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The State of the States: Dealing With the Other Estate Tax

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1. For many estate planners, certain issues were part of the wallpaper—they existed in the background of the process, but they rarely required specific attention. The planner's forms included the appropriate language to handle certain issues, and no one gave them a second thought. Chief among the issues to which this approach applied was the state estate tax. Because of the original approach under the Internal Revenue Code to the state death tax credit, payments to the state (other than the relatively rare state which retained an inheritance tax system) had no real impact on the total tax paid, and the standard form insured that they were handled appropriately.

   The changes over the past decade have made this approach impossible to maintain. The elimination of the state death tax credit and conversion to a deduction in computing the federal estate tax, the variety of laws adopted by the different states and the funding choice that may now be required have moved this issue from the background to the foreground.

2. The Good Old Days

   a. Prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), most states utilized Section 2011 of the Internal Revenue Code to calculate the state estate tax. Section 2011(a) provided:

      > 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. In essence, the state collected the total amount of the State Death Tax Credit, and defined its own tax as equal to this amount.

   c. The payment of state estate tax therefore did not increase the overall tax bill of a decedent; a portion of the tax calculated at the federal level was paid to the state, and a credit for the payment was reflected on the federal return.

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d. The credit also applied for any inheritance or other taxes assessed, so long as the taxes were actually paid.

e. This pick up tax approach was easy for the states to administer. Very little was required in terms of calculation or reporting, and most of the audit work (at least as to issues other than domicile) could be done at the federal level. If the IRS instituted an audit and increased the value of the gross estate, the amount of the state death tax credit increased, and the IRS required proof of payment of the state estate taxes before a closing letter could be issued, ensuring that states received the full amount of taxes after audit.

f. From a planner's perspective, the state death tax credit also made drafting relatively easy. Because the credit did not impose any additional tax, there was rarely a need to consider a particular state's laws when drafting a plan; only consideration of federal law was required in nearly all situations.

3. After the Credit

a. EGTRRA changed all of this. It phased out the State Death Tax Credit over a four year period beginning in 2002, with a graduated elimination completed by the end of 2004. IRC Section 2011(b)(2)

b. Beginning in 2005, the State Death Tax Credit was replaced by a deduction for the amount of state estate or inheritance taxes actually paid. IRC Section 2058(a) provides:

> For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate 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).

c. This new federal approach required states to create an independent system to tax estates, rather than merely relying on the federal system.

d. The shift to a deduction happened at the same time that the federal applicable exclusion amount (oftentimes referred to as the unified credit) increased significantly, from $675,000 when EGTRRA was passed to $3.5 million by 2009 and $5 million in 2010, 2011 and 2012.

e. While these changes impacted state revenues generated by the estate tax, it did not significantly reduce federal revenues because funds that had previously paid to the states were instead paid to the federal government without any “tax increase.”

4. State Responses

a. These two changes, the elimination of the State Death Tax Credit and the increase in the federal applicable exclusion amount, had a significant impact on state revenues. States were faced with a choice—allow the state estate tax to disappear (and all of the associated revenue with it), decouple from the State Death Tax Credit and refer to a prior version of federal law or impose an independent estate or inheritance tax.

b. About half of all states did not change their laws, which resulted in no state estate tax for the decedents domiciled there because the credit under IRC Section 2011 was eliminated. Four states, California, Florida, Nevada and Pennsylvania are prohibited by their state constitutions from imposing an independent state estate tax absent a popular vote to impose such a tax.

c. Many states revised their laws to impose a state estate tax that was not reliant on the federal system, an approach known as decoupling.

d. In the simplest version, decoupling required the estate to act as if the State Death Tax Credit still existed. The estate calculated the State Death Tax Credit under Section 2011 (treated as if it had not been repealed), and paid that amount to the state. While this payment had less value as a deduction than a credit, the amount of state revenue from the estate tax remained largely unchanged.

e. The increasing applicable exclusion amounts did threaten to impact the amount of revenue generated by the estate tax, so many states decoupled from the federal tax with reference to a specific year, providing for a state exemption at a lower rate than the applicable federal exclusion. This required a calculation of the state death tax credit based on the law in past years, assuming an applicable exclusion amount of something lower than the current amount. For example, in 2009, Illinois required the use of the $2 million applicable exclusion amount that applied in 2008, rather than the increased applicable exclusion amount of $3.5 million that applied in 2009.

f. Decoupling reduced the revenue impact imposed on the states by the elimination of the state death tax credit. It did impose an additional burden on individuals, as the state estate tax now increased the overall tax burden imposed at death.

g. From a planner's perspective, decoupling also made state estate taxes a potentially significant concern, requiring new considerations and more complex drafting. It also increased the importance of an individual's domicile, as the tax impact of the domicile determination could be substantial.

5. Current Status

a. As of this writing, the following states impose a separate state estate tax in 2011[2]:

State	Exemption	Tax Rate for Amts in Excess
Connecticut	$2.0 million	7.2-12%
Delaware	$5.0 million	16%
District of Columbia	$1.0 million	16%
Hawaii	$3.5 million	16%
Illinois	$2.0 million	16%
Maine	$1.0 million	16%
Maryland	$1.0 million	16%
Massachusetts	$1.0 million	16%
Minnesota	$1.0 million	41%
New Jersey	$ 675,000	16%
New York	$1.0 million	16%
North Carolina	$5.0 million	16%
Ohio	$ 338,333	7%
Oregon	$1.0 million	16%
Rhode Island	$ 859,333	16%
Vermont	$2.75 million	16%
Washington	$2.0 million	19%

[2] The most current information on state death taxes is on the McGuireWoods website, in a chart that is updated regularly by Skip Fox. The chart can be found at http://www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf

b. In addition, the following states impose an inheritance tax of some sort:

State	Exemption	Tax Rate for Amts in Excess
Indiana	$100	20%
Iowa	Zero	15%
Kentucky	$500	16%
Maryland	$150	10%
Nebraska	$10,000	18%
New Jersey	Zero	16%
Pennsylvania	Zero	15%
Tennessee	$1.0 million	9.5%

c. Note that Maryland and New Jersey impose both a state estate tax and an inheritance tax.

d. States continue to consider modifying or imposing a state estate tax as revenues remain stretched, and additional changes are likely in the coming years.

6. Practical Challenges in Decoupled States

   a. The trend towards decoupling has led to unanticipated issues, at least from an estate's (and an estate planner's) perspective where a decedent is domiciled in a decoupled state (or the decedent owned property situated in a decoupled state), particularly where the documents did not contemplate decoupling.

   b. Many estate planning documents include language that required funding the marital trust in a way that minimized all federal estate taxes, without regard to any state estate taxes. For example:

      …the largest pecuniary amount which will not result in or increase federal estate tax payable by reason of my death. In determining the pecuniary amount the trustee shall consider the credit for state death taxes only to the extent those taxes are not thereby incurred or increased…

      i. Prior to EGTRRA's state death tax credit phase-out, this formula was effective in minimizing both federal and state estate taxes, and it is still effective in those states which have not decoupled and do not refer to prior versions of Section 2011 in imposing a state estate tax.

ii. In states that have decoupled and now impose an estate tax with reference to a prior, smaller federal applicable exclusion amount, such a formula will result in the imposition of state estate taxes, as the marital trust is directed to be funded with an amount required to minimize federal estate taxes, even if that results in the imposition of state estate taxes. The formula does not take state estate taxes into account.

iii. By way of example, such a formula would impose $391,600 in Illinois estate tax (and a related federal deduction) at the first death in 2011, assuming there is a surviving spouse and the assets total $5 million. This is based on a 16% rate for assets in excess of $2 million.

c. Other estate planning documents include language that requires consideration of both federal and state estate taxes.

i. For example, the Northern Trust formbook provides:

…the largest pecuniary amount which will not result in or increase either (i) federal estate tax or (ii) state death taxes which are based upon the state death tax credit, that would be payable by reason of my death.

ii. This formula allows for a funding that would take into account both the federal and state estate taxes. It will avoid any taxes at the first death (which often reflects the grantor's intentions).

iii. This formula may result in the underfunding of the credit shelter trust for federal estate tax purposes, as the bypass trust would be funded with the amount that can pass free of both federal and state estate taxes.

iv. Depending on the assets owned by the surviving spouse at her subsequent death, however, this formula may result in additional taxes at the second death. Because some state estate tax statutes do not have a mechanism to ensure that the state estate tax is paid at the second death even if the surviving spouse has left the state, avoiding tax at the first death and then changing the surviving spouse's domicile prior to the second death may avoid all state level estate taxes.

d. Building flexibility into the estate plan is essential in this environment.

i. One option is to draft the documents to allow for disclaimer planning. If it is appropriate, the surviving spouse may choose to disclaim assets that would pass to the marital trust, thereby funding the bypass trust with additional assets. The disclaimer may result in state estate taxes on the death of the first spouse, but the overall tax burden may be lower on the death of the survivor if paying taxes at the first death allows for additional use of the lower brackets.

(a) The risk in this approach is the dependence on the surviving spouse to make a decision that may not be in her personal best interest, even if it is beneficial from an overall perspective.

(b) The surviving spouse also may take actions after the first death that are deemed to be acceptance under IRC Section 2518, making a qualified disclaimer impossible. For example, the surviving spouse may accept income payments from all of the assets without understanding the risks associated with the payment.

(c) Consideration of the fiduciary duties may also come into play, especially where the terms of the two trusts vary or the beneficiaries are different. See the discussion at page 9.

ii. Another approach to consider is drafting the marital trust to qualify for QTIP treatment under Section 2056. This approach will allow the executor to consider all of the factors at the time the estate tax return is filed, and elect to make a partial QTIP election over the marital trust to more fully utilize the federal applicable exclusion amount.

(a) The potential issue with this approach is that the portion of the trust that is not subject to the QTIP election nonetheless is required to distribute income to the surviving spouse, and cannot be drafted as a spray trust to benefit children or other descendants.

(b) In light of the increased applicable exclusion amount and the ability to use the income to make annual exclusion (or taxable) gifts, the increased flexibility available with this approach may be beneficial.

iii. An additional technique to consider is the so-called Clayton QTIP.

(a) A Clayton QTIP, named for Clayton v. Commissioner, 976 F2d 1486, and supported by Treas. Reg. §20.2056(b)-7(d)(3), allows the executor to determine the share of the marital trust for which QTIP treatment should be elected, with the balance automatically pouring into the bypass trust after the election has been made. This has the advantage of not forcing excess income to be distributed to the surviving spouse from the marital trust, thereby augmenting the survivor's estate.

(b) The challenge with a Clayton QTIP formula is two-fold. First, determining the proper amount over which a QTIP election should be made may be challenging for a non-professional executor. Second, the drafting involved may be both complex and difficult to explain both to the grantor and to the surviving spouse.

iv. A single fund trust also can be utilized to allow flexibility. Under this type of plan, there is no split between the two shares—the assets remain in a single fund.

(a) The single fund trust requires the use of a rolling fraction. The Trustee needs to keep track of the changes to the fraction that represents the two shares to ensure that the income from the marital portion is properly distributed and taxed, and that the share subject to any power of appointment is clear.

(b) Most formulas are drafted to direct that all payments are treated as made from the marital portion, thereby minimizing the share that will be taxable at the second death.

(c) This approach allows for flexibility, but is likely to be administratively complex for many trustees and difficult for most individuals to understand.

e. In many cases, the grantor did not consider these issues, or could not have predicted the choices involved and the calculations required to determine the most advantageous approach.

i. Depending upon the circumstance in place at the time of the first death, the appropriate approach may not be clear, making flexibility essential.

ii. Depending on the beneficiaries and their interests, the decision may also impact how much passes to a given beneficiary, which could result in conflict at the first death.

7. State QTIP Elections

a. Where it is available, a state only QTIP election allows for a solution to the choice between underfunding the federal applicable exclusion amount and paying state estate tax.

b. At this writing, nine states have adopted legislation to allow for a state only QTIP election—Illinois, Maine, Maryland, Massachusetts, New York, Ohio, Oregon, Rhode Island and Vermont.

c. The solution came at a cost—more complex drafting.

d. If the bypass trust is drafted to be QTIP-able under federal law (all income to the spouse, no other beneficiaries, etc), it is possible to split the bypass trust so that the full federal amount is allocated to it, but a portion of it is subject to a state only QTIP election.

e. Example: John died in Maine during 2011 owning assets totaling $11 million. John is survived by his wife Sally. In 2011, the federal applicable exclusion is $5 million and the Maine applicable exclusion amount is $1 million; Maine allows a state only QTIP election. Under John's documents, the following three trusts will be created:

Bypass Trust (exempt for federal & Maine purposes)	$1 million
Marital Trust #1(state only QTIP; exempt for federal purposes)	$4 million
Marital Trust #2 (federal & state QTIP)	$6 million

John's plan eliminates all taxes at his death. It fully funds the federal applicable exclusion in the form of the bypass trust and Marital Trust #1, both of which are treated for federal purposes as funding the applicable exclusion amount. At Sally's death, only Marital Trust #2 will be taxable in her estate for federal purposes; for Maine purposes, both Marital Trust #1 and #2 will be taxable in her estate.

f. This provides “the best of both worlds”—the least possible tax owed at the first death, while still utilizing all of the available federal applicable exclusion amount.

8. The Funding Choice

   a. Determining how to proceed in a decoupled state following a first death implicates a number of fiduciary duties—the duty of impartiality chief among them.

   b. The duty of impartiality requires a trustee to treat all beneficiaries fairly.

      i. “When there are two or more beneficiaries of a trust, the trustee is under a duty to deal impartially with them.” See Restatement of Trusts (Third), Section 183 (1992). The duty applies to simultaneous (where several beneficiaries are entitled to share in the income and principal) as well as successive interests.

      ii. The trustee has a duty of fairness to all of the beneficiaries and of impartiality among them. This duty requires a trustee to balance the competing interests of differently situated beneficiaries in a fair and reasonable manner.

      iii. The document may permit the trustee to favor one beneficiary over another. For example: “It is my intention that the needs of my spouse shall take priority over the needs of my children.”

      iv. While the question of the duty of impartiality of the trustee arises where there are successive beneficiaries, some being entitled to income, others being ultimately entitled to the principal, the question can also arise when the funding choice or tax election will impact the rights of various beneficiaries.

   c. This duty of impartiality can be brought to the fore when the choice arises whether to fund a bypass trust up to the full federal applicable exclusion amount (and pay state taxes currently) or to fund the bypass trust only up to the state exemption amount (and avoid all taxes). If the children are beneficiaries of the bypass trust during the spouse’s lifetime, they have an interest in seeing the bypass trust funded to the maximum extent possible, even at the cost of additional taxes. In contrast, the surviving spouse may prefer to see a greater share of the assets held in a marital trust to which all income is to be paid to him, and all taxes are avoided.

d. There is no clear resolution to this potential conflict. The trustee cannot favor one set of beneficiaries over another, absent clear language in the document. If the parties cannot agree on the best result in those circumstances, the trustee may be forced to ask a court for guidance.

e. In addition to the fiduciary duties brought to bear, other more tangible factors should be considered when determining the proper funding:

    i. Anticipated size of the surviving spouse's estate;

    ii. Surviving spouse's life expectancy;

    iii. Surviving spouse's needs for income and principal;

    iv. Possible federal and state transfer tax rates and exemptions at surviving spouse's anticipated date of death.

9. Methods for Minimizing State Estate Taxes

    a. Change of Domicile

        i. The most obvious way to avoid state estate taxes is to domicile in a state where there are no state estate taxes. Changing domicile is a popular approach for those living in many states, perhaps aided by the (generally warmer) geographic location of many of the states that do not impose any state estate taxes.

        ii. From a legal perspective, domicile is determined by intent—where did the individual intend to reside permanently. As with many legal issues, the answer to that question is oftentimes less clear than it may appear at first glance.

        iii. If a couple moves all of their belongings to a new state, there is little doubt that domicile has been changed. The challenge arises where the couple wishes to retain their prior residence in a state with a state estate tax, but change their domicile to a tax free state.

        iv. Changing domicile can be more complicated than many individuals believe. The numerical split of days between residences is one factor (a couple should spend more time in their state of domicile than in the non-resident state), but it is not necessarily the determinative factor.

        v. Amongst the other key actions for establishing a change domicile are the following:

(a) Obtain a driver's license in the new domicile;

(b) Relinquish the driver's license from the former domicile;

(c) Change address on passport to reflect new domicile;

(d) Register to vote in the new domicile;

(e) Vote in the new domicile;

(f) Execute estate planning documents in the new domicile;

(g) Reference the new domicile in trusts and other legal documents;

(h) File a non-resident state income tax return for income earned in the former domicile prior to relocation during the calendar year;

(i) File federal income tax returns using the address of the new domicile;

(j) Open bank accounts in the new domicile;

(k) Open investment accounts in the new domicile;

(l) Review the retention of business interests in the former domicile;

(m) Update billing addresses on credit cards to the new domicile;

(n) Update billing address on utility invoices to the new domicile;

(o) Relocate safe deposit box contents to the new domicile;

(p) Acquire license plates in the new domicile;

(q) Relocate heirlooms, mementos, works of art and other "near and dear" items to the new domicile;

(r) Hold family and social gatherings in the new domicile, rather than the former domicile;

(s) Affiliate with organizations in the new domicile;

(t) Disaffiliate with organizations in the former domicile, if possible;

(u) File an Affidavit of Residency in the new domicile, if permitted under state law.

vi. States with a state estate tax have become increasingly aggressive in challenging domicile, particularly where the change seems to have occurred shortly before death and with few of the factors noted having changed.

vii. In many cases, if a decedent no longer owned assets requiring the filing of a state estate tax return in the former domicile and had filed a final resident income tax return in a prior year, it is not clear if the former domicile will be aware that the death occurred, or that a tax return could have been required. The desire to avoid filings in the former domicile can place a premium on eliminating real property ownership in the former domicile.

b. Another method for minimizing state estate taxes, which also can be used to support a change in domicile, is to turn tangible assets into intangibles by changing their title. In many states, assets held in a trust, LLC, LP or other pass through entity are converted from tangible to intangible, avoiding taxation. These vehicles can be used for residences, tangible personal property and other assets that remain located in the former domicile.

i. Some states are aware of this approach, and have made efforts to prevent its effectiveness.

ii. For example, Maine subjects real or tangible property located in Maine that is transferred to a trust, LLC or other pass through entity to Maine estate tax in a non-resident's estate. M.R.S. Title 36, Sec. 4064.

c. Gifting also can be an effective way to minimize state estate taxes.

i. Only two states, Connecticut and Tennessee, have an independent gift tax.

ii. Connecticut has a one year look back period for gifts prior to death.

iii. States vary in the impact that prior taxable gifts have in the calculation of the state estate tax. In some cases, larger estates escape a second level of taxation on lifetime gifts, while smaller estates do not.

10. Conclusion

The challenges presented by the new world of estate planning are complex and interrelated. Considering how to plan for various state estate taxes, alongside the potential repeal of the estate tax, the risk of clawback, the new world of portability and the myriad of other challenges have made estate planning a dynamic and oftentimes headache-inducing field both in recent years and for the foreseeable future. Northern Trust stands ready to assist you as you confront these challenges. We look forward to working with you and your clients as we navigate this brave new world.

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