls due. Using the marital deduction defers tax until the death of the surviving spouse. Thus, it enables the assets to pass tax free to that spouse but will require the payment of tax when the surviving spouse dies on the value of the assets in the surviving spouse's estate. To the extent the spouse consumes or gives away these assets prior to death, the tax deferral may become tax avoidance.

Avoiding double taxation. Double taxation occurs where the same property is includable in two estates of persons of the same generation. If a husband dies, leaving property to his wife which is not eligible for marital deduction (*e.g.*, a nonqualified terminable interest), the property would be taxed to his estate and would be taxed again to his wife's estate if she should die still retaining the property. Double taxation can be avoided by careful planning as to which assets will pass to the spouse and in what manner. Furthermore, the phase-in of the unified credit increases through 1987 will make it necessary to allow for the maximum possible use of the "credit shelter," *i.e.*, the exemption equivalent amounts that can pass from both spouses absolutely free of tax.

Equalization. If one estate is very large, it may be taxed at higher brackets. By evening out the taxable estates of two spouses, the property will be taxed at lower marginal tax rates, thereby saving tax on the combined estates.

Minimizing the estate. It is always an estate tax saving device to reduce the assets includable in the gross estate. This is most commonly done by lifetime transfers. A program of lifetime transfers may be undertaken as part of the overall plan for the estate, but it is not specifically part of marital deduction planning.

The marital deduction can be a useful tool in avoiding double taxation and in breaking the rate table. However, the essence of maximizing the marital deduction is deferral, usually at the expense of equalization. In some cases, where there are substantial state death taxes and state death tax limitations on the marital deduction, maximizing the marital deduction may expose the estate to double taxation at the state level even though it is avoided at the Federal level.

Negligible state taxes

The term "jumbo" marital deduction ("JMD") describes a dispositive scheme whereby the testator

leaves the maximum amount to an exemption equivalent (or credit shelter) trust which will pass free of Federal estate taxes, and leaves the remainder to a surviving spouse. In situations where state death taxes are not a consideration (at this time, only the law of Idaho exactly matches the post-ERTA marital deduction), use of the JMD is simply a trade-off. Deferral is maximized in exchange for paying the rate table differential (the bracket cost of failing to achieve estate equalization) at the time of the second death.

When both deaths occur after all the phasing-in of bracket changes and the unified credit has been completed, the maximum cost of the rate table differential is predictable. That difference will be $117,000. For example, assume that the husband has $5 million, the wife has no assets, and both die after 1986. Here are comparisons of Federal results.

Equalization alternative. If the husband had used the pre-ERTA 50% maximum marital deduction, he would have left $2.5 million to his wife under the marital deduction and the other half in a residuary trust that would have been taxable at the husband's death but not taxed at the wife's later death. Results:

Tax at husband death (after unified credit)	$ 833,000
Tax at wife's later death (after unified credit)	833,000
Total taxes	$1,666,000

JMD alternative. If the husband had used a jumbo marital deduction and at the wife's later death her marital assets had not changed in value, the results would be as follows.

Tax at husband's death (after unified credit)	$ –0–
Tax at wife's death (after unified credit)	1,783,000
Total taxes	$1,783,000

The difference in total taxes (or rate table differential cost) is $117,000. The $117,000 difference will persist no matter how high the husband's original estate may spiral above $5 million, so long as the other factors remain constant. The reason for this constancy is the marginal bracket differentials. By shifting to his wife more than $2.5 million in assets, the husband has caused the excess to be taxed at 50% in her estate. By retaining those assets in his estate, $600,000 will come under the umbrella of the unified credit and the balance of $1.9 million will generate Federal estate tax of $833,000. If instead, that balance of $1.9 million is added to the wife's estate, her Federal estate tax thereon in the 50% bracket would be $950,000. The saving from using the lower brackets in the husband's estate is $117,000 ($950,000 minus $833,000).

If the husband's gross estate is less than $5 million and the surrounding factors remain unchanged, the cost of deferring the tax until the wife's death will be less than $117,000.

"Pick-up" state taxes. Many states have a death levy in the form of a "pick-up" estate tax. This type of tax is designed to absorb the full credit for state death taxes allowed by Section 2011 (and is therefore sometimes called a "sponge" tax). At the time of writing there are 17 states that have pick-up estate taxes.

Assume such pick-up state death taxes are factored into the computation in the years before the full phase-in of the reduced estate tax rates (until 1985) and the increased unified credit (until 1987). If the additional assumption is made that the JMD alternative presumes funding of the credit trust with an amount equal to the maximum unified credit (*i.e.*, 1982—$225,000; 1983—$275,000; 1984—$325,000; 1985—$400,000; 1986—$500,000 1987—$600,000), then the maximum rate table differential costs are as shown in Table I on page 38.

Substantial state taxes

There are 34 taxing jurisdictions other than the 17 states that have pick-up death taxes (33 states and the District of Columbia). Of these, 22 tax property that passes to the surviving spouse; seven jurisdictions exempt property passing to the surviving spouse; and five have pre-ERTA-type marital deduction limitations. Ten of these 34 jurisdictions have top marginal rates greater than 16%; under Section 2011 the maximum credit for state death taxes is allowable at a 16% effective rate. The effect of these complications can be illustrated as follows.

Example. A husband and wife are residents of Massachusetts. All assets are in the husband's name. He predeceases the wife, and both die after 1986. The husband's adjusted gross estate (*i.e.*, gross estate less Sections 2053 and 2054 deductions) totals $10 million and consists entirely of Massa-

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chusetts property. The wife neither increases nor dissipates the net estate.

The figures below compare the tax results if the husband uses (1) a 50% marital deduction AB trust will or (2) the unlimited marital deduction.

	50%	*100%*
Husband's death		
Federal taxable estate	$5,000,000	$ 0
Massachusetts taxable estate	5,000,000	5,000,000
Tentative Federal tax	2,275,800	0
Less: Unified credit	(192,800)	
Less: Section 2011 credit	(391,600)	
Federal tax	1,691,400	0
Massachusetts tax	707,000	707,000
Total	$2,398,400	$ 707,000
Wife's death		
Federal taxable estate	$5,000,000	$9,293,000
Massachusetts taxable estate	5,000,000	9,293,000
Tentative Federal tax	2,275,800	4,422,300
Less: Unified credit	(192,800)	(192,800)
Less: Section 2011 credit	(391,600)	(960,136)
Federal tax	1,691,400	3,269,364
Massachusetts tax	707,000	1,393,880
Total	$2,398,400	$4,663,244
Total both estates	$4,796,800	$5,370,244

The taxable estate for Massachusetts estate tax purposes is not necessarily the same as that for the Federal estate tax. The value of the Massachusetts gross estate equals that of the Federal gross estate as determined under the Code in effect on January 1,1975. However, the marital deduction for purposes of the Massachusetts estate tax may not exceed 50% of the Massachusetts adjusted gross estate.

Using the unlimited marital deduction increases the total taxes payable on both estates by $573,444. This is due to several factors. The 50% Massachusetts marital deduction limitation subjects approximately half the estate to the Massachusetts estate tax twice. This violates the principle of avoiding double taxation. Additionally, the 100% deduction causes a bunching effect on the second death, leaving the estate prey to the rate table differential at both the Massachusetts and Federal levels. This violates the equalization principle.

Another consideration is that on the husband's death there are no Federal taxes due. Since the Section 2011 credit is not refundable, there is no credit on the husband's death if the 100% marital deduction is used even though state death taxes of $707,000 must be paid. To quantify this result, note that if the 100% deduction is used, state taxes on both estates of $2,100,880 yield a Section 2011 credit of $960,136 or a 45.7% effective rate. If the 50% deduction is used, state taxes of $1,414,000 yield a credit of $783,200 or a 55.38% effective rate.

QTIP trust consequences

Let us alter the example to make husband and wife New York residents and add the further element that the husband elects to leave 100% of his estate to his wife in a QTIP trust.

The New York estate tax provisions are rife with anomalies and traps for those wishing to use the unlimited marital deduction. In the case of a $10 million estate, the marital deduction for New York estate tax purposes (as in Massachusetts) would be limited to 50% of the adjusted gross estate. For estates of decedents dying after 1978, the New York marital deduction is limited to the greater of $250,000 or 50% of the adjusted gross estate. (The New York income tax automatically adopts Federal income tax changes, but the New York estate tax does not adopt Federal estate tax changes absent express legislation. In light of the revenue cost to New York state as a result of ERTA's income tax provisions, it is unlikely the state will quickly act to dissipate another revenue source.) Moreover, no part of a QTIP trust, being a terminable interest, qualified for the marital deduction

Table I: Maximum Rate Table Differential Costs for Maximum Marital Deduction in States with "Pick-up" Death Taxes

	1982	*1983*	*1984*	*1985*	*1986*	*1987*
50% marital estate amount	$4,000,000	$3,500,000	$3,000,000	$2,500,000	$2,500,000	$2,500,000
Total Federal taxes (both estates)	3,075,200	2,534,600	2,025,000	1,530,400	1,462,400	1,388,400
Total state taxes (both estates)	560,800	458,400	364,000	277,600	277,600	277,600
100% marital estate amount	$7,775,000	$6,725,000	$5,675,000	$4,600,000	$4,500,000	$4,400,000
Total Federal taxes	3,529,150	2,828,700	2,193,950	1,607,200	1,534,400	1,458,600
Total state taxes[1]	742,600	602,800	471,800	346,800	335,600	324,400
Rate table differential (Fed.)	$ 453,950	$ 294,100	$ 168,950	$ 76,800	$ 72,000	$ 70,200
Rate table differential (state)	181,800	144,400	107,800	69,200	58,000	46,800
Total rate table differential	635,750	438,500	276,750	146,000	130,000	117,000

[1] This assumes no state death tax payable on husband's first death.

before ERTA. Since the New York estate tax has not adopted ERTA, a QTIP trust seems clearly not to qualify at all for the marital deduction for purposes of the New York estate tax. The starting point for determining a decedent's gross estate for New York estate tax purposes is the Federal gross estate. Therefore, a 100% QTIP bequest will yield no marital deduction for New York estate tax purposes. Nonetheless, however illogical and unfair, it would appear that the full value of the QTIP trust will be includable in the wife's New York estate upon her subsequent death as the trust would be part of her Federal gross estate under Section 2044. The effect of these rules is as follows:

Husband's death

	50% marital deduction	*100% marital deduction*	*100% marital deduction using QTIP*
Federal taxable estate	$5,000,000	0	0
New York taxable estate	5,000,000	$5,000,000	$10,000,000
Tentative Federal tax	2,275,800	0	0
Less: Unified credit	(192,800)	0	0
Less: Section 2011 credit	(391,600)	0	0
Federal tax	1,691,400	0	0
New York tax	541,500	541,500	1,436,500
Total	$2,232,900	$ 541,500	$ 1,436,500
Wife's Death			
Federal taxable estate	$5,000,000	$9,458,500	$ 8,563,500
New York taxable estate	5,000,000	9,458,500	8,563,500
Tentative Federal tax	2,275,800	4,505,050	4,057,550
Less: Unified credit	(192,800)	(192,800)	(192,800)
Less: Section 2011 credit	(391,600)	(985,292)	(853,544)
Federal tax	1,691,400	3,326,958	3,011,206
New York tax	541,500	1,328,200	1,154,565
Total	$2,232,900	$4,655,158	$ 4,165,771
Total both estates	$4,465,800	$5,196,658	$ 5,602,271

Thus, the QTIP alternative can result in the entire estate being taxed twice for New York estate tax purposes.

Credit trust "melt-down"

Commentators who discuss the possible use of the unlimited marital deduction add the caveat that, of course, a nonmarital share should be set aside to take full advantage of the maximum unified credit for each estate. This trust is variously referred to as the nonmarital trust, exemption equivalent trust or credit shelter trust. Generally, the will language requires funding of such exemption equivalent trust to the extent of the maximum amount which will pass free of Federal estate taxes. In 1987, the unified credit will reach its maximum, $192,800, equivalent to an estate tax exemption of $600,000.

If in the above examples provision were made for a credit shelter trust to be funded on the husband's death, the results are more complicated. Suppose the Massachusetts decedent had set up a credit shelter trust and funded it with $600,000. The taxes due Massachusetts are $707,000. Query: where are these funds to come from? If they come from the credit trust, (1) they dissipate it entirely, thereby defeating its purpose, and (2) there are insufficient funds anyhow. It would seem that some, if not all, the funds must come from the marital deduction portion of the estate. To the extent that the marital

Table II: Overfunding the Credit Shelter Trust to Pay Legacies, Administration Expenses and State Death Taxes

The following compares a $10 million estate of a New York couple where the first spouse to die establishes a regular credit shelter trust or, alternatively, an "anti-melt-down" credit shelter trust intentionally overfunded to end up with the net exemption equivalent.

	Credit Trust	*AMDT*
Husband's death		
Federal taxable estate	$ 600,000	$1,405,520
New York taxable estate	5,000,000	5,000,000
Federal estate tax	0	264,020
New York estate tax	541,500	541,500
Net to trust	58,500	600,000
Wife's death		
Federal taxable estate	$9,400,000	$8,594,480
New York taxable estate	9,400,000	8,594,480
Federal estate tax	3,306,600	3,022,235
New York estate tax	1,316,500	1,160,451
Net wife's estate	4,776,900	4,411,794
Total wife's estate & trust	4,835,400	5,011,794
Total New York estate taxes	$1,858,000	$1,701,951
Total Federal estate taxes	$3,306,600	$3,286,255
Total taxes	$5,164,600	$4,988,206

share is chargeable with estate taxes, it is ineligible for the deduction. This provision increases the Federal estate taxes, which causes a further charge against the marital share, once again making that portion ineligible for the marital deduction, thereby increasing Federal estate taxes, and so on.

This phenomenon has been referred to as the "melt-down" of the credit trust. Three potential causes of melt-down have been identified: (1) legacies; (2) administration expenses; and (3) state death taxes. Legacies accomplish the same result as the credit trust (that is, they achieve the result of leaving the beneficiaries' gifts free of estate taxes) and, therefore, do not warrant great concern. Administration expenses can yield an estate tax deduction or an income tax deduction. Where a maximum marital deduction is used there is usually no Federal estate tax due and administrators will presumably seek to use administration expenses as an income tax deduction. To the extent they are so used they will dissipate the corpus of the exemption equivalent trust, and estate planners and administrators should be aware of this. In large estates, state death taxes will be the major cause of melt-down.

In any state with an effective death tax rate higher than that provided for in the Section 2011 credit, a practitioner attempting to draft language for the funding of an exemption equivalent trust to be used with an unlimited marital deduction will face many problems if the estate is of substantial size. The melt-down effect should be more dramatic in the years prior to 1987 (before the full phase-in of the unified credit). Any time the state death taxes exceed the exemption equivalent, the phenomenon will come into play.

Anti-melt-down trusts

Most practitioners seem to accept the melt-down caused by state death taxes as a problem which cannot be avoided. Perhaps, however, it can be overcome by funding the exemption equivalent trust with an amount such that after paying all legacies, administration expenses and state death taxes, the net amount remaining will be the exemption equivalent. This funding mechanism may be referred to as an anti-melt-down trust (AMDT). The results using an AMDT in the $10 million New York estate illustrate the effects, as shown in Table II in the box on page 39.

The differences between the regular credit shelter trust and the AMDT are significant. If the AMDT is used, it results in an increased payment of $264,-020 on the first death (the New York death taxes will remain the same). The saving in total death taxes on both deaths will be $176,394. To defer the $264,020 payment on the first death will have to yield a 67% return to equal the $176,394 additional cost.

Simultaneous death

In the past, for most practitioners the simultaneous death clause in a will was rather standard. It simply established a presumption that the husband predeceased the wife, primarily so that the marital deduction could be used to split the rate tables when most of the assets were in the husband's estate.

If the general dispositive scheme now is to use the unlimited marital deduction, practitioners should provide for an alternative in the event of simultaneous death. Otherwise (as shown by the rate table differentials and the examples), the result can only be a higher tax bill. There should be provision for either a 50% marital bequest or an estate equalization bequest in the event of simultaneous death to avoid this result. ★