

# Planning for Property Interests in More Than One State After the Demise of the State Death Tax Credit

By William S. Forsberg and Darren M. Wallace

One of the most sweeping changes to federal estate tax law was the passage of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001. Pub. L. No. 107-16, 115 Stat. 38 (2001). As widely discussed in planning circles, EGTRRA dramatically increases federal exemption amounts until complete repeal of the federal estate tax in 2010 as scheduled. A less publicized, but equally important, provision of EGTRRA is the phase-out of the state death tax credit currently allowed under Code § 2011. Under EGTRRA, the state death tax credit disappears after 2004.

Many state-level estate taxes, how-

ever, are designed merely to equal the federal credit provided under Code § 2011. If a state-level estate tax is completely tied to the federal credit provided under EGTRRA, that state tax disappears in 2005 absent legislative action. Some states affected by this have acted but others have not—and many of those taking action have chosen different paths. This varied state response to EGTRRA has resulted in much confusion and complexity for estate planners. Clearly, for many practitioners, it has made both tax planning and—in some cases—even the fundamental task of computing state estate tax during administration more difficult and cumbersome.

This article will give a brief history of state death taxes, discuss the changes made to the state death tax credit by EGTRRA, review how different states have responded to EGTRRA changes, and finally pro-


vide some estate and tax planning tips for individuals who own real and tangible personal property located in more than one state.

## A Primer on the History of State Death Taxes

For many years before EGTRRA, the federal estate tax law allowed a dollar-for-dollar credit against the federal estate tax for state death tax actually paid, subject to a maximum calculated under a table of percentages applied to the taxable estate. Code § 2011 provides that a credit against federal estate tax shall be allowed for any estate, inheritance, legacy, or succession taxes actually paid to any state or the District of Columbia. The maximum credit for state death taxes calculated under Section 2011 is used, or picked-up, by some states as their own—and only—state estate tax. Other states impose a separate state estate tax or state inheritance tax but

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also impose a tax equal to the difference, if any, between the separate tax and the federally computed maximum state estate tax credit, so that the state collects what is in effect the greater of the two amounts.

EGTRRA, however, is phasing out the federal credit for state death taxes. The phase-out started in 2002 with only 75% of the credit allowed to be applied against federal estate taxes. In 2003 the allowable credit was 50%, in 2004 it is 25%, and in 2005 and thereafter there is no federal credit for state death taxes. For decedents dying after December 31, 2004, the credit will be replaced with a deduction under Code § 2058 against the federal gross estate for any estate, inheritance, legacy, or succession taxes actually paid to any state. All states lost revenue as a result of EGTRRA's phase-out of the credit for state death taxes, some more than others. For those states that have a pure pick-up estate tax system and are coupled with, or hooked up to, the federal system after EGTRRA, the phase-out of the federal credit for state death taxes has reduced and will continue to significantly reduce state revenues (absent, of course, state legislation enacting a stand-alone state death tax). For those states that decoupled from the federal regime following EGTRRA, the state revenue drop may be less—but the end result is a dual estate tax system, one at the federal level and one at the state level, with each decoupled state likely having different exemption amounts as well as different methods for calculating their state death tax.

The state tax laws are now in flux, and so something of a moving target, but the following is a breakdown of the various state-level tax regimes. Thirty-eight states now have only pick-up estate tax systems. Twenty-eight pick-up states have laws that automatically update their state estate tax laws when any change is made to the federal estate tax laws. For purposes of this article, *Florida* will be used as an example of these states. Ten pick-up states have estate tax laws that are tied to federal law but only when adopted as of a certain date or point in time. These states do not automatically change their death tax laws when there is a

federal law change but require affirmative state legislation to adopt federal changes. *Minnesota* is an example of these states. Twelve states have stand-alone estate or inheritance taxes and in these states, a pick-up tax is only paid to the extent it exceeds the separate state estate or inheritance tax. *Iowa* is an example of these states.

#### **Automatic Pick-Up States**

For those twenty-eight states that automatically adopt federal changes, EGTRRA was automatically incorporated into their respective death tax laws, including the phase-out of the federal state death tax credit. These states essentially stayed coupled, or hooked up to, the federal tax regime following enactment of EGTRRA, creating an interesting political dilemma. In a coupled state, legislative action to decouple from EGTRRA, in whole or in part (ostensibly to *preserve*, not increase, state tax revenues), could be viewed by its taxpayers as an indirect way of actually *increasing* state taxes, with the corresponding negative political backlash that follows tax hikes.

#### **Pick-Up By Choice States**

Ten states have pick-up estate tax systems tied to the applicable federal estate tax law at a fixed point in time, meaning the changes under EGTRRA do not have any effect at the state level. Essentially, there is no automatic change to the state-level estate tax laws when there is a federal change. These states can therefore take the wait-and-see approach. If federal law changes, the state has an opportunity to consider whether the changes are consistent with its fiscal policy and, if so, then determine if the federal changes should be adopted in whole or in part. This change, however, requires affirmative legislative action. If the federal law change is not revenue neutral, the state legislature may be inclined to do nothing, thereby decoupling from the federal estate tax system on that issue.

Although doing nothing in response to a federal estate tax change or publicized tax cut can hardly be viewed on the surface by taxpayers as enacting a state tax increase, the practical effect of state legislative inaction in wait-and-

see states is to do just that. State inaction may also have other adverse consequences. By preserving the status quo, a wait-and-see state preserves its state revenue stream that was in existence before the federal law change—but neighboring states that stayed coupled to the federal system, even after EGTRRA, effectively reduced and will soon eliminate their state-level estate taxes. The juxtaposition of a tax reduction in one state and a revenue neutral position in a neighboring state makes the latter, for tax planning purposes, a less desirable and attractive state for



**The federal estate tax law allowed a dollar-for-dollar credit against the federal estate tax for state death tax actually paid, subject to a maximum calculated under a table of percentages applied to the taxable estate.**



taxpayers, including property owners who may not be inclined to unnecessarily expose themselves to state-level estate tax if it can be avoided. The wait-and-see state, by embracing legislative inaction preserving state revenues, may put itself on a less competitive playing field for attracting new property owners and keeping those residents comparing the relative death tax costs of living or owning property in multiple jurisdictions.

#### **Stand-Alone Tax States**

Finally, twelve states have stand-alone state death tax systems that are not directly tied to the federal estate tax—ten states with inheritance taxes and two states with stand-alone estate taxes. These states also have death tax laws that provide that the decedent's estate will pay the higher of the stand-alone state death tax or the federal

pick-up estate tax. Depending on the provisions of the state-level tax, the phase-out of the state death tax credit may not affect state revenues in these jurisdictions as much as in other jurisdictions.

Of course, legislative action can be expected to the extent state budgets are severely affected, creating additional flux and complexity for tax planners and their clients. For example, Connecticut is phasing out its stand-alone succession tax, meaning that the elimination of the state death tax credit is expected to significantly affect its state-level revenue. This forced the legislature to temporarily unhook from the federal tax regime (effective July 1 of this year)—creating a new tax system for a six-month period that may require changes to wills and trusts for married clients with minimum-tax estate plans that use a trust funding formula based on the prior tax regime. Planning tips for residents of decoupled states are discussed further below.

### State Tax Rules for Nonresidents

The phase-out of the state death tax credit will affect tax planning for individuals who own real and tangible personal property located in more than one state. A Minnesota snowbird who owns a Palm Beach home and winters in Florida and a Florida resident who owns a Minnesota lake cabin and summers in Minnesota are good examples. The effect on property owners will vary depending on their state of domicile and the value of any real and tangible personal property located in a nondomiciliary state. Because not all states are coupled with, or hooked up to, the federal tax regime following

EGTRRA, an individual with real and tangible personal property located in multiple states will need to do some additional estate and tax planning based on the way state estate tax is calculated in those states.

Generally, for individuals domiciled in coupled states (Florida), there will be no state estate tax to pay after 2004, if *all* of the individual's real and tangible personal property is located in that domiciliary state. If the same individual also owned real or tangible personal property in another state and that ancillary state is decoupled from the federal system (Minnesota), then there may continue to be some state estate tax to pay after 2004 in the nondomiciliary state based on the pro rata portion of such nondomiciliary state property compared to the individual's entire gross estate. By contrast, if an individual is domiciled in a decoupled state (Minnesota) but owns real or tangible personal property in a coupled state (Florida), then the individual's overall state estate tax may be lower.

### The Effect on Property Owners: Owning Multi-State Property Interests Could Be Hazardous to Their Financial Health

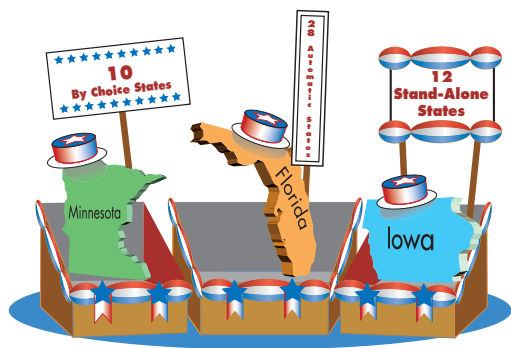
After EGTRRA, the manner in which property is treated for state death tax purposes could have a significant effect on how and where an individual chooses to live and own property. If an individual owns an interest in an entity, such as stock in a corporation that owns real and tangible personal property, then the value of his or her stock is considered intangible personal property in all states and is taxed at death in such individual's state of domicile. If, on the other hand, the real and tangible personal property is owned in the individual's name, or in some other form of joint ownership (for example, joint tenancy), such property will be taxed at death in the state where the property is *located*. The following five factual situations are possible scenarios an individual could encounter if he or she owns real or tangible personal property in more than one state—whether domiciled in a coupled, decoupled, or stand-alone state:

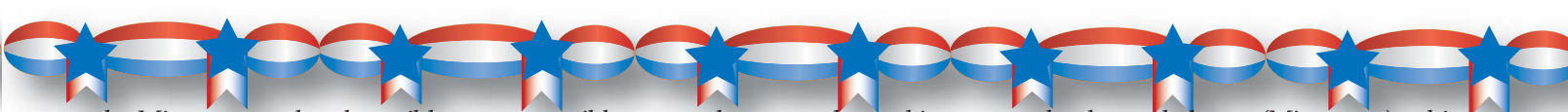
1. The individual is a resident of a coupled state and owns real or tangible personal property in a decoupled state.
2. The individual is a resident of a coupled state and owns real or tangible personal property in a stand-alone state.
3. The individual is a resident of a decoupled state and owns real or tangible personal property in a coupled state.
4. The individual is a resident of a decoupled state and owns real or tangible personal property in a stand-alone state.
5. The individual is a resident of a stand-alone state and owns real or tangible personal property in a coupled or decoupled state.

The following is a general discussion of various planning techniques to address certain state death tax issues in multiple jurisdictions following the complete phase-out of the state death tax credit in 2005. Of course, practitioners should be mindful that the different tax regimes, exemptions, and rates of decoupled and stand-alone states—not to mention nontax considerations and the particular circumstances of each client—must also be considered to ensure appropriate tax planning.

### Scenario # 1—Resident of a Coupled State Owning Property in a Decoupled State

This situation arises when the individual is a resident of a coupled state at death (Florida) but owns real and tangible personal property in a decoupled state (Minnesota). Because Minnesota is a decoupled state, if the real and tangible personal property is owned individually at death rather than in an entity (a corporation, LLC, or partnership), the real and tangible personal property will be subject to Minnesota estate tax even after the complete phase-out of the federal state death tax credit in the coupled state (Florida) in 2005. The result will be that the individual's estate will be subject to a Minnesota estate tax equal to the Minnesota estate tax rate times the proportionate date-of-death value of





the Minnesota real and tangible personal property compared to the value of the decedent's entire gross estate.

Three things aggravate this situation. First, after 2004, the individual's estate will only get a federal estate tax deduction for the Minnesota estate tax paid rather than the then phased-out, dollar-for-dollar offsetting "credit" against federal estate tax available pre-EGTRRA. This results in more combined federal and state estate tax for the individual's estate than if the real and tangible personal property were entirely taxed in the coupled state (Florida).

Second, the Minnesota estate tax is calculated, as is true with many states, based on the ratio of the gross value of the real and tangible personal property in the state (without reduction for mortgages or other liabilities that may encumber the property) compared to the value of the individual's federal gross estate. This proration based on gross figures, combined with the reduced federal tax credit for the payment of state-level tax, severely penalizes the coupled-state resident property owner with real estate and tangible personal property located in an ancillary decoupled state.

Third, this situation will require the filing of a separate state estate tax return in the decoupled state (Minnesota), increasing the costs of administration for the individual's estate. This may also cause delay in obtaining state tax clearance.

It is recommended that individuals in this situation consider transferring their real and tangible personal property located in the ancillary state to an entity that will not be subject to death taxes in that jurisdiction, such as a limited liability company, corporation, or partnership. This step also offers some added protection from creditors and other estate planning benefits (like ease of gifting and potential discounts on gift values).

#### **Scenario # 2—Resident of a Coupled State with Property in a Stand-Alone State**

This situation arises when an individual is a resident at death of a coupled state (Florida) and owns real and tan-

gible personal property located in a state with a stand-alone estate or inheritance tax (Iowa). Generally, stand-alone states that have a separate estate tax or separate inheritance tax still follow the intangible personal property—real/tangible personal property situs distinction when calculating their state estate or inheritance tax. That is, a nondomiciliary individual is only subject to the stand-alone state estate or inheritance tax on the property actually located in such state. Intangible personal property (for example, stock) for a nonresident individual is generally not subject to the nondomiciliary state's estate tax or inheritance tax laws.

Therefore, the advice for the practitioner is twofold. First, review the stand-alone state's tax laws and, if necessary, consult with local counsel to determine what is includible in the estate tax base or is subject to that state's inheritance tax. Second, if that state's laws provide that only real and tangible personal property owned by the individual and located in that state are subject to state estate or inheritance tax, then the general advice is the same as Scenario # 1—consider placing the real and tangible personal property located in the nondomiciliary state in an entity that is not subject to death tax in the ancillary state, such as an LLC, corporation, or partnership. If the nondomiciliary state taxes the real and tangible personal property located there, whether owned individually or in an entity, then title to the property is a non-issue for state death tax purposes. In that case, the individual should hold the real and tangible personal property in any form that best fits his or her family situation.

#### **Scenario # 3—Resident of a Decoupled State Owning Property in a Coupled State**

This is the opposite of Scenario # 1—the individual is domiciled in a decoupled state (Minnesota) but owns real and tangible personal property located in a coupled state (Florida). If the real and tangible personal property located in the coupled state (Florida) is owned by an entity (rather than titled in the individual's name), it may be taxed in


the decoupled state (Minnesota) at his or her death. Property titled in the individual's name, however, will be subject to apportionment and taxed in Florida. Florida is scheduled to have no state estate tax after 2004 following the phase-out of the state death tax credit. The individual's overall federal and state estate tax burden would be less because Minnesota's tax base for calculation of its state estate tax would be less because of the exclusion of the Florida real estate. In this situation, it would be better from a strict state death tax perspective for the individual to own the real and tangible personal property located in the coupled state (Florida) in his or her individual name, rather than in an entity. This would be especially true if the real or tangible personal property were encumbered by a large mortgage or other debt. Other factors, however, such as income tax and creditor protection considerations, may override the death tax benefits.

#### **Scenario # 4—Resident of a Decoupled State Owning Property in a Stand-Alone State**

This situation contemplates an individual dying a resident of a decoupled state (Minnesota) but owning real and tangible personal property in a state that has a stand-alone estate or inheritance tax (Iowa). Again, the recommendation is to first review the nondomiciliary state's estate tax laws carefully and consult local counsel if necessary before determining the appropriate course of action from a tax-planning perspective. In general, if the situs distinction between intangible personal property/real and tangible personal property is followed by the nondomiciliary, stand-alone state, then the property should be titled in the individual's name to avoid the domiciliary state's estate tax. This *assumes the stand-alone state tax bill is lower*—which is not always the case—and is subject, of course, to overriding considerations like creditor protection and added administrative costs.

#### **Scenario # 5—Resident of a Stand-Alone State Owning Property in Either a Coupled State or a Decoupled State**

If the individual dies domiciled in a



stand-alone state (Iowa) owning real or tangible personal property located in a coupled state, title to the coupled state property should be held in the individual's name to avoid the domiciliary state's stand-alone death tax. If, however, the property is located in a decoupled state, then a more complex multi-step analysis is required.

- *Step One:* Consider the overall state estate tax exposure in both the domiciliary state and the non-domiciliary decoupled state.



**Every client with property located in more than one state should consult with counsel to review the effect of EGTRRA and the state death tax laws that may adversely affect tax planning.**



- *Step Two:* Calculate the overall state estate tax exposure assuming the property located in the non-domiciliary decoupled state is taxable in the domiciliary state rather than the decoupled state.
- *Step Three:* Compare the overall tax burden from Steps One and Two.

If the overall tax burden is higher in Step One, consider transferring the real and tangible personal property located in the non-domiciliary state to an entity (an LLC or limited partnership). This will convert it to intangible personal property taxed in the individual's domiciliary state. If the Step Two tax burden is higher, continue to hold the real and tangible personal property in the individual's name so it is taxable in the decoupled non-domiciliary state.

### **Marital Tax Planning in Decoupled States**

In addition to the steps described above, planning for married clients in decoupled states requires the practitioner to review and, if necessary, revise the allocation formulas in those traditional estate plans that include a credit shelter trust. At the first death, the credit shelter trust should be funded based on the exemption allowed by the decoupled state rather than the federal exemption. Although this overfunds the marital share and may not fully use the federal exemption, it preserves by default a minimum tax plan by avoiding the state death tax and allows for flexible post-mortem planning options (such as partial QTIP elections and disclaimers, depending on the nature of the plan) to be reviewed after the dust has settled. For example, if it is unlikely that federal tax will be due at the second death, it probably makes sense to preserve the minimum tax scenario and leave the marital share overfunded. But, if it is likely that federal estate tax will be due at the second death, the client may decide the benefit of the ability to maximize federal exemption by a partial

QTIP election of the marital share or disclaimer of a portion of the marital share outweighs the burden of the state-level tax to be paid on the difference between the federal exemption amount and the state exemption amount. Of course, this analysis depends on a variety of factors, including the clients' asset picture and a difficult forecast of the future federal exemption amount in place at the second death (not to mention an assessment of the likelihood complete repeal will occur in 2010 as scheduled). The bottom line is that it is important to ensure that allocation formulas in marital plans work from a state-tax perspective in decoupled jurisdictions, and overfunding the marital share is just one of several tools for the estate planner.

### **Conclusion**

Tax planning for an owner of real and tangible personal property located in more than one state was difficult before the enactment of EGTRRA. It is more complex now because of the varying state responses to EGTRRA's phase-out of the state death tax credit and the state-level changes flowing from continuing budget shortfalls in many states. Every client with property located in more than one state should consult with counsel to review the effect of EGTRRA and the state death tax laws that may adversely affect tax planning. Caution is the order of the day, as many states are still in the process of enacting, and tinkering with, changes to their death tax laws. And, of course, the tax flux is not over, because the ultimate fate of the estate tax at the federal level has been the \$64,000 question since 2001. ■