

Costly New State Estate Tax Laws

In 2001, the federal government passed a tax act that made substantial changes to the federal estate tax laws (the 2001 Act). The most popular of these was the elimination of the federal estate tax for those who die in 2010; however, surviving to 2011 could be very expensive due to the sunset provision in the 2001 Act that causes the old rules (those in place prior to the 2001 Act) to once again apply.

The 2001 Act also contained a provision to gradually phase out the credit to which an estate was entitled for state estate tax paid. Prior to the 2001 Act, an estate was allowed a credit for state estate tax paid up to a certain limit. Many states, including the Commonwealth of Massachusetts, had an estate tax that was equal to the federal credit. This was coined a “sponge tax” as the state would sponge up an amount equal to the federal credit. This made state estate tax planning unnecessary as plans only needed to focus on federal estate taxes.

The phase out of the federal credit would serve to phase out the estate tax to which a state with a sponge tax would be entitled. Obviously, states were not too pleased that a federal statute would decrease state tax revenues. Many states, including the Commonwealth of Massachusetts, reacted by passing statutes to reform the state estate tax laws and decouple them from the federal laws.

The specific changes will not be addressed in this article as they are complicated and vary by state. As an example, I will address the Massachusetts change. The Massachusetts change does not adopt the increased federal exemption amounts as set forth in the 2001 Act. Although the federal law provides for an exemption of \$1.0 million for those dying in 2003, the Massachusetts change looks at the exemption amount that applied before the 2001 Act, or \$700,000.

Most estate plans were drafted to minimize federal estate tax; thus, in the case where a married individual died in 2003 with an estate exceeding \$1.0 million, the amount in excess of \$1.0 million would pass into a marital trust causing the federal estate tax to be zero. However, as a result of the new Massachusetts rules, in the same circumstances, Massachusetts estate tax in the amount of \$33,200 would be due nine months after the date of death of the individual. In 2009, the potential cost of the Massachusetts change increases to over \$229,000.

There are amendments that can be made to existing estate plans to minimize the impact of the Massachusetts change; however, the solution depends on the circumstances. In modest estates, the funding of the marital trust can simply be tied to the smaller state exemption amount as the additional federal exemption is not needed. In large estates, the funding of the marital trust can be tied to the larger federal exemption amount as the additional state estate tax will be offset by a savings of federal estate tax upon the death of the second spouse.

Another solution that has proved successful in allowing clients to have their cake and eat it is to carve out three trusts. The first will be a marital trust for the amount in excess of \$1.0 million which will be treating as a marital deduction trust for both federal and Massachusetts purposes. The second will be a Massachusetts only marital trust for the gap amount (\$300,000 presently) and the balance will flow into a family trust. This three trust arrangement eliminates federal and Massachusetts estate tax upon the death of the first spouse and minimizes each of the federal and Massachusetts estate tax upon the second death.

Although I have limited my example to Massachusetts, numerous other jurisdictions, including the District of Columbia, Illinois, Maine, Maryland, Minnesota, Nebraska, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, Vermont, Virginia and Washington passed estate tax changes that will impact their residents. Additional states are likely to follow suit in an effort to preserve tax revenue. Consequently, you should review your estate plan even if your planning was done within the past couple of years.

As always, I advise you to contact a professional who practices in your jurisdiction.

The author of this article, Joseph G. Imbriani, Esq., CPA/PFS, practices in the areas of taxation and estate planning and is a partner of the Boston law firm of Taylor, Ganson & Perrin, LLP.