Alerts and Updates

ESTATE AND INHERITANCE TAXES INCREASE AS STATES SEEK REVENUE

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As the U.S. Congress reviews proposed legislation affecting the federal estate tax law, which is currently scheduled to be fully repealed as of January 1, 2010, individuals may want to consider whether their states impose separate inheritance or estate taxes, and whether such taxes may apply to their estates or beneficiaries. A focus on state estate and inheritance taxes has become increasingly relevant as states create new ways to bolster their tax revenues. Some states are increasing their inheritance and estate taxes, and other states without these taxes are enacting legislation to create them.

Beginning in 2001, Congress gradually increased exemption limits for federal estate tax to its current exemption amount of $3.5 million. In addition, beginning in 2002, the dollar-for-dollar credit against federal estate tax available for estate and inheritance taxes paid to a state (the "non-federal-estate-tax credit") was gradually phased out and ultimately replaced in 2005 by a federal estate tax deduction for the amount of estate and inheritance taxes paid to a state. In many states, the inheritance and estate taxes were based upon the maximum non-federal-estate-tax credit, commonly referred to as a "pick-up tax." Since the non-federal-estate-tax credit expired in 2005, states that imposed the pick-up tax have lost significant revenue.

As a result of the elimination of the non-federal-estate-tax credit in 2005, some states enacted separate estate and inheritance taxes—opting to decouple from the federal estate tax system—while other states opted to not collect such taxes. This has resulted in a wide range of state-imposed estate and inheritance taxes. Individuals may want to determine what estate and inheritance taxes are imposed by their state of residence (or domicile) and those states in which they own real property, and what exemptions may be available to reduce or eliminate these state taxes.

Currently, 23 states and the District of Columbia impose either an estate tax or an inheritance tax, and two states—New Jersey and Maryland—impose both taxes. An estate tax is paid by the estate where, in contrast, an inheritance tax is generally imposed against the beneficiaries. The rates, exemptions and imposition of these taxes vary widely by state. Some states that impose an inheritance tax use the relationship to the decedent as the benchmark, while other states tax at a flat rate if the estate assets exceed a certain monetary threshold, regardless of the relationship of the beneficiaries to the decedent.

State inheritance and estate taxes are often imposed on estates that do not generate a federal estate tax. Taxpayers in states that impose an estate or inheritance tax may want to consider ways to reduce these taxes, including structuring their estate plans to take advantage of available exemptions for assets passing to a surviving spouse or domestic partner. For example, a married couple whose estates would not generate a federal estate tax may still have to structure an estate plan in such a way to qualify for a marital deduction from state estate and inheritance taxes or an exemption from these taxes up to a certain threshold amount. In addition, assets passing in trust may be inadvertently subject to state inheritance and estate taxes if the trust is not structured properly.

Issues to consider in reviewing state estate and inheritance tax implications include whether a deduction is available for assets passing to a surviving spouse or domestic partner and, if so, what requirements must be met to obtain such a deduction; and whether certain nonprobate assets, such as life insurance, can be structured to avoid state inheritance and estate taxes. For example, life insurance may be subject to state tax only if it is paid to the insured's estate, or may be exempt from these state taxes if the beneficiary or owner of the policy is a trust created either during the lifetime of the insured or under the insured's will.

In addition, an individual who maintains a residence in more than one state will wish to avoid having state inheritance and estate taxes imposed in a state other than his or her state of domicile on assets other than real property located in the nondomiciliary state. An individual may be considered to have two domiciles, given certain ties that are maintained to other states. For example, although an individual may currently reside in a state that has no estate or inheritance taxes, such as Florida, maintaining a second home in another state may result in the individual's being considered domiciled there as well and, therefore, subject to the other state's estate and inheritance taxes. In determining whether to impose an estate tax, a state may not only look at the amount of time spent in the state, but also where a taxpayer's employment income comes from, where he or she has memberships (religious or otherwise), where he or she is registered to vote, where cars are registered and in what state an individual's driver's license is issued. The fact that substantial periods of time are spent in another jurisdiction is not determinative of domicile. Tangible evidence of the intent to adopt one particular state as an individual's place of domicile may be significant in avoiding state tax implications.

As we reported in our prior *Alerts*, with changes in the federal estate tax on the near horizon (or perhaps more likely a temporary extension of the current regime) and states increasingly focusing on generating revenue through estate and inheritance taxes, interested parties concerned about state tax implications on their estate plans may want to seek legal counsel to determine the need to make modifications to their current estate plans to reduce or eliminate such taxes.

About Duane Morris

The attorneys in the Duane Morris Estates and Asset Planning Group assist clients with updating their estate plans and lifetime gift programs to take advantage of current planning opportunities, and work with them to make more extensive adjustments in changing economic times such as these. Individuals may want to review their estate plans every few years or sooner if certain life events, such as the birth or adoption of a child or a change in marital status occur, to ensure that their plans are up-to-date with both their objectives and current law.

For Further Information

If you have any questions about this *Alert* or would like more information, please contact any of the attorneys in the Estates and Asset Planning Practice Group, or the attorney in the firm with whom you are regularly in contact.