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The Leveraged Exclusion Amount: Still the Best Way to Reduce Ohio Estate Taxes for Married Clients

By James K. Leonard, Esq.

OSBA Board Certified Specialist in Estate Planning, Trust & Probate Law

Wright Law Co. LPA
Dublin, Ohio

Question: John has a \$1,000,000 estate. At his death, he leaves his estate in trust to his wife Mary. What is the best way to avoid Ohio estate tax at John's death and to minimize Ohio estate tax at Mary's death?

Answer: Leverage Ohio's estate-tax exclusion amount with Ohio's life estate marital deduction.

In my article in the July/Aug. 2001 issue of this journal,¹ I began with a similar question-and-answer and then described a technique, which I named the "leveraged exclusion amount," that zeroes out Ohio estate tax at the first death and minimizes the tax at the second death.

In his article in the Jan./Feb. 2002 issue, Marc R. Friedman, Legal Counsel for the Estate Tax Division of the Ohio Department of Taxation, approved the technique and expanded it in an important way.² Because the proper use of the technique requires a careful, integrated reading of the two articles, this journal's Editor-in-Chief felt that the present article, updating my original article, would be helpful to explain the status of the technique and how to use it.

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Ohio's estate-tax exclusion amount is \$338,333 for deaths in 2002 and later.³ Ohio's unique life estate marital deduction makes it possible for married clients to save Ohio estate taxes well beyond the savings permitted by their individual exclusion amounts.

The increased savings are achieved by careful elections made during the administration of the estate of the first spouse to die. The elections are possible if the decedent's estate plan has the mainstay feature for minimizing Ohio estate taxes – a credit shelter trust (called a Family Trust in this article) which is QTIPable so that Ohio estate taxes can be zeroed out at the first death.

The Life Estate Marital Deduction (LEMD), QTIP Deduction, and Leveraged Exclusion Amount (LEXA)

By a "QTIPable" trust, I mean a trust that qualifies for Ohio's QTIP (qualified terminable interest property) marital deduction under R.C. 5731.15(B). To qualify for QTIP status, a trust must pay all income to the surviving spouse at least annually, and only the spouse can be a beneficiary of the trust during her lifetime. The right to income must continue throughout the spouse's life, no matter what. The termination of income upon the spouse's remarriage, for example, would disqualify the trust from QTIP status.

For a QTIPable trust, there are two Ohio marital deductions that can be used for all or part of the trust:

- (1) The life estate marital deduction (LEMD), taken on Part I of Schedule M of the Ohio estate tax return, and
- (2) The QTIP deduction, taken on Part II of Schedule M.

The LEMD, which exists because of a quirk in R.C. 5731.15,⁴ is a deduction equal to the life-estate factor for the surviving spouse multiplied by the value of the trust assets. If Mary is 70 and the Section 7520 rate is 4.2% at John's death, her life-estate factor (LE) is 0.40758.⁵ If John leaves a \$1,000,000 QTIPable Family Trust for Mary, the trust qualifies for an LEMD of \$407,580 (= 0.40758 x \$1,000,000).

Alternatively, the Family Trust could be fully QTIPed and receive a \$1,000,000 marital deduction.

The LEMD leverages the \$338,333 exclusion amount to a much higher amount – the “leveraged exclusion amount” (LEXA), which is equal to \$338,333 plus the LEMD. The LEXA assets are Ohio tax-free at both the first death and the second death, just like credit shelter trust assets are free of federal taxes at each death. The John-and-Mary examples below explain how the LEXA works.

Examples and Practice Tips

If John’s estate is less than the \$338,333 exclusion amount, traditional A/B trust planning and administration is all that’s needed to make his estate Ohio tax-exempt at each death. In the examples below, John’s estate is greater than the exclusion amount.

Example 1. John’s estate is fully covered by his LEXA

Assume that John dies in 2003, with a \$500,000 estate going to a QTIPable Family Trust for Mary, who is 70 at John’s death.⁶ On Part I of Schedule M of the Ohio estate tax return, a \$203,790 LEMD is claimed with language like this:

Part I of Schedule M

For the Family Trust, valued at \$500,000 (as may be adjusted on audit), a marital deduction of \$203,790 is claimed for the value of the spousal life estate, calculated as follows:

Decedent’s DOD	1-15-2003
DOB of spouse	6-17-1933
Age (at nearest birthday) of spouse at DOD	70
Section 7520 rate (AFR) for DOD month	4.2%
Life estate factor (LE)	0.40758
Value of Family Trust (FT)	\$500,000
Value of life estate = LE x FT	\$203,790

The \$203,790 life estate marital deduction reduces the taxability of the Family Trust to \$296,210 (= \$500,000 – \$203,790), an amount completely covered by the availability of the estate’s \$338,333 exclusion amount. Thus, the Family Trust will be 0% included in (100% excluded from) the Ohio taxable estate of the decedent’s spouse.

At Mary’s death, the value of her life estate in the Family Trust goes to zero, making the Family Trust tax-exempt at the second death as well.⁷ This result is mentioned in the suggested language for Schedule M, which serves as a reminder to exclude the Family Trust from Mary’s taxable estate.

Example 2. John’s estate is larger than his LEXA

Same facts as Example 1, except that John’s Family Trust is \$1,000,000. This time, zeroing out the tax requires

a QTIP deduction on Part II of Schedule M, as well as the LEMD on Part I and the use of the exclusion amount.

The language in Part I follows the pattern of Example 1, except that the assertion about the inclusion of the Family Trust in the surviving spouse’s estate appears at the end of the language for Part II of Schedule M:

Part I of Schedule M

For the Family Trust, valued at \$1,000,000 (as may be adjusted on audit), a marital deduction of \$407,580 is claimed for the value of the spousal life estate, calculated as follows:

Decedent’s DOD	1-15-2003
DOB of spouse	6-17-1933
Age (at nearest birthday) of spouse at DOD	70
Section 7520 rate (AFR) for DOD month	4.2%
Life estate factor (LE)	0.40758
Value of Family Trust (FT)	\$1,000,000
Value of life estate = LE x FT	\$407,580

Part II of Schedule M

A fractional QTIP marital deduction is elected for the Family Trust. The numerator of the fraction is 254,087, determined as follows:

Value of Family Trust	\$1,000,000
Less life estate marital deduction in Part I	-407,580
Less Ohio exemption equivalent	-338,333
QTIP amount	<u>\$254,087</u>

The denominator is 1,000,000, which is the dollar value of the Family Trust. The resulting QTIP amount is \$254,087 (= 254,087 / 1,000,000 x \$1,000,000).

At the spouse’s death, the portion of the Family Trust included in the spouse’s Ohio gross estate will be as follows:

Ohio QTIP elected	\$254,087
Value of the Family Trust	\$1,000,000
Portion included	25.41%

The 25.41% inclusion in Mary’s estate assumes that the full \$338,333 exclusion amount is available to be applied to the Family Trust. If part of the exclusion has been used for other transfers at the first death, such as a gift to a child, then there will be an upward adjustment in the portion included at the second death.

The fractional inclusion of the Family Trust presumes that the trust will be administered as one unified trust. But the Trustee can divide the Family Trust into two subtrusts

under the authority of R.C. 1339.67(A), such that one subtrust will be 100% included in the surviving spouse's estate, and the other subtrust 0% included (i.e., 100% excluded). If principal distributions need to be made to the spouse (and the trust permits them), the Trustee can make them from the 100% included subtrust, which will reduce the Ohio tax at the second death more than would distributions from a unified Family Trust. Separate EINs and Form 1041's would be needed for the subtrusts.

What if John's estate is greater than the federal exclusion amount? Let's say that John dies in 2003 with a \$2,500,000 estate. This would typically lead to the formation of a \$1,000,000 Family Trust and \$1,500,000 Marital Trust.

If the Marital Trust is a QTIP trust, the life estate marital deduction will apply, and a Part I LEMD deduction can be taken as described above for the Family Trust. Also, a Part II QTIP election can be taken on the balance, resulting in zero tax at the first death. At the second death, only part of the Marital Trust will be included in the Ohio estate, as in the Family Trust example.

If the Family Trust or the Marital Trust gives the spouse a lifetime unrestricted withdrawal power or a testamentary general power of appointment, a full marital deduction would be claimed on Part I of Schedule M, and the trust would be fully included at the second death. During the administration at first death, it may be possible to scale the trust back to a QTIP trust via a disclaimer by the spouse, in which case the LEXA technique could then apply.

Example 3. Some of the trust assets are not included in the Ohio gross estate

Another situation that reduces tax at the second death is when the Family Trust contains assets – like life insurance death benefits payable to a beneficiary other than the estate (R.C. 5731.12), real estate and tangible personal property located outside Ohio (R.C. 5731.01(A)), and the part of a pension plan arising from employer contributions (R.C. 5731.09) – that are not part of the Ohio gross estate.⁸ For example, if two of John's assets in Example 2 were a \$150,000 Michigan vacation home and \$250,000 of life insurance proceeds payable to the trust, the size of the Family Trust for Ohio purposes would be \$400,000 less, and only \$17,119 of the trust assets would require a QTIP election, as shown in this suggested language for Schedule M:⁹

Part I of Schedule M

In the Family Trust, valued at \$1,000,000 (as may be adjusted on audit), these assets are not included in the taxable Ohio estate:

Michigan vacation home	\$150,000
Life insurance	\$250,000
Assets not part of Ohio estate	\$400,000

Under the authority of R.C. 1339.67(A), the Trustee divides the Family Trust into two subtrusts – an Ohio Exempt Family Trust comprised of the \$400,000 of assets that are not included in the Ohio estate, and an Ohio Partially Exempt Family Trust comprised of the other \$600,000 of trust assets. The Ohio Exempt Family Trust will not be included in the taxable estate of the spouse. The Ohio Partially Exempt Family Trust will be included in the spouse's taxable estate to the extent described in Part II below.

For the Ohio Partially Exempt Family Trust, a marital deduction of \$244,548 is claimed for the value of the spousal life estate, calculated as follows:

Decedent's DOD	1-15-2003
DOB of spouse	6-17-1933
Age (at nearest birthday) of spouse at DOD	70
Section 7520 rate (AFR) for DOD month	4.2%
Life estate factor (LE)	0.40758
Ohio Partially Exempt Family Trust (OPEFT)	\$600,000
Value of life estate = LE x OPEFT	\$244,548

Part II of Schedule M

A fractional QTIP marital deduction is elected for the Ohio Partially Exempt Family Trust. The numerator of the fraction is 17,119, determined as follows:

Value of Ohio Partially Exempt Family Trust	\$600,000
Less life estate marital deduction in Part I	-244,548
Less Ohio exemption equivalent	-338,333
QTIP amount	\$17,119

The denominator is 600,000, which is the dollar value of the Ohio Partially Exempt Family Trust. The resulting QTIP amount is \$17,119 (= 17,119 / 600,000 x \$600,000).

At the spouse's death, the portion of the Ohio Partially Exempt Family Trust included in the spouse's Ohio gross estate will be as follows:

Ohio QTIP elected	\$17,119
Value of the Ohio Partially Exempt Family Trust	\$600,000
Portion included	2.85%

Tax Savings with the LEXA Technique

If the present system Ohio estate tax stays in place, the factors affecting LEXA tax savings are the size of the first estate and whether it grows or shrinks during the spouse’s lifetime, the AFR at the first death, and the surviving spouse’s age and taxable estate. Assuming a 4.2% AFR, no change in the decedent’s estate during the spouse’s life, and a spouse estate of at least \$500,000, this table shows the potential savings of Ohio estate tax at the second death, for given surviving spouse ages and QTIP trust sizes:¹⁰

Spouse Age	QTIP Trust at First Death				
	\$500,000	\$750,000	\$1,000,000	\$1,500,000	\$2,000,000
	Ohio Estate Tax Savings at Second Death				
50	\$ 35,000	\$ 52,500	\$ 69,773	\$ 92,818	\$ 115,864
60	35,000	51,999	61,437	80,314	99,191
70	35,000	45,081	52,214	66,479	80,745
80	33,280	38,078	42,877	52,473	62,070

Conclusion

The LEXA technique is a powerful technique to reduce the Ohio estate taxes of married couples. The tax savings can be achieved through careful post-death administration, so long as the estate plan of the first spouse to die is based on a QTIPable trust. For Ohio tax planning, there is no downside to using the LEXA technique to zero out the tax at the first death, and this could pay big dividends at the death of surviving spouse. On the federal side, there may be concern that the payment of Family Trust income to the spouse will increase her federal estate taxes beyond the Ohio LEXA savings. In this situation, designing the Family Trust with a spouse disclaimer to allow income distributions to descendants or implementing a low-income portfolio for the Family Trust are possible solutions. ❖

broad enough to allow the deduction of a terminable interest – see, e.g., division (A)(1) and (4). The Estate Tax Division of the Ohio Department of Taxation takes the position that a QTIP trust can qualify either for a R.C. 5731.15(A) “life estate marital deduction” equal to the actuarial life estate of the trust assets, or for a R.C. 5731.15(B) QTIP deduction equal to the full value of the assets.

⁵ The examples in this article assume that the Section 7520 rate (applicable federal rate, or AFR) is 4.2%, which was the rate for January 2003. The life-estate (LE) factor is based on the surviving spouse’s age and on the AFR for the month of the decedent’s death. The younger the spouse’s age and the higher the AFR, the higher the LE factor will be. LE factors can be obtained in IRS Publication 1457 or from the Estate Tax Division of the Ohio Department of Taxation, (614) 387-1976 or (800) 977-7711. They are also available through software like Estate Planning Tools, sold by Brentmark Software, (407) 306-6160 or www.brentmark.com.

⁶ The age of the surviving spouse is her age on her birthday closest to the husband’s date of death.

⁷ The Estate Tax Division agrees that the trust assets are Ohio tax-free at the second death, so long as the spouse does not have a lifetime or testamentary general power of appointment over the trust assets.

⁸ The Estate Tax Division takes the position that life insurance proceeds, even if paid to a trust, are taxable to the extent that the Trustee uses the proceeds to pay debts and expenses of the estate. For non-Ohio assets in a trust, the Division’s position is that these assets are not taxable so long as the trust gives the Trustee authority to allocate the assets among subtrusts or to allocate them in a way that minimizes Ohio estate tax.

⁹ The suggested Schedule M language reflects the comments made to me by Marc R. Friedman (see endnote 2 and the accompanying text) after his review of a draft of this article. In the draft article, the same LEMD and QTIP election were taken, but the Family Trust was left intact, resulting in a 1.71% (17,119 / 1,000,000) inclusion of the Family Trust at the surviving spouse’s death. While the taxation result under the approach in the draft article is almost the same as what will happen under Mr. Friedman’s approach reflected in the accompanying text, his approach is technically correct. A QTIP election can be made only for assets that are included in the Ohio taxable estate, and therefore the denominator used in the fractional QTIP calculation must be comprised only of assets in the Ohio taxable estate.

¹⁰ Within the savings shown in the table is \$23,683 of savings achievable simply with A/B planning: 7% (rate of taxation in the spouse’s estate) x \$338,333 in the Ohio credit shelter trust = \$23,683. The LEXA amount greater than the federal exclusion amount results in tax savings only if the decedent’s trust is a QTIP trust. A power-of-appointment trust would be included in the spouse’s taxable estate.

¹ Leonard, J., “The Leveraged Exclusion Amount: A Powerful (but Short-Lived?) Technique for Ohio Estate-Tax Savings for Married Clients,” 11 PLJO 93 (July/Aug. 2001).

² Friedman, M., “Ohio Department of Taxation Position on QTIP-Friendly Trusts,” 12 PLJO 37 (Jan./Feb. 2002). Mr. Friedman expanded my technique by allowing a life estate marital deduction to be taken against the entire QTIP trust, followed by a QTIP marital deduction taken for the remainder interest in the trust. (While I have conceptual difficulty with the idea of taking a marital deduction for a remainder interest, I have no objection to Mr. Friedman’s taxpayer-friendly expansion of my technique. The expansion allows a smaller QTIP deduction to be used in the first estate, which in turn reduces the size of the surviving spouse’s taxable estate.) Mr. Friedman’s article makes unnecessary some of the mathematical steps in my original article and makes Example 2 in that article obsolete.

³ The \$338,333 exclusion results from the \$13,900 estate tax credit in R.C. 5731.02(B).

⁴ Unlike federal law, Ohio’s marital deduction law, R.C. 5731.15, allows some terminable interests to be deductible even if they don’t meet Ohio’s QTIP requirements in R.C. 5731.15(B). R.C. 5731.15(A) has language