

Lower federal death tax can trigger more taxes on the unmarried by states

A story released by Kiplinger.com on October 31, 2003, reports that as the federal estate tax marches toward oblivion, some state legislatures are making sure the death tax doesn't really die. More than one-third have already changed their laws so that the federal government's final take dwindles and state treasuries don't get taken along for the ride. So, if you have enough money to worry about estate taxes, you now have to fret about where you die. In some cases, states will siphon off a chunk of estates of less than \$1 million that aren't even on the federal government's radar.

Blame it on the so-called pick-up tax, an easily ignored levy that's been around almost as long as the estate tax. The tax used to apply only to the wealthiest 2% or so of Americans subject to the federal estate tax. And it really didn't cost anything because if the state didn't take the money, the feds would. The pick-up tax was designed to claim precisely the same amount that federal law allowed as a credit for state taxes paid.

When Congress voted in 2001 to eliminate the estate tax by 2010, the lawmakers also decided to phase out the death-tax credit -- and with it the pick-up tax -- on an even faster schedule. This year, the credit is just half of what it used to be; next year, it falls to 25%. Then, in 2005 the federal credit and all the pick-up tax revenue it painlessly channeled to the states disappear.

But states are not taking this loss of revenue lying down. So far, 18 plus the District of Columbia have changed their laws to keep the cash coming in. States continue to demand the same amount of death tax they were entitled to under the old rules. But because the feds won't give back as much via the credit, if you live in a decoupled state, your estate will wind up paying more death tax than if you had died in a state whose lawmakers are going along with the program.

How much money are we talking about? A taxable estate worth \$1 million in a decoupled state will pay an extra \$33,200 in death taxes this year. A \$5-million estate will pay an extra \$195,800 that would otherwise go to heirs.

Changes in state law also make a joke of the slow decline in federal estate-tax rates that precedes abolition of the tax in 2010. Before the law changed, the top federal estate-tax rate was 55%; it drops to 49% this year and will fall to 45% in 2007. But as much as 16 percentage points of the tax used to be diverted to the states via the death-tax credit. When the credit disappears -- and decoupled states still demand their 16% -- as much as 61% of a large estate could be

devoured by federal and state death taxes, notes Lawrence Chane, an estate-planning lawyer with Blank, Rome, in Philadelphia.

To further complicate matters, each decoupled state has its own cap on how much you can pass tax-free to heirs -- not counting a surviving spouse, who can inherit an unlimited amount free of both federal and state death taxes. And in most jurisdictions, the limit is lower than the amount the feds allow to pass tax-free -- or soon will be, as federal exempt amounts gradually increase from \$1 million this year, to \$1.5 million in 2004 and 2005, to \$3.5 million in 2009.

Sigrid and Bob Button of Portland, Ore., recently had to redo their estate plan. After Oregon decoupled, the couple discovered that the change would cost them money if Bob, the owner of a safety-consulting business, were to die this year.



The Buttons' original plan was one commonly used by married couples to avoid federal tax on the death of the first spouse. It directed that the maximum amount that can pass tax-free under the federal rules go into a so-called bypass, or credit-shelter, trust for the benefit of the widow or widower. Then at the survivor's death, the money in the trust would go tax-free to the couple's children.

When Oregon had the traditional pick-up tax, avoiding federal tax meant dodging the pick-up tax, too. But when the state decoupled, the Buttons' plan derailed. If the full federal exemption amount of \$1 million were to go into a bypass trust this year, it would trigger a pick-up tax of \$33,200. There are ways to plan around decoupling, but you'll need expert help.

The Buttons, who are both 51 years old, decided to build a disclaimer into their plan. This allows a person who inherits property to refuse to accept some or all of it. Under the Buttons' plan, the surviving spouse inherits everything. But if there is still a federal estate tax, or if the state death tax is onerous, the survivor can disclaim enough to fund a bypass trust to capture the maximum benefits possible at that time. This plan "allows some 20-20 hindsight," says Marsha Murray-Lusby, the Buttons' Portland lawyer. But, she warns, "disclaimers work best in a single marriage with kids of the same marriage." It could be risky giving a surviving spouse that much discretion over assets if you are afraid that kids from a previous marriage might be disinherited, she says. Single people have less chance of avoiding the state tax because they can't use bypass trusts or the marital deduction.