Proposal To Reinstitute State Death Tax Credit[1]

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I. PROPOSAL

Consideration should be given to reinstituting the state death tax credit if the estate tax system is revised. This would minimize and/or eliminate many of the cumbersome and complex provisions that exist, which a practitioner must plan appropriately for, when a client holds out of state property.

II. THE PROBLEM ADDRESSED BY THIS PROPOSAL

Under the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"), the state death tax credit is eliminated in years 2005 and beyond, and replaced with a deduction. This has seriously affected estate planning throughout the country. The state death tax credit's ("state death tax") reduction, and ultimate elimination, has created situations in which combined state and federal estate taxes raise very complex planning issues. Some states have enacted legislation that imposes taxation on a decedent's entire estate, even if only one asset is located in that state, and notwithstanding the fact that the decedent was not a resident of that particular state. Conversely, some states lose their entire estate tax revenue in 2005. The increase in the federal credit applicable exclusion amounts for estate tax has further complicated planning for both married and single persons from a state death tax perspective, and therefore overall estate tax planning has become more complex. The phase-out can also cause problems with other tax sections. Due to the various planning issues, practitioners in all states need to be aware of any client's out of state property and the appropriate estate or inheritance tax statute in those states.

III. BACKGROUND

Before EGTRRA, most states had a "pick-up" tax that allowed a state to collect the maximum federal credit on taxable estates, also called a "sponge tax". This system was easy to administer yet allowed states to collect revenue on estates that were taxed for federal estate tax purposes. While these states received revenue on taxable estates, estate taxes, at the state level, had little impact on planning. In essence, sponge-tax states are not able to collect estate taxes after 2004, unless their state death tax statute is modified. On the other hand, "decoupled" states, or states with non-sponge-tax formulas, will still receive estate tax at the state level. The phase out of the state death tax credit will not affect these states from receiving death taxes. To further the problem, many states with sponge tax statutes have enacted these and removed state death tax under a constitutional amendment, thus reform is impossible. The problem for practitioners is the complexity added to an already highly technical area.

IV. CURRENT LAW

Under IRC §2011, the credit for state death taxes was reduced in the years 2002, 2003, and 2004 by 25 percent each year. Beginning in 2005, there is no state credit; instead state death taxes will be deductible under new IRC §2058. EGTRRA's phase- out of the state credit causes its reductions in the tax rate in the first three years to come largely, or entirely, from the state tax, rather than the federal tax. The federal rate declined one percent to 38 percent in 2002, but rose to 41 percent in 2003 and 44 percent in 2004. From 2005 to 2009 the federal rate becomes the total rate, and varies from 45 percent to 47 percent. Thus, the top marginal federal estate tax rate causes substantially higher rates in each year from 2003 to 2009. The reduction in the total marginal rate in these years depends on whether states acquiesce to the phase-out of the state death tax. In reality, the impact of the state death tax credit phase out depends on the type of death tax imposed by a particular state as well as the value of the total estate, the state's applicable exclusion amount, whether the state death tax is completely phased out, whether the estate can benefit from the IRC §2058 deduction and whether the decedent owned property in more than one state.

Since the state death tax impact of IRC §2011 phase-out depends on the type of death tax imposed by a particular state, the various state statutory schemes must be explored. If all estate assets are located in a pick-up state, the pick-up tax equals the amount of the IRC §2011 state death tax credit actually allowed to the estate. When the credit drops to zero in 2005, the pick-up tax drops to zero.

States that now have estate taxes that will not be phased out by the elimination of the IRC §2011 credit are said to have "decoupled" estate taxes, or a "non- sponge" state estate tax. "Decoupling" means severing the relationship between the federal and state tax and imposing a state death tax using the pre-EGTRRA IRC §2011 rate schedule. Many states have taken this approach to increase revenue, but for individuals this causes an increase in taxes. A minority of states that have not decoupled have a "nullification" clause that makes pick-up tax void if the federal credit for state death taxes is repealed, or if the federal estate tax is repealed.

In decoupled estates with no marital deduction, the top marginal tax rate declines little between now and 2010, yet in some years will increase. The top state death tax credit rate under IRC §2011 (pre- EGTRRA) is 16 percent, and unless revised will be the top marginal state death tax rate. This rate applies to taxable estates in excess of $10,100,000. This means that while the state rate remains at 16 percent, the federal credit declines to four percent in 2004. In essence, the pure maximum marginal rate of state tax was 12 percent in 2004.

Due to this tax burden, even residents of sponge tax states have to be careful if their estate includes property located in a decoupled state. That decoupled state may impose taxes (on a limited pro-rata basis) if the federal and decoupled state exclusions differ. For example, if a decedent resided in a decoupled state, but held tangible property in Wisconsin, that state will levy a pro-rata estate tax if taxable distributions exceeded $675,000 even if those distributions did not exceed the $1.5 million federal exclusion amount for 2005.

V. COMPLEXITIES CAUSED BY CURRENT LAW

There are many complexities associated with the current law whether the taxpayer is married or single. These are outlined below.

A. Married Persons Planning Issues

There are many issues associated with planning for married couples. Many of these arise at the planning stage or on the first death. Analysis of EGRTTA has to be conducted when drafting documents for clients owning out of state property. For example, Kansas, Maine, Massachusetts, Minnesota, North Carolina and Washington have linked their exemption amounts to the scheduled increases in the federal credit before EGTRRA's enactment. The District of Columbia, New Jersey, Rhode Island and Wisconsin all have set their exclusions at $675,000; New York and Nebraska have frozen their limits at $1 million. Since states like these have not linked the value of assets exempt from state estate taxes to the increased exclusion amounts enacted by EGTRRA, estates in these jurisdictions may owe state estate taxes even if they are exempt from federal estate taxes. For instance, a New Jersey estate worth $1.5 million will be exempt from federal estate taxes in 2005, but it will still be subject to state estate taxes, because the available state exclusion is only $675,000. The state estate tax rate will be imposed on $825,000 ($1.5 million - $675,000). On the first death, many options may exist and decision-making can be difficult because of a variety of unknowns.

1. Credit and Marital Trusts

The difference between federal and state exclusions does more than complicate estate administration; it also creates potential problems for credit and marital trusts. When the first of a married couple dies, a formula division of the estate often produces a credit trust (also called bypass trust or residual trust), equal to the applicable exclusion amount. Until EGTRRA, such a division produced no state estate tax, because of IRC §2011(f). In a state that does not recognize EGTRRA's increases in the unified credit, that formula division will now generate a state death tax unless the state recognizes the increases in the applicable exclusion amount, as some states do. The state death tax could be avoided by limiting the credit trust to the size of the applicable exclusion amount under pre-EGTRRA law. For instance, if the provisions governing the creation of a testamentary credit shelter trust include minimum taxation language, a trust established in 2004 by a New Jersey decedent could be funded with only $675,000. An executor might fund a credit trust with less money than the decedent planned, to avoid federal and state estate taxes. By the same token, funding a credit trust to the federal applicable exclusion limit may inadvertently trigger state taxes that were not anticipated in the original estate plan. If the New Jersey trust was created with provisions that allowed the full use of the available federal credit, the estate would have to pay New Jersey estate taxes. While the state death tax may be an acceptable price for keeping the additional trust property out of the surviving spouse's gross estate, that will not be the case if the surviving

spouse lives to repeal of the federal estate tax or at death resides in a state that has a sponge tax holding no out of state property.

2. Example Illustrating Options

As stated above, many plans for married couples provide for a credit trust in order to utilize the applicable exclusion amount of the first spouse to die. This creates a problem if, for example, the federal exclusion amount is $2 million, but the state only provides an exclusion amount of $800,000. The formula now creates a credit trust of approximately $2 million, which exceeds the state exclusion amount by $1.2 million, thereby triggering a state tax on $1.2 million at the first death.

practitioner must consider whether it is preferable to pay the state tax on the first death, or to shrink the size of the credit trust to $800,000 in order to avoid the state tax. There are many factors that need to be weighed to make such a decision: the life expectancy of the survivor, the potential exclusion amount for federal tax in the year calculated to be that of the survivor's death, the estimated size of the survivor's estate, status of repeal or reform, liquidity and anticipated appreciation.

The planner does not have a crystal ball and much of this information requires prior guesswork and conjecture. The available information may or may not be much better nine or 15 months after the first death, but additional time at least preserves that possibility. Due to these issues, care has to be taken in planning and for using flexible estate plans have to be considered.

3. Solutions

Practitioners may address many of the EGTRRA-created issues by drafting flexible provisions and using such techniques as qualified disclaimers. For example, testamentary instruments may combine minimum total tax provisions with disclaimer powers that allow a surviving spouse to disclaim a portion of his bequest to a credit trust in order to avoid under-funding the credit trust. "Clayton QTIP" trusts3 serve this purpose admirably by deferring funding decisions until a testator's death, so these trusts may become more popular in decoupled states. In the context of plans in which use of a standard marital deduction formula clause would normally be utilized, the decoupling issue may make it more likely that other drafting options are explored. For example, a credit trust that is eligible for a QTIP election (at least for a fraction of the trust that is attributable to the difference between the state exclusion amount and the federal exclusion amount) may be created. The document would allow the estate's executor to elect the funding amount for a QTIP trust. If, after the first death, it appears prudent to make a QTIP election for more property than would be necessary in order to reduce the federal tax to zero, the executor or trustee can do so. Whatever solutions estate planners choose, they must recognize that EGTRRA has created a situation in which domicile considerations and careful vigilance will be the norm for some time to come.

a. Qualify Additional Property for the Marital Deduction

State death tax at the death of the first to die of spouses may be avoided by qualifying "additional" property for the marital deduction either through the use of an outright marital deduction or by funding a QTIP. A minimum total tax formula utilizing the lesser of the state death exclusion amount and the federal exclusion amount may divert a portion of the first spouse's federal exclusion to a QTIP trust at the expense of the credit trust. The problem is that upon the death of the surviving spouse, the property may be subject to both federal and state death tax depending on the exclusion amount in the year of the surviving spouse's death and the domicile of the surviving spouse on death. If the surviving spouse is willing to change his or her residence to a state that does not impose a tax, then state tax can be avoided. If however, the spouse is in a decoupled jurisdiction state death tax may be imposed even if no federal estate tax is imposed.

b. State QTIP Trust

Some states like Massachusetts, Rhode Island and Washington have tried to provide a solution to this dilemma by instituting state QTIP trusts. In these states, an executor funds the following trusts: a credit trust with the full federal and state exemption and a second credit trust with the difference between the federal and state exclusion, utilizing a state QTIP election, and a traditional QTIP trust with the remaining assets in the estate (federal and state amount over the federal annual exclusion). This solution eliminates the imposition of any state or federal estate tax on the first

spouse's death, but also effectively increases the surviving spouse's estate, because that spouse must receive the income from the state QTIP trust. Also a QTIP trust cannot make distributions to a nonspouse beneficiary during the spouse's lifetime. To illustrate, assume the decedent's estate is $3 million, federal exclusion amount is $1.5 million with a state exclusion amount of $1 million. The credit trust would hold $1 million, the QTIP credit would hold $.5 million ($1.5 less $1) and the QTIP would hold $1.5 million. In the year of the surviving spouse's death only the QTIP is taxed for federal purposes, the QTIP credit and QTIP are taxed for state purposes.

c. Clayton Trust
In other cases, the drafter may consider the use of a Clayton QTIP trust. A Clayton QTIP trust eliminates the surviving spouse's income interest for the nonelected portion. The spouse then receives all income for any portion of the credit trust for which the executor makes the QTIP election. In essence, the executor elects QTIP for a fraction of the credit trust that equals the difference between the federal exclusion and the state exclusion amounts.4 Although the regulation states that the executor making this election does not hold a power of appointment; it does not address the situation of a surviving-spouse executor/ trustee who decides, himself/herself whether or not he or she will receive income. If the spouse or another trust beneficiary is the executor or a trustee, it may be advisable to include provisions in the estate planning documents that require the beneficiary to utilize an independent party in making any distributions and/or in electing QTIP. This technique also requires states to allow QTIP elections.

Some practitioners have concerns about this approach due to Revenue Procedure 2001-38.5 Here, the Service stated that it will disregard a QTIP election if no QTIP election was needed to reduce the estate tax to zero. The planner must question whether Rev. Proc. 2001-38 refers only to the federal tax? According to IRS Letter Ruling 200236021, this very Rev. Proc. "was enacted to provide relief for surviving spouses and their estates in situations where a predeceased spouse's estate made an unnecessary qualified terminable interest property (QTIP) election under IRC §2056(b)(7) that did not reduce the estate tax liability." It is possible the protection of Rev. Proc. 2001-38 be waived by indicating on Schedule M that the estate elects out of protection. To avoid any problems, it is preferable to provide division of the trust for the QTIP portion. Then, Rev. Proc. 2001-38 should not apply since the QTIP portion was necessary to reduce the tax to zero.

d. Wait and See
The client may also choose to wait and see. Here, the client would fund a credit trust with the lesser of the federal and state exclusion amounts. While this may give rise to tax on the second death, it defers taxation. It also is less complex and avoids administration of extra trusts and/ or complicated elections. Due to the rapid increases in the federal exemption amounts no federal taxes may be owed anyway on the surviving spouse's death.

e. Pay Tax
Depending on the amount of state tax due, some clients may elect to pay this amount. This alternative avoids the taxation of income from the QTIP portion of the credit trust in the survivor's estate. Like the wait and see approach, additional trust administration and complexity is avoided. This also alleviates the concern of credit trust depletion due to mandatory income payments to spouse. f. Disclaimer This technique can be combined with the wait and see technique. This gives the surviving spouse the option on the first death to disclaim an amount equal to the state exclusion amount if he or she doesn't want to pay state tax or add the complexities inherent in the other options. Alternatively the amount equal to the federal exclusion can be disclaimed and state tax paid.

g. Gifting Prior to Death
Another option in states that impose no gift tax due to decoupling but impose a state death tax in excess of the state death tax credit, is to make a gift before death. This avoids a state death tax on the gifted property and allows a significant tax savings. This savings increased as the §2011 credit decreased in the years 2002 through 2004. In 2004 the savings will equal 12 percent of the gift. In 2005 and thereafter, when the state death tax becomes deductible, the maximum saving is in excess of eight percent. One must be aware of the three- year rule (IRC §2053) requiring inclusion of any gift taxes paid three years prior to death. One must also calculate the cost of the gift (use of decedent's federal exclusion amount and loss of step-up in basis). Gifts of cash will avoid the step-up issue.

h. Qualified Family-Owned Business Interest Election ("QFOBE")

If the state of the decedent's domicile has not conformed to any provisions of EGTRRA, it may still allow the IRC §2057 QFOBE. If so, a total of $1.3 million may be sheltered from state tax even if the state uses a lower applicable exclusion amount. On the other hand, certain favored EGTRRA amendments to IRC §2031(c), concerning qualified conservation easements, may not be applicable.

i. Sale of Property
The surviving spouse should consider the sale of property held in a state with a decoupled statute, particularly if the decedent is a resident in a sponge tax state. Obviously this technique may cause capital gains greater than the state tax savings although an IRC §1031 exchange can be explored. Alternatively this option allows the client to convert any real property domiciled in a decoupled jurisdiction into intangible personal property that will be taxed in the state of domicile.

j. Formation of Family Entity
Finally, any out of state real property in a decoupled jurisdiction can be contributed to a Family Limited Partnership or LLC. The family entity is now intangible property and should be taxed in the state of the decedent's domicile, not in the state where the real property exists.

B. Single Persons Planning Issues
The single person should explore options g through j above.

C. Additional Problems
The changes in the IRC §2011 credit also have an effect on the amount of the credit for previously taxed property because of the reference to IRC §2011 in IRC §2013(c)(1)(A). On January 1, 2005, the reference will be eliminated due to the repeal of the IRC §2011 credit. The result is an increase in the IRC §2013 credit both before and after January 1, 2005, because the IRC §2013(c) limitation is reduced. Similarly, the elimination of the IRC §2011 credit means that IRC §6166, permitting an extension of time to pay estate tax attributable to a closely-held business, can apply to the entire estate tax.

When a client's estate includes property in another state, it is generally advisable to include a provision in the will or trust concerning the source of funds that will be used to pay the various taxes and the persons responsible. The California apportionment statute applies only to federal and California estate taxes.6 In 2005, California estate taxes will no longer exist. The out-of-state statute may also come into play and properly passing to a surviving spouse may be looked to for payment of any tax. This is typically contrary to a decedent's wishes. In this light, it is best to tailor tax clauses depending on state of domicile and whether decedent owns property out of state.

VI. MERITS OF PROPOSAL
To do proper planning and eliminate tax burdens driven by a federal scheme that varies from state to state, consideration should be given to reinstating the death tax credit if the estate tax system is revised (absent repeal). There currently is inequality between the states and many states cannot constitutionally change. Most states have based their laws on a federal scheme that had been in place for two decades and change in some states is impossible.

Promoting the perception of fairness and efficiency in the administration of the internal revenue laws has long been a critical element of the Internal Revenue Service mission statement. Additionally, if the federal government desires additional revenue, this can be accomplished by raising rates or decreasing the unified credit. Substantial complexity would also be eliminated or reduced for the practitioner. Therefore, if current legislation is revised, consideration should be given to reinstituting the state death tax credit.

ENDNOTES
1. This article is based on a paper presented by Robin L. Klomparens and Betty J, Little, Executive Committee, Taxation Section of the State Bar of California, as part of the May 2005 annual Washington D.C. delegation co-sponsored by the State Bar of California and the Los Angeles County Bar Association Taxation Section. The comments contained in this paper are the individual views of the authors who presented them, and do not represent the position of the State Bar of California or the Los Angeles County Bar Association. Although the participants on the project might have clients

affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participants have been specifically engaged by a client to participate on this subject.

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3. This type of trust is named after the case of Estate of Clayton v. Commissioner (5th Cir 1992) 976 F2d 1486, reported in 14 CEB Est. Plan R. 80 (Dec. 1992).

4. See Treas. Regs. §20.2056(b)-7(d)(3) and §20.2056(b)-7(h) Example 6. 5. Rev. Proc. 2001-38, 2001-24 IRB 1335.

6. Cal. Prob. Code §20100(a).