

UBS Insight

The impact of decoupling on your estate plan



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Distinct state estate tax systems can present planning issues for affluent individuals

Like many affluent individuals, you likely have an estate plan designed to minimize potential exposure to estate taxes by taking maximum advantage of the federal estate tax exclusion amount. However, there is a little-known hurdle for high net worth individuals that can significantly impact their legacy planning goals.

A significant number of states have “decoupled” their estate tax from the federal estate tax system, so that they no longer use the same exclusion. Decoupled states typically apply lower exclusions, which means that residents of these states face more complicated estate planning—and, often, an increase in combined federal-state estate tax.

At death, when this issue has not been addressed, the family may be stuck with a tax at the state level even if there is no tax due at the federal level. Yet by understanding the implications of the new estate tax structure and examining estate planning alternatives, you may be able to combat additional tax exposure.

Implications of decoupling: lower state exclusions

The possibility of unexpected taxation stems from the elimination of the federal credit for state death taxes and increases over the past few years in the federal applicable exclusion amount (commonly called the estate tax “exemption”). The exemption was \$2 million from 2006 through 2008, and as of 2009 is \$3.5 million. In 2010, the federal estate tax is repealed but—unless the current law is altered—it returns in 2011 with an exemption of only \$1 million.

Until 2001, most states were tied to the federal system, with a “pickup” estate tax under which estates received a full credit for the state tax against the federal tax. Under this arrangement, one tax potentially offset the other so that state death taxes had little or no practical impact on individual estates. But the 2001 legislation phased out the credit until it reached zero in 2005. States whose estate tax system had simply been to impose a tax equal to the federal credit were then left with no estate tax system at all. The resulting revenue shortfall led many states to “decouple” their estate tax from the federal system or add an additional inheritance tax.¹

The exclusion amount varies from state to state, but it is almost always lower than the federal exclusion. As a result, some estates may be subject to both federal and state estate tax while others will escape federal taxation but find that state tax is owed. That can be a real trap for the unwary, making planning more important and also far more complicated.

A higher chance of state estate tax

If you live in a state that has decoupled its estate tax from the federal system or has a separate inheritance tax, your estate may be subject to a more complex interplay of federal and state estate taxes. In fact, in these states, there may well be a state estate tax even where an estate is not subject to federal estate tax.

Ensuring that your estate planning addresses the impact of decoupling is essential to securing your legacy goals.

For example, Tennessee has a different exclusion amount than the federal exemption. Because Tennessee has frozen its inheritance tax exclusion at \$1 million, a Tennessee resident who owns more than \$3.5 million of potentially taxable assets should plan as if his or her estate will owe both federal and state taxes. Moreover, if a Tennessee resident dies in 2009 with assets in excess of \$1 million but under \$3.5 million, he or she might escape federal estate tax but could owe up to \$225,900 in Tennessee inheritance tax.

Strategies to keep your legacy intact

The first step in protecting your estate is reviewing all existing wills and trusts. In particular, be alert to provisions leaving “the amount of the applicable federal exclusion” in a bypass (also called a credit shelter) trust.

Although an unlimited marital deduction means that no federal estate tax is ever due on assets left to a surviving spouse (except if he or she is not a U.S. citizen), those assets may be subject to tax when the second spouse dies. In order to use up the exclusion of the first spouse to die and thereby reduce the surviving spouse’s estate, married couples often use bypass trusts. Bypass trusts typically provide income to the surviving spouse for life, with the ability to

invade principal for specific purposes. But the bypass trust does not qualify for the marital deduction. So at the survivor’s death, the remaining principal is not subject to estate tax in the surviving spouse’s estate, but rather passes to or in further trust for the beneficiaries named by the first spouse, who are typically his or her children. In large estates, amounts beyond the applicable federal exclusion may be left to the surviving spouse either outright or in trust.

Bypass trusts continue to be an appropriate strategy for married couples seeking to shield assets from estate taxes. In a decoupled state, however, state tax could be due on the death of the first spouse if the bypass trust is to be funded with “an amount equal to the applicable federal exclusion amount.”

If a will funds a bypass trust at the higher federal exclusion level without factoring a smaller state exclusion, there may be unanticipated state estate tax on the first spouse’s death. A possible solution to this problem lies in funding a bypass trust with the maximum amount that will not create state OR federal tax and placing the balance in a marital trust designed to soak up the balance of the federal exclusion. Adopting this approach means there may be additional federal estate tax generated when the surviving spouse dies.

The decision hinges on whether you would rather defer all tax until the second spouse dies—even if the tax may then be larger because the maximum amount was not sheltered from federal tax at the first spouse’s death—or are comfortable paying tax at the state level on the first spouse’s death. Your attorney or estate planning professional can help you evaluate the legal and financial impact of each approach.

Adopting a flexible approach

One potential solution to the problem posed by decoupling is moving and establishing legal domicile in a state that has no estate tax or that has a tax still linked to the federal system. However, very few states have constitutional provisions governing estate tax, so most states legislatures can still change the rules. Where legislative action is possible, other states may still move toward decoupling from the federal system. In any case, moving solely for tax reasons is seldom advisable.

Because the estate tax situation is in flux on both the state and federal level, you will want to build as much flexibility as possible into your estate planning documents. If you live in a decoupled state, this may mean putting as much as possible into a bypass trust without exceeding the lesser of the state and federal tax exemptions, leaving the balance to your spouse

but including a disclaimer provision so that the spouse has a full nine months after your death to decide whether to disclaim part of the balance, which can then fund the bypass trust up to the full amount of the federal exclusion. This permits the decision of whether or not to pay the state tax up front in order to reduce federal tax later on to be made by the surviving spouse after your death, when he or she will have the best information to support that choice.

Ensuring that your estate planning addresses the impact of decoupling is essential to securing your legacy goals. It is advisable to consult your tax and legal advisors to help you craft a strategy that can help reduce your potential tax exposure while carrying out your wishes for your family.

Reducing the size of the taxable estate

Another way to battle the rising cost of estate taxes is to minimize the size of a potentially taxable estate, which may be especially appropriate for single taxpayers who are unable to utilize bypass trusts or the marital deduction. You may want to consider one or more of the following strategies.

Make lifetime gifts to family members

As of 2010, you may give up to \$13,000 each year to each of as many recipients as you choose without incurring federal gift tax. If giving the money away will not affect your lifestyle, you could give \$13,000 a year to each of three married children, their spouses and seven grandchildren, thereby removing \$169,000 from your estate each year without incurring federal gift tax. However, certain states may impose an additional state tax on gifts above certain annual exclusion amounts that may differ from the federal annual exclusion. Please consult your attorney or estate planning professional to help you incorporate annual gifts into your estate plan.

If the gifts take the form of appreciating securities, the additional appreciation will also be removed from your estate. Additionally, gifts of unlimited amounts may be made directly to medical or educational institutions to pay another person's qualified medical or educational expenses without federal gift tax, which can be a good way of providing financial assistance to children and grandchildren.

When the federal estate and gift tax were unified, many advisors recommended exceeding the annual tax-free limits and using up part of the lifetime exclusion. However, the lifetime gift tax exclusion is now frozen at \$1 million, so individuals contemplating large gifts need to be aware of this limit in their long-term planning.

Make gifts to charity

Possibilities include outright gifts, a donor advised fund and charitable trusts.

- *Outright gifts* are a simple way to help charities of your choice by writing a check or donating appreciated securities and, assuming that you file an itemized federal income tax return, take a deduction for the contributed amount. The charity will provide a letter documenting the contribution. Keep in mind, however, that the deduction may be limited by adjusted gross income amounts.
- *Donor advised funds* may be advisable for long-range giving. You may take an immediate tax deduction for your contributions even if you delay recommending specific gifts until a later date.

- *Charitable remainder trusts* (CRTs) may provide a distribution stream to the donor, with remaining principal in the trust at the end of its term (typically the donor's life) going to the designated charity or charities.
- *Charitable lead trusts* (CLTs) generally work in reverse, providing a stream of payments to charity with the balance at the end of the term going to your designated beneficiaries.

There are various tax considerations associated with many gifting strategies, so it is best to consult your Financial Advisor and tax professional before deciding on the best course of action.

¹ As of the date of this article, twenty-three (23) states plus the District of Columbia and Puerto Rico have state inheritance and estate taxes that differ from the federal system. See Jeffrey A. Schoenblum, 2009 Multistate Guide to Estate Planning 15-15 – 15-37 (CCH 2008).

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