# State Death Taxes in Uncertain Times

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## A. History of State Death Taxes

1. <u>Origins of State Estate Taxes</u>.

   a. The first state to impose a death tax was Pennsylvania, doing so in 1826. Between 1892 and 1916, 34 states enacted death taxes. Jeffrey A. Cooper, <u>Interstate Competition and State Death Taxes: A Modern Crisis in Historical Perspective</u>, 33 Pepp. L. Rev. 835, 847 (2006).

   b. In 1916, when Congress enacted a federal estate tax, nearly all states imposed a state death tax (only Alabama, the District of Columbia, Florida, Mississippi, New Mexico and South Carolina did not). Cooper, <u>supra</u>, at 837. Eight years later, in 1924, only three states did not impose a death tax (Alabama, Florida, and the District of Columbia). Cooper, <u>supra</u>, at 847.

   c. Many states were concerned about interstate competition, *i.e.* industrious and wealthy taxpayers relocating to a state with more favorable, or non-existent, death taxes (the "Florida Problem"). As a result, Congress enacted the credit for state death taxes. Cooper, <u>supra</u>, at 838.

2. <u>I.R.C. Section 2011 (and predecessor) Credit for State Death Taxes</u>

   a. The state death tax credit allowed states to impose a death tax and generate revenue without increasing an estate's overall tax (federal and state) liability.

   b. Congress first enacted a federal credit for state death taxes in the Revenue Act of 1924. Under the 1924 Act, the credit was limited to the lesser of (1) state death taxes paid, and (2) 25% of the federal estate tax liability. Revenue Act of 1924, Pub. L. No. 68-176, § 301(b), 43 Stat. 253, 304. <u>See</u> <u>also</u> Steven Maguire, Congressional Research Service Report for Congress, <u>State Estate and Gift Tax Revenue</u> 1 (2010).

   c. In 1926, Congress increased the credit to 80% of the federal estate tax liability. Revenue Act of 1926, Pub. L. No. 69-20, § 301(b), 44 Stat. 9,70.

   d. In 2003, total state revenue from state estate taxes was $6.7 billion. This is especially significant considering that in 2003, EGTRRA had already reduced

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the credit by 50%. Patrick R. Thiessen, The Death of the State Death Tax Credit: Can It Be Resuscitated?, 10 Marq. Elder's Advisor 309, 311-12 (2009).

3. Pick-Up Taxes and Inheritance Taxes. In response to the enactment of the federal credit for state death taxes, many states crafted their state death tax as a "pick-up tax," where the amount of state death tax liability was equal to the maximum federal credit. In 1933, thirty-six states imposed pick-up taxes. The "pick-up tax" captured tax money that, absent the state death tax, would have been paid, in any event, to the federal government. By 2001, 38 states imposed only a pick-up tax. Cooper, supra, at 840, 860.

4. Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and the Phase-Out of the I.R.C. Section 2011 Credit for State Death Taxes.

   a. With the passage of EGTRRA, Congress gradually phased out the I.R.C. Section 2011 credit for state death taxes starting in 2002, with the total repeal of the credit in 2005. See EGTRRA, Pub. L. No. 107-16, 115 Stat. 72. The credit was reduced by 25% in 2002, by 50% in 2003 and by 75% in 2004. In 2005, the credit was replaced by a deduction.

   b. EGTRRA interrupted the uniformity of the pick-up tax system. Cooper, supra, at 876.

   c. The changes to I.R.C. Section 2011 imposed by EGTRRA meant that state death taxes now imposed a direct burden on estates. Maguire, supra, at 1.

5. Response of the States.

   a. States with a pick-up tax faced a decrease in state estate tax revenue as a result of the phase-out of the I.R.C. § 2011 credit for state death taxes. Many states acted to separate – or "decouple" – the computation of state estate tax from the post-EGTRRA version of I.R.C. Section 2011. Cooper, supra, at 877-78.

   b. Nine states took legislative action to enact new death taxes.

   c. Arkansas, South Carolina and South Dakota repealed their estate taxes.

   d. Twenty-three other states took no legislative action, and allowed their state death tax to be repealed by EGTRRA.

6. Renewed Importance of State Estate Taxes as a Revenue Source.

   a. State estate tax rates vary, but some are up to 19% (or maybe even higher).

   b. The importance of the state estate tax as a revenue source varies, but is increasing in many states battling budget issues. Alaska's estate tax accounted for only 0.03% of its revenue for fiscal years 2005 to 2008. On the other hand, Pennsylvania's inheritance tax comprised 2.48% of tax revenue for the same time period. Of the states that imposed a tax for the period of fiscal years 2005 to 2008, Pennsylvania relied most heavily on this source of revenue, followed by New Jersey, New York, and Connecticut. During the same time period, Alaska, West Virginia, Utah, and New Mexico relied least on their death taxes. Maguire, supra, at 3-5.

7. 2010 Repeal of the Federal Estate Tax and 2011 Reinstatement. The repeal and reinstatement of the federal estate tax impacts state death taxes in mainly two ways:

   a. QTIP Elections. For states that do not allow "state only" QTIP elections even where a federal estate tax return is not filed, the ability to defer the incidence of state taxation through a QTIP election is suspended in 2010 because there is no mechanism available to make a QTIP election.

   b. Revival of "Pick-up Tax" in 2011. For states that have not decoupled or repealed their estate taxes, barring further changes to the federal estate tax law, in 2011 the state death tax credit will again be in force (and the deduction for state taxes will cease to be operative) and thus such states' pick-up style estate taxes will again be imposed.

B. Forms of State Estate Taxes – Post-EGTRRA and Repeal of the Federal Estate Tax (see ACTEC 2010 State Death Tax Chart attached as Appendix "A")

1. No State Estate Tax

Many states impose no state level estate tax now as a result of the elimination of the state death tax credit. The reason for the failure of such states to revise their statutes (*i.e.*, through decoupling) to avoid losing the revenue created by this tax varies from state to state. Here are two examples:

   a. "By accident"

      i. Illinois – Legislative paralysis.

      This topic is covered in sections in paragraphs C.2.c. and C.3.c. below.

      ii. Pennsylvania – State constitutional issues.

      Article VIII, section 1, of the Pennsylvania Constitution requires that the rate of tax imposed be "uniform, upon the same class of subjects." This "uniformity clause" has been interpreted to preclude the imposition of progressive taxation though the use of graduated rates, as is the case with the state death tax credit, since the rate increases incrementally with the size of the estate. Kelley v. Kalodner, 320 Pa. 180, 181 A. 598 (1935). The uniformity clause did not prohibit the application of an estate tax based on the graduated state death tax schedule when the estates assessed with the tax could receive a dollar for dollar offsetting credit against the federal estate tax. However, once the credit was substituted with a deduction, the imposition of the same graduated rates caused a constitutional problem. So, Pennsylvania is unable to impose a state estate tax based on the state death tax credit schedule while the credit is no longer available, absent a state constitutional amendment.

b. "On purpose"

As noted at paragraph A.5. above, several states have repealed their estate taxes. Other states have taken no action but allowed their state death tax laws to become inactive, with the complete phase-out of the state death tax credit under EGTRRA.

2. Separate State Estate Tax

Most states that continue to impose an estate tax continue to do so based on the graduated schedule of the pre-EGTRRA version of the I.R.C. § 2011 credit for state death taxes, with levels of exemption ranging from $675,000 to $3,500,000. At least one state, Ohio, has its own form of estate tax that is unrelated to the state death tax credit. Some states, like Connecticut, Delaware, and Massachusetts only impose an estate tax.

3. Inheritance Tax.

Some states, like Pennsylvania, no longer have an estate tax but continue to impose an inheritance tax. In other states, like Nebraska, the counties, not the state itself, impose an inheritance tax.

4. State Estate Tax and Inheritance Tax.

It appears that only Maryland and New Jersey continue to impose both an estate tax and an inheritance tax.

C. Recent Developments Regarding State Estate Taxes

1. Summary of State Death Tax Legislation. First, in response to the phase-out of the I.R.C. Section 2011 credit for state death taxes, and now, as a reaction to growing budget deficits and uncertainty in the federal estate tax system, a number of states have turned to state death taxes as a way to raise revenue. Rather than waiting for Congress to address estate tax repeal, several state legislatures have proposed or passed bills intended to clarify the application of their state death taxes, or, in some cases, to enact new taxes to generate additional funds. On the other hand, certain state legislators have taken this opportunity to advance the permanent repeal of state death taxes of any kind.

2. Pending Legislation[2].

a. Arizona. H.C.R. 2009 (concurrent resolution of the Arizona House of Representatives and Senate) was introduced on January 10, 2010 to put a proposal before the voters to amend the Arizona Constitution to prohibit the imposition of "estate, inheritance, legacy, succession or any other death tax or generation-skipping tax, however denominated."

b. Florida. H.B. 1197/S.B. 2620 (the "Florida Taxpayers Protection Act"), which if passed and signed by the Governor, would become effective on July 1, 2010, imposes a new Florida estate tax on the estates of nonresident decedents. The new tax would apply to (i) Florida real property, (ii) tangible personal property located in Florida, (iii) intangible personal property having a business situs in Florida, and (iv) stocks, bonds, debentures, notes, and other securities or obligations of corporations organized under Florida law.

i. The tax would apply "only to the extent the state in which [the decedent] is a resident imposes a tax on the estate or inheritance of a person who is not a resident of that state on such property located in that state.

ii. The tax rate would be the same as the rate imposed by the decedent's state of residence. The amount of tax due would be the additional tax resulting from adding the Florida property to the tax return filed in the decedent's state of residence. The tax would be due within 12 months of the decedent's death.

iii. As proposed, the Florida statute would create a complicated system of administration, whereby a nonresident decedent owning Florida property would be required to prepare multiple state estate tax returns to determine the tax due to Florida. The administrative and audit burden on the Florida Department of Revenue would also seem to be significant, as the bill would essentially require familiarity with the state death tax laws in every state.

c. Illinois. S.B. 3694 was introduced on February 11, 2010, and would reinstate the Illinois estate tax for 2010 as it existed in 2009 with a $2,000,000 exclusion amount and the availability of a separate state QTIP election. By its terms, S.B. 3694 would be effective immediately upon enactment and would presumably apply retroactively to the estates of Illinois resident decedents dying in 2010. Retroactive application of S.B. 3694 could be consistent with existing Illinois precedent permitting the retroactive application of the de-coupling amendments to the Illinois estate tax in 2003. See, e.g., McGinley v. Madigan, 366 Ill. App.3d 974, (1st Dist. 2006). However, the factors

[2] This outline is intended only as a summary of legislation pending in March 2010 and may not be exhaustive of all bills proposed or considered by the state legislatures.

important in that authority (e.g., a rate adjustment versus an entirely new tax, the relatively short period of retroactivity, and the opportunity for notice to the affected taxpayers) may be different in light of repeal. See Part C.5. for further discussion of retroactivity considerations.

d. Maryland. Two competing bills have been introduced in the Maryland legislature, along with an additional bill regarding the interpretation of existing estate plans in light of federal estate tax repeal.

   i. H.B. 312 (introduced January 27, 2010) and its companion S.B. 526 (introduced February 3, 2010) would eliminate the Maryland estate tax so long as the federal estate tax is repealed and would incorporate the applicable unified credit allowed against the federal estate tax as in effect on the date of the decedent's death.

   ii. S.B. 591 was introduced on February 5, 2010 and would increase the applicable exclusion amount for purposes of the Maryland estate tax from $1,000,000 to $2,000,000. If enacted, the change would be effective on July 1, 2010, but would apply to decedents dying after December 31, 2009.

   iii. H.B. 449, introduced on January 29, 2010, creates a rule of construction addressing the repeal of the federal estate tax and the operation of formula provisions in estate plans prepared before December 31, 2009. The bill is an attempt to avoid problems and unintended consequences resulting from the estate plans of decedents dying in 2010 that do not contemplate the repeal of the federal estate tax. H.B. 449 unanimously passed the Maryland House of Representatives on February 25, 2010.[3]

e. New Jersey. Two competing bills also have been introduced in the New Jersey legislature.

   i. S.B. 1242 (introduced February 8, 2010) extends the New Jersey estate tax to the real and tangible property of nonresident decedent estates located in New Jersey. Currently, the New Jersey estate tax applies only to the estates of resident decedents. The tax imposed by S.B. 1242 would be calculated by first determining the maximum credit for state death taxes that "would have been provided" under I.R.C. Section 2011 as in effect on December 31, 2001, then multiplying the credit by the fraction of New Jersey real and personal property relative to the entire nonresident decedent's estate. This amount is then reduced by the amount of New Jersey inheritance tax paid. The tax would apply

[3] Similar legislation has been introduced or enacted in several other states. See, e.g., H.B. 472, 16th Leg., Reg. Sess. (Idaho 2010); IND. CODE § 6-4.1-4-0.5(n) (2010); H.B. 1201, 85th Sess. (S.D. 2010); TENN. CODE § 32-3-113 (2010); WASH. REV. CODE § 11.108 (2010).

to the estates of nonresident decedents dying on or after the first day following six full calendar months after enactment.

ii. S.B. 1249 (introduced February 8, 2010) alternatively provides for the total repeal of the New Jersey estate tax and would apply to the estate of any New Jersey resident decedent dying on or after January 1, 2010.

f. New York. New York State Assembly proposed bill A9710, which was introduced on January 19, 2010, would clarify that New York will recognize an exclusion amount of $1,000,000 for New York state death tax purposes, subject to a state-only QTIP election when no federal estate tax return is required to be filed (either because of federal estate tax repeal or the value of the decedent's estate does not require filing a federal estate tax return).

3. Recently Enacted Legislation and Pronouncements.

a. Connecticut. For the estate of a decedent dying on or after January 1, 2010, the estate will not be subject to a separate Connecticut estate tax unless the amount of the estate's Connecticut taxable estate exceeds $3,500,000 (an increase from $2,000,000 under prior law). Beginning for the estates of decedents dying after July 1, 2009, the Connecticut estate tax is payable six months after the decedent's date of death. The Connecticut estate tax is not affected by the repeal of the federal estate tax. See CONN. GEN. STAT. § 12-391(c) ("in the event of repeal of the federal estate tax, then all references to the Internal Revenue Code…shall mean the Internal Revenue Code as in force on the day prior to the effective date of such repeal"). According to a Special Notice issued by the Connecticut Department of Revenue Services on March 8, 2010, regardless of the federal estate tax, estates of decedents dying during 2010 for which the amount of the Connecticut taxable estate exceeds $3,500,000 will be required to submit a Connecticut estate tax return along with a pro forma Form 706.

b. Delaware. H.B. 291 was introduced and passed in the Delaware House of Representatives on June 29, 2009, and passed the Senate on June 30, 2009. The Governor signed the bill on July 1, 2009, which reinstated a separate Delaware estate tax. The tax is based on the amount of I.R.C. Section 2011 credit for state death taxes allowable as of January 1, 2001 and adopts the $3,500,000 threshold for taxable estates effective in 2009 federal law.

c. Illinois. On September 8, 2009, the governor signed Public Act 96-789 permitting an Illinois-only QTIP election for purposes of the Illinois estate tax. Under 2009 law, Illinois recognized an exclusion amount of $2,000,000, so the Illinois QTIP election allowed taxpayers to defer Illinois tax on the $1,500,000 difference between the federal and Illinois estate tax exemptions. The Illinois estate tax expired on December 31, 2009, so the state QTIP election currently is not necessary.

d. New York. On March 16, 2010, the New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division, issued a notice permitting a separate New York state QTIP election when no federal estate tax return is filed (either because of repeal or when the value of the gross estate is below federal filing thresholds). In such a case, the estate must file a pro forma Form 706 with the New York return. See TSB-M-10(1)(M).

e. Rhode Island. The recent revisions to the Rhode Island estate tax appear to be as a result of the Governor's "Tax Policy Strategy Working Group." This group was chartered to "develop a tax strategy so that Rhode Island's tax structure is a competitive advantage in retaining jobs and recruiting businesses." The group recognized that Rhode Island's estate tax exemption of $675,000 was one of the lowest in the country and originally recommended an increase to $1,000,000. Ultimately, H.B. 5983 assesses a tax on estates with a net taxable estate in excess of $850,000, indexed for adjustments in the Consumer Price Index for all Urban Consumers. The Rhode Island tax is based on the maximum credit for state death taxes allowed by I.R.C. Section 2011 as in effect on January 1, 2001.

f. Vermont. On June 2, 2009, the Vermont legislature overrode the governor's veto of H. 442, which set the threshold for Vermont's estate tax to $2,000,000 (instead of following the increases in federal law). The change applied retroactively to resident decedents dying on or after January 1, 2009.

4. Recent and Pending Cases.

a. Washington QTIP Case. In October 2009, a group of estates and the Washington Attorney General on behalf of the Department of Revenue filed cross-motions for summary judgment regarding the application of the Washington estate tax to property held by a QTIP trust funded on the death of the first spouse prior to the enactment of the new Washington estate tax in 2005 (RCW 83.100 et seq.). In re Consol. Estates' Objections to Dep't of Revenue's Findings, No. 06-4-05865-5 SEA (Superior Court of Washington for King County).

i. According to the taxpayers, in defining the taxable estate for purposes of determining the Washington estate tax, the statute and the regulations issued by the Washington Department of Revenue provided that property transferred to a QTIP trust prior to the enactment of the Washington tax would be excluded from the decedent's Washington taxable estate (even though included in the decedent's federal taxable estate).

ii. The Department of Revenue disagreed, arguing that QTIP trust property included in the surviving spouse's federal taxable estate is included for purposes of determining the Washington taxable estate.

iii. On November 13, 2009, the trial court granted summary judgment in favor of the Department of Revenue. The taxpayers currently are seeking direct review by the Washington Supreme Court.

b. Estate of Kosakowski, 2009 N.J. Super. Unpub. LEXIS 3003 (N.J. 2009).

i. The plaintiff taxpayer appealed the denial of a motion for summary judgment in a case seeking the refund of previously paid New Jersey estate taxes. The plaintiff argued that the retroactive imposition of New Jersey estate tax was "manifestly unjust."

ii. The decedent died on February 9, 2002, prior to the decoupling amendments to New Jersey's estate tax system. The amendments, which were enacted in July 2002, were made retroactive to January 1, 2002. At issue was the imposition of New Jersey estate tax on estates in excess of $675,000 (rather than following the increased federal exemption of $1,000,000).

iii. In a case with distinguishable facts, the New Jersey Supreme Court declined to apply the amendments because of concerns about "manifest unjustice." See Oberhand v. Dir., Div. of Tax'n, 22 N.J. Tax 55, 60 (Tax 2005), rev'd, 388 N.J. Super. 239 (App. Div. 2006), rev'd in part, aff'd in part, 193 N.J. 558 (2008).

iv. In this case, the tax liability resulted from a disclaimer executed by the decedent's surviving spouse after the decoupling amendments had been enacted. The court concluded that the surviving spouse's choice to disclaim a portion of the decedent's assets in excess of $675,000 triggered the New Jersey tax (rather than allowing them to pass pursuant to the marital deduction) and that this choice was made with full knowledge of the amendments to the New Jersey estate tax system. Consequently, there was no manifest injustices that resulted from the retroactive tax amendments. See Rappeport v. Dir., Div. of Tax'n, 22 N.J. Tax 422 (Tax 2005).

c. Brooker v. Madigan, 388 Ill. App. 3d 410, appeal granted, 232 Ill. 2d 577 (Ill. 2009).

i. The decedent died in 2003 shortly after the deaths of her parents. The decedent received the bulk of her parents' estates, subject to significant federal and Illinois estate tax. At the decedent's death, Illinois assessed an estate tax equal to the "full credit calculable under I.R.C. Section 2011…as the credit would have been computed and allowed under the I.R.C. in effect on December 31, 2001."

ii. Because of the tax paid by her parents' estates, the decedent's estate was entitled to a credit against federal estate tax under I.R.C. Section 2013 for previously taxed property. The I.R.C. Section 2013 credit substantially eliminated the estate's federal estate tax liability, and the executor claimed no I.R.C. Section 2011 credit for state death taxes.

iii. Relying on the tax law term of art "allowed," the executor argued that because no I.R.C. Section 2011 credit for state death taxes was allowed by the IRS (*i.e.*, claimed on the decedent's federal estate return to reduce a tax liability), no Illinois tax was due. The Illinois Attorney General disagreed and assessed an Illinois estate tax liability, effectively on the I.R.C. Section 2011 credit for state death taxes "allowable" (*i.e.*, the credit available) to the estate.

iv. The executor and the Attorney General filed cross-motions for summary judgment regarding the interpretation of the Illinois Estate Tax Act. The trial court granted summary judgment in favor of the executor and viewed the Attorney General as essentially urging that "allowed" and "allowable" be construed synonymously in order to impose a tax on the estate. The Attorney General subsequently appealed the trial court's order.

v. In a 2-1 decision, the Illinois Appellate Court reversed and remanded with directions to enter summary judgment in favor of the state. The majority opinion acknowledged that "statutes imposing a tax are strictly construed against the government and in favor of the taxpayer," but concluded that "no formalistic rule of grammar or word form should stand in the way of carrying out the legislative intent" to assess a tax. The majority found that the word "allowed" when "read in light of the legislative purpose" to raise revenue required the estate to pay Illinois estate taxes. The Illinois Supreme Court then granted the executor's petition for leave to appeal.

d. <u>Estate of Pierson v. Dept. of Revenue</u>, 210 Ore. Tax LEXIS 11 (Oregon 2010).

i. The case was decided on cross-motions for summary judgment regarding the application of the Oregon inheritance tax. The decedent died on January 1, 2003 owning real property valued at $1,694,100. The personal representative elected I.R.C. Section 2032A valuation, which reduced the value of the property such that no federal estate tax was due. The personal representative claimed no credit for state death taxes under I.R.C. Section 2011 and paid no Oregon inheritance tax.

ii. The Oregon Department of Revenue asserted a deficiency based on the Oregon statute that calculated the tax liability as the "maximum amount of the state death tax credit allowable" under the I.R.C. on December 31, 2000. The personal representative contended that no state death tax credit was "allowable" because no credit was "allowed" on the decedent's federal estate tax return.

iii. The court focused on whether the word "allowable" in the statute could be read to mean the credit actually "allowed," which was the taxpayer's argument. The court rejected this position and concluded that "allowed" and "allowable" are different words with separate, established meanings in tax law. The court also reasoned that a reading of "allowable" and "allowed" as synonyms would depart from the plain language of the statute and frustrate the intention of the Oregon legislature.

5. Retroactivity of State Estate Tax Legislation. The standards for assessing the validity of potentially retroactive tax legislation vary from state to state, but focus in some form on general considerations of due process imported from the federal courts. See, e.g., Landgraf v. USI Film Products, 511 U.S. 244 (1994) (applying a two-step test whereby under step one a court interprets the language chosen by the legislature to determine if the legislature intended to apply the law retroactively and under step two the court analyzes whether retroactive application of the law would be a violation of the taxpayer's due process under either the state or the federal constitution). It is not necessarily true, however, that a challenge to a retroactive state tax would succeed or fail with a challenge to a retroactive federal tax. In states where the legislature enacts a retroactive "fix" to the estate tax, taxpayers should consider whether the applicable precedent supports a challenge based on notions of state due process.

6. Potential Exists for Inconsistent Results. The diversity of approaches adopted by state legislatures for implementing state estate taxes (and the judicial interpretation of those taxes) creates a risk of inconsistent results across jurisdictions, even with similar statutory language. See, e.g., Estate of Good, 213 Cal. App. 2d 45 (1963). The certainty provided by the "pick up" tax system has completely vanished, and taxpayers are left with a patchwork of state death taxes subject to multiple interpretations and contradictory results.

D. Planning Issues and Opportunities Surrounding State Estate Taxes

1. Continued Implications for Customary Family/Marital Trust Estate Plans and Formula Clauses

a. Differing Federal and State Exemption Amounts.

i. Federal Applicable Exclusion Amount (Unified Credit): In addition to the conversion of the state death tax credit to a deduction, EGTRRA increased the applicable exclusion amount (unified credit) under I.R.C. § 2010(c). The unified credit represents the portion of the federal estate which is exempt from federal estate tax. For decedents dying in 2002 and 2003, the applicable exclusion amount was $1,000,000; for decedent's dying in 2004 and 2005, the applicable exclusion amount increased to $1,500,000, for decedent's dying in 2006, 2007 and 2008, the applicable exclusion amount increased to $2,000,000 and for decedent's dying in 2009, the applicable exclusion amount increased to $3,500,000. In 2010, the applicable exclusion amount is not applicable, but it is returning in 2011, at $1,000,000. See I.R.C. § 2010(c).

ii. Forms of State Estate Tax: In general, states adopted two forms of a pick-up tax: (See J. Hellerstein & W. Hellerstein, State Taxation, ¶ 21.01 (Warren, Gorham & Lamont, 3d ed. Material updated on Checkpoint March 2010).

1. The first type is an estate tax which is equal to the state death tax credit under I.R.C. § 2011 as enacted and taking into account the changes in the federal tax code after the state estate tax was enacted. Id. at ¶21.01[2][b][ii][A]. For example, in Florida, an estate tax is imposed on resident decedents "the amount of which shall be a sum equal to the amount by which the credit allowable under the applicable federal revenue act for estate, inheritance, legacy, and succession taxes actually paid to the several states exceeds the aggregate amount of all constitutionally valid estate, inheritance, legacy, and succession taxes actually paid to the several states of the United States (other than this state) in respect of any property owned by such decedent or subject to such taxes as a part of or in connection with his or her estate." Fla. Stat. § 198.02. (See also Fla. Stat. § 198.03 for non-residents).

2. The second type, in "decoupled" states, picks up the state death tax credit under I.R.C. § 2011 as in effect on a specific date. Hellerstein & Hellerstein, supra, at ¶ 21.01[2][b][ii][B]. For example, New Jersey imposes an estate tax which is determined at the election of the executor to be either based upon the maximum state death tax credit allowable under I.R.C. § 2011 on December 31, 2001 or determined under a "simplified system" which would produce liability similar to the "pick up" tax. N.J.S. § 54:38-1. The effect is that New Jersey froze the applicable exclusion amount at $675,000. New York imposes a similar tax and froze the applicable exclusion amount at $1,000,000. N.Y. Tax Law § 951 (McKinney 2006).

iii. Marital Deduction/Credit Shelter Funding Clauses: Many wills for married couples are drafted with a formula clause designed to take advantage of both the marital deduction under I.R.C. § 2056 and the applicable exclusion amount under I.R.C. § 2010 when the first spouse passes away. The marital disposition will usually pass outright to the spouse or to a trust qualifying for the I.R.C. § 2056(b) (7) QTIP election. The nonmarital portion may be a continuing trust with benefits for both the surviving spouse and the decedent's children. When planning to take advantage of the federal applicable exclusion amount and to minimize state estate taxes, it is important to review the formula clauses in your clients' wills. See Zaritsky, Howard M., Waiting Out EGTRRA's Sunset Period: Practical Planning While Congress Debates Estate Tax Repeal, (Warren, Gorham & Lamont, Material updated on Checkpoint, August, 2004) ¶ 3.07[2][b].

b. State Death Taxes on the First Death. Depending upon the marital deduction/credit shelter funding clause, there may be state estate tax to pay at the death of the first spouse to die.

i. For example, if a New Jersey decedent passed away in 2009 and funded a credit shelter trust with $3,500,000 (the maximum amount that can pass free of federal estate tax), with the balance passing in a marital disposition, the decedent's executor would pay $229,200 in state estate tax to New Jersey even though there is no federal estate tax to pay. Another example of this is a clause which funds the marital portion with "the smallest amount (or fractional share) required to provide the maximum reduction in the federal estate tax, taking into account both the unified credit and state death tax credit, to the extent that this does not result in an increased state death tax." Zaritsky, supra, at ¶ 3.07[2][b][ii].

ii. On the other hand, in a "pick-up" state, like Florida, which retained an estate tax which referenced the federal applicable exclusion amount, if the decedent passed away in 2009 and funded a credit shelter trust with $3,500,000, with the balance passing to a marital disposition, the decedent's executor would pay no federal or state estate tax. See Hellerstein & Hellerstein, supra, at ¶ 21.01[2][b][ii][A].

c. Planning for the State Death Tax in an Environment when the Federal Estate Tax is Applicable.

i. The goal is to keep flexibility in the plan. Design a plan which will allow the credit shelter trust to be funded minimally with the state applicable exclusion amount and which will permit planning post-death. For example, fund the credit shelter trust with the maximum amount that can pass free of both federal estate tax and state estate tax. Try to preserve the option to fund additional amounts into the nonmarital disposition and pay some state estate taxes. Planning considerations should take into account the size of the estate of the couple, available federal unified credit remaining, whether there are children or descendants from other marriages, and generation-skipping planning contemplated.

ii. Example of when it might make sense for a married couple to pay some state estate taxes in the estate of the first spouse to die.

1. A married couple each has $2,500,000 of assets in individual names for total assets of $5,000,000 between them. Husband dies in 2009 as a New Jersey resident when the federal applicable exclusion amount is $3,500,000. Husband's will funds the credit shelter trust with the maximum that can pass free of both federal estate tax and state estate tax, or $675,000, and the balance of his estate ($1,825,000) passes to Wife outright. At Husband's death, his estate will pay no federal or state estate tax. Wife passes away a number of years later, a resident of New Jersey and at a time when the federal applicable exclusion amount is $3,500,000 and her taxable estate is $4,325,000 (assume no change in assets). Her executor will pay New Jersey estate tax of $316,000 and federal estate tax of $229,050 for total federal and state estate tax of $545,050.

2. Suppose instead that when Husband passed away, wife chose to disclaim $825,000 of her marital bequest to the credit shelter trust so that the total amount which passed to the credit shelter trust was $1,500,000. At husband's death, husband's executor pays state estate tax of $64,400 and no federal estate tax. At wife's death, she will have a federal taxable estate of $3,500,000. Wife's executor will not pay any federal estate tax and will pay state estate tax of $229,200 for total federal and state estate taxes in both estates of $293,600 - an overall savings of $251,450.

iii. Disclaimer Planning.

1. Transfer entire estate to spouse in a marital deduction disposition (*e.g.*, outright or QTIP trust). In the event that spouse disclaims all or a portion of the marital bequest, transfer disclaimed assets to a credit shelter trust for spouse and issue. Disclaimed amount can be equal to the state applicable exclusion amount or more if it is desirable to pay state estate taxes.

2. In the alternative, use a formula funding clause which funds the credit shelter trust with the maximum amount that can pass free of both federal estate tax and state estate tax. The balance will transfer to the surviving spouse in a marital deduction disposition. In the event of a disclaimer by the surviving spouse, the credit shelter disposition can be increased and state estate taxes can be paid to the extent desirable.

3. Requires a qualified disclaimer to the credit shelter trust (I.R.C. § 2518).

   (a) A writing which is an irrevocable and unqualified refusal by a person to accept an interest in property.

   (b) The refusal must be timely and the I.R.C. sets out this period: Within 9 months after the later of the day on which the transfer creating the interest in the disclaimant is made, or the day on which the disclaimant attains age 21.

   (c) The disclaimant must not have accepted any interest in the property.

   (d) As a result of the disclaimer, the interest passes without any direction on the part of the disclaimant, to the spouse of the decedent or to a person other than the disclaimant.

4. Advantages and disadvantages: Disclaimer planning allows for planning after the first spouse has passed away. The terms of the estate plan are straightforward and if the spouse does not disclaim, the spouse will receive all assets outright. If the spouse disclaims, the credit shelter trust can have provisions for both the spouse and the decedent's issue. Disadvantages are that the spouse may be reluctant to disclaim the assets; the terms of the credit shelter trust are restrictive because the spouse cannot have a lifetime or testamentary power of appointment, and the rules for a "qualified" disclaimer are rigid and inadvertently can be violated to preclude the disclaimer planning.

d. <u>Partial QTIP Election</u>.

   i. Use a formula funding clause which funds the credit shelter trust with the maximum amount that can pass free of both federal estate tax and state estate tax. The balance will transfer to the surviving spouse in a trust which meets the requirements for a QTIP trust under I.R.C. § 2056(b)(7). If the executor determines that it makes sense to pay some state estate tax at the death of the first spouse to die, then the executor will determine not to make an election under I.R.C § 2056(b)(7) to treat the property as marital deduction property for a portion of the trust. The portion that has not been elected for QTIP treatment will use the federal applicable exclusion amount to the extent not used by the credit shelter trust. (Consider this funding in a second marriage situation, when the spouses have issue from different marriages.)

ii. An alternative approach is to leave the entire estate to a trust which qualifies as a QTIP trust under I.R.C. § 2056(b)(7) and the executor determines the portion of the trust for which QTIP treatment will be elected.

iii. Advantages and disadvantages: Partial QTIP election planning allows for planning after the death of the first spouse to die. The trust is already created so the surviving spouse is not relinquishing assets and the concern over whether the disclaimer will be made by the surviving spouse is eliminated. A disadvantage is that the terms of the QTIP trust are for the spouse only and do not include issue or other beneficiaries.

e. <u>Contingent QTIP Election</u>. A contingent QTIP election is similar to partial QTIP planning but adds an additional layer of flexibility.

i. Transfer entire estate to a trust which qualifies as a QTIP trust under I.R.C. § 2056(b)(7). If the executor (other than the spouse) does not make a QTIP election for all of the property in the trust, the non-elected property will pass to another trust with different terms.

ii. In the alternative, use a formula funding clause which funds the credit shelter trust with the maximum amount that can pass free of both federal estate tax and state estate tax. The balance will transfer to a trust which qualifies as a QTIP trust under I.R.C. § 2056(b)(7). If the executor (other than the spouse) determines not to make an election under I.R.C. § 2056(b)(7) the portion for which a QTIP election was not made passes to the credit shelter trust. (Consider this funding in a second marriage situation, when the spouses have issue from different marriages.)

iii. Advantages and disadvantages: The non-elected portion can have more flexible terms than in a disclaimer situation and can include beneficiaries other than the surviving spouse which distinguishes this type of planning from the partial QTIP planning. A disadvantage is that the spouse should not be the person making the determination whether to elect QTIP treatment.

f. <u>Planning for the State Estate Tax when the Federal Estate Tax is Not Applicable.</u>

i. Even in a period when the federal estate tax is not applicable, in decoupled states, there may be state estate tax payable if the marital and nonmarital portions are funded in a fashion designed to maximize the carryover basis adjustments, without regard to state estate taxes.

ii. Wills have an added level of complexity because in 2011 unless there is additional Congressional action, the federal estate tax is scheduled to be reinstated with an applicable exclusion amount of $1,000,000.

iii. Some of the flexible planning options incorporated into plans for periods when the federal estate tax is applicable may not be effective. (Think about the partial QTIP election planning and the contingent QTIP planning. Are separate QTIP elections available in the state in which the decedent is domiciled at death? Consider potential problems with contingent QTIP planning because the federal regulations may not be applicable.)

iv. The $3,000,000 Spousal Property Basis Increase under I.R.C. § 1022.

1. The spousal property basis increase may be applied to "qualified spousal property."

2. Qualified spousal property is defined as either: property transferred outright to spouse or to qualified terminable interest property.

3. Qualified terminable interest property for purposes of the basis increase is defined in I.R.C. § 1022(c)(5).

    (a) Property which passes from the decedent in which the surviving spouse has a qualified income interest for life.

    (b) A qualified income interest for life is one in which the surviving spouse receives all of the income from the property payable at least annually and in which no person has a power to appoint any part of the property to any person other than the surviving spouse, during the surviving spouse's lifetime.

    (c) No federal QTIP election is required or even available.

v. During a period when the federal estate tax is not applicable, consider using a formula funding provision which funds the credit shelter trust with the maximum amount that can pass free of both federal estate tax and state estate tax. Special consideration needs to be given to the marital portion.

1. The marital portion should be transferred either outright to the surviving spouse or to a QTIP type trust (if in a state which will recognize the state only QTIP election).

2. If decedent passes away during a period when the federal estate tax is not applicable, depending upon congressional legislation and retroactive effect, QTIP trust may be exempt from federal estate taxation even if surviving spouse dies in a period when the federal estate tax is applicable. Then defer state estate tax until death of both spouses, but takes advantage of the applicable exclusion amount of both spouses at the state level. A great result if this works – Nobody knows yet!

3. For a state which does not recognize a state only QTIP election, consider an I.R.C. § 2056(b)(5) life estate with a general power of appointment (but be careful that you do not lose the qualified spousal basis adjustment under I.R.C. § 1022).

   (a) Generally, to qualify under I.R.C. § 2056(b)(5):

      i. The surviving spouse must be entitled to all of the income for life, payable at least annually.

      ii. The surviving spouse must have the power to appoint the entire interest (or a specific portion) in favor of the surviving spouse or of the estate of the surviving spouse, or in favor of either.

   (b) If you select this planning option and have a concern about the client retaining ability to take advantage of the I.R.C. § 1022 spousal basis adjustment, consider using a testamentary general power of appointment to the estate of the surviving spouse. This is a very broad power and some spouses may be reluctant to give the surviving spouse such power, especially in the case of a second marriage with issue from a different marriage.

2. <u>"State Only" QTIP Elections</u>

   a. The following states allow a state only QTIP election of one sort or another: Illinois, Indiana, Kentucky, Maine, Maryland, New Jersey, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, Washington.

   b. The purpose of a state only QTIP election, is the same as for a federal QTIP election – to defer the incidence of taxation on a trust until the death of the surviving spouse so that the spouse may rely for his or her support on the trust assets undiminished by state taxes.

   c. Some states, like New Jersey and New York, only allow a state only QTIP election if the estate is not required to file a federal estate tax return (e.g., in

2009 for estates that were below the $3.5 Million gross estate filing threshold, and for all estates in 2010 since there is no federal estate tax in effect.)

d. For states that allow a state only QTIP election even where there is a federal estate tax return filed, and where the state exemption is less than the federal exemption (*i.e.*, where the state estate tax was "decoupled" from the federal state death tax credit), in order to effectively defer the taxes, at least 3 trusts must be created on the death of the first spouse: a nonmarital trust (not subject to any QTIP election), a marital trust subject to the federal QTIP election and state QTIP election, and a marital trust subject to a state QTIP election but not a federal QTIP election.

e. For states that do not allow a state only QTIP election where a federal estate tax return is filed (*i.e.*, where the state estate tax is based on the state death tax credit but the exemption amount has been "decoupled"), the estates must either pay the tax on the portion of the estate exceeding the exemption amount, or, make the QTIP election for such portion despite that it provides no federal estate tax savings benefit.

f. For states that do not allow a state only QTIP election even if no federal estate tax return is filed, drafters need to consider whether it makes sense to create a trust that will qualify for the Marital Deduction without the QTIP election (such as by giving the surviving spouse a general power of appointment over the trust.) This is particularly an issue in 2010 when the estate tax is repealed so it is not possible to make a QTIP election for any portion of an estate.

g. Some states, like Pennsylvania, have their own set of rules for qualifying a trust for the deferral of state death taxes during the surviving spouse's life. In Pennsylvania, there is currently no estate tax tied to the federal estate tax concepts (*i.e.*, no "pick-up" style tax), but only an inheritance tax. The inheritance tax is imposed at a 0% rate on any property passing outright to the surviving spouse. 72 P.S. §9116(1.1)(II). The same 0% rate applies to any trust which qualifies as a "sole use" trust unless an election is made to accelerate the tax on the remainder. 72 P.S. §9113. A trust qualifies as a sole use trust if the trust property is for the sole use of the surviving spouse during his or her entire lifetime. All QTIP trusts (as well as other trusts qualifying for the marital deduction from the federal estate tax) qualify as a sole use trust because of the restriction that no one other than the spouse may be a beneficiary. However, nonmarital trusts (*i.e.*, credit shelter trusts) also qualify as sole use trusts if the spouse is the only beneficiary who could possibly receive trust distributions during his or her lifetime, irrespective of whether or not all of the income must be distributed to the surviving spouse. So, in Pennsylvania, it is common to structure both the marital and nonmarital trusts for the 0% tax rate available to surviving spouses so that the entire tax is deferred until the death of the survivor. (It is nevertheless important to consider not qualifying the trusts for sole use treatment under some circumstances such as where the trust is funded with life insurance which is exempt at the death of the first spouse but could be taxed at the death of the second spouse since it would then no longer have the character of life insurance. Also, if it's anticipated that the surviving spouse will die before the end of his or her actuarial life expectancy, or if there are fast appreciating assets in the trust, it may be beneficial to pay the tax on the first death based on the present value of the remainder to potentially save taxes on the second death.)

h. The risk for states with state only QTIP elections is that the surviving spouse will leave the state before his or her death and the state will lose sufficient nexus to tax the trust assets on the spouse's death. Query whether in such cases the surviving spouse's new state will have sufficient nexus to tax the trust and whether its estate/inheritance tax laws will be structured to do so. This is similar to the issue the federal government faces with spouses who are not U.S. citizens which is resolved by the Qualified Domestic Trust structure.

3. <u>I.R.C. Section 2013 Credit for Previously Taxed Property</u>. The authors are not aware of any state death tax statutes that explicitly incorporate the I.R.C. Section 2013 concept of a credit for estate tax paid on previously taxed property. The absence of such a credit for state death tax purposes in situations involving a close order of deaths (e.g., parents and child) can produce significant state tax liability on the same property passing between family members in short order, where no federal tax would be due (assuming the federal estate tax applies). Some state statutes may be read to incorporate an effective credit for previously taxed property, but such a position would depend on judicial interpretation. If a close order of deaths is anticipated, consider disclaimer and other planning alternatives.

4. <u>Lifetime Gifts to Reduce State Estate Taxes</u>.

a. In a "pick-up" state which has decoupled from the federal estate tax system, it may be possible to reduce the state estate tax payable by making a lifetime gift.

b. Why does this work: Under I.R.C. § 2011, the state death tax credit is a percentage of the adjusted taxable estate, which is simply the "taxable estate" reduced by $60,000. The "taxable estate" is determined under I.R.C. § 2051 and is defined as the gross estate reduced by various specified administrative expenses and other deductions. "Taxable Estate" is determined without regard to "adjusted taxable gifts" (<u>see</u> <u>also</u> I.R.C. § 2001).

c. For example, in New Jersey, an individual who died in 2009 with a taxable estate of $5,000,000 which passes to the decedent's issue, will owe $391,600 in New Jersey estate tax and $498,780 in federal estate tax for total federal and state estate taxes of $890,380. If instead, the individual made an outright $1,000,000 gift to her children during her lifetime and passed away with a taxable estate of $4,000,000, her New Jersey estate tax payable would be

$280,400 and her net federal estate tax payable would be $548,820 for total federal and state estate taxes payable of $829,220.

(The above example assumes that the individual passes away when the federal estate tax is applicable, the federal exemption for lifetime gifts is $1,000,000 and the federal applicable exclusion amount is $3,500,000.)

5. Residency and Domicile Considerations.

a. States may be more aggressive in asserting the application of all forms of state taxes. See, e.g., Sanchez v. Comm'r of Revenue, 770 N.W. 2d 523 (Minn. 2009) (finding that taxpayers had not changed their domicile from Minnesota despite selling their home, obtaining a South Dakota mailing address, applying for and receiving South Dakota drivers' licenses, opening South Dakota bank accounts and credit cards, registering their vehicles in South Dakota, registering to vote in South Dakota, and notifying insurance carriers of their change of address).

b. Multiple State Taxation of Intangibles: The Due Process Clause does not bar double taxation of the intangibles of a decedent by two states. See Curry v. McCanless, 307 U.S. 357, 59 S. Ct. 900 (1939); Hellerstein & Hellerstein, supra, at ¶ 21.08. A few states have adopted the Uniform Reciprocal Transfer Tax Act. The Uniform Act exempts personal property from taxation in a non-resident decedent's state, other than tangible personal property of the decedent having a situs in that state, if the decedent's state of residence has a reciprocal exemption. Hellerstein & Hellerstein, supra, at ¶ 21.08; See, e.g.: N.Y. Tax Law § 960-A (McKinney 2006).

c. Curry v. McCanless, 307 U.S. 357, 58 S.Ct. 900 (1939). Decedent died a resident of Tennessee. During her lifetime, decedent had transferred certain intangible assets, stocks and bonds to a trust company in Alabama. Trust provided that all income be paid to decedent for life and she had the testamentary power to appoint the trust corpus under her will. If she did not exercise the power of appointment, the property passed to her husband, her son and her daughter. In her will, the decedent bequeathed the trust property to the Alabama trust company to hold the assets in trust for the benefit of her husband, son and daughter. In her will she also appointed a Tennessee trust company as executor over the property which she owned in the state of Tennessee and she appointed the Alabama trust company as executor over the property which she owned in the state of Alabama. The will was probated in both Tennessee and Alabama. Both states assessed tax on the Alabama trust property. The Supreme Court held that both states had the power to tax the intangibles in the trust, noting that: "When the taxpayer extends his activities with respect to his intangibles, so as to avail himself of the protection and benefit of the laws of another state, in such a way as to bring his person or property within the reach of the tax gatherer there, the reason for a single place of taxation no longer obtains, and the rule is not even a workable substitute for the reasons which may exist in any particular case to support the constitutional power of each state concerned to tax." Curry, 307 U.S. at 367. The Court reasoned that the decedent's act of creating a lifetime trust in the State of Alabama and reserving in her will the ability to terminate the trust she had created "two sets of legal relationships resulting in distinct intangible rights." Curry, 307 U.S. at 369. The court reasoned that "we find it impossible to say that taxation of intangibles can be reduced in every case to the mere mechanical operation of locating at a single place, and there taxing, every legal interest growing out of all the complex legal relationships which may be entered into between persons." Curry, 307 U.S. at 373.

d. Multiple State Taxation of Tangible Personal Property and Real Property Barred: However, the Due Process Clause bars double taxation of tangible personal property and real property by two states. See Hellerstein & Hellerstein, supra, at ¶ 21.13.

e. Frick v. Commonwealth of Pennsylvania, 268, U.S. 473, 45 S.Ct. 603, (1925). Decedent died a resident of Pennsylvania. The state of Pennsylvania attempted to assess inheritance tax on the tangible personal property of the decedent located in Massachusetts and New York. (The New York property was the Frick Collection, an art collection permanently located in a building built specifically for the purpose of displaying the collection.) The Supreme Court held that it is a violation of the due process clause of the Fourteenth Amendment for a state to tax "tangible personalty having an actual situs in other states."

f. Practical approach if residency might be an issue.

   i. Determining decedent's domicile: States do not always agree on state of domicile of the decedent and the federal courts have only limited authority in resolving these disputes. See Hellerstein & Hellerstein, supra, at ¶ 21.09, citing Texas v. Florida, 306 U.S. 398, 59 S.Ct. 563 (1938) and Worcester County Trust Co. v. Riley, 302 U.S. 292, 58 S.Ct. 185 (1937).

   ii. Change of residency/domicile factors and procedures: Must look at the law of the state which client is exiting and the state to which the client is transferring residence. Client may determine to sever all ties with the state that he/she is exiting. But if not, analysis will take into account the contacts that the taxpayer has with each state and the residency test which the division of taxation applies in each state.

   iii. For a client with a possible domicile in more than one state, try to move as many connections affecting domicile to one state. Some factors which may be considered: ownership of real property, where is the largest residence, employment, where children attend school, voter registration, registration of automobiles, membership in social, business, civic, and religious organizations, where income tax returns are filed; address on returns filed with the IRS; address on passport and time spent in each state. Filings may be required in new state, like filing to obtain homestead protection. Zaritsky, supra, at ¶ 3.07[2][a].

iv. Need to consider practical considerations like whether the client is willing to sever contacts with a particular state – where is the client's extended family located? – How will the client care for himself or herself as s/he ages? Also look at whether a prenuptial agreement or a postnuptial agreement is involved and the implication that the laws of the new state will have on such agreements.

g. Many states have adopted the Interstate Arbitration of Death Taxes Act or the Interstate Compromise of Death Taxes Act which impact the process by which any dispute between taxing authorities would be resolved. These acts provide alternative procedures for resolving disputes between states over which should be entitled to collect taxes upon the estate of a decedent. For more information, see the website of the National Conference of Commissioners on Uniform State Laws at: http://www.nccusl.org.

6. Property subject to tax systems of foreign states.

a. Most states tax residents on their intangible property located anywhere in the world (which is deemed to be sitused where they are domiciled at death), but, only tax them on their tangible personal property and real property located within the state.

b. Most states tax nonresidents on their tangible personal property and real property located within the state. Some states tax nonresidents on intangible personal property related to carrying on a business activity within the state. At least one state also taxes such property that was transferred in contemplation of death. It's important to review the particulars of a foreign state's inheritance tax to understand the scope of its provisions.

c. Many states offer a credit for resident decedents with respect to property that is subject to tax in multiple states due to overlapping rules.

d. One way to simplify an estate administration and potential reduce the amount of tax due is to "transform" tangible personal property or real property located in a foreign state into intangible personal property by contributing it to a limited liability company or a limited partnership. It's important to evaluate the competing tax rates and determine if any taxes would apply to the contribution to the entity (*e.g.*, a realty transfer tax) to determine if this planning is appropriate. Note that at least one state, Maine, continues to impose its estate tax on real and tangible personal property located within the state that has been transferred by a nonresident to a limited liability company, a partnership, or a trust.

7. How to advise a client currently preparing a new estate plan.

a. State estate taxes now warrant a separate discussion with clients regarding the potential outcomes and tax liabilities.

b. Consider the trade-offs between the payment of state estate taxes and no federal estate tax.

c. Adjust formula provisions depending on whether the client intends to trigger a state estate tax and depending on whether the federal estate tax applies.

d. Build as much flexibility into the plan as possible to allow for decisions to be deferred until death since applicable facts and law continue to be in flux.

Appendix A

**2010 State Death Tax Chart**
**Revised March 20, 2010**

This chart is maintained for the ACTEC Website and is updated regularly. Any comments on the chart or new developments that should be reflected on the chart may be sent to cfox@mcguirewoods.com.[4]

| State | Type of Tax | Effect of EGTRRA on Pick-up Tax and Size of Gross Estate | Legislation Affecting State Death Tax | 2010 State Death Tax Threshold |
|---|---|---|---|---|
| Alabama | None | Tax was tied to federal state death tax credit. AL ST § 40-15-2.<br><br>Although law is ambiguous, there is probably no state death tax and this is the position taken by the Alabama Department of Revenue | | |
| Alaska | None | Tax was tied to federal state death tax credit. AK ST § 43.31.011. | | |
| Arizona | None | Tax was tied to federal state death tax credit. AZ ST §§ 42-4051; 42-4001(2), (12).<br><br>On May 8, 2006, Governor Napolitano signed SB 1170 which permanently repeals Arizona's state estate tax. | | |
| Arkansas | None | Tax was tied to federal state death tax credit. AR ST § 26-59-103; 26-59-106; 26-59-109, as amended March, 2003. | | |
| California | None | Tax was tied to federal state death tax credit. CA REV & TAX §§ 13302; | | |

[4] This chart was prepared by and is maintained by Charles D. Fox, IV and Adam M. Damerow of McGuireWoods LLP, Charlottesville, VA.

| State | Type of Tax | Effect of EGTRRA on Pick-up Tax and Size of Gross Estate | Legislation Affecting State Death Tax | 2010 State Death Tax Threshold |
|---|---|---|---|---|
| | | 13411. | | |
| Colorado | None | Tax was tied to federal state death tax credit. CO ST §§ 39-23.5-103; 39-23.5-102. | | |
| Connecticut | Separate Estate Tax | As part of the two year budget which became law on September 8, 2009, the exemption for the separate estate and gift taxes was increased to $3.5 million, effective January 1, 2010, the tax rates were reduced to a spread of 7.2% to 12%, and effective for estate taxes due on or after July 1, 2009, the Connecticut tax is due six months after the date of death. CT ST § 12-391. | | $3,500,000 |
| Delaware | Pick up Only | Tax tied to federal state death tax credit in effect on January 1, 2001 for decedents dying after June 30, 2009.<br>DE ST TI 30 §§ 1502(c).<br><br>The federal deduction for state death taxes is not taken into account in calculating the state tax. DE ST TI 30 §§ 1502(c)(2). | . | $3,500,000 |
| District of Columbia | Pick-up Only | Tax frozen at federal state death tax credit in effect on January 1, 2001.<br><br>In 2003, tax imposed only on estates exceeding EGTRRA applicable | | $1,000,000 |

| State | Type of Tax | Effect of EGTRRA on Pick-up Tax and Size of Gross Estate | Legislation Affecting State Death Tax | 2010 State Death Tax Threshold |
|---|---|---|---|---|
| | | exclusion amount. Thereafter, tax imposed on estates exceeding $1 million.<br>DC CODE §§ 47-3702; 47-3701; approved by Mayor on June 20, 2003; effective retroactively to death occurring on and after January 1, 2003.<br><br>No separate state QTIP election. | | |
| Florida | None | Tax was tied to federal state death tax credit.<br>FL ST § 198.02; FL CONST. Art. VII, Sec. 5 | HB 1197 was filed on February 22, 2010 to impose the Florida estate tax on non-residents only, effective July 1, 2010.<br><br>A companion bill, SB 2620, was filed in the Florida Senate on February 26, 2010. | |
| Georgia | None | Tax was tied to federal state death tax credit.<br>GA ST § 48-12-2. | | |
| Hawaii | None | Tax was tied to federal state death tax credit.<br>HI ST §§ 236D-3; 236D-2 | | |
| Idaho | None | Tax was tied to federal state death tax credit.<br>ID ST §§ 14-403; 14-402; 63-3004 (as amended Mar. 2002). | | |
| Illinois | None as of | Pick-up tax was frozen at | SB 3694 was | |

| State | Type of Tax | Effect of EGTRRA on Pick-up Tax and Size of Gross Estate | Legislation Affecting State Death Tax | 2010 State Death Tax Threshold |
|---|---|---|---|---|
| | January 1, 2010 | federal state death tax credit in effect on December 31, 2001 for decedents dying between January 1, 2003, and December 31, 2009.<br><br>Tax was imposed only on estates exceeding EGTRRA applicable exclusion amount, except that for decedents dying in 2009, tax imposed on estates exceeding $2 million (EGTRRA applicable exclusion amount for 2009 is $3.5 million). For decedents dying after December 31, 2009, tax is tied to current federal state death tax credit.<br>35 ILCS 405/2; 35 ILCS 405/3.<br><br>Illinois permits a separate state QTIP election, effective September 8, 2009. | introduced on February 11, 2010 to reinstate the Illinois Estate Tax for 2010 as it existed in 2009 with a $2 million exemption and a separate state QTIP election. It is unclear if the bill's effective date is January 1, 2010 or the date of enactment. | |
| Indiana | Inheritance tax | Pick-up tax was tied to federal state death tax credit.<br>IN ST §§ 6-4.1-11-2; 6-4.1-1-4.<br><br>Indiana has not decoupled but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election. | | |

| State | Type of Tax | Effect of EGTRRA on Pick-up Tax and Size of Gross Estate | Legislation Affecting State Death Tax | 2010 State Death Tax Threshold |
|---|---|---|---|---|
| Iowa | Inheritance tax | Pick-up tax tied to federal state death tax credit. IA ST § 451.2; 451.13.<br><br>Iowa has separate inheritance tax on transfers to remote relatives and third parties. | | |
| Kansas | None | For decedents dying on or after January 1, 2007 and through December 31, 2009, Kansas had enacted a separate stand alone estate tax. KS ST § 79-15, 203 | | |
| Kentucky | Inheritance | Pick-up tax was tied to federal state death tax credit.<br>KT ST § 140.130.<br><br>Kentucky has not decoupled but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election. | | |
| Louisiana | None | Pick-up tax was tied to federal state death tax credit.<br>LA R.S. §§ 47:2431; 47:2432; 47:2434. | | |
| Maine | Pick-up Only | For decedents dying after December 31, 2002, pick-up tax is frozen at pre-EGTRRA federal state death tax credit, and imposed on estates exceeding applicable exclusion amount in effect on December 31, | | $1,000,000 |

| State | Type of Tax | Effect of EGTRRA on Pick-up Tax and Size of Gross Estate | Legislation Affecting State Death Tax | 2010 State Death Tax Threshold |
|---|---|---|---|---|
| | | 2000 (including scheduled increases under pre-EGTRRA law) (L.D. 1319; March 27, 2003).<br><br>For estates of decedents dying after December 31, 2002, Sec. 2058 deduction is ignored in computing Maine tax and a separate state QTIP election is permitted. M.R.S. Title 36, Sec. 4062.<br><br>Maine also subjects real or tangible property located in Maine that is transferred to a trust, limited liability company or other pass-through entity to tax in a non resident's estate. M.R.S. Title 36, Sec. 4064. | | |
| Maryland | Pick-up Plus Inheritance | Tax frozen at pre-EGTRRA federal state death tax credit.<br><br>Effective January 1, 2004, the threshold for Maryland tax is capped at $1 million. Senate Bill 508 signed by Governor Erhlich on May 26, 2004.<br><br>Effective January 1, 2005, federal deduction for state death taxes under Sec. 2058 is ignored in computing Maryland estate tax, thus eliminating a cI.R.C.ular | | $1,000,000 |

| State | Type of Tax | Effect of EGTRRA on Pick-up Tax and Size of Gross Estate | Legislation Affecting State Death Tax | 2010 State Death Tax Threshold |
|---|---|---|---|---|
| | | computation. Senate Bill 508 signed by Governor Erhlich on May 26, 2004. MD TAX GENERAL §§ 7-304; 7-309, amended May 2004.<br><br>On May 2, 2006, Governor Erhlich signed S.B. 2 which limits the amount of the federal credit used to calculate the Maryland estate tax to 16% of the amount by which the decedent's taxable estate exceeds $1,000,000, unless the Section 2011 federal state death tax credit is then in effect. It also permits a state QTIP election. MD TAX GENERAL § 7-309 | | |
| Massachusetts | Pick-up Only | For decedents dying in 2002, pick-up tax is tied to federal state death tax credit.<br>MA ST 65C §§ 2A.<br><br>For decedents dying on or after January 1, 2003, pick-up tax is frozen at federal state death tax credit in effect on December 31, 2000. MA ST 65C §§ 2A(a), as amended July 2002.<br><br>Tax imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including | | $1,000,000 |

| State | Type of Tax | Effect of EGTRRA on Pick-up Tax and Size of Gross Estate | Legislation Affecting State Death Tax | 2010 State Death Tax Threshold |
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| | | scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount.<br>See, Taxpayer Advisory Bulletin (Dec. 2002), DOR Directive 03-02, Mass. Guide to Estate Taxes (2003) and TIR 02-18 published by Mass. Dept. of Rev.<br><br>Massachusetts Department of Revenue has issued directive, pursuant to which separate Massachusetts QTIP election can be made when applying state's new estate tax based upon pre-EGTRRA federal state death tax credit. | | |
| Michigan | None | Tax was tied to federal state death tax credit.<br>MI ST §§ 205.232; 205.256 | | |
| Minnesota | Pick-up Only | Tax frozen at federal state death tax credit in effect on December 31, 2000, clarifying statute passed May 2002.<br><br>Tax imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if | | $1,000,000 |

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| | | that amount is below EGTRRA applicable exclusion amount. MN ST §§ 291.005; 291.03; instructions for MS Estate Tax Return; MN Revenue Notice 02-16.<br><br>No separate state QTIP election permitted. | | |
| Mississippi | None | Tax was tied to federal state death tax credit. MS ST § 27-9-5.<br><br>Although law is ambiguous, there is probably no state death tax. | | |
| Missouri | None | Tax was tied to federal state death tax credit. MO ST §§ 145.011; 145.091. | | |
| Montana | None | Tax was tied to federal state death tax credit. MT St § 72-16-904; 72-16-905. | | |
| Nebraska | County Inheritance Tax | Nebraska through 2006 imposed a pick-up tax at the state level. Counties impose and collect a separate inheritance tax.<br><br>NEB REV ST. § 77-2101.01(1). | | |
| Nevada | None | Tax was tied to federal state death tax credit. NV ST §§ 375A.025; 375A.100. | | |
| New | None | Pick-up tax was tied to | | |

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|---|---|---|---|---|
| Hampshire | | federal state death tax credit.<br>NH ST §§ 87:1; 87:7. | | |
| New Jersey | Pick-up Plus Inheritance | For decedents dying after December 31, 2002, pick-up tax frozen at federal state death tax credit in effect on December 31, 2001.<br><br>Pick-up tax imposed on estates exceeding federal applicable exclusion amount in effect December 31, 2001 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount.<br><br>The executor has the option of paying the above pick-up tax or a similar tax prescribed by the NJ Dir. Of Div. of Taxn. NJ St §§ 54:38-1; approved on July 1, 2002.<br><br>In <u>Oberhand v. Director, Div. of Tax</u>, 193 N.J. 558 (2008), the retroactive application of New Jersey's decoupled estate tax to the estate of a decedent dying prior to the enactment of the tax was declared "manifestly unjust", where the will included marital formula | S. 1242, introduced on February 9, 2010, would extend the New Jersey Estate Tax to the real and tangible property of nonresident decedent estates located in New Jersey.<br><br>S. 1279, introduced on February 8, 2010, would repeal the New Jersey Estate Tax effective January 1, 2010. | $675,000 |

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| | | provisions.<br><br>In Estate of Stevenson v. Director, 008300-07 (N.J.Tax 2-19-2008) the NJ Tax Court held that in calculating the New Jersey estate tax where a marital disposition was burdened with estate tax, creating an interrelated computation, the marital deduction must be reduced not only by the actual NJ estate tax, but also by the hypothetical federal estate tax that would have been payable if the decedent had died in 2001.<br><br>A QTIP election for NJ estate tax purposes is only allowed to the extent permitted to reduce federal estate tax. | | |
| New Mexico | None | Tax was tied to federal state death tax credit.<br>NM ST §§ 7-7-2; 7-7-3. | | |
| New York | Pick-up Only | Tax frozen at federal state death tax credit in effect on July 22, 1998.<br>NY TAX § 951.<br><br>In 2002 and 2003, tax imposed only on estates exceeding EGTRRA applicable exclusion amount. Thereafter, tax imposed on estates exceeding $1 million. | A9710 which was introduced in the New York State Assembly on January 19, 2010 would clarify that the New York threshold is $1 million as of January 1, | $1,000,000 |

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| | | NY TAX §§ 952; 951; Instructions for NY Estate Tax Return.<br><br>Governor signed S. 6060 in 2004 which applies New York Estate Tax on a *pro rata* basis to non-resident decedents with property subject to New York Estate Tax.<br><br>On March 16, 2010, the New York Office of Tax Policy Analysis, Taxpayer Guidance Division issued a notice permitting a separate state QTIP election when no federal estate tax return is required to be filed such as in 2010 when there is no estate tax or when the value of the gross estate is too low to require the filing of a federal return. See TSB-M-10(1)M.<br><br>Advisory Opinion (TSB-A-08(1)M (October 24, 2008) provides that an interest in an S Corporation owned by a non-resident and containing a condominium in New York is an intangible asset as long as the S Corporation has a real business purpose. If the S Corporation has no business purpose, it | 2010. Currently, the law provides that the New York exemption is the tax on the unified credit on the date of a decedent's death not to exceed the tax on an estate of $1 million. This raised the issue that since there was no federal unified credit this year, was there a New York tax. | |

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| | | appears that New York would look through the S Corporation and subject the condominium to New York estate tax in the estate of the non-resident. There would likely be no business purpose if the sole reason for forming the S Corporation was to own assets. | | |
| North Carolina | None as of January 1, 2010 | Tax was frozen at federal state death tax credit in effect on January 1, 2001.<br><br>Tax was imposed only on estates exceeding EGTRRA applicable exclusion amount.<br><br>On August 2, 2004, Governor Easley signed Session Law 04-170, which adds to the tax base the amount of the federal deduction for taxes paid under § 2058. This eliminated an interrelated calculation of the North Carolina estate tax.<br>NC ST §§ 105-32.2; 105-32.1; 105-228.90.<br><br>No separate state QTIP election permitted. | | |
| North Dakota | None | Tax was tied to federal state death tax credit.<br>ND ST § 57-37.1-04 | | |
| Ohio | Separate state tax | Governor Taft signed the budget bill, 2005 HB 66, repealing the Ohio estate (sponge) tax | | $338,333 |

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| | | prospectively and granting credit for it retroactively. This was effective June 30, 2005 and killed the sponge tax.<br><br>Separate state estate tax rates may be found at OH ST § 5731.02.<br><br>Ohio permits a separate QTIP for its state tax. OH ST § 5731.15(B) | | |
| Oklahoma | None | The separate estate tax was phased out as of January 1, 2010. | | |
| Oregon | Pick-up Only | Tax frozen at the federal state death tax credit in effect December 31, 2001, pursuant to HB 3072, enacted on September 24, 2003.<br><br>For 2002, tax imposed only on estates exceeding EGTRRA applicable exclusion amount.<br>For decedents dying on or after January 1, 2003, tax imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law) even if that amount is below EGTRRA applicable exclusion amount.<br>The new law permits a separate QTIP election for state purposes. | | $1,000,000 |

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| | | OR ST § 118.010; Oregon Inheritance Tax Return; Inheritance Tax Advisory as of 11/4/03 from OR Dept. of Revenue.<br><br>On July 31, 2004, Oregon Department of Revenue adopted rule amendments with respect to the calculation of the tax.<br><br>Oregon also permits a separate state marital election for a trust of which the surviving spouse is the sole discretionary beneficiary. This is referred to as special marital property. OR. ST. §§ 118.005 to 118.840 | | |
| Pennsylvania | Inheritance | Tax was tied to federal state death tax credit. PA ST T. 72 P.S. §9117 amended December 23, 2003.<br><br>Pennsylvania had decoupled its pick-up tax in 2002, but has now recoupled retroactively. The recoupling does not affect the Pennsylvania inheritance tax which is independent of the federal state death tax credit.<br><br>Pennsylvania recognizes a state QTIP election. | | |
| Rhode Island | Pick-up | Tax frozen at federal state | | $850,000 |

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| | Only | death tax credit in effect on January 1, 2001. RI ST § 44-22-1.1.<br><br>Rhode Island recognized a separate state QTIP election in the State's Tax Division Ruling Request No. 2003-03.<br><br>Rhode Island's Governor signed into law on June 30, 2009, effective for deaths occurring on or after January 1, 2010, an increase in the amount exempt from Rhode Island estate tax from $675,000, to $850,000, with annual adjustments beginning for deaths occurring on or after January 1, 2011 based on "the percentage of increase in the Consumer Price Index for all Urban Consumers (CPI-U). . . rounded up to the nearest five dollar ($5.00) increment." HB 5983. | | |
| South Carolina | None | Tax was tied to federal state death tax credit. SC ST §§ 12-16-510; 12-16-20 and 12-6-40, amended in 2002. | | |
| South Dakota | None | Tax was tied to federal state death tax credit. SD ST §§ 10-40A-3; 10-40A-1 (as amended Feb. 2002). | | |
| Tennessee | Inheritance | Pick-up tax was tied to | | |

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| | | federal state death tax credit.<br>TN ST §§ 67-8-202; 67-8-203.<br><br>Tennessee has not decoupled, but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election. | | |
| Texas | None | Tax was tied to federal state death tax credit.<br>TX TAX §§ 211.001; 211.003; 211.051 | | |
| Utah | None | Tax was tied to federal state death tax credit.<br>UT ST § 59-11-102; 59-11-103. | | |
| Vermont | Pick-up Only | Tax frozen at federal state death tax credit in effect on January 1, 2001. VT ST T. 32 §§ 7402(8), 7442a, 7475, amended on June 21, 2002.<br><br>Threshold was limited to $2,000,000 in 2009 when the legislature overrode the Governor's veto of H. 442.<br><br>No separate state QTIP election permitted. | | $2,000,000 |
| Virginia | Pick-up Only (repealed, effective July 1, 2007) | Tax frozen at federal state death tax credit in effect on January 1, 1978.<br><br>Tax imposed only on estates exceeding | | |

| State | Type of Tax | Effect of EGTRRA on Pick-up Tax and Size of Gross Estate | Legislation Affecting State Death Tax | 2010 State Death Tax Threshold |
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| | | EGTRRA federal applicable exclusion amount. VA ST §§ 58.1-901; 58.1-902.<br><br>The Virginia tax is repealed effective July 1, 2007. | | |
| Washington | Separate Estate Tax | On February 3, 2005, Washington State Supreme Court unanimously held that Washington's state death tax was unconstitutional. Tax was tied to the current federal state death tax credit, thus reducing the tax for the years 2002 - 2004 and eliminating it for the years 2005 - 2010. Hemphill v. State Department of Revenue 2005 WL 240940 (Wash. 2005).<br><br>In response to Hemphill, the Washington State Senate on April 19 and the Washington House on April 22, 20, by narrow majorities, passed a stand-alone state estate tax with rates ranging from 10% to 19%, a $1.5 million exemption in 2005 and $2 million thereafter, and a deduction for farms for which a Sec. 2032A election could have been taken (regardless of whether the election is made). The Governor | | $2,000,000 |

| State | Type of Tax | Effect of EGTRRA on Pick-up Tax and Size of Gross Estate | Legislation Affecting State Death Tax | 2010 State Death Tax Threshold |
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| | | signed the legislation. WA ST §§ 83.100.040; 83.100.020.<br><br>Washington voters defeated a referendum to repeal the Washington estate tax in the November 2006 elections.<br><br>Washington permits a separate state QTIP election. WA ST §83.100.047. | | |
| West Virginia | None | Tax was tied to federal state death tax credit. WV § 11-11-3. | | |
| Wisconsin | None | As of January 1, 2008, tax is tied to current federal state death tax credit. WI ST § 72.01(11m). Thus, there currently is no tax.<br><br>For deaths occurring after September 30, 2002, and before January 1, 2008, tax was frozen at federal state death tax credit in effect on December 31, 2000 and was imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount. Thereafter, tax imposed | | |

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|---|---|---|---|---|
| | | only on estates exceeding EGTRRA federal applicable exclusion amount.<br>WI ST §§ 72.01; 72.02, amended in 2001; WI Dept. of Revenue website.<br><br>On April 15, 2004, the Wisconsin governor signed 2003 Wis. Act 258, which provides that Wisconsin will not impose an estate tax with respect to the intangible personal property of a non-resident decedent that has a taxable situs in Wisconsin even if the non-resident's state of domicile does not impose a death tax. Previously, Wisconsin would impose an estate tax with respect to the intangible personal property of a non-resident decedent that had a taxable situs in Wisconsin if the state of domicile of the non-resident had no state death tax. | | |
| Wyoming | None | Tax tied to federal state death tax credit.<br>WY ST §§ 39-19-103; 39-19-104. | | |