Advisory
TRUSTS AND ESTATES DEPARTMENT | AUGUST 2008

WIGGIN AND DANA
Counsellors at Law

2009 Federal Estate Tax Changes Focus Attention on State Estate Taxes

Non-Residents May Also Face State Estate Taxes

Federal Estate Tax Changes. Each U.S. citizen and permanent U.S. resident is entitled to an "applicable exclusion amount" that exempts up to a certain amount of an estate from the federal estate tax. For 2008, the applicable exclusion amount is $2 million. Up to $1 million of an individual's applicable exclusion amount may be used during life to shield taxable gifts from gift taxes. Up to $2 million, minus the amount used during life for taxable gifts, may be used to shield estate assets from the federal estate tax. On January 1, 2009, the applicable exclusion amount will increase to $3.5 million for federal estate tax purposes. The amount available to use for gift taxes will remain at $1 million.

Traditional Tax Efficient Estate Plan for Married Couples. In general, an increase in the applicable exclusion amount benefits everyone interested in reducing federal estate taxes. For married couples, however, it is possible to effectively double the amount that can pass federal estate tax free to heirs.

In order to ensure effective use of both spouses' applicable exclusion amount, married individuals with larger estates should generally have a will or revocable trust that provides that, upon the death of the first spouse, a portion or all of that spouse's estate, up to an amount equal to the available applicable exclusion amount, passes to a trust for the benefit of the surviving spouse. This trust, often referred to as the "Credit Shelter Trust" or "Estate Tax Sheltered Trust," is usually designed to give the surviving spouse access to trust income and principal without subjecting the trust to estate tax when the surviving spouse dies. Typically, the balance, if any, of the estate of the first spouse passes to the surviving spouse outright or to a trust for the surviving spouse's exclusive benefit which qualifies for the marital deduction. With such an estate plan, usually no federal estate tax will be due at the death of the first spouse, and the assets in the Credit Shelter Trust are not includible in the surviving spouse's taxable estate. This is sometimes referred to as a "Tax Efficient Estate Plan."

Decoupling: State Estate Taxes. For years, the planning just described worked very well to defer any estate tax until the death of the surviving spouse and to avoid entirely all estate tax on an amount up to the combined applicable exclusion amounts for both spouses. State estate taxes simply were not a problem because a mechanism in the federal estate tax law provided that the federal government shared a portion of the estate tax revenues with the states. If no federal estate tax was due, generally no state estate tax would be due either.

2009 Federal Estate Tax Changes Focus Attention on State Estate Taxes CONTINUED

More recently, however, the federal estate tax laws eliminated the revenue sharing mechanism. In response, many state legislatures (including those in Connecticut, New York, New Jersey, and Massachusetts) established separate state estate taxes that operate independently of the federal estate tax system. This separation of the federal and state estate tax systems is referred to as "decoupling." As a general rule, the amount that is exempt from tax under decoupled state estate taxes is capped at amounts ranging from $675,000 to $2 million.

For example, the amount that can pass tax free under the New York system is $1 million, and Connecticut does not assess an estate tax on taxable estates valued at less than $2 million.

Unless a married couple's estate plan has been updated recently to address decoupling, it is quite possible that one or both of their estates may owe state estate tax, even though one or both estates are exempt from federal estate tax. This problem will be exacerbated by the increase in the federal estate tax exemption to $3.5 million.

Addressing the Effect of Decoupling on the Traditional Tax Efficient Estate Plan. The decoupling of federal and state estate taxes significantly complicates estate planning for married couples. Under prior law, most estate plans focused solely on the federal estate tax and were designed to maximize the use of the federal applicable exclusion amount at the first spouse's death. Historically, such an estate plan also would avoid the imposition of state estate taxes at the first death. However, in a state with a new "decoupled" estate tax, a traditional Tax Efficient Estate Plan may result in the imposition of a state estate tax at the first spouse's death.

For example, assume a married couple resides in Connecticut. Further assume the husband has assets of $2.5 million and the wife has assets of $1.5 million, for a total of $4 million in family assets. Both spouses have wills that provide for a traditional Tax Efficient Estate Plan. If the couple's Tax Efficient Estate Plan is not revised to address decoupling, and the husband were to pass away in 2009, no federal estate tax would be due (because the federal exemption would be $3.5 million), but because the husband's taxable estate exceeded $2 million in value, a Connecticut estate tax of $138,800 would be imposed at the first spouse's death. A similar negative result would occur for a couple residing in New York, New Jersey, Massachusetts and several other states (with the notable exception of Florida). If, however, the decoupling problem were properly addressed, the estate tax could be $0 at the first death (and possibly also at the second death).

There are several ways decoupling can be addressed to minimize the impact of state estate taxes.

One option is to put in place a new estate plan that limits the Credit Shelter Trust to the maximum amount that will not trigger a state estate tax (e.g., $675,000 to $2 million, depending on the state). This plan will incur no state taxes at the first death, but may "waste" a significant amount of available federal tax exemption.

A second option is to implement a more flexible estate plan that gives either the surviving spouse or the executor the power to decide how much federal exemption to use. For example, an individual's will may include a "disclaimer" provision which allows the surviving spouse to decide how much to put in the Credit Shelter Trust. Alternatively, an individual's estate plan may provide for a Credit Shelter Trust to be funded with up to the maximum amount that will not trigger a state or federal estate tax, and a Marital Trust for any additional assets, but then allow the executor, through the use of various tax elections and fiduciary powers, to implement the optimal tax plan at the time of the individual's death. This might be done, for example, by not electing to qualify a portion of the Marital Trust for the marital deduction. This would increase the amount subject to state estate tax, but allow the estate to make fuller use of the federal applicable exclusion amount.

A third option is to disregard the decoupling problem and continue to have a traditional Tax Efficient Estate Plan based solely on the federal estate tax applicable exclusion amount. For some individuals with substantial wealth, the impact of the federal estate tax (with a rate of 45%) is of greater concern than the impact of state death taxes (which tend to have effective rates of up to 16%). These individuals may prefer to fund the Credit Shelter Trust with the maximum amount that is exempt from federal estate tax and maximize the potential tax, creditor protection and family wealth planning benefits of the Credit Shelter Trust. Although this approach may result in the imposition of state death taxes at the first spouse's death, for some individuals the best course may be to guarantee maximum use of the federal exemption at the first death in a manner that does not depend on actions taken by the surviving spouse or executor.

Other Decoupling Issues: Ownership of Real Property

Decoupling is not just a problem for married couples. The estates of individuals who own property in a state other than their home state can be subject to state estate taxes in that other state. Suppose you live in a state like Florida that does not impose its own state estate tax. If you own real estate outside of Florida, you may be surprised to learn that a state estate tax can be due on that real estate, even if the total value of the real estate is far less than the exemption from that state's estate tax.

For example, assume you are a Florida resident with a taxable estate of $10 million, and that one of your assets is a home in Connecticut worth $1.5 million. You might think that there should be no Connecticut estate tax because (1) you are not a Connecticut resident, and (2) the total value of your home in Connecticut is worth less than $2 million. (Connecticut exempts taxable estates of less than $2 million from estate tax.) Unfortunately, you would be mistaken. That is not the way Connecticut's (or New York's) estate tax law works. Instead, Connecticut will charge an estate tax equal to the tax your estate would have owed had you been a Connecticut resident (i.e., the tax on a $10 million estate) multiplied by the fraction of your estate located in Connecticut (in this case, 15%). The result in this example is that your estate would owe Connecticut tax of over $160,000.

Importance of Estate Planning to Address State Estate Taxes. State estate taxes have become much more complicated—and much more important—in individuals' estate plans. But deciding how to address them can be difficult. One must consider a variety of factors and make

2009 Federal Estate Tax Changes Focus Attention on State Estate Taxes CONTINUED

WIGGIN AND DANA

Counsellors at Law

a number of predictions regarding future events. Relevant factors may include a surviving spouse's life expectancy and projected wealth at his or her death, future estate tax rates and exemption amounts, as well as the possibility of future estate tax repeal, and the needs and intentions of heirs with respect to the use of assets, including, in particular, real property.

If you have not reviewed your estate plan in the past few years, it is probably advisable to do so to ensure that issues relating to state estate taxes are properly addressed.

If you have any questions about state estate taxes, or any other area of estate planning, attorneys in our Trusts and Estates Department would be pleased to assist you. Our names and telephone numbers are listed below.

TRUSTS AND ESTATES DEPARTMENT

Leonard Leader, *Chair*
203.363.7602, lleader@wiggin.com

John W. Barnett
203.498.4303, jbarnett@wiggin.com

Patricia R. Beauregard
203.498.4423, pbeauregard@wiggin.com

Robert W. Benjamin
212.551.2602, rbenjamin@wiggin.com

Michael T. Clear
203.363.7675, mclear@wiggin.com

Karen L. Clute
203.498.4349, kclute@wiggin.com

Daniel L. Daniels
203.363.7665, ddaniels@wiggin.com

Mark E. Haranzo
203.363.7640, mharanzo@wiggin.com

Helen C. Heintz
203.363.7607, hheintz@wiggin.com

Arsineh Kazazian
212.551.2632, akazazian@wiggin.com

David W. Kesner
203.498.4406, dkesner@wiggin.com

Charles C. Kingsley
203.498.4307, ckingsley@wiggin.com

David T. Leibell
203.363.7623, dleibell@wiggin.com

Virginia R. Robinson
203.363.7638, vrobinson@wiggin.com