STEP Cross-Border Estates Group

11 June 2009

Post Death Tax Planning

The US Angle

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Post Death Tax Planning – The US Angle

One may be excused for wondering at the present time whether there is, or will continue to be, a US estate tax. The answer is yes, probably, and in fact there are several relevant sets of death taxes. The details are beyond the scope of these notes, but a brief overview is essential before discussing post-death tax planning.

Status of "Repeal"

In 2001, the US federal estate tax was "repealed" in stages. Since then, the amount that each US citizen or domiciliary can pass during life or at death free of tax, by virtue of what is traditionally called the "Unified Credit", has been rising, while the top rate of tax has been dropping. The estate tax (but not the gift tax) is slated to disappear in 2010, only to reappear in 2011 with a $1 million "exemption"[1] and the old graduated rates unless Congress and the White House agree to enact a permanent repeal. It is unlikely that they will do nothing, but what they will do is still anybody's guess, especially in the current economic climate. The US legislative process requires consensus among both houses of Congress and the White House and therefore involves a great deal more haggling than usually in the UK.

Several proposals have been introduced recently, the most likely to succeed being S. 722 ($3.5 million "exemption") and H.R. 2023 ($2 million "exemption") or a combination of the two. Among other changes, both would also introduce "portability" of the exemption of the first spouse to day in much the same way as has recently been enacted in the UK. In the meantime, we may well see a series of stop-gap extensions of the present system.

Present Exemption and Rates

As things stand, the "exemption" for US citizens and domiciliaries dying in 2009 is $3.5 million, and $1 million for those dying in 2011 and beyond. The 2009 rate of tax is a flat 45%. From 2011, the rates will range from 41% to 55%, with a 5% surcharge on estates between $10 million and $17,184,000 designed to claw back the benefit of the "exemption" and graduated rates. The effect is that estates over $17,184,000 will suffer a flat 55% rate of tax.

Those who are neither citizens nor domiciliaries of the United States, for whom only US assets are subject to tax, are still entitled only to a very low "exemption" of $60,000. Rates range from 26% 45% in 2009, and from 26% to 55% in 2011.

As the present system does not permit the "portability" of the first spouse's exemption, standard US estate planning still calls for it to be used by means of a non-marital trust or outright legacy.

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[1] The term "exemption" has generally herein been put in inverted commas because the relevant relief is actually a credit against the tax on a specified amount, which is more easily conceptualised as an exemption.

Other Taxes

The US federal generation-skipping transfer tax may also apply if there are dispositions for "skip-persons" more than one generation removed from the deceased/donor. There is an exemption from this equal to the estate tax credit ($3.5 million in 2009, $1 million in 2011), and the tax is imposed at the top rate of estate tax in effect at the relevant time. Effective use of this exemption usually calls for a trust for the eventual benefit of grandchildren.

On top of this, many individual states impose their own estate or inheritance taxes – creditable against the federal tax, but still in effect when and if the federal tax disappears. Rates vary, but can reach levels on the order of 19 or 20%, and these taxes are not covered by the US/UK estate and gift tax treaty.

US Post Death Tax Planning -- Overview

The US federal estate tax system is not particularly open to post mortem estate planning unless it has been anticipated and specifically drafted for. In order to secure marital or charitable relief, dispositions in the requisite form must occur by the terms of the will or by operation of law. There is little scope for adjustments to those dispositions to be altered by the beneficiaries so as to be read back into the will, and post mortem variations run the risk of being treated as taxable gifts by the beneficiaries. Likewise, there is limited scope to carve out part of a marital legacy to create or increase the "taxable" estate to make use of the Unified Credit.

Preliminary Issues

Income Tax Issues

Post-death income tax planning is a subject in and of itself, but I will mention briefly that care should be taken in selecting the estate's income tax year. There may also be scope to achieve a step-up in basis for purposes of calculating capital gains where assets are held at death in a company that is not fiscally transparent. It is possible to make a "check the box" election up to 75 days after death to treat the company as fiscally transparent and thereby qualify the assets for the step-up. In both cases, it is important to take advice pretty promptly after death as to potential income and capital gain issues.

Alternate Valuation Date

The US federal estate tax is generally levied on assets at their value on the date of death, but when this has fallen it is possible to elect instead to sue the value six months after death. If elected, this alternate valuation date must be used for all estate assets, except that assets sold or distributed before that date must be valued as of the sale or distribution.

Basic Marital Deduction Overview

Because the principle focus of most basic estate planning is to protect the "exemption" of the first spouse to die by making an appropriate non-marital disposition and to obtain marital relief for the balance of the estate, a very brief overview of the US federal estate tax marital deduction rules may be helpful.

A legacy or inheritance from a US citizen or domiciliary may qualify for the marital deduction in two ways: if it is an outright entitlement for the surviving spouse, or if is it is by a qualifying trust for his or her benefit. (It is also possible to achieve the same result with a near-equivalent to a trust such as a usufruct so long as the other requirements are met.)

The most common form of marital trust is a Qualified Terminable Interest Property (QTIP). The surviving spouse must be entitled to all the income, no one other than the spouse may receive income or capital during his or her lifetime (so there may be no overriding power of appointment, for example), and an election must be made to qualify as a QTIP and subject the trust assets to US federal estate tax at the death of the surviving spouse.

If the deceased is not a US citizen or domiciliary, a marital a legacy or inheritance may qualify for the marital deduction in only one way – if it is held in a Qualified Domestic Trust (QDOT), either under the terms of the will, or if the surviving spouse receives an absolute entitlement to assets which he or she then settles on an inter vivos QDOT before the estate tax return is filed.[2] In addition to all the other requirements for a marital deduction trust, a QDOT must have additional security arrangements to ensure collection of US federal estate tax when the surviving spouse dies or receives capital during his or her lifetime: at least one trustee must be a US citizen or corporation and have authority to pay the tax, and if the assets exceed $2 million, the trustees must include a US bank or provide a suitable bond to the IRS.

Planned Post-Death Adjustments

It is useful to distinguish between what I will call "planned" post-death adjustments, which take advantage of flexibility built into the estate plan for certain tax decisions to be made in light of circumstances determined after the date of death, and "unplanned" post-death adjustments. "Planned" adjustments are one of the reasons US wills tend to be so long compared to English wills, and a full explanation of their uses would be equally long and complicated, so this note only offers a brief overview.

One typical post-death adjustment is the partial QTIP election, whereby an election may be made only to qualify a portion of a marital trust for the marital deduction. The portion as to which the election is not made may then be held in trust either for the spouse alone (though it will not be includible in his her estate when he or she dies), or on more flexible terms. This allows a decision to be made post-death based on the spouse's needs, the tax treatment of the estate assets, their value, etc. If the will does not use up all of the available "exemption" of

[2] The latter method can in appropriate circumstances have an income tax advantage if the spouse is not a US resident, as it may then be a foreign grantor trust whose income and gains are attributed to the surviving spouse, who is not a US taxpayer, rather than the beneficiaries on her death, who may well be US citizens or residents. The recent changes to the relevant property regime in the UK, however, may make this undesirable if the surviving spouse is domiciled in the UK for IHT purposes.

the first spouse to die, for example, the partial election allows the taxable (but for the "exemption") portion of the estate to be increased accordingly. Sometimes, it is desirable to create a taxable estate in excess of the "exemption" – for instance, if graduated rates apply and the estate of the first spouse to die is much smaller than the survivor's then paying tax on the first estate may be less expensive than paying more on the survivor's estate; or if the first spouse to die is domiciled in the UK for IHT purposes but the survivor is not, there will be unavoidable IHT on the first death, and it may be desirable to trigger US federal estate tax at the same time so that the tax may be offset.

Another method sometimes used to achieve a similar end is the "disclaimer" trust, whereby the will leaves the surviving spouse an absolute entitlement but provides that in the event she disclaims some or all of it, the disclaimed potion passes instead to a trust, typically for the benefit of the spouse and issue. In order to achieve the desired end, the disclaimer must generally be in the form of a "qualified disclaimer" discussed below.

It is also possible through careful drafting of alternate formulae to cater for other contingencies that can only be determined after death – such as whether the first spouse to die is domiciled in the United States, as there is no mechanism there for a lifetime determination. A will might, for example, provide that in the event the testator is finally determined to be a US domiciliary after application of the US/UK Estate and Gift Tax Treaty, then one set of dispositions apples, with an entirely different set of dispositions if he or she is not.

Unplanned Post-Death Adjustments – the "Qualified Disclaimer"

The principle method of altering the dispositions so as to back-date the effect to the date of death is the "qualified disclaimer". This means "an irrevocable and unqualified [sic] refusal by a person to accept an interest in property" in the prescribed form.

The definition and effect of a qualified disclaimer are set out in IRC § 2518 in the Appendix. Briefly, the effect of a qualified disclaimer is that the disclaimed assets are treated as if transferred by the deceased or donor (in the case of a lifetime gift), and the disclaimant is not treated as making a gift. In order for a post-death disclaimer to qualify –

- It must be in writing,
- It must be delivered to the executor or other holder of legal title within 9 months of the later of the date of death or the disclaimant's 21st birthday,
- The disclaimant may not have accepted the interest or any of its benefits in the meantime, and
- As a result of the disclaimer, the interest must pass
    - without any direction by the disclaimant, and
    - to the spouse of the deceased or a person other than the disclaimant.

Partial disclaimers (including of an undivided portion) are permitted, and a written transfer to the persons who would have received the interest had there been a qualified disclaimer may qualify if it meets all of the other requirements.

Interaction of Qualified Disclaimer and Deed of Variation Rules

It is sometimes possible to achieve the desired end on both sides of the Atlantic by drafting a deed of variation that also meets the requirements of a qualified disclaimer, but because of the prohibitions in the qualified disclaimer rules against (1) direction by the disclaimant and (2) subsequent benefit by any disclaimant other than the surviving spouse, there will be circumstances in which it is not possible. It is not possible, for example, to vary a discretionary trust to create a dual-qualified life interest for the spouse without making the spouse party to the redirection of the assets into the life interest. The life interest would have to be the default provision on failure of the discretionary trust, which would be unlikely unless the situation is specifically anticipated and drafted for.

If it happens to be the case that a will creates a trust that does not meet the specific US requirements for marital relief – which might be either a discretionary trust or a defeasible life interest for the widow – it is not really possible to engraft the necessary US marital trust provisions by means of a variation, but it might be possible to secure US marital relief if by disclaiming her interest in the will trust, the widow caused the estate assets to pass to her absolutely on intestacy. Circumstances when this will be the case are of course limited.

On the other hand, if the will contains a "disclaimer trust" provision – such as "if my Wife disclaims any of my residuary estate passing to her [absolutely] under this will, then I give my residuary estate to my Trustees [in trust to pay all the income to her ...]". In such a case, one would need to draft a "disclaimer" for the widow to sign that meets the requirements of a deed of variation (as it would not qualify as a disclaimer for UK IHT purposes) as well as a qualified disclaimer for US purposes.

While this all may sound very complicated and too restrictive to be of general use, remember that it is not always necessary have a qualified disclaimer. If the deceased is not a US citizen or domiciliary, for example, it will not be necessary to secure US marital relief with respect to non-US situate assets (remembering to consider treaties), or if the beneficiary is not a US citizen or domiciliary, it may not be necessary for a deed of variation to avoid the making of a deemed gift by the beneficiary. International families can present many permutations, so each case must be considered carefully.

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11 June 2009

Appendix – IRC § 2518

(a) General rule

For purposes of this subtitle, if a person makes a qualified disclaimer with respect to any interest in property, this subtitle shall apply with respect to such interest as if the interest had never been transferred to such person.

(b) Qualified disclaimer defined

For purposes of subsection (a), the term "qualified disclaimer" means an irrevocable and unqualified refusal by a person to accept an interest in property but only if—

(1) such refusal is in writing,

(2) such writing is received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates not later than the date which is 9 months after the later of—

(A) the day on which the transfer creating the interest in such person is made, or

(B) the day on which such person attains age 21,

(3) such person has not accepted the interest or any of its benefits, and

(4) as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either—

(A) to the spouse of the decedent, or

(B) to a person other than the person making the disclaimer.

(c) Other rules

For purposes of subsection (a)—

(1) Disclaimer of undivided portion of interest

A disclaimer with respect to an undivided portion of an interest which meets the requirements of the preceding sentence shall be treated as a qualified disclaimer of such portion of the interest.

(2) Powers

A power with respect to property shall be treated as an interest in such property.

(3) Certain transfers treated as disclaimers

A written transfer of the transferor's entire interest in the property—

(A) which meets requirements similar to the requirements of paragraphs (2) and (3) of subsection (b), and

(B) which is to a person or persons who would have received the property had the transferor made a qualified disclaimer (within the meaning of subsection (b)),

shall be treated as a qualified disclaimer.