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The Unfortunate State Tax Side Effects Of Federal Death Tax 'Repeal'

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The recent federal legislation "repealing" the estate tax[1] is burdened with numerous complexities. Issues unfurl kaleidoscopically over the 10-year life span of this unusual act, presenting considerable planning challenges for taxpayers and their advisors. On top of the federal tax confusion, however, lies yet another significant collection of issues — the state tax side effects of the federal death tax "repeal."

By repealing the federal credit for state death taxes, the 2001 Act effected an immediate and significant reduction in state tax revenues. We now have a federal tax regime that actually appropriates state death tax revenues to increase federal death tax collections. Moreover, should carryover basis ever come to pass, the ramifications for state taxation will become even more interesting. Finally, if the federal death tax never really goes away, and carryover basis never really arrives,[2] it will be the states that are left with the task of paying for much of the 2001 Act.

If the federal death tax never really goes away, and carryover basis never really arrives, it will be the states that are left with the task of paying for much of the 2001 Act.

These state tax side effects seem not to have been given much consideration in the course of the federal death tax debate, yet they hold profound fiscal consequences for the states. People who pay state and local taxes — not just death taxes but franchise, income, sales, and property taxes as well — may soon discover that the state tax side effects of federal death tax repeal are quite costly. In the current era of declining state revenues and distressed state budgets this risk is particularly severe. This article offers an early examination of the short-term state tax consequences, and the long-range state tax implications, of the 2001 Act.

Relevant Features of the 2001 Act

The 2001 Act contains two features of direct relevance to state taxation: the reduction, replacement, and ultimate repeal of the federal credit for state death taxes (the "credit"); and the eventual (?) substitution of a modified carryover basis ("carryover basis") for the current basis step-up effected on death. The specifics of these particular aspects of the 2001 Act must be reviewed before turning to the state tax picture.

II. IRC Section 2011 Credit For State Death Taxes

Currently, Internal Revenue Code section 2011 provides a credit against federal estate tax for "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" section 2011(a). The credit is on a sliding scale, measured by a percentage of the "adjusted taxable estate."[3]

Under 2001 law, the federal estate tax reaches its maximum 55 percent rate at taxable estates over \$3 million. Section 2001(c). The credit for state death taxes starts at 0.8 percent of adjusted taxable estates over \$40,000; is 8.8 percent for an adjusted taxable estate of \$3 million; and ultimately reaches a maximum credit equal to 16 percent for adjusted taxable estates of \$10,040,000 and higher. Section 2011(b).

The taxpayer dying in 2001 with a \$20 million taxable estate would thus pay roughly \$11 million in federal estate tax, but against that federal liability could credit up to \$3.2 million (roughly) of state death taxes. As a result, in any of the dozens of "soak-up" states discussed below, the tax on the \$20 million estate of a decedent dying in 2001 would comprise \$3.2 million in state death tax, and \$11 million less \$3.2 million or \$7.8 million in federal death tax.

[1] Public Law 107-16, "The Economic Growth and Tax Relief Reconciliation Act of 2001" (the 2001 Act), signed June 7, 2001. Federal and state estate, inheritance, and succession taxes are referred to herein as "death tax."

[2] Given that the death of the death tax has been extended over a 10-year run, and son-of-death-tax is scheduled for release on January 1, 2011, there is ample reason to question whether the federal death tax is really dead. In the author's view it seems quite likely that 2010 will dawn with the death tax still in fine health, made leaner through lower rates and higher exemptions, but newly appreciated by the voting public as a friendlier monster than carryover basis.

[3] "Adjusted taxable estate" is the taxable estate, less \$60,000.

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The 2001 Act scales back the federal credit; substitutes a federal deduction for state taxes; and eventually (obviously) makes even the deduction irrelevant on full repeal of the federal death tax. Specifically, the 2001 Act provides that, for decedents dying in 2002, the federal credit is reduced to 75 percent of the amount originally specified in section 2011(b), then falls to 50 percent of that amount in 2003, and 25 percent in 2004. For decedents dying after 2004 there is no federal credit.

In lieu of the credit, the 2001 Act provides a new federal deduction for decedents dying in 2005 and thereafter. In computing the value of a taxable 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" would be allowed as a deduction.[4] For 2005, the 2001 Act specifies a maximum federal death tax rate of 47 percent; that rate decreases to 46 percent for decedents dying in 2006; to 45 percent for 2007, 2008, and 2009, and "ultimately" to zero in 2010.[5] The interworkings of the federal rate cuts, the reductions in the state death tax credit, and particular states' tax laws are the source of the first set of state tax side effects.

II. Carryover Basis

The second feature of the 2001 Act that has profound significance to state taxation is the partial repeal of the federal basis step-up, and its replacement with the modified carryover basis. Currently, IRC section 1014 provides that "the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall .... be the fair market value of the property at the date of the decedent's death ... " section 1014(a). The 2001 Act legislated the repeal of section 1014 with respect to decedents dying after December 31, 2009.In place of the fair market value basis of section 1014, the 2001 Act provides a general carryover basis regime, but with potentially significant modifications. New section 1022 first provides that, for property acquired from a decedent dying after December 31, 2009, the property will be treated as transferred by gift. As a result, the character of built-in gain as to the decedent (e.g., recapture) carries over into the hands of the heirs.[6]

Section 1022 then provides that "the basis of the person acquiring property from such a decedent shall be the lesser of (A) the adjusted basis of the decedent, or (B) the fair market value of the property at the date of the decedent's death." Section 1022(a)(2). The federal basis of inherited property thus starts with the decedent's federal adjusted basis, although valuations may be necessary if it appears (as with the total disaster scenario of overleveraged depreciated assets) that fair market value is even less than federal basis.

Section 1022 then adds several important things to the decedent's federal basis. These additions come with the overall caveat that they cannot increase the basis of any interest in property acquired from the decedent above its fair market value in the hands of the decedent as of the date of the decedent's death. Section 1022(d)(2).

The first addition is a general aggregate basis step-up of $1.3 million ("the $1.3 step-up"). (Inflation adjustments begin after 2010). Section 1022(b)(2), (d)(4). The $1.3 step-up is applicable to property that was owned by the decedent at the time of death. Special rules are prescribed to identify the portion of jointly held property and community property that will be considered as owned by a decedent; to treat property transferred by the decedent to a revocable trust as owned by the decedent; and to exclude property over which the decedent has a power of appointment. Section 1022(d)(1)(B)(i)-(iv). Property also will be treated as not basis-adjustable if it is acquired by gift (or for less than adequate consideration) within three years of death (unless the donor was the decedent's spouse, and had not himself or herself acquired the property within the three-year period by gift). Section 1022(d)(1)(C). Stock in certain DISCs, PFICs, FPHCs, etc. also is excluded. Section 1022(d)(1)(D).

The second set of additions to the federal basis of basis-adjustable property (the "loss step-up") is more sophisticated. Section 1022 provides that the $1.3 step-up is to be increased by (1) any capital loss carryover under section 1212(b) that would, but for the decedent's death, be carried over from the decedent's last taxable year to a later taxable year of the decedent; plus (2) any net operating loss carryover under section 172 that would, but for the decedent's death, be carried over from the decedent's last taxable year to a later taxable year of the decedent; plus (3) "the sum of the amount of any losses that would have been allowable under section 165 if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death." Section 1022(b)(2)(C). The federal basis of assets acquired from a decedent will thus be increased by the decedent's unused capital loss carryover, NOLC, and section 165 losses.

Importantly (even more so in the state income tax context), this provision transmogrifies potential future capital, ordinary, and section 1231 loss deductions of the decedent into asset basis for the heirs. The resultant shift in character (e.g., capital loss carryforwards become basis in depreciable assets), in timing (NOLCs are refreshed, but a specific built-in loss is spread across all the assets), and in the identity of the taxpayer affected by such items (no longer Grandpa, but Grandson) can have significant income tax consequences.

The carryover basis treatment of other kinds of "suspended" losses of a decedent is not entirely clear. For example, losses suspended under the passive loss rules are triggered during the taxable year in which a taxpayer disposes of his entire interest in the activity. Section 469(g). In the case of a disposition by death, this rule triggers losses, to the extent suspended losses exceed the excess of (x) the heir's basis in the property over (y) the decedent's adjusted basis. With carryover basis, that excess is presumably reduced. As a result, a larger portion of the decedent's suspended passive losses should be treated in the year of death as loss not from a passive activity. Such losses

[4] One interesting sidelight of the federal fiddling with state tax credits and deductions is the survival of the text of the statutory credit mechanism, and the date-based introduction of the deduction. Section 2011(g) simply says "[t]his section shall not apply to the estates of decedents dying after 12/31/04 [sic]." Section 2058 is effective for estates of decedents dying after that date. 2001 Act section 532(d). It may be too much "shades of capital gains," but should politics require, it would not take much drafting to extend the life of some amount of credit in respect of state death taxes.

[5] If the sun eventually sets as decreed by Congress, in 2011 everything returns to the status quo ante the 2001 Act, *i.e.*, a 55 percent maximum federal estate tax rate, and a 16 percent maximum credit for state death taxes.

[6] S. Rep. No. 107-30; H.R. Rep. No. 107-37.

presumably are deductible in the decedent's last return, but if they give rise to an NOLC there is a circularity in the statute. The amount of the suspended loss triggered under section 469(g) is tied to the amount of heir's basis step-up, but the amount of the step-up depends on the amount of the decedent's allowable losses. Moreover, inasmuch as the losses would not have been triggered but for the decedent's death, one might question whether that loss is that an NOLC which would, "but for the decedent's death," be carried over from the decedent's last taxable year to a later taxable year of the decedent. The "right" answer should be that suspended passive losses unused at the time of the decedent's death afford the heirs a basis step-up, but the wording of the statute leaves something to be desired.

The third set of federal adjustments (the "spousal step-up") relates to "qualified spousal property." Any outright interest in property acquired from a decedent by the decedent's spouse, plus certain defined "qualified terminable interest property" acquired by the spouse, is eligible for an additional $3 million basis increase.

Taken together, the three step-ups (collectively the "basis increase")[7] mean the decedent's assets can pass to his heirs with an aggregate step-up in basis, over a pure carryover basis, of as much as $4.3 million plus the amount of the decedent's unused losses.[8]

The federal statute the provides a simple but significant rule for allocating this basis increase: "The executor shall allocate the adjustments under subsections (b) and (c) on the return required by section 6018 [the federal estate tax return] . . . Any allocations made pursuant to subparagraph (A) may be changed only as provided by the Secretary." Section 1022(d)(3). As clarified in the legislative history: "Basis increase will be allocable on an asset-by-asset basis (in addition, basis increase could be allocated to a share of stock or a block of stock). However, in no case can the basis of an asset be adjusted above its fair market value. If the amount of basis increase is less than the fair market value of assets whose basis are eligible to be increased under these rules, *the executor will determine which assets and to what extent each asset receives a basis increase*."[9] Oh most fortunate executor!

Before leaving the federal legislation it must be noted that, purely as a matter of overall tax burden, there clearly are individuals for whom the 2001 Act is a mixed blessing, or even a disaster. For persons with highly appreciated, quite valuable, and illiquid assets, the substitution of a federal capital gains tax for a 55 percent federal death tax, together with the opportunity for further deferral, can indeed be very attractive. Even as the federal death tax rate drops, and state income taxes are added to the mix, the overall tax burden on such estates and heirs often will be considerably reduced.

On the other end of the spectrum, however, are individuals who die possessed of assets encumbered by debts that exceed basis. Through 2009, the estates of such individuals enjoy a basis step-up that purges the estate, and the heirs, of taxable income. At the same time, the indebtedness depresses the value of the taxable estate. After 2009, however, the fact that there is no net value becomes irrelevant. At that point the heir inherits both the encumbered asset and the decedent's built-in gain, with the attendant income tax bill. While the transfer of encumbered assets to the heirs on death does not itself trigger gain, section 1022(g)(1), "in determining the adjusted basis of such property, liabilities in excess of basis shall be disregarded." *Id.* The heirs thus inherit the built-in gains, negative capital accounts, etc. In some cases an inheritance will in fact be a tremendous and financially jeopardizing tax burden. Disinheriting the ne'er-do-wells takes on an entirely new meaning!

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The second set of state tax side effects thus stems from the fact that, with carryover basis, federal death taxes do not go away — they are instead transformed into income taxes on the heirs. The implications for federal tax planning are significant, even if difficult fully to engage in this era of death tax twilight. On the state tax front, however, the picture is even more complex.

State Tax Side Effects of Credit Repeal

Under the credit, U.S. taxpayers enjoyed a federal/state death tax regime that had settled into a generally uniform allocation of death tax revenues and, more importantly, a relatively uniform nationwide approach to state death taxation. This state of relative calm was not accidental.

The early history of death taxes in America is recounted in a fascinating 1941 article by Eugene E. Oakes, then a professor of economics at Yale.[10] Professor Oakes weaves his way through the short-lived (1797-1802) legacy duty of the American central government, Pennsylvania's 1826 inheritance tax on collateral heirs, levied to finance a canal, and Louisiana's plainly discriminatory 1828 tax on property left to nonresident aliens. Throughout America's 19th century numerous states experimented with different forms of death

[7] Presumably any remaining state death taxes will increase the heirs' basis in the inherited property. *See* section 164.

[8] A final note is warranted regarding the 2001 Act's treatment of assets transferred in satisfaction of a pecuniary bequest. With the "old" step-up in basis at death, a transfer of property in satisfaction of money owed to a decedent was considered a recognition event to the estate, but frequently produced little or no taxable gain. With carryover basis, the estate will often have assets with basis less than fair market value, creating a risk of substantial taxable gain to the estate. New section 1040 specifies that an estate transferring property in satisfaction of a pecuniary bequest recognizes gain only to the extent the fair market value of the asset at the time of such transfer exceeds its fair market value at the time of death. Section 1040(a). This is, effectively, the same as the "old rule" — only post-death appreciation triggers tax to the estate. The pecuniary beneficiary will, however, now be given an asset with a basis that combines the decedent's adjusted basis, plus the allocated portion of the basis increase plus the gain taxed to the estate at transfer. Any difference between the value of the asset and such conglomerate basis will, on disposition, produce taxable gain to the beneficiary. Section 1040(c).

[9] S. Rep. No. 107-30 (emphasis added).

[10] Oakes, "Development of American Death Taxes," 26 *Iowa L. Rev.* 451 (1941).

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tax, and this revenue source became increasingly of interest to the states.

New York's 1885 enactment of a 5 percent tax on collateral heirs was, in Professor Oakes's view, "the turning point in the development of state death duties . . . . The success of this measure precipitated a wave of legislation that had by no means run its course when the federal estate tax was enacted in 1916."[11] Quoting from a 1907 report to the Proceedings of the National Tax Association, Professor Oakes records that by 1907 "[i]nheritances are now taxed to a greater or less extent in thirty-six States of the Union, and in Hawaii and Porto Rico [sic]. Twenty States of the Union tax both direct and collateral heirs; and in thirteen States the inheritance tax is in some degree progressive."[12]

By 1916, 43 states had enacted some form of death tax. Professor Oakes further reported that while in 1886 there were two operative state death taxes that produced revenues of $710,000, by 1907 state death taxes yielded approximately $10 million and by 1916, when the federal estate tax came to be, the 43 state death taxes "now accounted for $30,748,000, or 8.4 percent of the total state tax revenue."[13]

Of particular significance in the context of the 2001 Act, Professor Oakes's article recounts the years-long federal-state tension that ultimately gave rise to the credit:

> [A]t the center of the controversy during the interval between 1916 and 1924 were the debates over two specific issues: the multiple taxation of personal property and the continuance of the federal levy on estates as a permanent part of the nation's tax structure . . . . The climax of this controversy was reached during the period from 1924 to 1928 and out of it emerged a compromise solution: the continuing use of the federal estate tax, which must now be recognized as a permanent thing, and the adoption of an 80 percent credit for state taxes paid against the amount due under the federal tax of 1926."[14]

The credit thus represented, at its enactment, a solution to federal-state wrangling over death tax money. It was a compromise that recognized the encroachment of the federal government on traditional sources of state revenues, and sought to recompense the states, in some comprehensive and efficient manner, for the federal incursion. It was conceived, not as a federal stipend to the states, but as a form of revenue sharing.

Two decades after Professor Oakes penned his conception of the state death tax credit, a commission report of the federal Advisory Commission on Intergovernmental Relations (CACIR) expressed a similar understanding, and chose for its first subject a report on the "Coordination of State and Federal Inheritance, Estate and Gift Taxes."[15] Again the commission described the development of the credit as a federal-state compromise, and noted its peculiarly important role as a harbinger of federal-state coordination and cooperation:

> The interrelationship of the State and National death taxes centers around the tax credit for taxes paid to States allowed under the Federal estate tax, an arrangement which constitutes the one major legislative effort to coordinate State and Federal taxation. The performance of the estate tax credit as an intergovernmental tax coordinator is cloaked with far greater significance than the revenue importance of these taxes would suggest. It is widely viewed as a gauge of the ability of this Federalism to coordinate its constituent members into a cohesive entity able to serve the needs of a dynamic society.
>
> The Federal tax credit served a double purpose. It provided tax reduction, an objective of Federal tax policy in the 1920s. By allowing a credit for State taxes, it reduced the combined Federal-State tax burden . . . . Introduction of the tax credit, moreover, fixed a floor under state death taxes in order to deter interstate competition for wealthy residents. This had the effect of enabling the States, through appropriate legislation, to impose death taxes as high as 80 percent of the Federal tax liability without adding to the net tax burden of their taxpayers.[16]

The commission concluded, however, that "[t]he tax credit has now been in operation for 35 years [but d]evelopments since its adoption have seriously impaired such effectiveness as it had at its inception."[17] Detailing the various changes that had undermined the credit, and had specifically undercut states' shares of death tax revenues, the commission made a variety of general and technical recommendations designed to "revitalize an intergovernmental arrangement to which the States attach symbolic significance far and above its dollar and cent value."[18] Out of these and other recommendations came technical changes to the credit, ultimately leading to the 16 percent incarnation in place in 2001.

By the time the 2001 Act was passed, every one of the 50 states and the District of Columbia had in place a state death tax that reflected, largely or entirely, the federal credit.[19] Approximately three dozen states and the district had death taxes that were pure pickup taxes — the only death tax in those jurisdictions was a tax fully absorbed by the credit. The remaining states had death taxes that combined a state estate or inheritance tax with a credit pickup tax, in many cases the pickup functioning only to ensure that the state tax maximized the utility of the credit. Significantly, at least seven states took action quite recently to better correlate their state death taxes with the credit. Connecticut, for example, scheduled its separate inheritance tax for repeal after 2004. And New York State,

[11] *Id.*, at 457.

[12] *Id.*, at 458, quoting from West, "Taxation of Inheritances," 1907 Proceedings of the National Tax Association, 224, 226.

[13] *Id.*, at 460, citing Parker, "Federal and State Death Taxes" (1933), 53.

[14] *Id.*, at 468.

[15] ACIR, January 1961. The ACIR was created under Pub. L.86-380 and charged with "the duty . . . to recommend, within the framework of the Constitution, the most desirable allocation of governmental functions, responsibilities and revenues among the several layers of government" (among other things!). *Id.*, at (iii). In 1961 its members included Gov. Abraham Ribicoff of Connecticut, Sen. Edmund Muskie, Sen. Sam Ervin, and Rep. Wilbur Mills.

[16] *Id.*, at 10, 28.

[17] *Id.*, at 13.

[18] *Id.*, at (iv).

[19] See Clarke, "Federal Estate Tax Repeal Will Have a Significant Impact on the States," 12 *State and Local Taxes Weekly* (RIA) No. 27 (Jul 2, 2001); FTA Bulletin B-07/01 (Feb 22, 2001); Hellerstein and Hellerstein, *State Taxation*, p. 21.

one of the last states to adopt a pickup tax to match the federal credit, eliminated its independent state death tax just last year.

This state motion in the direction of coordinating state death taxes under the credit had the salutary effect of simplifying state estate taxation. After decades of uncertainty regarding the application of state death taxes to movable and intangible property, a concern that Professor Oakes cited as one of the two problems driving resolution of the federal-state estate tax tug-of-war, state death taxes settled, with the occasional help of the U.S. Supreme Court,[20] into a basic, simple pattern. State estate taxes generally are imposed on the estate of resident (i.e., domiciliary) decedents, measured by the values of (i) all real property located in the state, (ii) all tangible personal property having an actual situs in the state, and (iii) all intangible assets, wherever located. State estate tax on the estates of nonresidents generally is measured by (i) the real property located in the state, (ii) tangible personal property having an actual situs in the state,[21] and (iii) in some cases, intangible assets employed in carrying on an in-state business.[22]

State inheritance taxes similarly follow the domicile of the decedent. Heirs of decedents domiciled within a state pay inheritance tax on the in-state real and personal property, and all intangibles, passing from the decedent. Heirs of nonresident decedents pay tax based on the in-state real and personal property passing from the decedent.[23]

Regardless of whether a state has an estate tax or an inheritance tax, therefore, the states essentially impose death tax only on (i) real and personal property[24] physically within their borders;[25] and (ii) intangibles owned at death by their domiciliaries.[26] In the preponderance of the states, the state death tax is fully absorbed by the federal credit,[27] and thus is largely invisible.

The interstate efficiency in death taxes brought about by the credit has, however, a price — the anomalous price of tying a considerable amount of state tax revenues to a law that states cannot control. Any 50-state survey of existing state tax laws is a difficult proposition, and summarizing the results of such surveys is even dicier, given the nuances and refinements that often cannot be expressed in summary formats. Projecting future years' state tax revenues is harder still, particularly when revenues are dependent on people dying. It seems fair to say that no one really knows how much repeal of the credit will cost the states.

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That said, both the Center on Budget and Policy Priorities (CBPP)[28] and the Federation of Tax Administrators (FTA)[29] have recently published analyses that endeavor to quantify the fiscal effects for all 50 states of the loss of the credit.[30] The numbers are significant.

Based on data reported by the IRS in its *Statistics of Income Bulletin*, CBPP reports that, for the three dozen or so states which had pure pickup taxes, the average aggregate amount of the annual federal credit allowed in respect of state death taxes in each of 1995, 1996, and 1997 was approximately $2.422 billion. For the remaining states, with a combination of pickup and additional state death taxes (including, at the time, New York), the average aggregate amount of the annual federal credit claimed was $1.262 billion. While it mixes apples and oranges to some degree to add these numbers together to estimate state revenue losses under the 2001 Act, it is nonetheless clear from the IRS data that the total amount allowed as federal credits in respect of state death taxes paid averaged $3.684 billion in each of the years 1995-97.

To update the 1995-97 numbers, CBPP estimated the year 2000 amounts of federal credit claimed. The first group of data estimated death tax revenues in states with pure pickup taxes, where each dollar of state death tax could be presumed to be matched by the federal credit. In CBPP's view, "[t]his information, from budget documents and discussions with state revenue officials provides more recent information on the amount

[20] *See, e.g., Senior v. Braden*, 295 U.S. 422 (1935) (real estate subject to death tax in the state where located); *City Bank Farmers Trust Co. v. Schnader*, 293 U.S. 112 (1934) (tangible personal property taxed in state where located at death). The discussion in "Due Process Limits on State Estate Taxation: An Analogy to the State Corporate Income Tax," 94 *Yale L.J.* 1229 (1985), offers a compendium of U.S. Supreme Court decisions that shows the development of the law on the permissible reach of state death taxes.

[21] N.Y. Tax Law sections 954, 960.

[22] Ohio Rev. Code section 5731.19(A).

[23] N.J. Rev. Stat. section 54:34-1.

[24] There can of course be state-to-state differences in their characterization of assets. For example, is a co-op apartment real property, or intangible personal property? See *Estate of Jack*, 126 Misc. 2d 1060 (Sur.Ct 1985) (co-op is real property).

[25] States also may differ as to the situs of an asset. Compare *City Bank, supra* note 20 (nonresident's art loaned for display in Pa. is taxable by Pa. as present in the state at the time of death); N.Y. Tax Law section 960(d) (nonresident's art on loan to a public gallery or museum will not be considered sitused in New York).

[26] There are risks of inconsistent domicile claims. *See Texas v. Florida*, 306 U.S. 398 (1938), a rare case in which the U.S. Supreme Court intervened in a four-state dispute. California and Texas both famously claimed Howard Hughes to be domiciled in their states. *See Calif. v. Texas*, 437 U.S. 601 (1938), and related cases. Reportedly the intervention of a federal magistrate finally prompted those two states to split the difference and go home. *See* 94 *Yale L.J.* 1229, *supra* note 20, at n.1. And as Mr. Dorrance's heirs discovered, conflicting signals as to one's domicile can lead two states to tax intangibles wealth, and there may be no federal remedy for the conflicting state tax claims. *Dorrance's Estate*, 309 Pa. 151 (1932) (determining Mr. Dorrance to be taxable as a domiciliary of Pennsylvania); 116 NJL 362 (1934) (determining Mr. Dorrance to be taxable as a domiciliary of New Jersey). *See also* the Uniform Interstate Arbitration of Death Taxes Act, and the Uniform Interstate Compromise of Death Taxes Act, under which signatory states may attempt to reach some rational resolution of multiple domicile claims.

[27] Again, some conflicts exist, particularly in determining the "allocations" of the credit across multistate estates, but these seem to be few. *See Tharalson v. State*, 281 Or. 9 (1978) for a discussion of these issues.

[28] McNichol *et al.*, "Repeal of the Federal Estate Tax Would Have Cost State Governments Billions in Revenue," CBPP, Dec 12, 2000). (This report was published in *State Tax Notes*, Sep 18, 2000, p. 781; at *2000 STT 182-22;, and at Doc 2000-24043 (6 original pages).)*

[29] "Repeal of Federal Estate Tax Would Have Effect on States," FTA No. B-07/01, Feb 22, 2001 (FTA). (This report was published in *State Tax Notes*, Mar 12, 2001, p. 903; at *2001 STT 48-60*; and at *Doc 2001-7018 (5 original pages)*.)

[30] Both reports considered the state revenue consequences of a federal repeal of the estate tax. Neither seems to have contemplated the prospect that federal repeal would start with the state death tax credit, and would effectively repeal state death taxes five years in advance of federal tax repeal.

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of revenue a state collects in estate taxes.[31] For states with more than a pure pickup death tax, information was collected through survey of revenue officials in each of these states. If the federal estate tax had been repealed [i.e., the credit eliminated entirely] in fiscal year 2000, each state would have lost approximately the amount of revenue shown . . . "[32]

From the updated fiscal 2000 estimates, CBPP projected that a full repeal of the federal credit as of fiscal 2000 would represent an annual loss to the states of approximately $5.5 billion in credit-sheltered death tax revenues — $4.382 billion in pure pickup states, plus $1.129 billion in the hybrid states. For some states, such as New York, the loss of a projected $450 million in tax revenues would not be automatic — it would depend on the state legislators' response to the federal death tax repeal. For other states, such as Florida, the CBPP-projected loss of a projected $780 million in state revenues would be automatic. In a hybrid state like Connecticut, with a federally linked pickup tax and some additional state death tax, the estimated annual revenue loss of $140 million from repeal of the federal credit would be automatic as well.

While CBPP has a point of view, and its report reflects that, the 1995-97 IRS statistics it relies on are "hard" numbers.[33] The IRS information on the "Amount of Credit for State Taxes Paid Against the Federal Estate Tax" showed a total of $3,002,950,000 in 1995; $3,749,867,000 in 1996; and $3,301,324,000 in 1997.[34] Even by Washington standards (as immortalized by Senator Dirksen), we are talking real money. With estate tax revenues widely projected to increase,[35] it can safely be said that the state tax revenue tied up in some fashion with the federal credit regime clearly exceeds $5 billion currently, and the CBPP's projection of a $9 billion state revenue loss by 2010 seems quite attainable.

The FTA report bears this out. The FTA gathered information from the U.S. Census Bureau on State Government Finances in 1999. Based on their 1999 data, state death tax revenues in the pure pickup states aggregated $3.95 billion. Death tax collections by hybrid states in 1999 aggregated an additional $3.6 billion in 1999. The FTA declined to speculate on the portion of that $3.6 billion in hybrid tax that was offset by federal credits, although clearly some significant part of the death taxes collected by hybrid states was offset by federal credits. For example, the IRS SOI reported that federal credits in 1997 for New York death taxes aggregated $499.7 million, an amount that is about half of the Census Bureau's report of $1.071 billion as New York's 1999 death tax revenue.[36]

[31] CBPP, p. 4.

[32] CBPP, p. 6.

[33] CBPP Appendix I.

[34] *Statistics of Income*, Internal Revenue Service, Summer 1999.

[35] The Joint Committee on Taxation projected the 2009 cost of full federal estate tax repeal at more than $50 billion annually. Federal estate tax receipts for fiscal 2000 were $29 billion. Their implied growth in the federal estate tax is comparable to the 60 percent increase projected by the CBPP. p. 6.

[36] According to the FTA, on average state death tax revenues represent 1.5 percent of total revenues. The actual percentages of death tax revenue vary widely from state to state. For Alaska, estate tax revenues represent only 0.2 percent of the 1999 total; New Hampshire, however, faces a loss of 4.6 percent of its revenues, and Florida faces a 2.7 percent loss, a larger proportional effect than the 2.3 percent loss of federal revenue projected for full federal repeal (should it come to that in 2010).

The difficulty states faces in absorbing that level of revenue loss may be compounded by the weakening national economy. A recent report of the Rockefeller Institute of Government[37] noted that the inflation-adjusted growth in state tax revenues in January - March 2001, was just 2.8 percent. Among the "highlights," the Rockefeller Report noted that: "The Midwest and Southeast continue to have the slowest revenue growth, but there are signs that the slowing is spreading to other parts of the country; [and] fewer states are cutting taxes this year than in the last several . . . . "[38] Of potentially greater concern is a Rockefeller Institute report issued in late June 2001, which identifies 30 states that have announced revenue problems for 2001. These shortfalls were running from 1 percent to 9+ percent of fiscal 2000 expenditures — indicating that further (and unanticipated) revenue losses from state death taxes will simply add to widespread existing problems.

Clearly, states already suffering revenue pressures will have to do some additional scrambling when the federal credit repeal takes effect in January. Thus, we have Gov. Jeb Bush (R) writing to Florida legislators just weeks after the enactment of the 2001 Act, notifying them that something will have to be done very soon about the state's looming fiscal 2003 loss of $210 million in death tax revenue. That was last summer. Presumably Florida's revenue picture, and those of most of the states, has become considerably bleaker in the wake of the horrors of September 11, just as the need for basic state and local governmental services has escalated.

A comparison of New York's statute to that of other states reveals yet another very significant issue that is raised by the structure of existing state laws, and the immediacy of the federal credit repeal. States such as Florida and Connecticut directly tie the amount of their state death tax to the amount of the credit. The Connecticut statute provides that, for a resident, "the amount of the [estate] tax shall be the amount of the federal credit allowable for estate, inheritance, legacy and succession taxes . . . under the provisions of the federal internal revenue code in force *at the date of such decedent's death* in respect to any property owned by such decedent or subject to such tax is as part of or in connection with the estate of such decedent." CT section 12-391(a) (emphasis added). For nonresidents, the Connecticut tax "shall be computed by multiplying (1) the federal credit . . . under the provisions of the [Code] *in force at the date of such decedent's death* by (2) a fraction," which is the value of the estate taxable by Connecticut over the total value of the estate. CT section 12-391(b) (emphasis added). Florida's statute is similar. FL section 198.02. Florida goes it one better, however, by including in its state constitution the following prohibition:

> No tax upon estates or inheritances or upon the income of natural persons who are residents or citizens of the state shall be levied by the state, or under its authority, in excess of the aggregate of amounts which may be allowed to be credited upon or deducted from any similar tax levied by the United States or any state.

FL Const. section 5.

[37] State Revenue Report No. 44, Fiscal Studies Program, The Nelson A. Rockefeller Institute of Government (June 2001) (the Rockefeller Report).

[38] *Id.*, p. 1.

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Tax Analysts

Table 1					
	2001	**2002**	**2003**	**2004**	**2005**
Connecticut Estate:	$ 5,000,000	$ 5,000,000	$ 5,000,000	$ 5,000,000	$ 5,000,000
New York Estate:	$15,000,000	$15,000,000	$15,000,000	$15,000,000	$15,000,000
Total Estate:	$20,000,000	$20,000,000	$20,000,000	$20,000,000	$20,000,000
Federal Tax Pre Credit:	$11,000,000	$10,000,000	$ 9,800,000	$ 9,600,000	
Federal Tax Pre Deduction:					$9,400,000
Connecticut Tax:[41]	$ 800,000	$ 600,000	$ 400,000	$ 3,200,000	0
New York Tax:[42]	$ 2,400,000	$ 2,600,000	$ 2,800,000	$ 3,000,000	$ 3,200,000
Total Federal credit:	$ 3,200,000	$ 2,400,000	$ 1,600,000	$ 800,000	0
Total Federal Deduction:					$ 3,200,000
Total Paid to CT and NY:	$ 3,200,000	$ 3,200,000	$ 3,200,000	$ 3,200,000	$ 3,200,000
Total Paid to U.S.:	$ 7,800,000	$ 7,600,000	$ 8,200,000	$ 8,800,000	$ 7,896,000
TOTAL TAX:	$11,000,000	$10,800,000	$11,400,000	$12,000,000	$11,096,000
TOTAL OVERALL RATE:	55%	54%	57%	60%	55.5%

New York's laws are constructed differently. The New York estate tax provides, effective February 1, 2000, that the estate tax for residents is "an amount equal to the maximum amount allowable against the federal estate tax as a credit for state death taxes . . . " N.Y. Tax Law section 951(a). "If the transfer of any part of the estate of a deceased resident is subject to a tax imposed by another state or states with respect to which credit against the federal estate tax is allowed . . . the tax imposed by [section 952(a)] shall be reduced by the lesser of (1) the amount of the death tax paid to the other state . . . that is allowable as the federal credit . . . ; [and] (2)" a fraction equal to the total non-New York gross estate divided by the total gross estate.

Under New York's constitution, however, "every law [other than an income tax] which imposes, continues or revives a tax shall distinctly state the tax and the object to which it is applied, and it shall not be sufficient to refer to any other law to fix such tax or object." N.Y. Const. Art. 3, section 22. As a result, New York does not reference the federal credit as that in effect at the date of death. Instead, New York's statute provides that:

> [F]or purposes of this [Article 26 — Estate Tax], any reference to the Internal Revenue Code means the United States Internal Revenue Code of 1986 [26 USCA section 1 et seq.], with all amendments enacted on or before [August 5, 1997]. [By way of contrast:] Notwithstanding the foregoing, the unified credit against the estate tax provided in [section 2010] of the Internal Revenue Code shall, for purposes of this article, be the amount allowed by such section under the applicable federal law in effect on the decedent's date of death, [to a maximum unified credit of $1 million.][39]

The federal death tax credit thus is defined in New York by reference to the Internal Revenue Code as in effect on August 5, 1997. On that date, the maximum credit allowable against the federal estate tax for state death taxes was 16 percent.[40] Under the current New York statute, therefore, estate tax is imposed at a 16 percent maximum rate, even if the credit is repealed.

New York's current statutory reductions for other states' death taxes cause even more confusion. The tax imposed by section 952(a) is reduced by the lesser of the amount paid to other states allowable as the federal credit, or a specified fraction. If the death taxes on a New York resident's property in another state (such as Connecticut) are reduced in lockstep with the reduction in the federal credit, then the amount that is allowed to be subtracted from New York's 16 percent tax is reduced as well.

The interaction of these two different tax structures means that the scaleback of the federal credit to 75 percent in 2002 (i.e., a federal credit of 12 percent) directly reduces Connecticut's estate tax, while New York's estate tax stands at 16 percent, and might even be said to increase (as a percentage of the New York taxable estate) as the Connecticut tax falls. Comparing the tax liabilities of a New York resident decedent in each of 2001-2005 shows very clearly the significant state tax mess that is created by the 2001 Act, as seen in Table 1.

Table 1 illustrates four very important points. First, federal collections will actually increase, from $7.8 million under 2001 law to $7,896,000 under 2005 law (when state death tax is deducted from the taxable estate, rather than credited against the federal tax). They peak at $8.8 million (a $1 million federal increase) in 2004, when the credit is down to 25 percent, and rates are still at 48 percent.

Second, lockstep states like Connecticut lose state revenues first. Connecticut collects $800,000 of state death tax in 2001, and nothing in 2005.

[39] N.Y. Tax Law section 951.

[40] IRC section 2011(b), as in effect through 2001.

[41] Total current federal credit times Connecticut estate, divided by total estate.

[42] Total 1997 federal credit minus tax paid to Connecticut.

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Third, with an all-New York estate the states' revenues stay constant, but with a multistate estate New York's revenue, in dollar terms, actually increases. This is because New York's tax is pegged to the old credit, while its subtractions are pegged to actual payments.

Fourth, the tax burden of the New York decedent increases, from $11 million in 2001 to $12 million in 2004, then falls back to about $11.1 million as the phased-out state death tax credit is replaced by a deduction. Absent a change in New York's tax law, the $20 million New York decedent who lives to see the 10 percent federal rate cuts in 2007 will save only $240,000 in tax, or 1.2 percent.

Of course, by 2010 (assuming full federal repeal, and no New York changes), our decedent's total bill would fall to $3.2 million, representing an effective 21.3 percent New York tax on the $15 million New York taxable estate.

As the history of state death taxes in general, and New York's in particular, shows, there is a fiscal danger in maintaining a significant state death tax when neighboring and competing states have none.

As the history of state death taxes in general, and New York's in particular, shows, however, there is a fiscal danger in maintaining a significant state death tax when neighboring and competing states have none. Individuals with movable asset portfolios are heavily incentivized to move themselves and their assets out of the reach of state death tax. Losing such residents costs personal income tax revenues, sales and miscellaneous tax revenues,[43] and the economic activity that is generated by wealthy residents. And in the end, the state loses the death tax revenues as well.

The problem of state-to-state competition in death taxation was cited as a reason for the 1926 enactment of the federal credit, and 70 years later was cited again as the reason to conform New York's estate tax to a pure pickup tax.[44] Indeed, on the full effectiveness of New York's pure pickup tax on February 1, 2000, Gov. George Pataki (R) issued a press release crowing that "New Yorkers will no longer have to flee the state in their golden years to preserve their legacies for their children and grandchildren . . . . The elimination of the estate tax will help even more [than property tax reductions] by allowing parents and grandparents to stay here in New York close to their loved ones." With the federal credit now consigned to extinction, and New York dangling as one of the few states statutorily and constitutionally able to continue to impose a separate state death tax, the specter of grandparents fleeing from their New York loved ones once again looms.

For states such as Connecticut, the picture also is not pretty. Over the space of four years, and in the face of a general economic downturn, it will, by virtue of conforming its death taxes to the federal credit, no longer have any death tax.

This is the conundrum Washington foisted on the states when, midway through 2001, it decreed that states would either immediately lose 25 percent of their death tax revenues, or would immediately face the problem of nonconforming and disproportionate taxes. And this conundrum is by no means confined to the "Blue States."

It would have been much more in keeping with the historical genesis and purpose of the credit to leave it on the table until the very end of the federal estate tax, and to afford states the time to decide their next move. Generally speaking, repealing the federal estate tax altogether would simply return states to the status quo circa 1915, when there was no federal death tax, and state estate and inheritance taxes were imposed in accord with each state's own view of appropriate state taxation. But outright repeal of the federal estate tax is not what has transpired. The federal tax continues for the next 10 years at rates of 45-50 percent, and its eventual total demise is far from certain. For at least 10 years, therefore, and perhaps indefinitely, we have a federal estate tax that continues, divorced from the historic federal-state death tax compromise.

It needs, of course, to be said that nothing in the 2001 Act bars states from continuing to impose state death taxes, and nothing mandates that the federal government must underwrite state death taxes through federal tax credits. States can, and perhaps will, enact new state death taxes to replace state revenues lost to the 2001 Act. There are, however, a number of problems in maintaining separate state death tax regimes. These problems did not exist, at least to the same degree, back in 1916.

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For example, in dozens of states the tax structure has been built around the assumption of a federal credit. Where death taxes are statutorily defined by reference to the federal credit, new state tax legislation or even a constitutional amendment would be required to resurrect a death tax. That may be a political impossibility.

People also are much more mobile than they were in 1916. Full-scale abandonment of one's historic domicile for warmer, sunnier climes is a common feature of later life. Individual wealth also is increasingly represented by intangibles, rather than land. Competition fostered by divergent state death taxes thus will be even more intense than it was when the credit came to be.

Furthermore, states that continue a separate death tax may be obligated to administer such taxes without the support of a federal system. This is both practically difficult and certain to further complicate state-to-state death tax comparisons.

[43] In defending its discriminatory taxation of New York nonresidents following the partial repeal of New York City "commuter tax," New York cited, and attempted to quantify, the many additional taxes specifically imposed on, or actually paid by, residents, over and above those paid by nonresidents.

[44] Rubenstein and Schwartz, *Historic New York State Estate and Gift Tax Reform*, N.Y.S. Bar Ass'n (1997).