

NAVIGATING THE FEDERAL AND STATE ESTATE TAX MAZE

To taxpayers, the Economic Growth and Tax Relief Reconciliation Act of 2001 may have meant income tax cuts resulting in more current after-tax income, but to financial planners it has meant more work for clients to develop strategies to minimize *both* federal and state estate taxes, a less widely-publicized section of the 114-page law.

Why? For starters, it has changed the basic provisions of *federal* estate tax law, culminating in their expiration in 2010, which planners have had to factor into existing and new estate plans:

- A gradual increase in the portions of estates' values that are exempt from the federal estate tax from \$675,000 for those of people dying in 2001 to \$3.5 million for those of people dying in 2009.
- A gradual reduction in the maximum tax rate from 55 percent to 45 percent for estates of people dying in 2007, 2008, and 2009.
- The uncertainty as to whether such changes will be made permanent, be amended under some future law, or be undone in the improbable, but not impossible, absence of any new legislation applicable to 2011 and beyond.

At year-end 2005, exemption from the federal tax rises from \$1.5 million to \$2.0 million for estates of those dying in 2006 (and as its maximum rate falls from 47 percent to 46 percent). But consumers will also have to cope with the continuing proliferation of changes at the *state* level resulting from the act.

Why? Since 1926, states have been able to piggyback on the federal estate tax, enacted in 1916, by adopting state estate taxes for which they siphoned off a limited share of the revenues collected from their deceased residents' estates in accordance with the federal tax's provisions – without raising estates' total tax bills. The limit: 16 percent of taxable estates' values, equal to the maximum for which estates could claim credit for state taxes on their federal tax returns.

As adoption of the "pick-up" tax spread, states came to rely more on it and less on other wealth transfer or "death" taxes. In 1980, as noted by Daphne A. Kenyon in *State Tax Notes* last May, 12 states relied exclusively on pick-up taxes, 29 on a combination of inheritance and pick-up taxes, and eight on free-standing estate and pick-up taxes. By 1998, the number relying exclusively on pick-up taxes had jumped to 33, the number imposing both

inheritance and pick-up taxes had slumped to 13, and the number collecting both free-standing estate and pick-up taxes had fallen to four.

The 2001 act impacted this pattern in three major ways:

It repealed the credit for state estate taxes in 25 percent increments over a 4-year period ending this year, raising revenue going to the Treasury and leaving states – of which 37 relied on the pick-up tax exclusively by last year – scrambling for a substitute source of funds. In the aggregate, all forms of state wealth transfer taxes accounted for only 1.2 percent of all state tax revenues in 2003, according to Kenyon.

It precipitated a flurry of activity in state capitals to decide how to make up the lost revenue. States without estate taxes were encouraged to adopt them. States with estate taxes were encouraged to raise their rates and/or otherwise raise more funds. The result: a varied pattern with differences in maximum estate tax rates and exemptions among the states as well as between the states and the federal government, even leading to cases of states taxing estates whose values are too low to be taxed by the feds, now that exemptions are higher. State governments have not been alone in being engaged in a flurry of activity to deal with estate tax reform. With the changes in state taxes and a decline in their uniformity, financial planners have had to scurry to develop suitable estate plans for clients in a wider range of circumstances, giving unprecedented attention to state estate taxes.

It allowed estates to deduct state estate taxes on federal estate tax returns, starting this year.

With estate tax credits and the pick-up tax becoming only a memory, will the same fate be in store for other state wealth transfer taxes, relieving financial planners from having to deal with them?

Kenyon seemed to think so. “I expect over time the remaining states with wealth transfer taxes will come under pressure to repeal them,” she wrote, “and unless the federal estate tax and accompanying state credit is reenacted, I think state wealth transfer taxes will eventually disappear.”

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