

Taking Full Advantage of the Ohio Marital Deductions

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I. Comparison of Federal and Ohio Law

A. I.R.C. § 2056 (see Appendix A for complete text)

2056(c): The federal marital deduction is generally available for bequests, devises, inheritances, survivorship interests, life insurance proceeds, exercise of power of appointment in favor of spouse.

2056(b): “Limitation in the case of Life Estate or Other Terminable Interest”: Life estates for surviving spouse do not qualify for marital deduction, with three exceptions:

1. Life estate with general power of appointment in surviving spouse (lifetime or testamentary). § 2056(b)(5)

NOTE: General POA will result in taxation in surviving spouse’s estate under § 2042.

2. QTIP (Qualified Terminable Interest Property) for which an election is made. § 2056(b)(7)

Requirements:

- The surviving spouse is entitled to all income, payable at least annually;
- No person (including the surviving spouse) has a power to appoint any part of the property to anyone other than the surviving spouse while the spouse is alive.
- An irrevocable election to treat the property as QTIP is made on the estate tax return.
- The surviving spouse has the right to require the trustee to reinvest unproductive assets in productive assets.

NOTE: QTIP election will result in taxation in the surviving spouse’s estate under § 2044.

3. A charitable remainder unitrust or annuity trust where the surviving spouse is the only beneficiary that is not a charity or an ESOP. § 2056(b)(8).

B. O.R.C. § 5731.15 (see Appendix B for complete text)

§ 5731.15(A)(1) – (6) list interests which qualify for the Ohio marital deduction: bequests, devises, inheritances, dower, survivorship interests, exercise of power of appointment in favor of spouse.

§ 5731.15(B)(1)–(3) contain Ohio’s QTIP election (with corresponding inclusion in surviving spouse’s estate under O.R.C. § 5731.131 (A)(4).)

CRITICAL POINT: The O.R.C. does not have a section that limits the deduction in the case of a “life estate or other terminable interest,” as is the case under I.R.C. § 2056(b). Furthermore, although the statutory language is not precise, the O.R.C. would seem to allow a deduction for a pure income interest that is left to a spouse. Indeed, “any interest in property” that passes to the spouse qualifies, so long as it meets one or more of the criteria listed in paragraphs (1) – (6) of subsection (A) of § 5731.15. It is the position of the Ohio Department of Taxation that paragraphs (1) and (4) allow for a marital deduction for a pure income interest in a surviving spouse. These paragraphs read as follows:

(A) (1): The interest was bequeathed or devised to the surviving spouse in the will of the decedent;

(A) (4): The decedent transferred the interest to the surviving spouse at any time.

RESULT: For a trust that leaves a life estate to the surviving spouse only (i.e. a lifetime income interest, without the possibility of any other person receiving income or principal during the life of the surviving spouse), the trustee can employ one of two Ohio marital deductions, or a combination of both:

- The Ohio Life Estate Marital Deduction (“LEMD”) (O.R.C. § 5731.15(A)(1) and (4)) for the present value of the surviving spouse’s life estate.
- The Ohio QTIP Election (O.R.C. § 5731.15(B)), as to any portion of the interest for which an election is made.

See Marc R. Friedman, Esq. (Legal Counsel, Estate Tax Division, Ohio Department of Taxation), “Ohio Department of Taxation Position on QTIP-Friendly Trusts,” 12 Probate Law Journal of Ohio 37 (Jan./Feb. 2002) (see Appendix C).

II. Examples and Implementation

A. The Basic Concept

1. EXAMPLE: \$100,000 Trust, with life estate in surviving spouse, remainder to others (and which would otherwise qualify for the Ohio Qualified Terminable Interest Property election (i.e. a “QTIP-Friendly Trust”). Note that a sprinkle trust will not qualify. A QTIP-Friendly trust has two legal components, each of which can be valued.

- a. Life Estate

Valuation requires:

- i. Interest Rate: Use I.R.C. § 7520 rate in effect on date of death. January 2006 Rate: 5.4%. (One source for finding these rates is www.tigertables.com/7520.htm).
- ii. Age of surviving spouse to nearer birthday.
- iii. Life Estate Factor. Use Table S to find the Life Estate Factor. (Table S is found in I.R.S. Publication 1457 and in Treas. Reg. § 20.2031-7(d)(7). It is also accessible at www.irs.gov » “Forms and Publications” » “Publication Number.”) (See Appendix D for a part of the table.)

Assuming a 75 year old surviving spouse and a 5.4% interest rate, the Life Estate Factor is .40537. The value of the life estate of a \$100,000 Trust is:

$$.40537 \times \$100,000 = \$40,537.$$

- b. Remainder Interest.

The value of the remainder interest of a \$100,000 trust (under the above assumptions) is the Remainder Factor from Table S (.59463) multiplied by \$100,000:

$$.59463 \times \$100,000 = \$59,463.$$

or

| | |
|-----------|-------------|
| \$100,000 | Principal |
| (40,537) | Life Estate |
| 59,463 | Remainder |

2. Applying Ohio law, as interpreted and implemented by the Department of Taxation:

\$40,537 is deductible under the Life Estate Marital Deduction

\$59,463 is eligible for a QTIP election.

B. Application to Estate Planning and Administration Context.

1. In the A/B Trust scenario, assume a \$2,000,000 Family (B) Trust funded entirely with Ohio property, a Section 7520 Rate of 5.4%, and a 75 year-old surviving spouse.

NOTE Federal Tax Law: The \$2,000,000 trust principal is exempt from estate tax at death of first spouse pursuant to the federal estate tax exemption, and the value of the trust at the death of the surviving spouse will not be includible in his or her estate.

If the trust qualifies for the Ohio LEMD (i.e. it's "QTIP-Friendly"), then take advantage of Ohio law on the Estate Tax Return as follows.

| | |
|-------------|--|
| \$2,000,000 | Principal |
| (338,333) | Ohio Exemption Equivalent (to estate tax credit of \$13,900 under O.R.C. § 5731.02(B)) |
| (810,740) | Life Estate Marital Deduction = .40537 x \$2,000,000 (Schedule M, part I) |
| <hr/> | |
| \$ 850,927 | QTIP Election (Schedule M, part II) |

Upon the death of the surviving spouse, 42.55% of the value of the trust (\$850,927/\$2,000,000) will be included on his or her Ohio Estate Tax Return. If the LEMD had not been employed at the first death and if only the QTIP election had been used, then 83.10% would be includible at second death.

If the Family Trust had not been QTIP-Friendly (e.g. a sprinkle trust), then all but \$338,333 of the \$2,000,000 would have been taxable at first death, resulting in a tax of \$114,700.

2. If the A Trust side of the A/B Trust is QTIP-friendly, then we can again apply the LEMD for Ohio purposes. (This will result in a second LEMD on the same Estate Tax Return.)

NOTE Federal Tax Law: if a federal QTIP election is made for the entire Marital Trust, then the entire \$1,000,000 will qualify for the marital deduction, resulting in no tax. At the death of the surviving spouse, however, the entire value at that time will be includible in his or her estate.

Ohio result:

Assume a \$1,000,000 QTIP-Friendly Marital Trust, a 5.4% § 7520 Rate, and 75 year-old surviving spouse.

| | |
|-------------|-----------------------------|
| \$1,000,000 | Principal |
| (405,370) | LEMD = .40537 x \$1,000,000 |
| _____ | (Schedule M, Part I) |

594,630 QTIP Election (Schedule M, Part II)

Upon the death of the surviving spouse, 59.46% of the value of the trust will be includible in his or her estate for Ohio purposes (\$594,630/\$1,000,000).

3. Another A/B Trust scenario: Assume a \$2,000,000 QTIP-Friendly Family Trust funded partially with property that is exempt from Ohio estate tax (and continue to assume a 5.4% § 7520 Rate and a 75 year-old surviving spouse).

NOTE: Certain 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) – are not part of the Ohio gross estate. The Estate Tax Division of the Ohio Department of Taxation 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.

Assets not includible in Ohio gross estate:

| | |
|--------------------------|------------------|
| Florida Real Estate | \$500,000 |
| Life insurance proceeds: | <u>\$250,000</u> |
| | \$750,000 |

Under the authority of R.C. 1339.67(A) (Consolidation and Division of Trusts) and the Trustee’s allocation powers as set forth in the Trust, the Trustee divides the Family Trust into two sub trusts – an Ohio Exempt Family Trust comprised of the \$750,000 of assets that are not included in the Ohio estate, and an Ohio Partially Exempt Family Trust comprised of the other \$1,250,000 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 below.

| | |
|-------------------------------|-------------------|
| Total B Trust Allocation | \$2,000,000 |
| Ohio Exempt B Trust | <u>(750,000)</u> |
| Ohio Partially Exempt B Trust | \$1,250,000 |

| | |
|---|-------------------------------------|
| Ohio Estate Taxation of Partially Exempt B Trust: | |
| \$1,250,000 | Principal |
| (338,333) | Ohio Exemption Equivalent |
| (506,713) | LEMD = .40537 x \$1,250,000 |
| | (Schedule M, Part I) |
| <u>404,954</u> | QTIP Election (Schedule M, Part II) |

Upon the death of the surviving spouse, 32.4% of the Partially Exempt Family Trust will be includible in his or her Ohio gross estate (\$404,954/\$1,250,000).

4. Assume a \$1,000,000 Family Trust subject to Ohio tax, a higher § 7520 Rate (6.0%) and a younger surviving spouse (age 59).

| | |
|-------------------|--|
| \$1,000,000 | Principal |
| (662,320) | LEMD = .66232 Life Estate Factor x \$1,000,000 |
| <u>(337,680)</u> | Exclusion |
| 0 | |

Under this scenario, the entire value of the trust will be excluded from the surviving spouse's estate.

NOTE: The technique demonstrated in this outline is sometimes referred to as "leveraging the exclusion amount." See, James K. Leonard, Esq., "The Leverage Exclusion Amount: Still the Best Way to Reduce Ohio Estate Taxes for Married Client." (See Appendix C)

C. "Don't Worry, Be Happy."

What if a fiduciary has already filed a return on the death of the first spouse and has QTIP'd the entire QTIP-friendly A or B Trust, or both? Under Ohio law, the QTIP election is irrevocable once made. O.R.C. § 5731.15(B)(2). What result?

The position of the Ohio Department of Taxation is to allow an amended return to claim a LEMD on the QTIP-friendly trust. The Department reasons that the QTIP election is not being revoked. The fiduciary is simply changing the percentage or the amount. The tax liability is not changing. (If the LEMD would have consumed the entire A or B trust, then retain at least \$1 of QTIP election for such trust).

What about the statute of limitations on refunds (3 years, 9 months after date of death) under O.R.C. § 5731.28? Not a problem, because the amended return is not claiming a refund.

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APPENDICES

- A. I.R.C. § 2056
- B. O.R.C. § 5731.15
- C. Marc R. Friedman, Esq., “Ohio Department of Taxation Position on QTIP-Friendly Trusts,” 12 Probate Law Journal of Ohio 37 (Jan./Feb. 2002). James K. Leonard, Esq., “The Leveraged Exclusion Amount: Still the Best Way to Reduce Ohio Estate Taxes for Married Client,” 14 Probate Law Journal of Ohio 5 (Sept./Oct. 2003). Reprinted with permission of West Group.
- D. Part of Table S, I.R.S. Publication 1457