ABA Tax Section News Quarterly *May 1, 2004*

The Rising Significance of State Death Taxes

By: Carolyn Joy Lee

The 2001 federal legislation "repealing" the estate tax included, as a revenue-raising feature for the federal fisc, the phased-out repeal of the federal credit for state death taxes. Internal Revenue Code §2011 had provided a sliding-scale 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," with the maximum credit equal to 16% for adjusted taxable estates of $10,040,000 and higher. IRC §2011(c). That credit is now being phased out in 25% increments over 2002-2004, and in 2005 will be replaced with a federal deduction for state death taxes. For decedents dying after 2004, therefore, there is no federal credit, only a deduction against the ultimately-to-be-phased-out federal tax. IRC §2011(g).

Prior to the 2001 federal legislation virtually every state had some form of death tax designed to maximize the utility of the federal credit. This uniformity in the state tax treatment of death taxes was the product of an historically significant compromise, brokered in the 1920's, through which the federal government and the states arrived at a mutually agreeable allocation of death tax revenues. Specifically, the federal credit for death taxes represented, at its enactment, a solution to federal-state wrangling over death tax monies that began in the nineteenth century. The federal credit 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, and had the salutary effect of eliminating state-to-state competition in death tax regimes, and making state death taxes all but invisible to taxpayers and tax planners. (This early history of death taxes in America is recounted in a fascinating article by Eugene E. Oakes, then a professor of economics at Yale. *Development of American Death Taxes*, 26 Iowa L. Rev. 451 (1941).)

With the repeal of the federal credit, however, a variety of new state death tax patterns have emerged. In some states, such as Connecticut, the state estate tax was pegged by statute to the amount of the federal death tax credit. In such states, the federal legislation had the immediate effect of reducing the state tax rate (and taking those additional monies in as federal estate tax revenues). Other states, such as New York, had an estate tax that was drafted to match the federal credit, but was not directly derivative of the federal Code. In New York the federal legislation did not affect the amount of the state estate tax, meaning that New York decedents continue to pay the same state tax as before, but get a smaller credit against their federal taxes. Indeed, after the "repeal" of the federal death tax, the total estate tax rate for New York taxpayers can be as high as 60%. And some states, such as Florida, are constitutionally

prohibited from imposing any state death tax in excess of that allowable as a federal credit. In Florida, therefore, the repeal of the federal credit mandated a reduction in state revenues that can only be undone by a (highly unlikely) constitutional amendment.

Even without state action, the federal legislation effected immediate state-to-state differences in the application and cost of death taxes. An early estimate by the Center on Budget and Policy Priorities projected that a full repeal of the federal credit, based on fiscal 2000 numbers, would represent an *annual* loss to the states of approximately $5.5 billion. Given the significant amounts of state tax revenues in play it was inevitable that states would respond with their own legislative initiatives, and inevitably would respond in differing ways. We are now inheriting that wind.

New Jersey, for example, enacted legislation effective July 1, 2002, to "freeze" its estate tax at the amount of the maximum federal credit as of December 31, 2001 (*i.e.*, before the phase-out began), and also to cap the exclusion at $675,000, rather than following the federal increases in the exemption amount. Jurisdictions as varied as The District of Columbia, Maryland, Massachusetts, Minnesota, Nebraska, North Carolina, and Wisconsin have decoupled their death taxes from an automatic phase-out that would follow repeal of the federal credit, and legislation is pending in numerous other states to do likewise. For those keeping count, more than a dozen states have enacted various forms of decoupling legislation since the federal "repeal," preserving in various forms their own death taxes notwithstanding that this means their domiciliaries will pay more death taxes than those of neighboring states, or of course those in sunny Florida.

What this means for tax advisors is that we must now be very sensitive to the states in which clients are domiciled (and to states which may lay claim to domicile), and also to the states in which their assets are located. The Florida domiciliary who owns a summer home in New York may pay estate tax; the one owning the home in Connecticut may not. Consideration also should be given to the form in which assets are held. A decedent dying with ownership interests in an LLC may present a significantly different state estate tax picture than the decedent owning assets outright.

In the real world, of course, clients do not always report in to their estate tax advisors every time they acquire or dispose of assets. The job of the estate planner thus is not solely to become familiar with the new patchwork of state death taxes, but also to sensitize one's clients to the nuances state death taxes now can present for both the locus and the form of investment.

Of potentially greater complexity are the state tax issues that will arise should federal "carryover basis" ever come to pass. New IRC §1022 provides for carryover basis effective 2010 (but would allow certain additions to the decedent's federal basis, including a $1.3 million fixed step-up, a step-up for spousal property, and a step-up for unused losses, which add even more planning intrigue). Fundamentally, carryover basis changes the tax consequence of death from an inheritance/transfer tax event to a potential income tax event. It changes as well the identity of the taxpayer, from the decedent (or his heirs) to the persons ultimately effecting a taxable disposition. And it changes the timing of the imposition of tax, from a tax imposed at the time of death to a tax imposed at the time of a taxable disposition. The federal rules also would provide some opportunity to target the limited allowance for basis increases to specific assets.

These changes in the nature of the tax imposed by reason of death can have profound state and local tax consequences. For example, Florida does not have a personal income tax. Prior to the federal legislation, Florida collected estate tax of as much as 16% from decedents domiciled in Florida. If under the new regime Florida heirs inherit property with a carryover basis, they will pay no state income tax on the sale of such property. By contrast, if the Florida decedent's property passes to heirs who are residents of New York City, the sale of such property with a carryover basis will produce, for New York, state and local income taxes of over 12% (at today's rates).

As this simple example shows, carryover basis will place a premium on planning techniques that take advantage of the state-to-state differences in income tax regimes. Such planning may occur within the four corners of the Will, as different assets are directed to different heirs, or may span years following death, as heirs seek to manage the timing and form of their dispositions to reduce state and local income taxes.

Overall, state taxes appear not to have been given much if any consideration in the course of the federal death tax debate. As a result, we have now inherited a new world in which state taxes have become an essential part of estate planning, and the nationwide simplicity that once prevailed has been replaced by very different, and no doubt competing, state tax regimes.

Unfortunately, this balkanization of American taxes is not confined to the deathbed. The federal tax stimulus legislation enacted in the wake of September 11, 2001, included significant one-time "bonus" depreciation deductions for assets acquired post-September 10. States soon recognized that their faltering state budgets could not absorb such generous deductions; most particularly could not do so in March, 2002, effective retroactively to September of 2001. What therefore followed were a host of state laws decoupling state depreciation deductions from federal depreciation. These laws will required taxpayers will business assets to maintain two (or more, when AMT is counted) sets of books over the life of the assets, in order to properly record the differing federal and state depreciation deductions, basis and ultimately gain or loss on assets that qualified for federal but not state bonus depreciation.

Even the federal rate changes have ramifications for state and local taxpayers. With the reduction in federal income tax rates to 15% for dividends and capital gains, and the increase in various state personal income tax rates to address budgetary shortfalls, increasing numbers of taxpayers are finding themselves caught up in the federal alternative minimum tax, under which deductions for their state and local income taxes are disallowed. This situation can put a premium on timing, whether of gains and losses or of tax payments, yet the need for such planning is not as widely recognized as it should be.

Federalism is a wonderful concept. In the area of taxation, however, these instances of federal/state nonconformity show that it is a mixed blessing, and increasingly a source of inefficiencies and problems for both taxpayers and those who advise them.