PLANNING FOR KANSAS DEATH TAXES IN 2003: A "NOTICE-ABLE" DIFFERENCE

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Introduction

The 2002 Kansas legislature failed to pass legislation proposed by the Estate Tax Advisory Committee to the Kansas Judicial Council which would have conformed the Kansas Estate Tax Act[1] with the 2001 Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"). Instead, the 2002 Kansas legislature enacted an ill-conceived "inheritance tax." The failure to conform the Kansas estate tax to current Federal law affects decedents dying on or after January 1, 2002 (the effective date of the estate tax provisions under EGTRRA). The enactment of a new "inheritance tax" affected decedents dying on or after June 6, 2002.

In reaction to these developments, the Real Property, Probate and Trust Section of the Kansas Bar Association formed an "ad hoc" committee consisting of Martin Dickinson, Terry Fry, Nancy Roush, Tim O'Sullivan, and Jim Weisgerber (of the Kansas Department of Revenue) to formulate a death tax proposal for introduction in the 2003 Kansas legislative session. The resultant proposal, approved by the Kansas Bar Association and supported by the Kansas Society of Certified Public Accountants, consisted of a "stand alone" Kansas estate tax which would be revenue neutral, *i.e.*, it would raise the same amount of estate tax as under the Act (approximately $40 million/year). Although the proposal totally "decoupled" the determination of Kansas estate taxes from Federal law, it nonetheless incorporated most of the current Federal estate tax concepts in determining the value of the gross estate and allowable deductions in arriving at the taxable estate. The proposal anticipated a filing threshold of approximately $700,000 (the filing threshold in 2002 under the Act), but left it to the legislature to determine the specific filing threshold and marginal estate tax brackets. The proposal also called for the retroactive repeal of the newly

[1] Imposing a "pick-up" tax equal to the amount of the state death tax credit provided by Federal law under which the "applicable exclusion amount" (*i.e.*, the amount not subject to Federal estate tax due to application of the unified credit amount) and the state death tax credit are statutorily tied to 1997 Federal law, with the substantially increased estate tax applicable exclusion amounts enacted at the Federal level O'Sullivan and Weaver, 2002 Kansas Death Tax Legislation: An Emperor in Need of Clothes, *The Journal of the Kansas Bar Association*, November/December 2002.

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enacted Kansas "inheritance tax," which the Committee concluded was poorly drafted, virtually unworkable and in large measure, unenforceable.[2]

Although the 2003 Kansas legislature conceded that the Kansas "inheritance tax" should be repealed (repealing it retroactively under provisions of Senate Bill 94), it did not enact the "stand alone" Kansas estate tax proposal (Senate Bill 148). This latter failure continued the problematic dichotomy in which EGTRRA determines the taxable estate and filing threshold for Federal estate tax purposes, while its 1997 predecessor law determines the filing threshold, taxable estate and state death tax credit for Kansas estate tax purposes.

This article addresses the substantive problems presented by this continuing Federal and Kansas estate tax disharmony. Additionally, the authors discuss a recent Kansas Department of Revenue Notice promulgated after the close of the 2003 legislative session. That Notice clarifies in favor of taxpayers most of the statutory ambiguities latent in this nonconformity. Finally, the authors outline strategies for reducing Kansas estate taxation and drafting strategies for married clients which provide maximum flexibility in minimizing both Federal and Kansas estate taxation in a shifting death tax environment.

Genesis and Nature of Nonconformity Problem

In 1998, the Kansas legislature enacted legislation, proposed and supported by the Kansas Bar Association, repealing the Kansas Inheritance Tax Act. In its place was enacted the Kansas Estate Tax Act ("the Act"), found at K.S.A. 79-15,100 et seq., discarding taxation based upon relationship to the decedent but preserving from the Kansas Inheritance Tax Act a Kansas death tax equal to the amount of the state death tax credit permitted under Section 2011 of the Internal Revenue Code ("the Code"). The Act specifically provides that the state death tax credit is to be

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[2] The myriad systemic statutory and practical problems associated with the "inheritance tax" were discussed by the authors in a prior Journal article. O'Sullivan and Weaver, 2002 Kansas Death Tax Legislation: An Emperor in Need of Clothes, *The Journal of the Kansas Bar Association*, November/December 2002 at pg. 19.

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determined under provisions of the Code as of December 31, 1997 ("prior Federal law"). The Federal state death tax credit is limited both by the scheduled amount under Section 2011 (based upon the value of the "adjusted taxable estate" as defined therein) and the actual Federal estate tax liability. As a result, states such as Kansas which imposed a death tax equal to the amount of the state death tax credit did not increase the total death tax liability of an estate. Amounts equal to the available credit simply were payable to the state, rather than to the Federal government.

Congress intended this revenue sharing/death tax neutral aspect of the state death tax credit when it was enacted in 1924. Predictably, all states chose to impose an estate tax at least equal to the amount of the Federal state death tax credit. This estate tax is often referred to as the "pick-up" tax due to states having "picked up" the amount of such credit as a base estate tax liability.[3]

The death tax neutral aspect of the "pick-up" tax ended for Kansas decedents dying after December 31, 2002. EGTRRA provides for estate tax applicable exclusion amounts for decedents dying on or after January 1, 2002, substantially in excess of those under prior Federal law. However, because provisions of the Act require it to be interpreted under Federal law as in effect December 31, 1997, the lower applicable exclusion amounts under such prior Federal law remain applicable in determining Kansas estate taxes under the Act. In drafting the Act, the Kansas Revisor of Statutes Office did not "float" the amount of the "pick-up" tax with any subsequent change under Federal law. The Revisor no doubt concluded that the "float" alternative would violate the Kansas Constitution by impermissibly delegating Kansas legislative authority to the Federal government.[4]

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[3] A substantial majority of states, including Kansas, had also imposed a separate inheritance or estate tax in addition to the "pick-up" tax. However, prior to recent budget shortfalls a substantial percentage of states over the past two decades repealed their separate estate or inheritance taxes.

[4] Article 2, §1 of the Kansas Constitution vests legislative authority for the State of Kansas in the House of Representatives and the Senate. Any delegation of authority by the Legislature that is legislative in nature is unconstitutional. A delegation of authority is legislative in nature if it vests the delegate with discretion to make decisions that will change existing state law. *See Von Ruden v.*

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EGTRRA provides for a $1.0 million applicable exclusion amount for decedents dying on or after January 1, 2002, with further scheduled increases to $1.5 million for decedents dying in 2004 and 2005, $2.0 million for decedents dying in 2006 through 2008, $3.5 million for decedents dying in 2009, a one year repeal for decedents dying in 2010, and a reversion to prior Federal law for decedents dying in all subsequent years (*i.e.*, a $1.0 million applicable exclusion amount). Thus, until 2011 when the applicable exclusion amounts under prior Federal law and EGTRRA are scheduled to be identical, taxable estates in excess of the applicable exclusion amount under prior Federal law ($700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005 and $1.0 million in 2006 and subsequent years) will nonetheless remain liable for the "pick-up" tax assessed under the Act, irrespective of whether there is sufficient Federal estate tax liability under EGTRRA against which the "pick-up" tax may be credited.

The position of the Kansas Department of Revenue (the "Department") is consistent with this analysis. On June 27, 2002, the Department issued Notice 02-01.[5] The Notice states that "under current law, the Kansas estate tax will not be affected by the recent changes to Federal law."[6] Therefore, assuming no prior taxable gifts, a $1.0 million taxable estate of a decedent dying in 2002 or 2003 would have no Federal estate tax liability. However, it would be liable for the Kansas "pick-up" tax in the amount of $33,200.[7] This represents an approximate 11% Kansas "pick-up" tax rate on the $300,000 difference between the $700,000 applicable exclusion amount

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Miller, 231 Kan. 1, 13 (1982). Thus, a provision tying Kansas law to a Federal statute subject to amendment by the United States Congress could be construed as an unconstitutional grant of legislative authority to the United States Congress because the future exercise of Congressional discretion could alter existing state law.

[5] Kansas Department of Revenue Office of Policy & Research, Notice 02-01, *Recent Changes in the Taxation of Estates of Decedents Dying on or After January 2, 2002* (June 26, 2002) (as modified July 1, 2002).

[6] There is an error in the Department's Notice which should be noted. The Notice states that the nonconformity issue arises with respect to decedents dying on or after January 2, 2002, whereas the correct date is January 1, 2002, the effective date of the increased applicable exclusion amount under EGTRRA.

[7] The sum of $33,200 equals the applicable state death tax credit on a $1.0 million taxable estate under prior Federal law.

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under prior Federal law and the $1.0 million applicable exclusion amount under EGTRRA. The amount of "pick-up" tax caused by the Act's nonconformity with current Federal law increases dramatically in subsequent years due to the increasing disparity between the scheduled Federal applicable exclusion amount increases under EGTRRA and those under prior Federal law. For example, the $64,400 "pick-up" tax liability for a decedent dying in 2004 is almost double that of a decedent dying in 2003 and an approximate 10% Kansas "pick-up" tax rate on the difference between the $1.5 million EGTRRA applicable exclusion amount and the $850,000 applicable exclusion amount under prior Federal law.

In addition to lower applicable exclusion amounts, determining the "pick-up" tax under prior Federal law creates other problems and inequities. First, the state death tax credit is predicated both upon the amount of the "adjusted taxable estate" (which in turn determines the available state death tax credit) and the actual Federal estate tax liability (which "caps" the amount of such credit). Consequently, practitioners and the Department must apply tax principles under prior Federal law irrespective of whether those principles have been modified or rendered moot through subsequent Federal legislative or regulatory action.

Secondly, it creates the issue of whether such tax elections as the Qualified Terminable Interest Property (or "QTIP") and special use valuation elections can be made under the Act in circumstances where no Federal estate tax return is filed or where an inconsistent election is made on the Federal return in circumstances where both Federal and state returns are filed.

Third, it creates a patent inequity in marginal Kansas estate tax brackets. The state death tax credit was enacted when the Federal estate tax exemption was $60,000. Consequently, the "adjusted taxable estate" is defined as the taxable estate (net amount prior to tax of a decedent's estate for Federal estate tax purposes, exclusive of prior "adjusted taxable gifts"), less $60,000 (the

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threshold at which estate tax was then imposed). As a result, the amount of the available state death tax credit at the threshold of the applicable exclusion amount of $700,000 in 2002 and 2003 under prior Federal law is quite sizable ($18,000 based upon an adjusted taxable estate of $640,000). For adjusted taxable estates in excess of $640,000, the state death tax credit commences at a low bracket of 4.8% for the next $200,000, gradually increasing to 16% for adjusted taxable estates in excess of $10,040,000. Because the Act presumes that estates are subject to Federal estate tax (and thus eligible for the state death tax credit) for each dollar over the applicable exclusion amount under prior Federal law, Kansas estate tax is imposed at a 37% rate (the marginal Federal estate tax bracket under the unified schedule) for taxable estates between $700,000 and $750,000 and 39% for estates between $750,000 and $1,000,000 until the excess available state death tax credit at the filing threshold (plus the 4.8% applicable "pick-up" tax rate on the excess over the filing threshold) is fully utilized. Only at that "cross-over" point (approximately $760,000) does the "pick-up" tax rate drop back to the otherwise applicable 4.8% rate.

Fourth, it requires all prior "adjusted taxable gifts" of a decedent to be determined. "Adjusted taxable gifts" are non-exempt gifts (*i.e.*, not for certain medical and educational expenses exempt under Section 2503(e) of the Code), which are not deductible (*i.e.*, not qualifying for the marital or charitable gift tax deduction), and which are in excess of any applicable annual gift tax exclusion under Section 2503(b). Taxable gifts made prior to death reduce both the "adjusted taxable estate" (and thus the amount of the available state death tax credit based on assets includible in the taxable estate) and the amount of available unified credit remaining at death for estate tax purposes (and thus the size of the estate which is subject to Federal estate tax under prior Federal law and which is required to file under the Act). This injects additional

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complexity into Kansas death tax computations. Normally, with a "stand alone" state estate or inheritance tax, the consideration of prior gifts is limited to a relatively short period prior to death, e.g., one year of death under provisions of the former Kansas Inheritance Tax Act. Although this computation doesn't increase the amount of the state death tax credit (which does not consider prior "adjusted taxable gifts"), it can result in an increase in the amount of Federal estate tax under prior law which is a "cap" on the amount of the state death tax credit (the "pick-up" tax).

In addition to the nonconformity in the filing threshold related to the applicable exclusion amounts under current Federal law and the Act, prior Federal law also fails to consider the phase out of the credit for state death taxes enacted under EGTRRA (25% reduction for decedents dying in 2002, a 50% reduction in 2003, a 75% reduction in 2004, and no credit in 2005 and subsequent years when the credit switches to a deduction for state death taxes paid).[8] Thus, the "pick- up" tax is based upon the state death tax credit under prior Federal law, notwithstanding its phase out at the Federal level. As a result of the total phase out of the state death tax credit, the erstwhile death tax neutrality feature of the "pick-up" tax will no longer be applicable for decedents dying after December 31, 2004, under any circumstance in which any state death tax is imposed.[9]

Anemic 2003 Kansas Legislative Response

As noted in the introduction, the 2003 Kansas legislature failed to pass the "stand alone" estate tax proposal which would have rectified the foregoing problems. This failure no doubt resulted at least in part from a lack of understanding of this complex problem by many legislators. Other legislators who grasped the nature of the problem perhaps determined that the most expedient political track was simply to do nothing, particularly as certain lobbying groups had

[8] *See* I.R.C. §§ 2011(b)(2), 2011(f), 2058.

[9] Ironically, because the Federal estate tax brackets will be in a narrow range of 45% to 47% in 2005 when the state death tax credit changes to a deduction, the economic benefit of the deduction in 2005 and subsequent years will significantly exceed the 25% of the state death tax credit applicable in 2004.

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raised objections to the proposal ranging from its omission of some estate tax benefits under Federal law[10] to a fear that the enactment of the proposal would either be perceived by the electorate to be a "new tax" or somehow make it easier for the legislature to pass future estate tax increases.

In an attempt to at least mirror state filing thresholds with those at the Federal law on a delayed basis, a provision was added to Senate Bill 94 (which repealed the 2003 "inheritance tax") conforming the Kansas estate tax filing threshold for decedents dying on or after January 1, 2007 to the filing threshold under applicable Federal law as of December 31, 2002. As a result, the filing thresholds for decedents dying on or after that date are scheduled to be in conformity with EGTRRA ($2,000,000 in 2007 and 2008, $3,500,000 in 2009, a total exemption in 2010, and $1,000,000 in subsequent years). However, this provision was given insufficient consideration prior to passage. Although the filing threshold for decedents dying on or after January 1, 2007, is tied to the filing threshold under current Federal law, no other provision of the Act was amended. Consequently, the determination of the amount of the Kansas estate tax remains tied to prior Federal law. Thus, a gross estate of a decedent dying on January 1, 2007, with a value of the minimum amount which would require the filing of a return ($2.0 million assuming no prior adjusted taxable gifts) would have Kansas estate tax imposed upon the value of the taxable estate in excess of $1.0 million (the applicable exclusion amount under prior Federal law), while an estate barely under the filing threshold would not be required to file irrespective of how much the taxable estate exceeded the applicable exclusion amount under prior Federal law. This provision creates a patent inequity and raises the constitutional specter of equal protection issues.

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[10] Such as special use value and conservation easements which were not included in the proposal due to their complexity and limited benefit at low marginal Kansas estate tax brackets.

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Legislators were informed during the 2003 session that retaining the current Kansas estate tax provisions without amendment would severely limit the Department's ability to enforce the Act. Absent the addition of enforcement provisions, reliance on its enforcement would continue to be based primarily upon Federal estate tax return audits, as the state death tax credit is only available on a Federal estate tax return with respect to death taxes actually paid to the state. However, with the substantially increasing applicable exclusion amounts and filing thresholds under EGTRRA, a substantial percentage of estates owing Kansas estate tax will no longer be required to file Federal estate tax returns. Thus, the legislature deemed it advisable to add enforcement and procedural provisions to Senate Bill 94 which were in Senate Bill 148 (the "stand alone" estate tax proposal).[11]

Techniques to Reduce the Kansas Estate Tax

A simple technique to reduce Kansas estate tax liability is to make gifts. Gifts made prior to death which are not includible in the taxable estate under Section 2035 of the Internal Revenue Code reduce the amount of the "pick-up" tax in circumstances where Kansas estate tax would otherwise be owing in the absence of such gifts. Due to amendments made under the Economic Recovery Tax Act of 1981 (ERTA), other than gifts of life insurance policies on the life of the donor and transfers of taxable retained interests in property (e.g., a life estate in which the remainder interest in the property had been previously transferred), most gifts are not subject to the three year "gift in contemplation of death" provisions of Section 2035 of the Code. As noted above, the state death tax credit determined under Section 2011(b) is based upon the "adjusted

[11] Among these enforcement and procedural provisions are criminal penalties for fraudulent returns, personal liability of the personal representative for non-payment of the tax limited to amounts in the estate available to pay the tax, the concept of a "deemed executor" (basically a party succeeding to property of the decedent) responsible for filing the return and remitting the tax if there is no appointed Executor or Administrator, transferee liability, tax liens (in circumstances where the Director has reason to believe property subject to the tax is to be sold or transferred out of state in a manner which would frustrate collection of the tax), interest (1% per month up to 24%) on unpaid tax, and penalties (25% for failure to reasonably attempt to comply, 50% plus interest for failure to file within 20 days of notice from the Director) waivable by the Director for reasonable cause.

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taxable estate," defined in Section 2011(b)(3) as the "taxable estate" less $60,000 (the estate tax exemption prior to the rate structure being unified). Consequently, as prior adjusted taxable gifts which are not includible in the taxable estate are not considered in determining the available state death tax credit, the "pick-up" tax is reduced by both exempt and taxable gifts which are not includible in the taxable estate.[12]

However, any Kansas death tax savings resulting from gifts would normally be at low marginal estate tax brackets.[13] Moreover, if appreciated property is the subject of a gift, the loss of the "step up" in income tax basis due to the property not being included in the donor's taxable estate would result in s high percentage of situations in an income tax detriment in excess of any Kansas estate tax savings resulting from the gift. A clear exception would be exempt gifts or gifts within the annual gift tax exclusion which would otherwise have been taxable at the high marginal Kansas estate tax rate noted above with respect to limited amounts just in excess of the filing threshold under the Act.

Valuation reduction techniques such a Family Limited Partnerships (FLPs) also can be employed to reduce the size of the taxable estate and thus exposure to Kansas estate taxation. However, given the low marginal estate tax brackets under the Act, unless there is a benefit in using these techniques to also reduce Federal estate taxation, the cost of these techniques and the possible lower income tax basis following death with respect to gifted property would normally be expected to render these techniques of limited utility in reducing Kansas estate taxes.

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[12] Under the unified gift and estate tax structure enacted under the Tax Reform Act of 1976, prior adjusted taxable gifts are considered in determining the amount of Federal estate tax.

[13] For example, the marginal rate is 4.8% for adjusted taxable estates between $640,000 and $840,000 (equivalent to taxable estates between $700,000 and $900,000).

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Modifying Marital Deduction Formula Clauses

In addition to the use of "bypass" trusts for married individuals which have the capability of fully utilizing the applicable exclusion amount of both spouses, further reduction in Kansas estate taxes may be obtained by modifying marital deduction formula clauses in testamentary instruments.[14] Depending upon the precise language of the formula clause, and assuming no prior taxable gifts were made which would reduce the applicable exclusion amount, existing formula clauses would fund the "bypass" share in the estate of a married decedent dying in 2003 with either the sum of $700,000 (if such clause minimizes exposure to both Federal estate tax and Kansas death taxes) or $1.0 million (if the formula clause is designed solely to minimize exposure to Federal estate tax). Because such formula clauses are typically designed to take full advantage of the applicable exclusion amount for Federal estate tax purposes, it would be expected that a substantial majority of existing formula clauses literally fall, or would be judicially interpreted to fall, in the latter category. That is, most existing formula clauses are not drafted to address the unanticipated nonconformity problem of there being a "pick-up" tax liability on amounts not subject to a Federal estate tax liability. Thus, there is potential exposure to Kansas estate tax liability with respect to such formula clauses on the "gap amount" representing the difference between the applicable exclusion amount under prior Federal law and the greater applicable exclusion amount under current Federal law funding the "bypass" share.

Thus, consideration should be given in this period of Federal and state death tax nonconformity to revising marital deduction formula clauses to fund the "bypass" amount with the amount minimizing both Federal estate tax and Kansas "pick-up" tax. For example, the formula clause could provide for either (1) an increase in the marital amount by the minimum amount

[14] These formula clauses are designed to divide the estate in marital deduction and "bypass" (or "applicable exclusion amount") shares for estate tax purposes.

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necessary to avoid Kansas estate taxes with respect to marital deduction bequests (in situations where the "bypass" share is the residuary bequest) or (2) a reduction in the "bypass" share amount by the minimum amount necessary to avoid Kansas estate taxes with respect to "bypass" share bequests (in situations where the marital deduction share is the residuary bequest).[15] The authors refer to this provision as a "cutback" clause, as it "cuts back" the otherwise applicable amount funding the "bypass" share to that minimum amount necessary to avoid imposition of the Kansas estate tax under the Act. By its terms, it would only be operative in circumstances where full funding of the current applicable Federal applicable exclusion amount would result in the imposition of a Kansas estate tax.

This type of modified formula clause would be of particular consideration in estates where any resulting increase in the marital deduction share necessary to avoid Kansas estate tax would be unlikely to increase the surviving spouse's Federal estate tax liability after considering the anticipated size of the surviving spouse's taxable estate in relation to scheduled future increases in the applicable exclusion amounts under EGTRRA.

Should Formula Clauses for Kansas Estate Tax Purposes be Interpreted Under 1997 Federal Law?

The foregoing modified formula clause strategy would be unnecessary if existing formula clauses funding the "bypass" share would be interpreted by the Department under prior Federal law (*i.e.*, the law of December 31, 1997) for "pick-up" tax purposes. Under prior Federal law, such formula clause would fund the "bypass" amount with the then applicable exclusion amount, irrespective of whether the marital share was the specific bequest or the recipient of the residue following satisfaction of the "bypass" share bequest.

[15] Thus, a formula clause would be modified to provide under a "notwithstanding" provision that the formula normally utilized to eliminate federal estate taxes would be further adjusted to eliminate the "gap amount" problem.

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The authors suggested in a prior Journal article[16] that there is at least an arguable position that as the Kansas estate tax is determined by the state death tax credit under prior Federal law, formula clauses should similarly be interpreted under prior Federal law. An interpretation of the formula clause which considered subsequent Federal estate tax changes arguably would constitute an unconstitutional delegation of authority to the Federal government. Notice 02-01 provides that "By statute, Kansas has incorporated by reference Federal law as it existed on December 31, 1997." If the Department or the Courts adopted a position that Kansas already has essentially "decoupled" in all respects from current Federal law by enacting a "stand alone" estate tax (*i.e.*, the "pick-up tax" under 1997 Federal law), consistency would offer some support for this position. Such interpretation would permit the funding of the "bypass" share with the full applicable exclusion amount under current Federal law without incurring a Kansas estate tax liability on any excess of this amount over the applicable exclusion amount under prior Federal law (the "gap amount"). Under this interpretation, practitioners would have no need to employ the strategy discussed below of dividing the QTIP trust and making inconsistent Federal and state QTIP elections in order to achieve the same substantive result.[17]

Adoption of a modified formula clause including a "cutback" clause (guarding against the interpretation of the formula clause under current Federal law) would avoid the imposition of a Kansas estate tax on the "gap amount" irrespective of the interpretation given marital deduction formula clauses. However, administrative difficulties as to the amounts actually funding the "bypass" and marital shares would be present absent a "taxpayer friendly" interpretation by the

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[16] Supra, fn. 1.

[17] There is a cogent contrary rationale that will and trust law is dispositive as to the amount funding the "bypass" share, with the Act determining the resulting Kansas estate tax consequence. Viewed from that perspective, no impermissible delegation has occurred. In the event such contrary position legally prevailed, the modified formula clause strategy suggested above would avoid the imposition of any Kansas estate tax by automatically "cutting back" the amount funding the "bypass" share to the applicable exclusion amount under prior Federal law.

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courts or the Department that formula clauses are to be read under prior Federal law. In such absence, there would be the issue of whether the "bypass" share is to be fully funded with the current Federal applicable exclusion amount (due to the formula clause being interpreted under 1997 Federal law irrespective of the amount actually funding the "bypass" share, thus rendering the "cutback" clause inoperative) or, alternatively, only with the 1997 applicable exclusion amount (due to the formula clause being interpreted for Kansas estate tax purposes under current Federal law with respect to the amount actually funding the "bypass" share, thereby activating the cutback clause to avoid the imposition of Kansas estate tax).

Following the close of the 2003 Kansas legislative session on June 20, 2003, the Department issued Notice 03-08.[18] This notice, more fully discussed below, principally posited a formal "decoupling" of Kansas estate taxes from the current Federal estate tax system. As a result, taxpayers will no longer be required to make consistent tax elections between the Federal and Kansas estate tax returns with respect to a decedent dying on or after May 22, 2003 (the "sine die" date of the 2003 Kansas legislature). Although not specifically addressing marital deduction formula clauses, the authors have confirmed with a Department official that the Department will interpret marital deduction formula clauses under prior Federal law, irrespective of the amount of assets actually funding the "bypass" share. It is anticipated that future notices or pronouncements of the Department will formally confirm this position.

While this position would appear to remove the need to modify formula clauses to include a "cutback" clause, it has not been yet adopted through a formal announcement. Even if such a taxpayer friendly position is taken by the Department, the Department could change its position. Moreover, the legislature is free to subsequently enact a "stand alone" estate tax, rendering such

[18] Kansas Department of Revenue Office of Policy & Research, Notice 03-08, *Implications of 2003 Session HB2005 for the Kansas Estate (Pick-Up) Tax* (June 20, 2003).

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an interpretation moot. Thus, it may be advisable nonetheless to include a "cutback" clause in conjunction with one of the other techniques discussed below to provide post-mortem flexibility in dealing with any such eventuality.

Under this favorable interpretation by the Department, the estate of the first spouse should achieve the benefit of the current applicable exclusion amount under Federal law for Kansas estate tax purposes despite using a marital deduction formula clause that applies current Federal law for funding purposes. Such applicable exclusion amount, if placed in a properly drafted "bypass" trust or given directly to non-spousal beneficiaries, will not be includible in the surviving spouse's estate for Federal or Kansas estate tax purposes, irrespective of any subsequent appreciation. For practitioners utilizing a "cutback" clause, this interpretation would not trigger the "cutback" clause and therefore, would not reduce the amount funding the "bypass" share.

Approach if Single QTIP or "Bypass Trust" Qualifies as QTIP

Even had the Department not issued Notice 03-08 with its apparent taxpayer friendly interpretation of marital deduction formula clauses, no modification of the marital deduction formula clause would be required to avoid the imposition of Kansas estate tax on the death of the first spouse if either the "bypass trust" qualified for the marital deduction as "qualified terminable interest property" (or "QTIP") trust under Section 2056(b)(7) of the Code, or if all assets were left in a single QTIP trust (with no "bypass" share). A formula partial QTIP election could be made for Federal estate tax purposes under either approach to qualify that portion of the trust for the marital deduction to the extent necessary to also avoid the Kansas "pick-up" tax.[19]

However, drafting a "bypass trust" which qualifies as a QTIP trust or utilizing a single QTIP is normally less desirable than using a modified formula clause to avoid payment of the

[19] Treas. Reg. §20.2056(b)-7(h), Ex. 7.

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Kansas "pick-up" tax. QTIP trusts are required to pay all trust income to the surviving spouse, at least annually, and are not permitted to have any other beneficiaries during the surviving spouse's lifetime. On the other hand, a "bypass trust" not needing to qualify for the marital estate tax deduction may provide for discretionary distributions of income and principal to the surviving spouse, and include "sprinkle" provisions authorizing the distribution of income (and possibly principal) to the testator's (or settlor's) descendants or others. Moreover, even if the mandatory distributions of income in a "bypass trust" qualifying for QTIP treatment would not result in unnecessary additional estate taxation upon the surviving spouse's death, trust income required to be distributed to the surviving spouse would be subject to the potential claims of the surviving spouse's creditors or those of a subsequent spouse upon a remarriage. In addition, the flexibility provided by "sprinkle" provisions and the benefit in having trust income taxed at potentially lower income tax brackets of descendants receiving discretionary trust distributions would be lost.

Import of Notice 03-08

Consistent with the Department's administrative decision that the 2003 Kansas legislature's failure to enact a "stand alone" estate tax results in a total "decoupling" of Kansas estate tax from the current Federal estate tax, Notice 03-08 permits tax elections (such as a QTIP or "special use" election) for Kansas estate tax purposes with respect to decedents dying on or after May 22, 2003, irrespective of whether such elections are consistent with those made on any Federal estate tax return (Form 706) filed for the estate. Consequently, a QTIP election for Kansas estate tax purposes may include the "gap amount" even though no QTIP election was made on such amount on a Federal estate tax return.

As the effective date of the Notice is not based on any statutory provision, there appears to be no legal basis for the Department's inconsistency in the tax treatment of decedents dying before

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and after May 22, 2003. Thus, taxpayers dying prior to such date are likely to challenge this arbitrary treatment. Unless the Department concedes such challenges or all such challenges are otherwise settled out of court, a taxpayer victory on the disparity issue could be pyrrhic. If the Department prevails judicially on the merits as to pre-May 22, 2003 decedents (*i.e.*, formula elections are to be interpreted under current Federal law and elections not made at the Federal level are ineffective for Kansas estate tax purposes), favorable Kansas estate tax treatment otherwise accorded decedents dying on or after May 22, 2003 would be jeopardized. This possibility provides yet another reason to include modified formula clauses in otherwise appropriate situations.

Notice 03-08 provides taxpayers with the greatest possible flexibility in making estate tax elections at the Federal and state level. A formula election may be made with respect to a QTIP trust of that portion of the trust in excess of the current Federal applicable exclusion amount for Federal estate tax purposes and of that greater amount in excess of the applicable exclusion amount under prior Federal law for Kansas estate tax purposes, irrespective of whether a Federal estate tax return must be filed. Although the Department's position with respect to QTIP elections is to be commended as a pragmatic solution in making the Act workable under EGTRRA despite Kansas legislative inaction, it is likely to result in the preclusion of the "gap amount" (in addition to the applicable exclusion amount under prior Federal law) for which only a Kansas QTIP election was made in the surviving spouse's estate. This is because the inclusion of QTIP property in the surviving spouse's estate under the Act is predicated upon Federal law. Both current and prior Federal law under Section 2044 of the Internal Revenue Code provide that only QTIP property for which a QTIP election is made for Federal estate tax purposes is includible in the surviving spouse's estate. Consequently, the failure to make a QTIP election for Federal estate tax

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purposes on the predeceased spouse's death with respect to the "gap amount" should preclude its inclusion in the surviving spouse's estate for both Federal and Kansas estate tax purposes, notwithstanding a QTIP election having been made on such amount was made for Kansas estate tax purposes. However, as long as the Department interprets marital deduction formula clauses under prior Federal law, such a disparate formula election would be unnecessary, as the "bypass" share would be determined under prior Federal law under the Act, irrespective of the fact that the actual amount funding such "bypass" amount was determined under current Federal law.

Should Notice 03-08 be retracted by the Department or its underlying principles judicially invalidated (along with the Department's favorable interpretation of marital deduction formula clauses), a modified marital deduction formula clause would protect against any adverse Kansas estate tax consequence. If no significant adverse Federal estate tax consequence would be likely to result from excluding only the applicable exclusion amount under prior Federal law from the surviving spouse's taxable estate, "pick-up" tax liability would normally be avoided by making a full QTIP election. Alternatively, if it would be prudent to keep the full current applicable exclusion amount out of the surviving spouse's estate for Federal estate tax purposes despite the imposition of a "pick-up" tax on the "gap amount," no QTIP election would be made with respect to the "gap amount" funding the QTIP trust and a formula partial QTIP trust election would be made with respect to only that portion of the QTIP necessary to reduce the Federal estate tax liability to zero. The determination of whether to make a full or partial QTIP election would take into consideration that any "pick-up" tax incurred as a result of a partial election would be at a tax rate significantly less than the marginal Federal estate tax rate (approximately 11% between $700,000 (the applicable exclusion amount in 2003 under prior Federal law) and $1.0 million (the applicable exclusion amount in 2003 under current Federal law)), whereas a surviving spouse who

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is likely to have a taxable estate would have a marginal estate tax rate of at least 39% (the 2003 marginal Federal estate tax bracket).[20]

However, even assuming the surviving spouse would be subject to an estate tax, the appropriate strategy is not simply comparing the estate tax bracket of the predeceased spouse's estate with the anticipated estate tax bracket in the surviving spouse's estate. By deferring Federal estate tax at the death of the first spouse in conjunction with incorporation of proper provisions in the QTIP, the surviving spouse could implement appropriate estate planning techniques (e.g., gifting, family limited partnerships ("FLPs"), limited liability companies ("LLCs"), grantor retained annuity trusts ("GRATs"), private annuities, self-canceling installment notes ("SCINs") and qualified personal residence trusts ("QPRTs")) which would either exclude QTIP trust assets from the surviving spouse's estate or significantly reduce their value for Federal estate tax purposes.

Although the Service will ignore a QTIP election if no election is necessary to avoid Federal estate tax, it will not ignore a QTIP election if at least a partial QTIP election is necessary to avoid Federal estate tax.[21] Applying this principle, should Notice 03-08 at any time cease to be legally effective to permit inconsistent elections at the Federal and state levels and the Department no longer interpret marital deduction formula clauses under prior Federal law, a modified formula clause could be utilized in conjunction with an additional provision splitting the QTIP into two QTIP trusts. One QTIP trust would hold the "gap amount." The other QTIP trust would hold any remaining trust balance. An alternative method of accomplishing the same result would be to include a provision in the testamentary instrument authorizing the Trustee or Executor to divide

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[20] "Time value of money" concepts should not be a factor in that decision. Although deferring estate taxes permits the continued investment of the deferred tax, the surviving spouse's estate would incur a Federal estate tax not only on the deferred amount, but also on all income and appreciation on the deferred amount added to the marital deduction share.

[21] Rev. Proc. 2001-38, 2001-24 I.R.B. 1335; Priv. Ltr. Rul. 200219003 (February 5, 2002).

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the QTIP trust. In the absence of this type of provision in the testamentary instrument, Kansas statutory authority would have to be followed in making the division.[22]

Utilizing this "division of QTIP" approach, the fiduciary could then make a formula election to the extent necessary to avoid Federal estate tax, with such formula election by its terms specifically applying first to that portion of the QTIP not holding the "gap amount." This should avoid the "pick-up" tax and be honored for Kansas estate tax purposes, as the election was in fact necessary to avoid Federal estate tax under prior Federal law, yet not result in the inclusion of the "gap amount" in the surviving spouse's estate for Federal estate tax purposes, as the election was unnecessary to avoid Federal estate tax under current Federal law. However, the "gap amount" QTIP in that event could be includible in the surviving spouse's estate for Kansas estate tax purposes, as it would have been honored for Federal estate tax purposes (thereby causing inclusion in the surviving spouse's estate) under prior Federal law. In any event, this technique should permit the deferral of Kansas estate taxation on the "gap amount" at the death of the first spouse without causing the inclusion of the "gap amount" in the surviving spouse's estate for Federal estate tax purposes.

It is important to note that in the event that marital deduction formula clauses are not interpreted by the Department under prior Federal law, but the Department nonetheless permits inconsistent elections, the foregoing QTIP strategy is the only method which can maximize the benefit of the applicable exclusion amount under current Federal law for Kansas estate tax purposes. This benefit is in addition to the other benefits accorded QTIP trusts over outright spousal bequests, e.g., asset management, asset protection against creditor claims and claims of a spouse upon remarriage, "reverse QTIP elections" for generation skipping tax purposes and the

[22] *See* K.S.A. § 58a-417 (authorizing a trustee to divide a single trust into two or more trusts "if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust.")

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ability to take advantage of the estate tax credit for prior transfers (the "TPT" credit) discussed below.

Clayton Strategy

To provide additional flexibility, the provisions of a will or revocable trust may specify that any portion of the QTIP trust with respect to which a QTIP election is not made is to be added to the "bypass trust." This avoids the normally undesirable income and estate tax and asset exposure consequences resulting from mandatory income distributions to the surviving spouse from that portion of the QTIP trust for which a marital estate tax deduction was not elected.[23] This strategy is often referred to as the "Clayton strategy" after the decision in the Third Circuit which approved this technique over the Service's objection.

There are other considerations in determining whether the non-elected QTIP portion should remain a QTIP trust or instead fund a "bypass trust" under the "Clayton strategy." To provide the maximum flexibility, tax and asset protection benefits, it normally is not advisable to provide the surviving spouse with a mandatory income interest in the QTIP assets funding the "bypass trust" as a result of a non-election. Consequently, a non-election precludes the possibility of the surviving spouse's estate receiving the benefit of the credit for estate taxes on prior transfers (the "TPT" credit) under Section 2013 of the Internal Revenue Code should the surviving spouse predecease the due date of the estate tax return (9 months with a 6 month automatic extension to file). In that event, it normally would be desirable to elect only a portion of the QTIP trust for

[23] The consistent position of the Service since QTIP trusts were enacted under the Economic Recovery Tax Act of 1981 ("ERTA") was that the marital deduction would be lost if the provisions of the testamentary document provided that the portion of the QTIP trust with respect to which a QTIP election was not made on the estate tax return passed into a trust which did not also qualify as a QTIP. However, the Service was consistently unsuccessful in judicially defending this position, finally acquiescing in the decisions of three Circuits and the Tax Court holding the Service's regulatory position to be erroneous. *Estate of Clack v. Commissioner,* 106 T.C. 131 (1996), *acq.* 1996-2 C.B. 1; *see also Estate of Spencer v. Commissioner,* 43 F.3d 226 (6th Cir. 1995) *rev'g Estate of Spencer v. Commissioner,* T.C. Memo. 1992-579 (1992); *Estate of Robertson v. Commissioner,* 15 F.3d 779 (8th Cir. 1994) *rev'g Estate of Robertson v. Commissioner,* 98 T.C. 678 (1992); *Estate of Clayton v. Commissioner,* 976 F.2d 1486 (5th Cir. 1992) *rev'g Estate of Clayton v. Commissioner* 97 T.C. 327 (1991).

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marital estate tax deduction treatment in order to take maximum advantage of the TPT credit.[24] The amount of this credit can be sizable, for as long as the surviving spouse has a probability of living at least a year at the time of death of the predeceased spouse,[25] the TPT estate tax credit under Section 2013 of the Code is based (with certain limitations) on the hypothetical amount of estate tax that would have been incurred by the surviving spouse's estate by the inclusion of the value (under the Service's tables) of the life estate (due to the mandatory income interest) on the non-elected portion of the QTIP that was subject to estate taxation in the estate of the predeceased spouse.[26] This result ensues even though the only amount of the non-elected portion that would actually be included in the surviving spouse's taxable estate would be the income of the non-elected QTIP portion to which the surviving spouse was entitled during the period following the predeceased spouse's death.[27]

As long as the Department interprets marital deduction formula clauses under prior Federal law or Notice 03-08 permits inconsistent QTIP elections in circumstances where a modified marital deduction formula clause is used, the benefit of the "Clayton strategy" would be primarily with regard to Federal estate taxation. The "gap amount" would fund the "bypass" share under the marital deduction formula clause with no adverse Kansas or Federal estate tax consequence in the former scenario. In the latter, inconsistent Federal and state QTIP elections could be made with respect to the "gap amount" to avoid Kansas estate taxation on the "gap amount" following the

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[24] *See, e.g.*, Priv. Ltr. Rul. 200218003 (Jan. 7, 2002).

[25] Treas. Reg. §20.7520-3(b)(3).

[26] Treas. Reg. §20.2013-4(a), Ex. 2.

[27] If the surviving spouse is serving as Executor, the Service could argue that the surviving spouse has made a gift (at least of the mandatory income interest of the non-elected portion) to the other beneficiaries of the "bypass trust" to the extent a full QTIP election was not made. This argument can be avoided by including a "savings clause" which provides that the surviving spouse may not make a QTIP election if a gift would result from a partial QTIP election, reposing such authority in that circumstance in the next successor Trustee or a named Special Trustee.

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death of the predeceased spouse without causing its inclusion in the surviving spouse's estate for Federal or Kansas estate tax purposes.

The "Clayton strategy" is particularly attractive in situations where the TPT credit would likely be unavailable (*i.e.*, the surviving spouse's estate is not likely to be subject to Federal estate tax) or even if available, the possibility of the credit is secondary to the additional flexibility, income tax and creditor protection benefits which can be obtained under a "bypass trust" arrangement. However, the client or the client's spouse may not be agreeable to its inclusion unless the non-elected portion funds a "bypass trust" principally benefiting the surviving spouse. If not, the will or revocable trust might have to be drafted to include a special "bypass trust" principally for the benefit of the surviving spouse which would be the repository for the non-elected portion.

In situations in which the "Clayton strategy" would be otherwise desirable except for the potential loss of the TPT credit, a modified "Clayton strategy" provision would be preferred, limiting the non-elected portion funding the "bypass trust" to the "gap amount" portion. The balance would remain in the QTIP. This would avoid a "pick-up" tax on the "gap amount," secure the benefits of the "bypass trust" with respect to the non-elected "gap amount" and protect any potential TPT credit.

Although such modified "Clayton strategy" provision would provide that the non-elected portion over the "gap amount" would remain a QTIP trust and thus not fund a "bypass trust" having more flexible provisions, this drawback would normally be of little consequence. Partial QTIP elections would most likely be made to balance estates for estate tax purposes or maximize the TPT credit where the surviving spouse either predeceased the due date of the estate tax return for the predeceased spouse or is not likely to survive such date for an extended period. In this era

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of increasingly flat Federal estate tax return brackets, vastly increased applicable exclusion amounts, and the potential for a total repeal of the Federal estate tax, there is little resonance to the strategy of incurring any Federal estate tax at the death of the predeceased spouse in the vast majority of circumstances in which the surviving spouse is likely to live for an extended period. Even in the rare situation where this strategy might be advisable, most of the flexible elements of a "bypass trust" are still obtainable on the amount subject to a Federal estate tax liability by eschewing a partial QTIP election on any amounts over the "gap amount" in favor of making a disclaimer under the type of disclaimer provision discussed below.

Whether a full or modified "Clayton strategy" is used, due to the promulgation of Notice 03-08 permitting inconsistent QTIP elections on the Federal and Kansas estate tax returns, it is advisable to avoid ambiguity by providing that the portion of the QTIP Trust funding the "bypass trust" applies to the portion not elected at the Federal level. It also would be normally advisable to include a "savings clause" that in no event would any amount elected for QTIP treatment for Kansas estate tax purposes on a Kansas estate tax return filed by its due date fund the "bypass trust" if such funding would jeopardize the qualification of such amount for the marital estate tax deduction for Kansas estate tax purposes. This would avoid the "gap amount" being subject to Kansas estate tax in the circumstance where the "cutback clause" was activated due to marital deduction formula clauses not being interpreted for Kansas estate tax purposes under current Federal law and the Department would otherwise not honor the QTIP election on the "gap amount" even though valid under prior Federal law due to the "gap amount" not remaining in the QTIP.

Moreover, a QTIP election can be made at the Federal level at any time, even following the due date of the Federal estate tax return, as long as the election is made on the first estate tax

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return filed for the decedent.[28] Consequently, it would also be advisable in circumstances where the modified "Clayton strategy" is employed to provide that the election shall be deemed not to have been made if not made by the due date of the Federal estate tax return. This avoids a technical "open ended" period for the activation of such provision in circumstances where no Federal return is required to be filed. As the amount funding the "bypass trust" due to a non-election is limited under the modified "Clayton strategy" to the "gap amount," the inclusion of this provision does not jeopardize the ability to make a QTIP election on a late filed Federal return with respect to amounts which would be subject to a Federal estate tax liability in the absence of such election.

Incorporating a Disclaimer Provision

An alternative to the "Clayton strategy" is to include a specific disclaimer provision in the testamentary instrument providing that, in the event of a disclaimer of the spouse's beneficial interest in the QTIP, the disclaimed amount would fund a "bypass trust" type of arrangement. Alternatively, a partial QTIP election could be made with respect to the QTIP trust (the non-elected portion remaining a QTIP trust) in circumstances where the surviving spouse predeceased the due date of the Federal estate tax return or otherwise had a very short life expectancy to maximize the benefits of the TPT credit. If the disclaimer option is exercised, Section 2518 of the Code requires that it be made within nine months of date of death.

Although this alternative approach preserves the ability to maximize the TPT credit which the unmodified "Clayton strategy" does not, it has some detriments not present under the "Clayton strategy." First, a disclaimer has mandatory state and Federal procedural requirements which impose additional burdens, incur additional costs and are susceptible to error. In addition, it is the

[28] Treas. Reg. §20.2056(b)-7(b)(4)(i).

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Service's position that the surviving spouse may not possess a limited or special power of appointment over a trust funded as a result of a spousal disclaimer.[29] The disclaimer strategy should be given significant consideration over an unmodified "Clayton strategy" provision in situations where preserving the potential benefit of the TPT credit is paramount (*i.e.*, the surviving spouse's estate is likely to be subject to Federal estate taxation), particularly if the couple is elderly, thereby enhancing the chances of achieving the benefit of the TPT credit. It would not likely be exercised, however, unless the surviving spouse was comfortable with his or her beneficial interest under the "bypass trust" arrangement.

For practitioners employing the QTIP strategy, disclaimers would normally be of benefit only if the surviving spouse is likely to be subject to Federal estate taxes, survives the predeceased spouse by nine months, and wishes to incur Federal (and Kansas) estate taxation at the first death in order to achieve greater estate tax savings at the surviving spouse's death under the circumstance where the benefits of a flexible "bypass trust" arrangement are deemed superior to simply making a partial QTIP election whereby the non-elected portion would still pay all income to the surviving spouse.

As noted above, situations justifying the incurrence of a Federal estate tax at the death of the first spouse when the surviving spouse is likely to live for an extended period of time following the death of the predeceased spouse would be quite rare indeed. Thus, in most situations, a modified "Clayton strategy" provision in conjunction with a disclaimer provision would be the preferred approach in providing the greatest flexibility in minimizing both Federal and Kansas estate taxation without adverse impacting other estate planning goals.

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[29] *See* Treas. Reg. § 25.2518-2(e)(2); *see also Estate of Lassiter v. Commissioner,* T.C. Memo 2000-324, 80 T.C.M. (CCH) 541 (2000); *Estate Chamberlain v. Commissioner*, T.C. Memo 1999-181, 77 T.C.M. (CCH) 2080 (1999).

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Does the Kansas Filing Threshold Currently Comport with that at the Federal Level?

Notice 02-01 takes the position that the language in the Act under K.S.A. 79-15,103 which specifically limits the imposition of a "pick-up" tax liability to estates "required by Federal law to file a return for Federal estate taxes" does not conform the Kansas Estate Tax Act to current Federal law. The arguable contrary position that the literal wording of the statute should govern has a substantial risk of not being judicially sustained. As noted above, the Act provides that specific references to the Internal Revenue Code are to prior Federal law. Although the reference in K.S.A. 79-15,102 (a) to estates "required by Federal law to file a return for Federal estate taxes" does not specifically reference any provision of the Code, consistency of construction would militate in favor of a construction that such provision means filings required under prior Federal law. Moreover, the introductory sentence of the Act in K.S.A. 79-15,101(a) states that "Any term used in this act shall have the same meaning as when used in a comparable context in the internal revenue code." It would have been anomalous in this context for the Kansas legislature to have intended that filing thresholds were to be determined under subsequently enacted Federal law while the Act is tied to Federal law existing in 1997.

Second, the judicial rule of statutory construction that death tax statutes, like all statutes, are to be construed if possible in a manner which would uphold their constitutionality.[30] Thus, a construction taking into account subsequent changes under EGTRRA would be unlikely if such construction would mean that the Kansas legislature has unconstitutionally delegated a significant factor in determining Kansas estate taxation to the Federal government.

[30] *City of Baxter Springs v. Bryant,* 226 Kan. 383, 385, 598 P.2d 1051, 1054 (1979).

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Third, such construction would create a patent inequity. Decedents whose gross estates are equal to the filing threshold, no matter how minimally and no matter how large the amount of allowable deductions, would have to pay the full "pick-up" tax to the extent the taxable estate exceeded the applicable exclusion amount under prior Federal law. On the other hand, estates below such filing threshold, no matter how minimally and no matter how small the amount of allowable deductions, would owe no "pick-up" tax.

This is not to suggest that personal representatives should not advance the position on a return that no "pick-up" tax is owed by estates below the current Federal filing threshold. There is at least a possibility that such position would be judicially sustainable.

Dividing Marital Estates to Minimize Kansas Estate Tax

Because Notice 03-08 permits full funding of the current applicable exclusion amount under Federal law at the death of the first spouse without incurring any Kansas estate tax, it is important to divide marital estates in a manner which maximizes this benefit. If the total value of the estates of both spouses (the "marital estate") is at least twice that of the current applicable exclusion amount and the spousal property does not consist substantially of assets which are non-transferable (such as IRAs), the spousal estate can normally be divided so that each spouse would fully fund the current applicable exclusion amount irrespective of the order of deaths. If the marital estate is less than twice the current Federal applicable exclusion amount but over twice the applicable exclusion amount under prior Federal law, logistical problems ensue. Dividing the estates in that situation involves guesswork as to which spouse will predecease the other and consequently which is the appropriate spouse to hold an amount equal to the applicable exclusion amount under prior Federal law plus the amount of the marital estate in excess of twice the applicable exclusion amount under prior Federal law. The other spouse would then hold an

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amount approximately equal to the applicable exclusion amount under prior Federal law. The risk of the spouse having the lesser estate predecease the other spouse can be ameliorated through the spouse having the greater estate reposing in the spouse having the lesser estate a general power of appointment in the estate of such spouse in the event the spouse possessing such power predeceases the spouse reposing such power.[31] The predeceased spouse could simply exercise such power to the extent necessary to fully fund the current applicable exclusion amount. This approach may also be desirable for Federal and Kansas estate tax purposes in circumstances where assets do not lend themselves to division (e.g., IRAs, qualified retirement plans and qualified stock options).[32] General powers of appointment also can be made reciprocal to arguably achieve a "step up" in income tax basis in the assets of both spouses at the death of the first spouse irrespective of the sequence of deaths.[33]

New Forms

The Kansas Department of Revenue's Notice 02-01 provides for new death tax forms. To address the nonconformity issue, estates over the filing threshold under prior Federal law must file Form K-707 with the Department of Revenue. If a Form 706 is required to be filed for the decedent's estate, it must be attached to the Form. Under the Notice, elections made on Form 706 filed at the Federal level are binding for Kansas estate tax purposes. If a Federal estate tax return is not required to be filed for the estate, the Notice states that a pro forma estate tax return would have to be prepared and attached (which would require the use of old software incorporating, according to the Notice, the version of Form 706 dated July 1998), applying prior Federal law "across the board." At least ostensibly, the Department would look to that return in determining

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[31] O'Sullivan and Weaver, Using Two Trusts with Reciprocal Spousal General Powers of Appointment, *Estate Planning,* June 2003 at pg. 283.
[32] *Id.*
[33] *Id.*

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the taxable estate and the amount funding the "bypass share." This buttresses the argument posited above (supported implicitly by the Department under Notice 03-08) that prior Federal law should govern the interpretation of marital deduction formula clauses. For example, let us assume a married taxpayer dies in the year 2002 leaving a $900,000 estate. The estate would not be required to file a Federal estate tax return under current Federal law, but under the Department's position would be required to file a pro forma estate tax return applying prior Federal law. The filing of that return would result in no "pick-up" tax being incurred, as all amounts over the applicable exclusion amount under prior Federal law would be shown as eligible for the marital estate tax deduction on the pro forma return, notwithstanding the fact that all estate assets actually funded the "bypass share" due to the formula clause being interpreted under current Federal law. If the Department had not taken the same implicit position under Notice 03-08 with regard to the interpretation of marital deduction formula clauses, its position arguably would have been internally inconsistent.

Notice 02-01's requirement that estates below the filing threshold under prior Federal law but which have property passing to a beneficiary subject to the new "inheritance tax" discussed below must file Form K-708 has been rendered moot by the retroactive repeal of that tax by the 2003 Kansas legislature.

Notice 03-08 sanctions a "stand alone" approach to interpretation of the Act, providing totally independent forms for Kansas estate tax purposes. For decedents dying on or after May 22, 2003, all estates, even those otherwise filing a Federal estate tax return, must complete the April 1997 version of the Federal Form 706 in conjunction with new Form K-707, which is available on the Department's web site (www.ksrevenue.org). The estate is also required to file a copy of any Federal estate tax return filed with the Service. This requirement is for the sole purpose of

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allowing the Department to determine the consistency of valuations and deductions between the two returns in the vast majority of circumstances where current Federal law and prior Federal law are identical in such determinations, as Notice 03-08 expressly permits inconsistent tax elections for decedents on or after such date.

The Department is likely to have significant administrative problems in its enforcement of the Act, particularly with regard to estates not required to file a Federal estate tax return. The Department is quite shorthanded in available personnel to administer the filing of these returns, determine the completeness and accuracy of the return, including fair market values, decide the legal efficacy of tax elections (whether or not made at the Federal level), and determine whether administrative, marital and charitable deductions were appropriately taken. Audit rates could be quite low. No doubt there also will be some personal representatives who are unaware of the nonconformity issue between the Federal and Kansas filing thresholds or who intentionally choose non-compliance.

As noted above, the 2003 Kansas legislature passed the provisions of Senate Bill 94 which were incorporated into House Bill 2005 and signed by Governor Sebelius into law on May 20, 2003. Section 45 of that law not only retroactively repealed the "inheritance tax" enacted just one year previous, it provides for refunds to taxpayers who paid the tax. On June 20, 2003, the Department of Revenue issued Notice 03-07 providing for the manner in which such refund would be claimed.[34] New Form K-709 has been issued for that purpose.

[34] Kansas Department of Revenue Office of Policy & Research, Notice 03-07, *Retroactive Repeal of Succession Tax Refund Procedures* (June 20, 2003).

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Prospects for Future Kansas Legislation

The gravity of the Kansas death tax situation has been substantially mollified by the Department's promulgation of Notice 03-08. The Department should be praised by practitioners for taking a truly valorous position in the face of legislative inaction. Resolving most issues in favor of Kansas taxpayers is logically sound. It also avoids the mind-boggling complexities and substantial legal costs which would otherwise have been attendant to both planning around and legally challenging such issues as whether marital deduction formula clauses should be interpreted under current Federal law or prior Federal law or whether elections made for Kansas estate tax purposes need also be made on a Federal estate tax return filed for the estate. There remains the problem of applying prior Federal law which may become increasingly antiquated over time and the inequity of high marginal estate tax brackets for amounts just over the filing threshold. However, on balance these problems would appear to be minor in view of the Department's considerable concession that married taxpayers may plan to utilize the full current Federal applicable exclusion amount for Kansas estate tax purposes upon the death of the first spouse.

Prior to January 1, 2007, when the filing threshold for Kansas estate tax purposes will be in conformity with current Federal law, the Kansas legislature appears unlikely to either enact a "stand alone" estate tax or conform the "pick-up" tax to current Federal law prior to its complete phase out for decedents dying on or after July 1, 2005. Political pressures against a "stand alone" estate tax, along with the promulgation of the Department's Notice 03-08 which substantially lessens the benefits of such a proposal, make it unlikely that the 2004 Kansas legislature will pass a "stand alone" estate tax unless as a means of raising additional revenue. Furthermore, in this era of state fiscal austerity, the loss of revenue which would result from conforming the filing threshold (and applicable exclusion amount) to current Federal law is not expected to be politically

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palatable in the foreseeable future. Even the statutorily scheduled January 1, 2007 Federal filing threshold conformity date is subject to further legislative deferral.

Conclusion

The 2003 Legislature's retroactive repeal of the Kansas "inheritance tax" and the Department's promulgation of taxpayer friendly Notice 03-08 have helped to calm an otherwise chaotic Kansas death tax situation. As a result, public and professional pressure on the Kansas legislature to enact a "stand alone" Kansas estate tax has significantly abated.

By the year 2005, when the state death tax credit under EGTRRA fully phases out at the Federal level and state death taxes are relegated to a deduction against Federal estate tax, most states likely will have enacted separate death taxes in order to replace lost revenue. Unless the fiscal crisis faced by the states substantially subsides over the next few years, the ability of states to require the Federal government to, in effect, contribute over 40% (the marginal Federal estate tax bracket) of the state death tax liability of estates required to pay Federal estate taxes (due to its deductibility), may prove too politically attractive to ignore. Compared with state death taxes imposed mainly or exclusively on larger estates, other tax sources are normally deductible on a less frequent basis, at lower tax brackets, and imposed on a much broader base of voting taxpayers.

In this era of continuing Federal and state death tax uncertainty, practitioners in consultation with their clients, should consider the inclusion of modified marital deduction formula clauses, full or modified "Clayton strategy" provisions, divisions of QTIP provisions, reciprocal general powers of appointment and disclaimer provisions in testamentary instruments. In addition, practitioners should review the division of estates between spouses to ensure proper balancing for both Federal and Kansas estate taxation. Finally, in appropriate circumstances,

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particularly with regard to estates which would otherwise incur a significant Federal estate tax liability or which are just over the Kansas filing threshold, gifts or valuation reduction techniques should be considered to reduce Federal and Kansas estate tax liability.

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