

Impact of State Death Taxes on Estate Planning

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Much has been written in the press about the pending (albeit temporary) repeal of the federal estate tax. Less has been written about the actions of state governments to modify (which is to say, increase) state death taxes in the wake of the federal estate tax repeal. Even if it turns out that total federal estate tax repeal is not achieved, the federal estate tax exemption has increased, and, as a result, has eliminated the estate tax at the federal level for many estates. But many people are unaware that an estate that may owe no federal estate tax might still owe a state estate tax. In some cases, the state estate tax can also be eliminated, but that may require changes to one's estate planning documents.

Background

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") provides that the federal estate tax exemption, currently \$1.5 million, will increase incrementally to \$3.5 million as of 2009. The federal estate tax is scheduled to be completely repealed in 2010, but, unless Congress acts, the tax is scheduled to be reinstated in 2011 with an exemption of \$1 million.

Historically, many states imposed a state estate tax that was equal to the maximum state death tax credit allowed on a decedent's federal estate tax return. This meant that only estates that would owe federal estate taxes would be subject to the state estate tax. It also meant that the total estate tax due was not increased; instead, a portion of the estate tax otherwise payable to the federal government was paid to the state. (For this reason,

taxes structured this way are sometimes referred to as "pick up" or "soak up" taxes.)

Among other things, EGTRRA phased out the state death tax credit. Beginning in 2002, the credit has been reduced by 25 percentage points each year (25% in 2002; 50% in 2003; 75% in 2004) and will be eliminated and replaced by a deduction in 2005. The EGTRRA change reduces, and eventually eliminates, the estate tax revenue of those states that base their estate tax on the state death tax credit. This has forced the states to consider changes in their death taxes. The responses have not been uniform.

State Responses to the Federal Tax Changes

Many states, in an effort to maintain estate tax revenues, have enacted legislation to "decouple" their estate tax laws from the federal system, so as to avoid the impact of the EGTRRA changes. For example, New York and New Jersey have fixed their estate tax exemptions at \$1 million and \$675,000, respectively, and calculate their estate tax by using the tax rate schedules set forth in the Internal Revenue Code in effect in 2001. In general, New York and New Jersey disregard the phase-out of the state death tax credit and collect the amount of the credit that would have been allowed if the decedent had died in 2001. As a result, estates of decedents dying in these states, and states with similar legislation, may have to pay more in combined federal and state estate taxes than they did prior to enactment of EGTRRA. Further, since the state exemption no longer equals the federal exemp-

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tion, some New York and New Jersey estates will now owe state estate tax but no federal estate tax. For example, a New York decedent who dies this year with a taxable estate of \$1.5 million will owe New York estate tax of \$64,400, but will not owe any federal estate tax.

Other states have elected to conform their state estate tax exemption to the increased federal estate tax exemption and to retain an estate tax based on the federal state death tax credit. Once the credit is phased-out under the EGTRRA, these states will not have any state estate tax, although these states may impose a separate inheritance or succession tax. Florida, Pennsylvania and Connecticut fall into this latter category. Connecticut, however, has also adopted an "alternate" estate tax that will take effect if Connecticut does not receive certain federal funding. The statute applies to decedents dying between July 1, 2004 and December 31, 2004. During this period, Connecticut's estate tax exemption will be reduced to \$1 million and, disregarding the phase-out of the state death tax credit, the estate tax on estates in excess of \$1 million will be calculated by using the state death tax credit rates in effect as of January 1, 2001. (As we go to press, the Connecticut legislature is considering more general decoupling legislation.)

Estate Planning Implications

The decoupling of the federal and state estate tax systems has an impact not just on the calculation of the tax due, but also on the way estate plans need to be structured, if the goal is to minimize all death taxes. For married couples, an important element of estate planning is structuring a plan so as to use the estate tax exemption available to both spouses to pass a maximum amount of assets to descendants free of estate tax. Assets passing to a surviving spouse who is a U.S. citizen are not subject to estate tax because of the unlimited marital deduction for federal estate tax purposes. This can be used to ensure that there is no tax due at the death of the first

spouse, but, without proper planning, the exemption of the first spouse to die can be wasted, resulting in an increased tax at the death of the second spouse.

For example, assume a husband dies in 2004 leaving his entire \$3 million estate to his wife outright. As a result of the unlimited marital deduction, there is no estate tax due at his death. However, at the death of his wife, the \$3 million she received from her husband (plus any of her own assets) would be subject to estate tax. If the wife dies in 2005, only the first \$1.5 million would be exempt from estate tax. The separate \$1.5 million exemption amount that had been available with respect to the husband's estate has not been effectively used to shelter any assets from tax.

A common planning technique that is used to preserve the exemption amount available to each spouse is to establish a "credit shelter" (or "bypass") trust at the death of the first spouse. The trust is funded with assets of the deceased spouse, up to the federal estate tax exemption amount. Any assets in excess of the exemption amount then pass to the surviving spouse. Because the estate tax exemption is allocated to the trust assets, the trust is not subject to estate tax at the death of the first spouse or at the death of the second spouse. Because of the unlimited marital deduction, the assets passing to the surviving spouse are not subject to estate tax.

For example, assume a husband with a \$3 million estate provided that at his death a "credit shelter" trust would be established that would be funded with assets up to the federal estate tax exemption amount. The balance of his estate would pass to his wife. If the husband dies in 2004, when the federal exemption is \$1.5 million, the trust would receive \$1.5 million, his wife would receive \$1.5 million, and there would be no federal estate tax due. At the wife's subsequent death, say, in 2005, the trust assets would pass to the couple's descendants with no further tax,

and the wife could also leave an additional \$1.5 million to the couple's descendants free of federal estate taxes. Using the available federal estate tax exemption for both estates (\$1.5 million in 2004 for the husband and \$1.5 million in 2005 for the wife), the couple is able to pass \$3 million to their children free from federal estate tax.

Maximizing the Federal Exemption May Result in State Tax

As a result of the EGTRRA changes and the states' legislative responses to retain their estate tax revenue, planning for married couples using the estate tax exemption has become more complicated. In states, such as New York, New Jersey and Massachusetts, which do not recognize the increase in the federal exemption amount, fully funding the credit shelter trust with the federal exemption amount will result in a state estate tax. For example:

- a New York resident who dies in **2004** could fully fund a credit shelter trust with **\$1.5 million** in assets without triggering a federal estate tax, but such funding would trigger **\$64,400** of New York estate taxes.
- a New York resident who dies in **2006** could fully fund a credit shelter trust with **\$2 million** in assets without triggering a federal estate tax, but such funding would trigger **\$99,600** of New York estate taxes.
- a New York resident who dies in **2009** could fully fund a credit shelter trust with **\$3.5 million** in assets without triggering a federal estate tax, but such funding would trigger **\$229,200** of New York estate taxes.

In states which have de-coupled, married clients and their advisors now need to consider whether or not it makes sense to fully fund the credit shelter trust with the federal exemption amount and pay state estate tax, or whether the trust should be funded with the smaller state exemption amount. Depending on the wealth of a couple relative to the increase in the federal estate exemption and the couple's ages, paying state estate tax in order to protect a greater amount from estate tax at the death of the second spouse may or may not be appropriate. For instance, for an older wealthy couple, the cost of the state estate tax at the first death might be a small price to pay for a fully funded credit shelter trust in light of the potential estate tax savings at the death of the surviving spouse. For a younger couple, paying additional tax might not make sense because any potential estate tax savings is likely to be a long way off. Accordingly, clients should consult with their advisors to review and structure their estate plan in a manner appropriate for their particular circumstances.

Comparison of Federal and New York Exemption Amounts

Year	Federal Exemption	New York Exemption
2004 - 2005	\$1,500,000	\$1,000,000
2006 - 2008	\$2,000,000	\$1,000,000
2009	\$3,500,000	\$1,000,000

Impact of Increased Exemption Amount on Total Tax Burden in a Decoupled State (New York)

Year	Value of Taxable Estate	Federal Estate Tax	NY Estate Tax	Total Tax Due
2004	\$1,000,000	\$0	\$0	\$0
2004	\$1,500,000	\$0	\$64,400	\$64,400
2004	\$2,000,000	\$200,100	\$99,600	\$299,700
2004	\$3,000,000	\$659,500	\$182,000	\$841,500
2005	\$1,000,000	\$0	\$0	\$0
2005	\$1,500,000	\$0	\$64,400	\$64,400
2005	\$2,000,000	\$225,000	\$99,600	\$324,600
2005	\$3,000,000	\$695,000	\$182,000	\$877,000
2006	\$1,000,000	\$0	\$0	\$0
2006	\$1,500,000	\$0	\$64,400	\$64,400
2006	\$2,000,000	\$0	\$99,600	\$99,600
2006	\$3,000,000	\$460,000	\$182,000	\$642,000
2007 - 08	\$1,000,000	\$0	\$0	\$0
2007 - 08	\$1,500,000	\$0	\$64,400	\$64,400
2007 - 08	\$2,000,000	\$0	\$99,600	\$99,600
2007 - 08	\$3,000,000	\$450,000	\$182,000	\$632,000
2009	\$1,000,000	\$0	\$0	\$0
2009	\$1,500,000	\$0	\$64,400	\$64,400
2009	\$2,000,000	\$0	\$99,600	\$99,600
2009	\$3,000,000	\$0	\$182,000	\$182,000

In Focus: The Alternative Minimum Tax

The alternative minimum tax (or AMT) is a tax some individuals have to pay in addition to regular income tax. The term "alternative" does not denote a choice between different income tax methodologies, but rather a different set of rules for calculating income tax. The AMT is a parallel tax system. The taxpayer must pay a total tax equal to the greater of the tax calculated under the regular income tax rules and the tax calculated under the AMT rules.

The AMT was originally conceived as a way to ensure that those with very high incomes did not escape income taxation by using sophisticated tax shelters or excessive deductions. Over time, however, the AMT has become a tax payable by an increasing number of people, including those with annual incomes below \$100,000. Due in large part to recent income tax rate cuts, the AMT may apply to as many as one-third of all taxpayers by 2010.

Among the important aspects of the AMT are following:

- The AMT exemption is \$40,250 for unmarried filers and \$58,000 for married couples filing jointly. This exemption is reduced when AMTI (an individual's income in excess of the AMT exemption) exceeds \$112,250 for single filers and \$150,000 for married filers. The AMT exemption is eliminated entirely when AMTI exceeds \$273,500 for single filers and \$382,000 for married filers.
- AMT tax rates start at 26% for the first \$175,000 of AMTI and rise to 28% for amounts above \$175,000, contrasted with regular income tax rates which begin at 10% and rise to 35%.

- Personal exemptions and certain tax credits are not allowed, and many itemized deductions are reduced or eliminated, such as the deduction for state and local taxes, interest on second mortgages not used for home improvements, and medical expenses.

- The realization of large long-term capital gains or the exercise of incentive stock options may trigger AMT. Long-term capital gains receive the same treatment under the AMT rules as when calculating regular income tax. However, a large capital gain may reduce or eliminate the AMT exemption thus triggering AMT. The exercise of incentive stock options generally will not be taxable as income for regular income tax purposes. Under the AMT rules, the difference between the exercise price and the fair market value of the stock at the exercise date may trigger AMT.

AMT Liability: If the result of the AMT calculation is higher than regular income tax, the taxpayer must pay the additional "alternative" tax.

Example: A taxpayer's regular income tax is \$53,000. When the taxpayer calculates tax using the AMT rules, her tax is \$47,000. Because the regular income tax liability is greater than the AMT, no additional tax is owed.

Example: A taxpayer's regular income tax is \$53,000. When the taxpayer calculates tax using the AMT rules, her tax is \$61,000. The taxpayer must pay \$8,000 of AMT in addition to her regular income tax of \$53,000.

AMT Credit: In some circumstances an AMT credit will result from the payment

of AMT. This credit can be used in subsequent years to reduce your taxes when regular taxes exceed AMT. The AMT credit used may not exceed the difference between the regular income tax and the AMT.

Example: A taxpayer has a \$9,000 AMT credit available from 2003. In 2004, the taxpayer's regular income tax is \$41,000. The AMT is \$35,000. The taxpayer will not pay AMT because regular income tax exceeds AMT. Even better, the taxpayer may claim \$6,000 of AMT credit, reducing her regular tax to \$29,000. The remaining AMT credit of \$3,000 will be available for subsequent years.

In the near future, the AMT may become the tax payable by most middle and upper income taxpayers. While it is unclear whether Congress will act to provide AMT relief to taxpayers, in the meantime taxpayers are well advised to consult with tax professionals to reduce their AMT liability.

The Wiggin and Dana Estate Planning Advisory is a periodic newsletter designed to inform clients and other interested persons about issues and developments in the law affecting trust and estate administration and estate and tax planning for individuals and their families, fiduciaries, investment advisors and business owners. Nothing in the Estate Planning Advisory constitutes legal advice, which can only be obtained as a result of personal consultation with an attorney. The information published here is believed to be accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues. If you would like to be added to the distribution list for the Wiggin and Dana Estate Planning Advisory, please contact Karen Osborn at 203.498.4449.

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