



How to avoid state estate tax surprises

These days, state estate taxes are catching many families by surprise. Why? Because state estate tax became somewhat convoluted when the federal estate tax exemption began increasing and the federal estate tax credit for state estate tax was phased out, both thanks to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Some states decided to “decouple” from the federal estate tax system, and, in many states, state estate taxes have increased.

What is “decoupling”?

Decoupling refers to the fact that the federal and state estate taxes are no longer in sync with one another. Before the enactment of EGTRRA, almost every state had a “pick-up” tax with respect to estates.

The federal estate tax return allowed a credit for amounts paid to states for state estate tax. Most states, in turn, defined the state estate tax amount as equal to the maximum amount for which the estate was allowed the credit. In essence, the states said, “The federal government gives you a credit for this amount, so we may as well take it.” It didn’t cost the estate anything, because a federal credit was allowed if the tax was paid to the state.

So, for example, if your estate had a \$200,000 federal estate tax bill and was allowed a state estate tax credit of up to \$50,000, the state estate tax bill was \$50,000 and your estate paid \$150,000 in federal estate tax and \$50,000 in state estate tax. If the state didn’t have an estate tax, your estate paid the entire \$200,000 in federal estate tax. Either way, your estate paid the same amount.

Current law

Under current law, there’s no federal credit for state estate tax paid. Instead, there’s a deduction. The bottom line is that, to the extent a state estate tax is paid, the combined total estate tax paid will now exceed the amount that would have been the combined total under the old system.

States that previously relied on the “pick-up” tax to calculate the estate tax due to them have had to change the way they determine their state estate tax. Some states simply let their state estate tax die with the elimination of the federal credit. Those states that have retained the state estate tax generally have congregated into two camps:

1. States that have chosen to follow the federal estate tax exemption amount, and
2. States that have frozen the exemption amount at some level other than the current federal exemption amount.

Many states instruct estates to make the calculation that would have been in effect if the full state estate tax credit were still in effect, but to use the current state exemption amount. Thus, even though there no longer is a “pick-up” tax, the states calculate the state estate tax liability as if the pick-up were still in existence.

Knowing whether there is a discrepancy between your state’s exemption amount and the federal exemption amount is relevant. For example, if your estate plan calls for assets up to the federal exemption amount to pass estate tax free into a family trust and the balance to go to your spouse, you might expect no estate tax liability. But if your state’s exemption is just \$1 million, there will be some state estate tax due at your death. The tax liability itself may not be significant, but it’s important to know whether it looms on the horizon.

Multistate jurisdictional issues

If you have estate tax liability in more than one state, things get more complicated. Multiple calculations based on each state’s allowable exemption may be required. For instance, if your home state has a \$2 million exemption but you own land in a neighboring state with just a \$1 million exemption, you may owe no tax in your home state but have a liability in the neighboring state. Again, the dollar amount might not be terribly significant, but having an expectation that no estate tax will be due and then learning that a tax is due could be disturbing.

One way to avoid — or at least minimize — state estate tax liability is to plan properly. Particularly when it comes to business interests or real estate holdings outside of your home state, you might be able to minimize your exposure to another state’s estate tax by owning those assets through a revocable trust or some other entity.

Eliminate surprises

Bear in mind that each state is different, so it’s vital you understand the rules that affect you. The bottom line is that, as with virtually anything, planning can reduce the surprises and help you face the future. Decoupling doesn’t have to derail your estate plan.

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