First Published in the Hawaii Bar Journal, No. 13, 2011

IS THE HAWAII ESTATE TAX OUR STATE'S NEWEST SUPERTRAMP? THOUGHTS ON MANAGING AN INVASIVE TAX

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This article will cover the following:

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I. INTRODUCTION

Hawaii is especially vulnerable to invasion from alien species.[2] Our geographic isolation and lack of predators provide the perfect opportunity for their accidental or purposeful introduction which can significantly disrupt the normal functioning of our local ecosystem.[3] Aggressive invaders, such as the coqui frog, are referred to by biologists as "supertramps."[4] The supertramp is "blessed" with an uncanny ability to invade distant habitats at a high dispersal rate while thriving in even hostile environments. The invasion of a "supertramp" has a negative effect on the local ecology and as in the case of the coqui frog, a negative impact on the local economy.[5]

Without much fanfare, Hawaii might have inadvertently introduced a tax version of the coqui frog when it enacted its own estate and generation-skipping transfer taxes on April 30, 2010 (collectively, the "transfer taxes") in a manner that belied the potentially negative consequences for Hawaii residents, non-residents owning Hawaii property and their advisors who fail to account for the additional taxes. The law, which started as House Bill 2866, was vetoed by then Governor Linda Lingle. Her veto was overridden.[6] The law became effective for all Hawaii residents (and non-Hawaii residents owning Hawaii property) dying on or after May 1, 2010.[7]

By the time this article was submitted for publication, the new taxes had been around for almost nine months. During this time, practitioners and advisors across the state provided their candid feedback about the taxes to this author. From their comments, it is fair to say that the new Hawaii transfer taxes requires one to become comfortable with the "uncomfortable," especially as it pertains to two specific issues.

First, the calculation of the Hawaii transfer taxes requires one "take flight in a time machine." The law not only requires a stop in the year 2000 in order to calculate the Hawaii tax, but from there, one must travel to the year 2009 in order to calculate a "fictional" federal estate tax, which serves as a limitation on the Hawaii tax. This two-step process, in and of itself, requires much patience. One must resist the natural urge to resort to complete denial (as in, "this cannot be the way to calculate the tax.").

Second, the effect of the new taxes on the traditional trust funding formulas for married couples is profound. Even though it has been nine months since enactment, many practitioners are still reluctant to commit to a new formula that would maximize the use of both the federal and state exemption at the first spouse's death. Most practitioners were waiting for the federal government to decide what to do with the federal estate tax. Unfortunately for those who waited, among the laws passed through the federal "Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010" (the "Federal Tax Act of 2010") was an increase in the federal tax exemption to $5,000,000.[8] Though the increase is very helpful to high net worth individuals, Hawaii estate tax will now arise at the death of a first spouse (with an estate over $3.5 million) if the local practitioner

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2 *See* Earlham College Biology Department, *Introduced Species in Hawaii* (Senior Seminar 2002). The article can be found at http://www.earlham.edu/~biol/hawaii/introduction.htm.

3 *Id*.

4 *See* Hans Sin & Adam Radford, *Coqui Frog Research and Management Efforts In Hawai`i*(USDA/APHIS/WS, National Wildlife Research Center 2007)(" Managing Vertebrae Invasive Species: Proceedings of an International Symposium"), pages 157 to 167.

5 *Id*.

6 Go to: http://capitol.hawaii.gov/session2010/lists/measure_indiv.aspx?billtype=HB&billnumber=2866. The bill was vetoed by Governor Lingle on April 28, 2010. The legislature overrode her veto on April 30, 2010.

7 The law was passed as Act 74, Session Laws of Hawaii 2010.

8 *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312.

does not alter his or her traditional funding formula to accommodate the efficient use of both the federal and state exemptions. Practitioners should consider a formula that will stand the test of time and will provide flexibility in the event the Hawaii estate tax is modified or repealed.

The purpose of this article is to offer hope and some comfort. As explained in Section III, the calculation of the tax is frustrating but doable. Furthermore, as illustrated in Section V, because the state has granted the use of a separate state marital or QTIP marital deduction, one can maximize the use of both the federal and state exemptions of married couples (regardless of where either exemption lands in the future), such that there should be no federal or state estate tax at the first spouse's death. Section V also provides sample funding formula language that is intended to carry out the maximum use of both exemptions while deferring any state or federal estate tax until the death of the second spouse.

II. BACKGROUND

For the past five years, Hawaii (along with approximately 33 other states)[9] had no estate tax.[10] When existing federal law fully phased out the state death tax credit in 2005, Hawaii's estate taxes became "dormant." The expectation was that Hawaii's estate tax would return in 2011 because the federal law that phased out the state death tax credit (and thus, the Hawaii estate tax) was to sunset on December 31, 2010.[11] Rather than trust the federal government to allow the sunset to occur, however, Hawaii decided to create its own estate tax. The new Hawaii estate tax is now separate and independent from the federal transfer tax system.

As it stands under this new law, Hawaii residents with taxable estates valued at greater than $3.5 million and married couples with combined taxable estates valued at greater than $3.5 million need to consider the effect that Hawaii's estate tax will have on their estate plan.[12]

Likewise, Hawaii non-residents owning Hawaii property (e.g., Hawaii real estate or tangible or intangible personal property physically located in Hawaii) valued at greater than $3.5 million and married non-residents owning Hawaii property valued at greater than $3.5 million need to consider the effect that Hawaii's estate tax will have on their planning. For both Hawaii residents and non-residents, no Hawaii estate tax is assessed on taxable estates valued at or below $3.5 million.[13]

Lastly, Hawaii non-residents, who are also non-U.S. citizens, owning Hawaii property valued at greater than $60,000 and married non-resident, non-citizens owning Hawaii property valued at greater than $60,000 need to consider the effect that Hawaii's estate tax will have on their planning.[14]

III. DETERMINING THE HAWAII ESTATE TAX

As was the case under prior law, the Hawaii estate tax still equals the "federal credit."[15] However, the "federal credit" is now defined as "the maximum amount of the credit for state death taxes allowed by § 2011 of the Internal Revenue Code ("IRC"),

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[9] *See* State Death Chart, currently as of May 11, 2009, which is prepared and maintained by Charles D. Fox on behalf of the American College of Trust and Estate Counsel ("ACTEC"). See www.ACTEC.org.

[10] This was due to the fact that the trigger for the tax was based on the amount of "state death tax credit" that the federal government deemed available to use as an offset against federal estate taxes owed. See, "old" Hawaii Revised Statutes § 236D-3 which provides, "A tax in an amount equal to the *federal credit* is imposed on the transfer of the taxable estate of every resident." Old HRS § 236D-2 defined "federal credit" as "the maximum amount of credit for state death taxes allowed by section 2011[of the Internal Revenue Code] for the decedent's adjusted taxable estate." The credit was adjusted periodically and, as it was changed, the amount that a state could claim as its estate tax also changed. Id. Thus, when the federal government completely phased out the state death tax credit in 2005, the states that remained "coupled" with the federal law levied no estate tax. See, IRC § 2058 (which replaced the credit for state death taxes with a deduction for state death taxes paid), 26 U.S.C. § 2058.

[11] P.L. 107-16, §901(a)-(b), also known as the "Economic Growth and Tax Relief Reconciliation Act of 2001" or "EGTRRA," provides that provisions for the state death credit phase-out and its replacement with a deduction shall not apply to years beginning after December 31, 2010.

[12] New HRS §236D-B provides that a decedent shall be entitled to all applicable exclusions or exemption amounts as determined by the Internal Revenue Code as of December 31, 2009, including up to a $3,500,000 applicable exemption amount as allowed on December 31, 2009, as further adjusted by law. HB2866, Section 5 provides that the Act "shall apply to property interests of persons who die after April 30, 2010."

[13] Tax Information Release No. 2010-06 provides that "decedents dying on or after May 1, 2010 with a taxable estate of $3,500,000 or less are not subject to Chapter 236D, HRS."

[14] *See* Tax Information Release ("TIR") 2010-06, page 2 for an explanation of the $60,000 exemption.

as it existed on December 31, 2000."[16] As an offset against exposure to the new tax, a Hawaii decedent is now allowed a $3.5 million exemption as allowed by IRC § 2010 **as it existed on December 31, 2009**.[17]

A. Is Hawaii's Exemption Truly Independent or Tied to the Federal Exemption?

The Hawaii exemption is "up to" $3.5 million, which amount can be "further adjusted by law,"[18] many practitioners wondered whether the exemption could be less or more in the future, depending on where the federal exemption landed. In this regard, the State Department of Taxation's Tax Information Release 2010-06 is enlightening. First, it confirmed that the exemption is $3.5 million. Period. Although there was no explanation of the phrase "up to," TIR 2010-06 clarified that one "adjustment" allowed to the exemption would be to reduce it for gifts made during a person's lifetime that utilized the person's lifetime gift tax credit.[19] Thus, the Hawaii exemption is $3.5 million. It *is not* a "ceiling" that will be "adjusted" according to what the federal law is at the time. As explained by the Tax Information Release:

> Due to the uncertainty of what form the federal estate tax and generation-skipping tax will take, Act 74 avoids this issue by adopting the federal estate tax and generation-skipping tax at certain fixed times where the tax law was certain. Generally, Act 74 adopts the IRC as of December 31, 2009; except for the federal credits for state death or transfer taxes paid, which are adopted for Hawaii tax purposes as written on December 31, 2000. Because specific provisions were adopted at fixed points in time, the projected uncertainty regarding federal estate tax law has no impact on Hawaii Estate and Transfer Tax under Chapter 236D, HRS. *Whatever policies become law federally will no longer have any impact on Hawaii law.* As the federal estate and generation-skipping transfer tax laws exist today, the taxes will resurrect on January 1, 2011 with a provision for a federal tax credit for state death taxes paid. This credit will no longer have a direct impact on Hawaii law. Administration of the Hawaii Estate and Transfer Tax will be dictated as the law provides on December 31, 2009, with the credits for taxes provided on December 31, 2000.[20]

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[15] HRS § 236D-3.

[16] New HRS § 236D-2 amends the prior definition of "federal credit" to now read as "the maximum amount of credit for state death taxes allowed by section 2011 *of the Internal Revenue Code as it existed on December 31,2000*, (26 U.S.C.) for the decedent's adjusted taxable estate." (Addition is italicized to highlight the change). States commonly "decouple" themselves from the federal estate tax by basing its estate taxes on the state death tax credit as it existed on a particular date. According to one source, approximately 14 states base their estate tax on the state death tax credit as of a particular date. See "State Death Chart," as of May 11, 2009, prepared and maintained by Charles D. Fox on behalf of the American College of Trust and Estate Counsel ("ACTEC"). Hawaii's decoupling date is December 31, 2000. HRS § 236D-2.

[17] New HRS § 236D-B.

[18] *Id*.

[19] TIR 2010-6, page 2, provides," the applicable exclusion amount will include any additional adjustments made under Section 2010, IRC, including any reduction in the applicable exclusion amount due to taxable gifts made during a person's lifetime."

[20] *Id* at 5.

B. The Hawaii Estate Tax Equals the Federal Credit

The federal credit is determined by the use of IRC § 2011 as of December 31, 2000,[21] which provides that the credit shall not exceed the amount stated in Table B of the Instructions to Form 706 (Revised July 1999) ("Table B"):

TABLE B - COMPUTATION OF MAXIMUM CREDIT FOR STATE DEATH TAXES, AS OF DECEMBER 31, 2000, BASED ON FEDERAL ADJUSTED TAXABLE ESTATE (ATE)				
(1)	(2)	(3)		(4)
If ATE Exceeds	But Does Not Exceed	Then Credit Equals This Amount . . .		Plus percentage x the amount over column (1)
40,000	90,000		-	0.8%
90,000	140,000	$	400	1.6%
140,000	240,000		1,200	2.4%
240,000	440,000		3,600	3.2%
440,000	640,000		10,000	4.0%
640,000	840,000		18,000	4.8%
840,000	1,040,000		27,600	5.6%
1,040,000	1,540,000		38,800	6.4%
1,540,000	2,040,000		70,800	7.2%
2,040,000	2,540,000		106,800	8.0%
2,540,000	3,040,000		146,800	8.8%
3,040,000	3,540,000		190,800	9.6%
3,540,000	4,040,000		238,800	10.4%
4,040,000	5,040,000		290,800	11.2%
5,040,000	6,040,000		402,800	12.0%
6,040,000	7,040,000		522,800	12.8%
7,040,000	8,040,000		650,800	13.6%
8,040,000	9,040,000		786,800	14.4%
9,040,000	10,040,000		930,800	15.2%
10,040,000	-		1,082,800	16.0%

In order to use Table B, the practitioner must first determine the "adjusted taxable estate," which is defined as the "taxable estate" reduced by $60,000.[22] The "taxable estate" is generally the value of the gross estate less deductions for (i) expenses, indebtedness and taxes, (ii) losses;
(iii) charitable contributions; and (iv) bequests to the surviving spouse.[23] Once the adjusted taxable estate is determined, that amount is applied against the table to derive the federal credit, which amount is then deemed to be the Hawaii estate tax.

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[21] Per HRS § 236D-2. IRC § 2011 (26 U.S.C. § 2011) provides in pertinent part:

> a) In general.—The tax imposed by section 2001 shall be credited with the amount of any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia, in respect of any property included in the gross estate (not including any such taxes paid with respect to the estate of a person other than the decedent).
>
> (b) Amount of credit.—The credit allowed by this section shall not exceed the appropriate amount stated in the following table:
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> * * * *

See Table B in the text above for the IRC § 2011(b) table.

[22] *See* Internal Revenue Code § 2011(b), as of December 31, 2000. "For purposes of this section, the term 'adjusted taxable estate' means the taxable estate reduced by $60,000."

[23] HRS § 236D-2, as amended, provides that the taxable estate means the taxable estate as defined in Sections 2051-2056 of the Internal Revenue Code. Section 2051 provides that the taxable estate is determined by deducting from the value of the gross estate certain deductions, including

The calculation of the federal credit is illustrated by the following example. Suppose an unmarried Hawaii resident dies on January 1, 2011 with a *taxable* estate of $5.0 million. The federal credit would be $391,600, calculated as follows:

Federal Taxable Estate	$ 5,000,000
Less: Adjustment	(60,000)
Adjusted Taxable Estate ("ATE")	$ 4,940,000

Assuming a federal taxable estate of $5,000,000, $60,000 is first subtracted to determine the federal adjusted taxable estate of $4,940,000. This adjusted amount is then used to compute the maximum credit for state death taxes utilizing Table B (above). According to the Table, the federal credit is $391,600, or $290,800 + (11.2% x ($4,940,000 - $4,040,000)). Since the Hawaii estate tax equals the federal credit, the Hawaii estate tax would be $391,600, before any statutory limitation on this amount is applied. The limitation on this tax, if any, comes from the same source, the $3.5 million state exemption, in two different forms.

First, the $3.5 million dollar exemption is the equivalent of "jumping off a cliff." If the taxable estate of a decedent is over $3.5 million, the Hawaii estate tax must be calculated using IRC § 2011 (as it existed on 12/31/00). In contrast, if the taxable estate is at or under $3.5 million, then the Hawaii estate tax need not be calculated. Simply stated, taxable estates valued at $3.5 million or less are exempt from the Hawaii estate tax, while the same tax is imposed on estates valued over $3.5 million.[24]

Second, if the estate is valued over $3.5 million, the $3.5 million exemption does not limit exposure as a true exemption. This is the most troubling and confusing aspect of calculating the tax, for good reason. We have been raised under a long-standing federal estate tax system that allows us to offset the estate tax with the estate tax exemption. For example, a $3.5 million federal exemption (in 2009) provided a decedent's estate with $1,455,800 in applicable credit. The credit was used as a dollar-for-dollar offset against the federal estate tax. In contrast, the relief afforded by the $3.5 million state exemption (despite its statutory anchoring to the federal exemption as it existed in 2009) cannot be used in the same manner. As the Hawaii estate tax is equal to the amount determined to be the federal credit, no where in that calculation does the Hawaii exemption apply.[25] It cannot directly offset the Hawaii estate tax. Thus the Hawaii exemption is not usable as a credit. It is, however, usable through IRC § 2011(f), as explained in further detail below. Thus practitioners must familiarize themselves with the IRC § 2011(f) limitation, as it existed on December 31, 2000, and understand that the benefit of the Hawaii exemption is derived through this limitation.

C. The § 2011(f) Limitation on the Hawaii Estate Tax

Once the federal credit is determined, IRC § 2011(f), as of December 31, 2000, provides that the credit (and thus, the Hawaii estate tax) cannot exceed the federal estate tax imposed by section 2001.

> (f) **Limitation based on amount of tax.** - The credit provided by this section shall not exceed the amount of tax imposed by section 2001, reduced by the amount of the unified credit provided by section 2010.[26]

Because the legislature defined the "Internal Revenue Code" for Hawaii estate tax purposes as the Internal Revenue Code as of December 31, 2009, while tying only Sections 2011, 2012 and 2604 to the Internal Revenue Code as of December 31, 2000, the Hawaii Department of Taxation's current interpretation of IRC § 2011(f) as a limitation against the Hawaii estate tax is as follows:

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but not limited to "Expenses, indebtedness, and taxes" (§2053), "Losses" (§2054), "Transfers for public, charitable, and religious uses" (§2055) and "Bequests, etc., to surviving spouse" (§2056).

[24] Tax Information Release No. 2010-06 supports this proposition by stating that "decedents dying on or after May 1, 2010 with a taxable estate of $3,500,000 or less are not subject to Chapter 236D, HRS."

[25] The Hawaii estate tax equals the federal credit. The federal credit equals the amount of tax credit provided the adjusted taxable estate. The adjusted taxable estate equals the taxable estate minus $60,000. The taxable estate equals the gross estate minus applicable deductions. The Hawaii exemption is not part of this equation.

[26] IRC § 2011(f) (2000).

> (f) **Limitation based on amount of tax.** - The credit provided by this section [as of December 31, 2000] shall not exceed the amount of tax imposed by section 2001 [as of December 31, 2009], reduced by the amount of the unified credit provided by section 2010 [as of December 31, 2009].[27]

As a result of the "split-in-time" references between the year 2000 (for §§ 2011 and 2011(f)) and year 2009 (for §§ 2001 and 2010), one must analyze the 2011(f) limitation using what is referred to as the "time machine" approach. Though this does not require the use of an actual time machine, it does require the creation of a "fictional" federal tax as it would have existed in the year 2009, to determine the limitation of a Hawaii estate tax, stuck in the year 2000.

Here's how the limitation works. Assume an unmarried Hawaii resident dies on January 1, 2011 with a taxable estate of $3.6 million. Before applying the 2011(f) limitation, the tentative Hawaii estate tax is $238,800. As reflected in the illustration that follows, IRC § 2011(f), then limits the Hawaii tax to the decedent's *fictional* federal estate tax liability, *as of December 31, 2009*. The limitation results in a Hawaii estate tax of $45,000.

	Fictional Federal	Hawaii
Gross Estate After Deductions (Other Than Marital Deduction)	$ 3,600,000	$ 3,600,000
Less: Marital Deduction	-	-
Less: State Taxes Paid Deduction	N/A	N/A
Taxable Estate	3,600,000	3,600,000
Plus: Adjusted Taxable Gifts	-	N/A
Less: Adjustment	N/A	(60,000)
Adjusted Taxable Estate	3,600,000	3,540,000
Tentative Estate Tax	1,500,800	238,800
Less: Gift Tax Paid or Tax Credit Used	-	N/A
Gross Estate Tax	1,500,800	238,800
Less: Applicable Credit Amount	(1,455,800)	-
Less: Credit for State Death Taxes Paid	(45,000)	N/A
Estate Tax	$ -	$ 45,000

As reflected above, a $3.6 million estate results in a tentative fictional federal estate tax of $1,500,800. In 2009, a $3,500,000 exemption equaled a $1,455,800 applicable credit amount to use as an offset against the tentative estate tax. The difference between the two ($1,500,800 tax minus the $1,455,800 applicable credit amount) results in a federal estate tax of $45,000. Since IRC § 2011(f) provides that the federal credit (e.g., the tentative Hawaii estate tax, or $238,800) cannot be greater than the (fictional) federal estate tax, the credit, and thus the Hawaii estate tax, is reduced to $45,000.

IV. THE NEGATIVE EFFECT OF THE HAWAII ESTATE TAX ON TRADITIONAL MARITAL DEDUCTION PLANNING

There are two primary objectives in traditional marital deduction planning. The first is to completely defer the estate tax until the death of the second spouse. The second is to fully utilize the estate tax exemption of the first spouse to die, to the extent possible.

A. Objective 1: Complete Deferral of the Estate Tax at First Spouse's Death

[27] TIR 2010-06 does not go through the lengths of explicitly stating how the IRC § 2011(f) limitation works. Admittedly, more guidance may be necessary from the State to confirm this interpretation. To be clear on this issue, the above interpretation of 2011(f) is the State's interpretation, not the author's. It is based on direct conversation and involvement in calculating hypothetical numbers side-by-side with Department officials. This is further confirmed by the State's draft instructions to Form M-6, where it is clear that the 2011(f) limitation is calculated based on a fictional federal estate tax using the IRC as it existed in 2009.

Before Hawaii decoupled from the federal estate tax, complete deferral of the federal estate tax was accomplished by using a combination of the federal exemption and the marital deduction (which is allowed on transfers during life or at death between spouses).

> **EXAMPLE**: Assume the estate of the first spouse to die was $6,000,000 and the federal exemption was $5,000,000. There would be no estate tax owed at the first spouse's death because $5,000,000 would be shielded by use of the federal exemption. The remaining $1,000,000 would be shielded by use of the marital deduction. Note that the estate tax on the $1,000,000 is merely "deferred" because this amount is includible in the estate of the surviving spouse, which may result in estate tax at the surviving spouse's death.

Because the marital deduction is unlimited (assuming the surviving spouse is a U.S. citizen)[28], the use of both the deduction and the federal exemption could shield even the largest estates from estate tax at the first spouse's death.

> **EXAMPLE**: Assume the estate of the first spouse to die was $500,000,000, the federal exemption was $5,000,000 and the surviving spouse was a U.S. citizen. There would be no estate tax owed at the first spouse's death because $5,000,000 would be shielded by use of the federal exemption. The remaining $495,000,000 would be shielded by use of the unlimited marital deduction. Note that the estate tax on the $495,000,000 is merely "deferred" because this amount is includible in the estate of the surviving spouse, which may result in estate tax at the surviving spouse's death.

The flexibility afforded by the unlimited marital deduction made it possible to draft a trust formula clause, which generally allocated an amount equal in value to the existing federal exemption of the first spouse to die to a "credit shelter" trust, with the remaining amount going to the "marital" trust. Because the marital trust was drafted to qualify for the marital deduction, the amounts held in it were shielded from estate tax by the deduction, while the amounts in the credit shelter trust were protected against estate tax by the federal exemption.

> **EXAMPLE**: Assume the estate of the first spouse to die was $6,000,000 and the federal exemption was $5,000,000. Assume further that all $6,000,000 was funded into a revocable trust that included a standard trust formula clause creating both "credit shelter" and "marital" trusts. There would be no estate tax owed at the first spouse's death because $5,000,000 would be funded into the "credit shelter" trust and shielded by use of the federal exemption. The remaining $1,000,000 would be funded into the "marital trust" and shielded by use of the marital deduction. Note that the estate tax on the $1,000,000 is merely "deferred" because this amount is includible in the estate of the surviving spouse, which may result in estate tax at the surviving spouse's death.

Armed with the flexibility of the unlimited marital deduction to accommodate any legislative increases or decreases in the federal exemption, this funding formula was enough to assure a married couple that there would be no "accidental" estate tax owed at the death of the first spouse. Any estate tax owed at the first spouse's death would be purely voluntary and purposeful.

B. Objective 2: Full Use of the Estate Tax Exemption of the First Spouse to Die

Because the traditional funding formula efficiently used the federal exemption, ensuring full use of the first spouse's exemption merely came down to making sure the value of both spouse's estate were equalized to avoid inadvertent wasting of the first spouse's exemption. With advanced planning, the estate of the first spouse could fully use the spouse's federal exemption, regardless of which spouse died first.

[28] IRC §2056(d)(1) provides that the estate tax marital deduction is not available if the surviving spouse is not a U.S. citizen.

> **EXAMPLE**: Assume the combined value of a spousal estate is $10,000,000. Of that amount, Spouse A's estate is $9,000,000 and Spouse B's is $1,000,000. If Spouse A passed away first, the estate would fully utilize Spouse A's $5,000,000 exemption and shield the remaining $4,000,000 by use of the marital deduction. At Spouse's 2 death, his or her estate would include the $4,000,000 previously shielded by Spouse A's marital deduction. The estate of Spouse B would fully utilize Spouse B's $5,000,000 exemption to offset Spouse B's $5,000,000 estate. However, if Spouse B were to pass away first, the estate could not fully utilize Spouse B's $5,000,000 exemption because Spouse B's estate is only $1,000,000. $4,000,000 of Spouse B's exemption would be wasted, creating unnecessary estate tax at Spouse A's death. By equalizing the estate of Spouse A and Spouse B, however, so that their estates were both valued at $5,000,000 there would be no wasting of either spouse's exemption, regardless of who dies first.

C. Utilizing the Traditional Formula in a Hawaii Estate Plan for Married Couples no Longer Satisfies Marital Deduction Planning Objectives.

When Hawaii was coupled with the federal estate tax, there was no Hawaii estate tax at the death of the first spouse's death. Hawaii estate tax only arose when federal estate taxes were owed. Thus, a funding formula which focused only on the efficient use of the federal exemption of the first spouse to die (through a credit shelter trust) in combination with the unlimited marital deduction (through a marital trust) was all that was needed to defer both federal and Hawaii estate taxes until the death of the second spouse. However, when Hawaii decoupled from the federal estate tax on May 1, 2010, the traditional funding formula no longer provided a "safe harbor." Here is why.

If the federal exemption is *less than* the Hawaii exemption, the wording of the traditional funding formula will result in the credit shelter trust being funded with the amount equal in value to the federal exemption. Though this will result in deferral of both the federal and Hawaii estate tax at the first spouse's death, funding the credit shelter trust in this manner will underutilize the first spouse's Hawaii exemption, possibly creating additional Hawaii estate taxes at the death of the second spouse.

> **EXAMPLE**: Assume the estate of the first spouse to die was $6,000,000, at a time when the federal exemption is $1,000,000 and the Hawaii exemption is $3,500,000. Assume further that all $6,000,000 was funded into a revocable trust that included a standard trust formula clause creating both "credit shelter" and "marital" trusts.
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> There would be no federal estate tax at the first spouse's death because $1,000,000 would be funded into the "credit shelter" trust and shielded by use of the federal exemption. The remaining $5,000,000 would be funded into the "marital trust" and shielded by use of the marital deduction.
>
> Likewise, there would be no Hawaii estate tax at the first spouse's death because $5,000,000 would be shielded by the marital deduction. The remaining $1,000,000 would be covered by utilizing only $1,000,000 the $3,500,000 Hawaii exemption.
>
> The $5,000,000 that qualified for the marital deduction would be includible in the estate of the second spouse and subject to federal and Hawaii estate taxes.
>
> Due to the use of the standard trust formula, $2,500,000 of the first spouse's Hawaii exemption is "wasted," resulting in additional Hawaii estate taxes in the estate of the second spouse.

If the federal exemption is *greater than* the Hawaii Exemption, funding the credit shelter trust with the amount equal to the federal exemption will overwhelm the first spouse's Hawaii exemption and result in Hawaii estate taxes.

> **EXAMPLE**: Assume the estate of the first spouse to die was $6,000,000, at a time when the federal exemption is $5,000,000 and the Hawaii exemption is $3,500,000.

> Assume further that all $6,000,000 was funded into a revocable trust that included a standard trust formula clause creating both "credit shelter" and "marital" trusts.
>
> There would be no federal estate tax at the first spouse's death because $5,000,000 would be funded into the "credit shelter" trust and shielded by use of the federal exemption. The remaining $1,000,000 would be funded into the "marital trust" and shielded by use of the marital deduction.
>
> In contrast, Hawaii estate tax of $391,600 would be owed at the first spouse's death because only $1,000,000 would be shielded by the marital deduction. The remaining $5,000,000 would overwhelm the $3,500,000 Hawaii exemption, resulting in the tax.
>
> Due to the use of the standard trust formula, a Hawaii estate tax of $391,600 is owed at the first spouse's death.

Every practitioner should be aware that continued use of the traditional funding formula could at the death of the first spouse, result in (i) underutilization of the Hawaii exemption, leaving the surviving spouse with an "inflated" Hawaii estate; or (ii) overutilization of the Hawaii exemption, triggering Hawaii estate tax. A formula that focuses only on funding the credit shelter trust for federal exemption purposes is no longer acceptable. The subsections that follow offer thoughts on specific planning techniques (and a sample formula) that should optimize the use of both the federal and state exemptions and allow for a deferral of both taxes at the death of the first spouse.

V. MARITAL DEDUCTION PLANNING NOW REQUIRES FLEXIBILITY

The new objective of marital deduction planning for Hawaii married couples is to provide the trustee with as much flexibility as possible to decide how to fund the credit shelter trust and marital trust(s). The techniques which provide this flexibility include: (1) Partial QTIP elections; (2) Clayton QTIP elections; (3) the Hawaii QTIP election (with a heartfelt thanks to the Hawaii Department of Taxation for its foresight in authorizing the state election). Of the three techniques, the Hawaii QTIP election is the by far the most efficient of the group. Thus, most of the remaining discussion on marital deduction planning will focus on the Hawaii QTIP.

A. Partial QTIP elections and Clayton QTIP elections

Some Hawaii practitioners are contemplating funding the entire trust estate into a single QTIP (qualified terminable interest property) trust at the first spouse's death. The "executor" would then make the appropriate (partial) state and federal QTIP elections in order to fully maximize the use of both the federal and Hawaii exemptions while zeroing out both estate taxes at the first spouse's death.[29]

The problem with the partial QTIP election approach is that the non-QTIP elected assets would still be subject to QTIP limitations (i.e., all net income to spouse). A QTIP only trust does not allow any of the trust assets to be used for anyone other than the surviving spouse's benefit and requires all income go to the surviving spouse. This may not be consistent with your client's desires, especially in a second family situation. Furthermore, a partial QTIP election can become a tax-happy "Robin Hood." Because all net income must be paid to the spouse from both the QTIP and non-QTIP portions of the marital trust, income paid from the non-QTIP portion, if any, will take from the portion that would otherwise be exempt from estate taxes at the surviving spouse's death and add it to the surviving spouse's estate. Second, discretionary principal distributions are essentially made pro-rata from the QTIP and non-QTIP portion. Principal paid from the non-QTIP portion, if any, will take from the portion that would otherwise be exempt from estate taxes at the surviving spouse's death and add it to the surviving spouse's estate. Thus, a partial QTIP election may effectively "steal" from the non-taxable estate and "give" what is stolen to the taxable estate.

A better way to utilize the partial QTIP election approach is to provide the executor with a Clayton QTIP option. A Clayton QTIP is preferable to an ordinary partial QTIP election because the non-QTIP portion can pass to a credit shelter trust,

[29] See Treas. Reg. Section 20.2056(b)-7(d)(3) and -7(h) (example 6) (providing that the marital deduction is allowed for a QTIP trust that is funded only to the extent that a QTIP election is made).

which does not need to require the payment of net income to the surviving spouse. Furthermore, discretionary principal distributions can be made from the marital trust rather than the family trust, which is more tax efficient, and the credit shelter trust can also permit distributions to other family members. The authority for a Clayton QTIP comes from Treas. Reg. § 20.2056(b)-7(d)(3), which provides that QTIP assets will retain its status as a qualifying income interest even if a contingency allows the portion of the QTIP assets for which the election is not made to pass or to be held for the benefit of persons other than the surviving spouse.

Keep in mind that if the surviving spouse serves as executor of the deceased spouse's estate, there is a concern that a gift is made to the other beneficiaries if the surviving spouse accepts a lesser interest upon making the Clayton QTIP election. Therefore, you may want to consider permitting a Clayton QTIP election to be made only be an independent executor, rather than the surviving spouse.

B. The Hawaii QTIP Election

On October 6, 2010, the State of Hawaii Department of Taxation issued Tax Information Release No. 2010-09, which authorized the use of a separate and independent Hawaii marital deduction and QTIP election. Thus, even if no QTIP election is made for federal estate tax purposes, a separate and independent Hawaii QTIP election is allowed. Conversely, if a QTIP election is made for federal estate tax purposes, a Hawaii QTIP election need not be made. The allowance by Hawaii to permit a state QTIP election is monumental. Once again, it is possible to defer both the federal and Hawaii estate taxes at the death of the first spouse while fully utilizing the first spouse’s federal and Hawaii exemptions.

Unfortunately, drafting a funding formula to utilize the Hawaii QTIP election is complex and difficult. First, it necessitates a three-trust approach, rather than the traditional two-trust approach. If GST (generation skipping transfer tax) planning is involved, a fourth trust may also be necessary. Second, it requires flexible language that allows for proper funding of the three trusts depending on whether the federal exemption is greater or less than the Hawaii exemption at the death of the first spouse.

The funding formula works as follows: At the first spouse’s death, an “exempt trust” would first be funded with an amount that is equal to the (a) federal exemption, if the federal exemption is less than the Hawaii exemption; or (b) Hawaii exemption, if the Hawaii exemption is less than the federal exemption. Next, an “exempt QTIP trust” would be funded with the “gap amount,” or the difference between the federal exemption and Hawaii exemption. The executor would be allowed the flexibility to make the appropriate Hawaii or federal QTIP election, based on which election would result in the lesser of Hawaii or federal estate tax. Lastly, the balance of the property not funded into the “exempt trust” or the “exempt QTIP trust” would be funded to a “marital QTIP trust.” The executor would be allowed to make the appropriate Hawaii *and/or* Federal QTIP elections for the assets held in this trust.

> **EXAMPLE**: Assume the estate of the first spouse to die was $6,000,000, at a time when the federal exemption is $1,000,000 and the Hawaii exemption is $3,500,000. Assume further that all $6,000,000 was funded into a revocable trust that included a three-trust funding formula which provided the trustee with the flexibility to use both the Hawaii and federal QTIP elections as necessary.
>
> There would be no federal or Hawaii estate tax at the first spouse’s death. Furthermore, the estate could fully utilize both the federal and Hawaii exemptions.
>
> The first $1,000,000 would be funded into the “exempt trust” because the federal exemption is less than the Hawaii exemption. For federal estate tax purposes, the $1,000,000 federal exemption would shield these assets from federal estate tax. For Hawaii purposes, $1,000,000 of the $3,500,000 Hawaii exemption would shield these assets from the Hawaii estate tax.
>
> The “gap amount” of $2,500,000 would be funded into the “exempt QTIP trust.” For federal estate tax purposes, the $2,500,000 would not be subject to federal estate tax because the trustee would make the federal QTIP election on the federal estate tax return to treat this amount as part of the federal marital QTIP. This would result in a

QTIP marital deduction of $2,500,000. For Hawaii, the $2,500,000 would not be subject to Hawaii estate tax because the trustee would *not* make the Hawaii QTIP election. The remaining $2,500,000 in Hawaii exemption would shield these assets from the Hawaii estate tax.

The remaining $2,500,000 would be funded into the “marital QTIP trust.” The trustee would make both the federal and Hawaii elections on the assets held in this trust. There would be no federal or Hawaii estate tax on this amount because of the resulting QTIP marital deduction for both federal and Hawaii purposes.

Assume

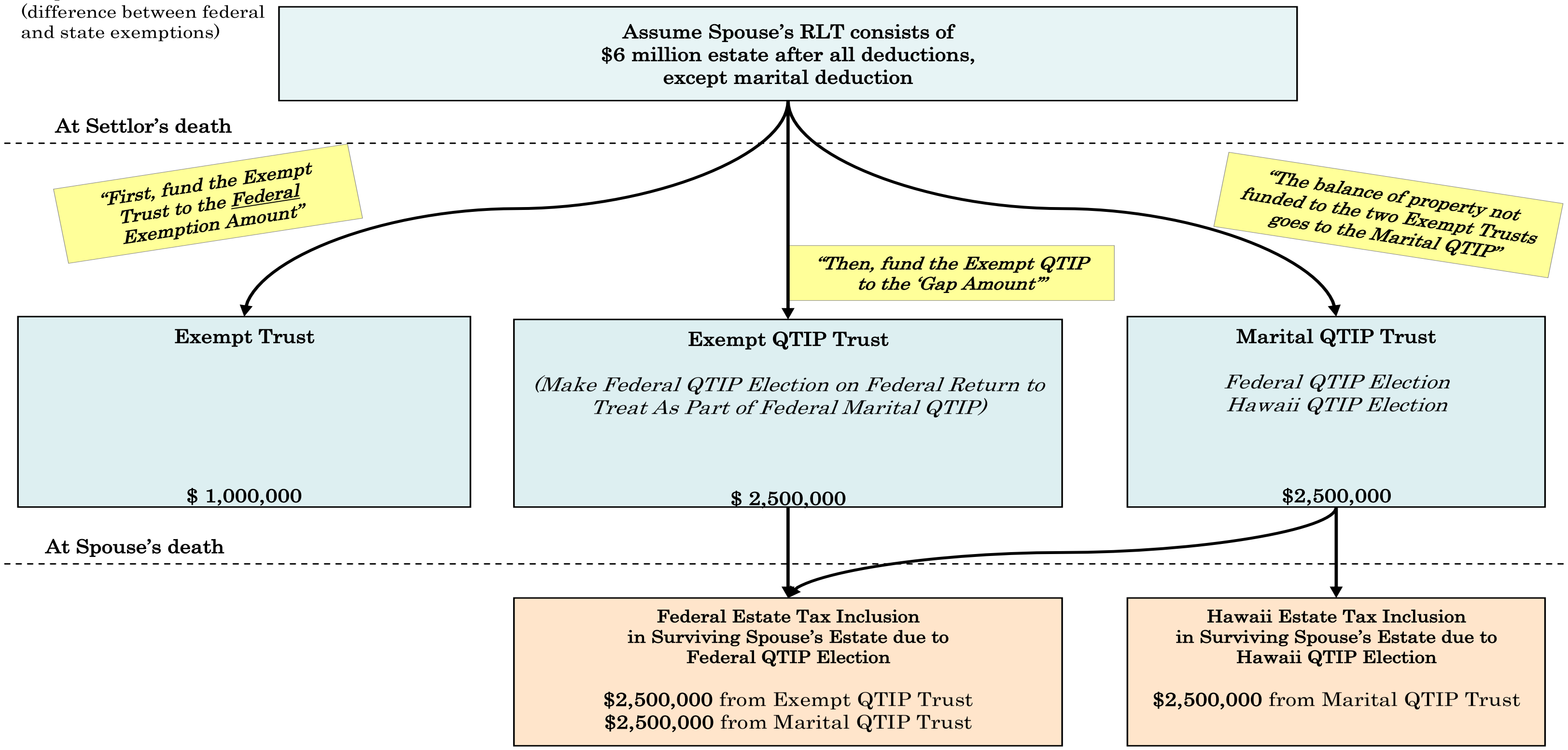
Estate = $6 mil.

Federal Exemption = $1 mil.

State Exemption = $3.5 mil.

"Gap Amount" = $2.5 mil. (difference between federal and state exemptions)

FULLY UTILIZE EXEMPTIONS THROUGH APPROPRIATE QTIP ELECTIONS
THREE SUB-TRUST APPROACH
ILLUSTRATION I
Federal Exemption < State Exemption



CONCLUSION: If Hawaii QTIP election is allowed for Hawaii estate tax purposes, this is one option to consider in regards to fully utilizing both federal and state exemptions. Otherwise, Hawaii exemption could be underutilized at death of first spouse.

The example and illustration provided above assumes that the Hawaii exemption is greater than the federal exemption. The following example illustrates how the three-trust approach works when the federal exemption is greater than the Hawaii exemption. As the $5,000,000 federal exemption is in fact higher than the Hawaii exemption (for at least the next two years), the following example and illustration are more pertinent for practitioners to review and understand:

> **EXAMPLE**: Assume the estate of the first spouse to die was $6,000,000, at a time when the federal exemption is $5,000,000 (as it is under current law) and the Hawaii exemption is $3,500,000. Assume further that all $6,000,000 was funded into a revocable trust that included a three-trust funding formula which provided the trustee with the flexibility to use both the Hawaii and federal QTIP elections as necessary.
>
> There would be no federal or Hawaii estate tax at the first spouse's death. Furthermore, the estate could fully utilize both the federal and Hawaii exemptions.
>
> The first $3,500,000 would be funded into the "exempt trust" because the Hawaii exemption is less than the federal exemption. For Hawaii estate tax purposes, the $3,500,000 exemption would shield these assets from Hawaii estate tax. For federal purposes, $3,500,000 of the $5,000,000 exemption would shield these assets from the federal estate tax.
>
> The "gap amount" of $1,500,000 would be funded into the "exempt QTIP trust." For Hawaii estate tax purposes, the $1,500,000 would not be subject to Hawaii estate tax because the trustee would make the Hawaii QTIP election on the Hawaii estate tax return to treat this amount as part of the Hawaii marital QTIP. This would result in a Hawaii QTIP marital deduction of $1,500,000. For federal purposes, the $1,500,000 would not be subject to federal estate tax because the trustee would <u>not</u> make the federal QTIP election. Instead, the remaining $1,500,000 in federal exemption would shield these assets from the federal estate tax.
>
> The remaining $1,000,000 would be funded into the "marital QTIP trust." The trustee would make both the federal and Hawaii elections on the assets held in this trust. There would be no federal or Hawaii estate tax on this amount because of the resulting QTIP marital deduction for both federal and Hawaii purposes.

Assume

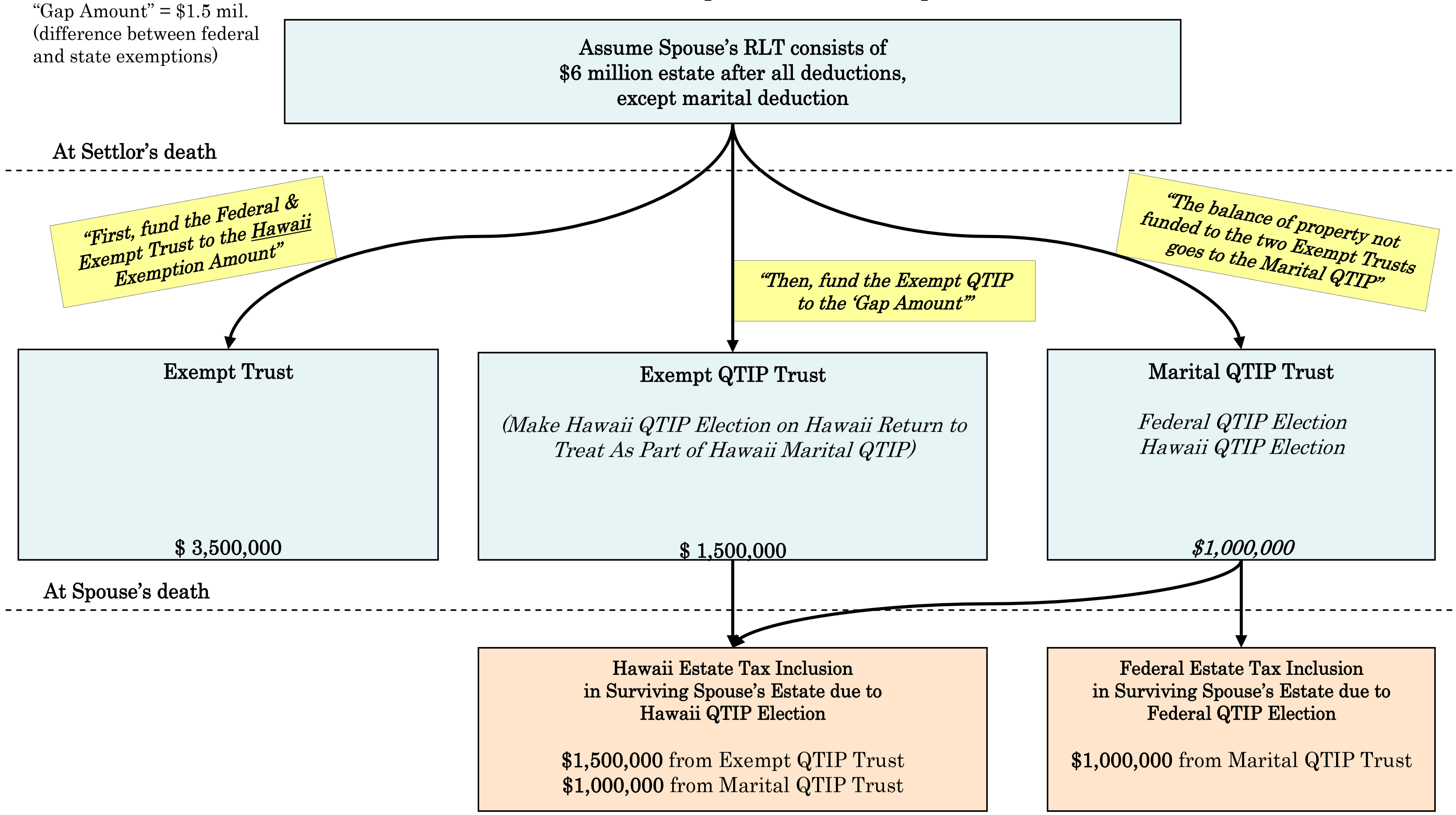
Estate = $6.0 mil.

Federal Exemption = $5.0 mil.

State Exemption = $3.5 mil.

"Gap Amount" = $1.5 mil. (difference between federal and state exemptions)

FULLY UTILIZE EXEMPTIONS THROUGH APPROPRIATE QTIP ELECTIONS
THREE SUB-TRUST APPROACH
ILLUSTRATION II
Federal Exemption > State Exemption



CONCLUSION: If Hawaii QTIP election is allowed for Hawaii estate tax purposes, this is one option to consider in regards to fully utilizing both federal and state exemptions. Otherwise, Hawaii estate tax could result at the death of the first spouse.

Seasoned practitioners have been working to create with a funding formula that incorporates the three-trust approach and utilizes the Hawaii QTIP election.[30] The sample that follows is a consolidation of different approaches from these practitioners, as well as practitioners from other states (who have been dealing with decoupled state estate taxes for many years). That being said, the language should not be used as "drag and drop" template. Provisions normally included as part of the funding formula have been purposely omitted to highlight the relevant provisions. It should be thought of as a baseline for further development and discussion of a workable formula. As you will see, the key to the language is the flexible nature of the funding, which gives the informed trustee the ability to make the appropriate state and/or federal elections and utilize the appropriate amount of exemption based on the situation as it exists at the death of the first spouse.

SAMPLE LANGUAGE - THREE SUB-TRUST FUNDING FORMULA
INTENDED TO FULLY UTILIZE BOTH STATE AND FEDERAL EXEMPTIONS
DISPOSITION OF TRUST ESTATE AT SETTLOR'S DEATH IF SPOUSE SURVIVES
(PECUNIARY)

Section 1. **Disposition of Trust Estate If Settlor's Spouse Survives.** If the settlor's spouse survives the settlor, then at the settlor's death the trustee shall retain and administer as the EXEMPT TRUST an amount equal to the largest dollar amount that (without considering the federal or state estate tax marital or charitable deduction in effect at the time of the settlor's death) can pass from the settlor's gross estate free of federal and state estate taxation, taking into consideration (i) the value of all available credits against the estate tax (only to the extent that state death taxes are not thereby increased); (ii) all deductions (other than the marital or charitable deduction) against the estate tax; and (iii) all taxable transfers which pass outside of this trust.

The trustee, after segregating the assets of the EXEMPT TRUST, shall then retain and administer as the EXEMPT QTIP TRUST an amount equal to the largest dollar amount that can pass from the settlor's gross estate without the imposition of either federal or state estate tax, given the settlor's then remaining federal or state exemption.

The trustee, after segregating the assets of the EXEMPT TRUST and the EXEMPT QTIP TRUST, shall hold the remaining trust estate as the MARITAL QTIP TRUST.

The trustee shall have the sole discretion to select the assets which shall constitute the EXEMPT QTIP TRUST and MARITAL QTIP TRUST, including the discretion to make basis adjustments under Internal Revenue Code § 1022, if then in effect. In no event, however, shall there be included in such trusts any asset or the proceeds of any asset which will not qualify for the federal or state estate tax marital deductions. Such trust estates shall be reduced to the extent that they cannot be created with such qualifying assets, and the amount of any such reduction shall be added to the EXEMPT TRUST.

Section 2. Disposition of the Exempt Trust. The trustee shall distribute to the settlor's spouse net income and principal of the trust estate as the trustee in its sole discretion determines to be necessary or advisable for the spouse's health, maintenance, and support and the settlor's children and/or the issue of the settlor's children for their health, maintenance, support and education, without equalization or proration among them. In making any distributions, the trustee may take into consideration all other funds available to such beneficiaries for such purposes. Payments of income or principal to or for any of such beneficiaries shall not be taken into account in any later or final distribution of trust principal to such beneficiaries. In regards to the net income or principal of this trust, the trustee shall first consider needs of the settlor's spouse. Any uncertainty or conflict concerning

[30] The author thanks the many practitioners who shared their experiences and frustration with drafting a new formula clause. Special recognition goes to Bonnie Moore, Esq. (of Hawaii) and Jeffrey Moore, Esq., (of Saalfeld Griggs in Salem, Oregon), for their assistance in developing the sample language.

distributions or the investment management of such income or principal shall be decided in favor of the settlor's spouse, even if it is detrimental to or excludes current or future beneficiaries. This trust shall terminate upon the death of the settlor's spouse and, the then remaining assets, including any accumulated and accrued but undistributed income, shall be allocated into shares of equal value and distributed to separate trusts established for the benefit of each of the settlor's then living children, or the issue of a then deceased child, per stirpes.

Section 3. Disposition of the Exempt QTIP Trust. All net income of this trust shall be paid to the settlor's spouse in convenient installments, at least quarterly. The trustee shall also distribute to the settlor's spouse the principal of the trust estate as the trustee, in its sole discretion, shall determine to be necessary or advisable to provide for the settlor's spouse's health, education, maintenance, and support. The trustee shall take into consideration all other funds available to the settlor's spouse for such purposes.

The amount allocated to this trust may be subject either to federal estate taxation or to state estate taxation. The settlor hereby authorizes the trustee or the Personal Representative of the settlor's estate to elect for the trust for the benefit of the settlor's spouse to be treated as qualified terminable interest property ("QTIP") for the purpose of qualifying for the federal or state marital deduction allowable in determining the federal and state estate tax at the settlor's death.

Without limiting the discretion contained in the preceding sentence, the settlor intends for the trustee or the Personal Representative to make the respective federal and/or state QTIP election(s) if an estate tax would be imposed without such an election, unless the timing of the deaths of the settlor and the settlor's spouse and the computation of the combined death duties on their two estates render such an election inappropriate.

If the election provided for in this paragraph is made, then, notwithstanding any other provision of this agreement, the trustee shall not have any rights, powers, duties, authorities, privileges, or immunities, whether or not discretionary, if and to the extent that such rights, powers, duties, authorities, privileges or immunities would disqualify the trust corpus for the marital deduction. If the election provided for in this paragraph is not made, then this trust shall nonetheless continue, and shall be held administered, and terminated pursuant to the terms of this Section.

The settlor also directs that, notwithstanding any other provision of this agreement, in establishing and administering this trust:

(i) ACCOUNTING: If the trustee is in doubt as to whether, in accordance with generally accepted principles of trust accounting, any disbursement should be charged, or receipt credited, to income or principal, the trustee shall charge such disbursement to principal and credit such receipt to income.

(ii) UNPRODUCTIVE PROPERTY: The trustee shall manage the trust so that there shall be produced such a periodically distributable income as is consistent with the value of the trust property and its preservation. Therefore, the settlor's spouse shall have the right to require that any unproductive property in this trust shall be made productive or be converted to productive property within a reasonable time.

(iii) AGREEMENTS ON MARITAL DEDUCTION: If the availability of a state and/or federal estate tax marital deduction shall require the trustee to sign any agreement or undertaking, or make any election, the settlor directs the trustee, without liability or accountability, to enter into such agreement, undertaking or election as shall be required to assure the availability of such deduction.

If the settlor's spouse disclaims, in whole or in part, any interest in or power over any property placed in this EXEMPT QTIP TRUST, the property or the portion of the property to which such disclaimer pertains shall be added to and become a part of the principal administered, and distributed under Section 8. Any taxes due as a result of any such disclaimer shall be paid first from the assets of the Section 8. In addition to any method of disclaimer recognized by law, the settlor's spouse may disclaim in whole or in part by a writing delivered to the trustee.

The EXEMPT QTIP TRUST shall terminate upon the death of the settlor's spouse. Upon termination, the trustee shall pay any accrued and accumulated but undistributed income to the estate of the settlor's spouse. The remaining trust estate shall then be held under Section 8.

Section 3. Disposition of the Marital QTIP Trust. All net income of this trust shall be paid to the settlor's spouse in convenient installments, at least quarterly. The trustee shall also distribute to the settlor's spouse the principal of the trust estate as the trustee, in its sole discretion, shall determine to be necessary or advisable to provide for the settlor's spouse's health, education, maintenance, and support. The trustee shall take into consideration all other funds available to the settlor's spouse for such purposes.

The amount allocated to this trust may be subject either to federal estate taxation or to state estate taxation. The settlor hereby authorizes the trustee or the Personal Representative of the settlor's estate to elect for the trust for the benefit of the settlor's spouse to be treated as qualified terminable interest property ("QTIP") for the purpose of qualifying for the federal or state marital deduction allowable in determining the federal and state estate tax at the settlor's death.

Without limiting the discretion contained in the preceding sentence, the settlor intends for the trustee or the Personal Representative to make the respective federal and/or state QTIP election(s) if an estate tax would be imposed without such an election, unless the timing of the deaths of the settlor and the settlor's spouse and the computation of the combined death duties on their two estates render such an election inappropriate.

If the election provided for in this paragraph is made, then, notwithstanding any other provision of this agreement, the trustee shall not have any rights, powers, duties, authorities, privileges, or immunities, whether or not discretionary, if and to the extent that such rights, powers, duties, authorities, privileges or immunities would disqualify the trust corpus for the marital deduction. If the election provided for in this paragraph is not made, then this trust shall nonetheless continue, and shall be held administered, and terminated pursuant to the terms of this Section.

The settlor also directs that, notwithstanding any other provision of this agreement, in establishing and administering this trust:

(i) ACCOUNTING: If the trustee is in doubt as to whether, in accordance with generally accepted principles of trust accounting, any disbursement should be charged, or receipt credited, to income or principal, the trustee shall charge such disbursement to principal and credit such receipt to income.

(ii) UNPRODUCTIVE PROPERTY: The trustee shall manage the trust so that there shall be produced such a periodically distributable income as is consistent with the value of the trust property and its preservation. Therefore, the settlor's spouse shall have the right to require that any unproductive property in this trust shall be made productive or be converted to productive property within a reasonable time.

(iii) AGREEMENTS ON MARITAL DEDUCTION: If the availability of a state and/or federal estate tax marital deduction shall require the trustee to sign any agreement or undertaking, or make any election, the settlor directs the trustee, without liability or accountability, to enter into such agreement, undertaking or election as shall be required to assure the availability of such deduction.

> If the settlor's spouse disclaims, in whole or in part, any interest in or power over any property placed in this MARITAL QTIP TRUST, the property or the portion of the property to which such disclaimer pertains shall be added to and become a part of the principal administered, and distributed under Section 8. Any taxes due as a result of any such disclaimer shall be paid first from the assets of the Section 8. In addition to any method of disclaimer recognized by law, the settlor's spouse may disclaim in whole or in part by a writing delivered to the trustee.
>
> The MARITAL QTIP TRUST shall terminate upon the death of the settlor's spouse. Upon termination, the trustee shall pay any accrued and accumulated but undistributed income to the estate of the settlor's spouse. The remaining trust estate shall then be held under Section 8.

VI. GENERATION SKIPPING TRANSFER TAX PLANNING

While allocation of federal GST exemption should be allowed under the three-trust approach, questions remain on how to allocate the Hawaii GST exemption to the same trusts. Under federal rules, GST is automatically allocated to irrevocable transfers to trusts where a GST event is implicated, so long as the transfer does not fall within the estate-tax inclusion period (ETIP).[31] The allocation is generally made across the board, which is not necessarily a good thing because a GST exemption is not a true exemption and not a credit against the GST tax. Rather, it is a rate reducer. So if GST is automatically applied to "all" assets, the entire transfer is still subject to tax at an effective rate of GST tax (called the "applicable rate"), which is determined by multiplying the percentage of property to which the GST exemption has not been allocated (called the "inclusion ratio") by the maximum federal estate tax rate.[32] Thus, a primary goal of GST planning is to ensure that all trusts are assigned an inclusion ratio of 1 or 0 (e.g., trusts that are either totally taxable or totally exempt).[33] The fractional inclusion ratio that can arise from automatic allocation of the GST exemption may result in wasting of the GST exemption and creates the likelihood of unnecessary taxation. To alleviate this situation, the automatic allocation of federal GST exemption can be opted-out of through federal Form 709 (gift tax return), Form 1041 (fiduciary tax return) or Form 706 (estate tax return), depending on the timing of the allocation.

For Hawaii GST planning purposes, there are a couple of basic issues that need to be addressed by the State before reliable planning can commence. First, will Hawaii allow for automatic allocation as well? There is no guidance from the Department of Taxation as of the date this was submitted for publication. Second, whether automatic allocation is allowed or not, how will practitioners, advisors and accountants either allocate Hawaii GST or opt-out of the automatic allocation of Hawaii GST? If Hawaii adopts an opt-out system, perhaps the Department of Taxation will allow use of the 2009 federal Form 709, 1041 and/or 706 as a temporary reporting mechanism until a Hawaii GST return is developed.

VII. THE NEW HAWAII ESTATE TAX AND THE FEDERAL "TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION AND JOB CREATION ACT OF 2010"

In light of recent changes to the federal transfer tax system as a result of the 2010 federal tax act, a couple of items are worth mentioning because of its potential effect on the Hawaii estate tax.

(1) Portability: Current federal rules now allow spouses to freely transfer unused federal estate tax (but not GST) exemption from the deceased spouse to the surviving spouse. Will Hawaii allow for "portability" of the Hawaii estate tax exemption as well? Either way, practitioners should consider adding portability provisions to their trust and/or will forms.

> **Last Will and Testament Sample Language**: If, at the time of my death, the federal and/or state estate tax laws shall provide for portability of the federal and/or state exemption between spouses, I hereby authorize my Personal Representative to sign any return, agreement or undertaking, without liability or accountability for entering into such return, agreement or

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[31] *See* Treas. Reg. §26.2632-1(c)(3) for rules on when the ETIP terminates.

[32] *See* IRC § 2642(b)(3).

[33] *See* IRC § 2642(a)(1), Treas. Reg. § 26.2642-1(a). The numerator of the "applicable fraction." is the amount of the GST exemption allocated to the trust. The denominator is the value of the property transferred, reduced by the sum of (1) any federal estate tax or state death tax recovered from the trust attributable to the transfer, and (2) the gift or estate tax charitable deduction, if any, allowed for the property. IRC § 2642(a)(2), Treas. Reg. § 26.2642-2(a)(1).

> undertaking, as shall be required to assure the transfer of any unused federal and/or state exemption to my spouse, if then surviving.
>
> **Trust Sample Language**: If, at the time of the settlor's death, the federal and/or state estate tax laws provide for portability of the federal and/or state exemption between spouses, the settlor hereby authorizes the trustee to sign any return, agreement or undertaking, without liability or accountability for entering into such return, agreement or undertaking, as shall be required to assure the transfer of any unused federal and/or state exemption to the settlor's spouse, if then surviving.

(2) Opt-Out Of Modified Carryover Basis And Elect Estate Taxation For 2010: Will Hawaii conform to the 2011 federal tax rule that allows an estate of a decedent who passed away in 2010 (in Hawaii's case, a decedent who passed away with a Hawaii estate on or after May 1, 2010) to elect to use either "the modified carryover basis and no estate tax rule" or "the stepped-up basis, but estate tax rule"?

VIII. NON-RESIDENTS AND NON-CITIZENS OWNING HAWAII SITUS PROPERTY

Note that the Hawaii estate tax also applies to any mainland resident or foreign citizen who owns Hawaii real property or "tangible and intangible property" that's located in Hawaii, subject to available offsets for taxes paid to the resident's home state or home country on the same assets and adjustments to the $3.5 million exemption.[34] Not all of these adjustments are positive. For instance, a Japanese national, as a foreign citizen, who owns a Hawaii condo valued at more than $60,000 should consider whether Hawaii estate taxes are due because the exemption allowed a non-U.S. citizen in 2009 is $60,000, not $3.5 million.

IX. WHAT FORMS TO FILE?

While no official form has been released by the State Department of Taxation, a draft Form M-6 has been circulated for review and comment. According to the instructions to the draft Form M-6, Federal Form 706, as of December 31, 2009, should be prepared (but not filed) for purposes of calculating the fictional federal estate tax. The draft Form M-6 does not provide for the reporting of the new Hawaii generation-skipping transfer ("GST") tax or allow for allocation of the Hawaii GST exemption.

X. CONCLUSION

Whether Hawaii's estate tax is our next "supertramp" remains to be seen. On the one hand, the combination of the Hawaii QTIP and sound planning seems to overcome the Hawaii estate tax. On the other hand, doing what is necessary to minimize the Hawaii estate tax may lead to other problems. Not only does a practitioner have to account for the (1) federal exemption; (2) federal QTIP marital deduction; (3) Hawaii exemption; (4) Hawaii QTIP marital deduction; (5) federal GST exemption; <u>and</u> (6) Hawaii GST exemption when drafting a trust, an individual or corporate trustee will have to know how to account for each tax benefit when funding up to 3-4 (or possibly more) trusts. And even if that is accomplished, specific beneficiaries may need to be named in order to qualify for the tax benefits. The named beneficiaries may not be who the settlor would otherwise name. Thus, a practitioner will need to further assist a client who is developing an estate plan and explain the pros and cons of forsaking non-tax goals in order to enjoy tax benefits. Quantitative calculations and assessment of whether a voluntary estate tax at the death of the first spouse is more beneficial than zeroing out the tax at the first death may become necessary. Of course, getting to this point assumes that the client comes in to get the appropriate work done. But what of the thousands (maybe even tens of thousands) of Hawaii residents who do not adjust their formulas in time to account for the new Hawaii estate tax?

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[34] See, HRS §§ 236D-A and 236D-4.