www.lawyersusaonline.com
LawyersUSA

Practice makes perfect. Sub SIGN FREE E-ma

Wednesday, July 12, 2006 Law

From the March 29, 2004 Lawyers USA.

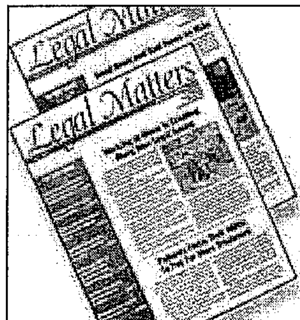
Order a REPRINT of this Story

Guest Article

State Estate & Inheritance Taxes Are Becoming A Major Headache

By Jeffrey A. Baskies

Have clients called you yet in response to the March 15 Forbes article entitled "Florida or Bust"? I would not be surprised if some do. When an influential, national publication like Forbes starts advising readers to consider moving to avoid state estate taxes, then we must really have an issue. In the words of Billy Joel, some clients are going to be "Movin' Out."

ADVERTISEMENT


Get client newsletters tailored to your practice areas!
Click here for more information.

In the article, estate planning attorneys in Illinois and Tennessee are quoted as advising clients to move to Florida (or some other estate tax haven) to save money for their heirs. I communicated with the attorney quoted from Tennessee, and he told me he's had two clients move to Florida in the past month alone.

While wealthy clients have benefited by changing their domicile from higher tax states (like New York) to lower tax states (like Florida), now even moderately wealthy clients should consider a move.

The 2001 Tax Act

In 2001, Congress passed and the president signed the federal Economic Growth and Tax Relief Reconciliation Act. As you all know, the act impacted estate planning in a number of ways, but one significant change was the repeal of the federal state death tax credit. The credit was reduced in stages: 75 percent credit allowed in 2002, 50 percent allowed in 2003, 25 percent allowed in 2004, and 0 percent allowed after Jan. 1, 2005. And the credit was replaced by a deduction for state estate or inheritance taxes paid.

While this change in the law has been official since 2001, perhaps the public is becoming more aware of it now (as evidenced by the Forbes article) due to the reduction to a 25 percent credit this January and the pending full phase out at the end of this year.

More importantly to our clients, the impact of the 2001 act is not being felt evenly or uniformly

around the country. As the accompanying chart (see page 29) indicates, residents of half the states in the nation, are going to benefit by paying zero state death taxes, while residents in the other half of the states will face a myriad of different taxing schemes.

The bottom line, however, is simple. If your clients live in (or own property in) one of the 25 states which will continue to have a death tax, then they should be aware of their pending tax situation and their options.

Movin' Out?

From a tax advisor perspective, the decision seems so easy. If clients are wealthy enough that it matters, why would they remain in a state that may tax their wealth on death, when they can totally avoid that tax?

In the Forbes article, they offered an example of a client living in Illinois with an estate of $50 million. According to the author, that client's estate would owe approximately $7.5 million in state death taxes if he died a resident in Illinois; whereas, he'd owe none if he died a resident of one of the 25 estates with no death tax. It appears, the author may have failed to account for the value of the deduction for the state death taxes, but at a round 45 percent marginal rate), the benefit of moving is still about $4.125 million.

That's more than just walking around money. If you told a client he could sign a document you created (some sort of magic trust) that would automatically save him $4 million in taxes (and he wouldn't even risk IRS scrutiny), he would certainly pay attention. Well, now it seems certain that if you tell a client about the difference in taxes if he dies a resident of (or even just owning property in) one of the taxing states vs. moving, then I assume you will have his undivided attention.

Nevertheless, moving to a tax-favored jurisdiction is not necessarily as easy as it sounds. Many clients would like to move for tax purposes without really moving. Of course, change of domicile planning is all about the little differences that matter.

The ability to avoid a state's taxing authority rests on a sliding scale. On one end, the client who sells his house in New York and moves full-time to a golf community in Florida (living there for many years) will be safely considered a Florida domiciliary for state death tax purposes. On the other end, a client who retains his New York home and in fact lives there 10 months per year, while spending a couple months each winter playing golf in Florida, almost assuredly will not be recognized as having left New York's taxing authority. But there are so many clients who fall in between.

In general, clients wishing to move to a new domicile but who are not willing to give up all ties to their former state of domicile face a facts-and-circumstances test. Whether or not they changed domicile is based on their state of mind and intentions as evidenced by a host of factors that will be considered (dependent on state laws), generally including:

- Did the clients sell their old primary residence?
- Did the clients buy a new residence in the new state?
- Did the clients spend more than 183 days per year out of the old state of residence?
- Did the clients spend more than 183 days per year in the new state?
- Did the clients register to vote in the new state?

- Did the clients register their automobiles and obtain driver's licenses in the new state?

- Did the clients execute any documents (new wills, declarations of domicile, etc.) evidencing their intention to change states of residence?

- Did the clients join religious institutions in the new state?

The taxing authorities in the new state are generally happy to have new residents, but the taxing authorities in the old state may fight if enough revenue is at stake. You should advise clients who are not clearly moving of the key elements tested in the state they are leaving and how they should try to meet as many as possible. Plus, if there is any way to give up real estate ownership in the former state (by sale, gift, certain trusts, partnerships or corporations), that will help as well. Finally, giving up real property and any other property sitused in the old state will be very important as avoiding a probate there may be the difference in success or failure.

What If The Client Does Not Want To Move?

Not every client will see the benefits in giving up their house, their friends and their proximity to their families just to save a few dollars. Thus, many of us will be planning for clients who intend to stay residents of a death tax state. In that case, you need to do your best to help those clients minimize the impact of your state death taxes. While the planning opportunities will obviously vary by state, some common issues to consider include the following.

In Massachusetts, where I live, and in a few other states (apparently including Tennessee), the state death tax levels are set so that there is unique planning needed on the first death. When the first spouse dies, a credit shelter trust is set up for the amount of the state death tax exemption, then a "QTIP" trust is set up for the balance of the federal unified credit amount (and a marital deduction is taken for state estate tax purposes but not federal) and then a marital share (outright or trust) usually receives the balance. This type of planning is imperative in states like Massachusetts that allow it.

In states with an inheritance tax, usually the amount of the tax varies depending upon who inherits, so your clients should consider the impact of the state's inheritance tax when planning how to leave their assets.

Lifetime giving becomes even more important for wealthy clients living in states with a death tax. Often the states do not have a gift tax. So giving away as much as you can during lifetime (including taking advantage of all the federal exemptions - like the $11,000 per year, medical and educational gifts, etc.) may save significant death taxes. One problem with lifetime giving is the carry-over basis for the beneficiaries, so be careful of the income tax consequences when advising clients to make gifts.

Deathbed planning may become a pivotal opportunity for clients in states with death taxes. Substantial deathbed gifts will not save any federal estate taxes, but they may avoid significant state death taxes - again many states have no gift tax. Another deathbed technique addressed in the Forbes article involves setting up a line of credit at a bank and then having the agent draw on that line to fund cash gifts just before death. That gives a full-basis asset to the beneficiaries while creating a deductible debt for federal estate and state death tax purposes. However, an obvious problem with deathbed planning is not every client has an opportunity to do it. And nobody knows who will. But, if having the opportunity to utilize deathbed planning is important to your clients then be sure they create a durable power of attorney clearly authorizing such planning.

Conclusion

The impact of the Act is being felt in many ways in the estate planning community. It certainly has created uncertainty and frustration for many clients. But to advise clients as best we can, we

need to consider if moving to a death-tax-free state is worthy of our clients' consideration. For clients facing significant state death taxes, the answer appears to be "yes." Whether or not they ask us, we should be advising clients who live in or own property in death tax states to consider the benefits of moving out.

Jeffrey A. Baskies, Esq., who practiced estate planning in Florida for many years, is currently the CEO of Lawyers Weekly Inc. in Boston. Board certified as a specialist in wills, estates and trusts law by the Florida Bar, his column runs regularly in Lawyers Weekly USA, the national newspaper for small law firms. If you have questions or issues relating to estate planning, please feel free to e-mail Jeff at jbaskies@lawyersweekly.com. All questions are encouraged.

© 2004 Lawyers Weekly Inc., All Rights Reserved.

Order a REPRINT
of this Story

User Agreement For Subscriber-Only Online Benefits | Help | Our Privacy Policy
Send any questions or comments to comments@lawyersweekly.com

Subscriber Services: 1-800-451-9998 **Technical Support**: 1-800-444-5297 ext. 8156
© Copyright 2006 Lawyers Weekly, Inc. All Rights Reserved

Lawyers Weekly does not use spyware; however, we link to a number of other sites and do not take responsibility for any spyware they i

This site is best viewed with Internet Explorer 6 (click here to download) or Netscape 7 or higher (click here to download)
208.49.101.98/5.93