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"In recent years, Delaware, New Jersey and Tennessee have repealed their estate taxes and Connecticut, the District of Columbia, Hawaii, Maine, Maryland, Minnesota, New York, Rhode Island, and Vermont have made major changes to theirs. As a result, state estate tax systems are more varied than ever before. High-net-worth individuals and their advisers should take these differences seriously. This article provides an overview of the current state estate tax landscape, explains how state estate taxes impact high-net-worth individuals, discusses how high-net-worth individuals and their advisers should approach state estate taxes, and describes some of the more idiosyncratic features of today's state estate tax systems."

Peter Tucci provides members with commentary that examines the current state of state estate taxes.

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Here is his commentary:

EXECUTIVE SUMMARY:

In recent years, Delaware, New Jersey and Tennessee have repealed their estate taxes and Connecticut, the District of Columbia, Hawaii, Maine, Maryland, Minnesota, New York, Rhode Island, and Vermont have made major changes to theirs. As a result, state estate tax systems are more varied than ever before. High-net-worth individuals and their advisers should take these differences seriously. This newsletter provides an overview of the current state estate tax landscape, explains how state estate taxes impact high-net-worth individuals, discusses how high-net-worth individuals and their advisers should approach state estate taxes, and describes some of the more idiosyncratic features of today's state estate tax systems.

FACTS:

For decades, a federal tax credit made it possible for states to impose estate taxes at no additional cost to resident estates, and so all 50 states and the District of Columbia imposed them. Federal legislation enacted in 2001 replaced the credit with a (much less valuable) deduction.[i] In the years since, the fundamental unpopularity of wealth transfer taxes and competition between states for wealthy residents have led many jurisdictions to repeal or substantially scale back their estate taxes. A number of jurisdictions have estate taxes that are tied to the existence of the federal tax credit, and so even though these jurisdictions' estate taxes remain on the books, they do not have any effect. Today, just 12 states and the District of Columbia have an estate tax in effect.[ii]

COMMENT:

State estate tax systems are more varied than ever before. This article provides an overview of the current state estate tax landscape, explains how state estate taxes impact high-net-worth individuals, discusses how high-net-worth individuals and their advisers should approach these taxes, and describes some of the more idiosyncratic features of today's state estate tax systems.

The Basic Structure and Its Implications

Each estate tax jurisdiction (except Maryland and Vermont) imposes a graduated tax on resident estates whose values exceed a specified exclusion amount.[iii] Real or tangible property owned by a nonresident decedent but located in an estate tax jurisdiction may also be subject to state estate tax. Exclusion amounts range from $1 million in Massachusetts and Oregon to $5.74 million in New York.[iv] The most common top statutory marginal rate is 16%—a legacy of the federal tax credit, which was worth up to 16% of the value of a decedent's taxable estate[v]—but Connecticut and Maine have top rates of just 12%, while Washington State's top rate is 20%.[vi] In Illinois, Massachusetts, and Rhode Island, statutory rates begin at 0.8%, while in Minnesota the lowest marginal rate is 13%. Maryland and Vermont tax each dollar above their respective exclusion amounts at a flat 16% rate:

Table 1: State Estate Tax Exclusions and Top Rates (2019)		
State	**Exclusion Amount**	**Top Statutory Rate**
Connecticut	$3,600,000	12.00%
District of Columbia	$5,681,760	16.00%
Hawaii	$5,490,000	15.70%
Illinois	$4,000,000	16.00%
Maine	$5,700,000	12.00%
Maryland	$5,000,000	16.00%
Massachusetts	$1,000,000	16.00%
Minnesota	$2,700,000	16.00%
New York	$5,740,000	16.00%
Oregon	$1,000,000	16.00%
Rhode Island	$1,561,719	16.00%
Vermont	$2,750,000	16.00%
Washington	$2,193,000	20.00%

Table 2 (below) shows the practical effect of state estate taxes in 2019 for taxable estates of $10 million, $12 million, $50 million, $200 million, and $1 billion in the 13 jurisdictions with an estate tax.[vii]

The numbers in Table 2 reflect the additional tax liability, expressed as a percentage of the decedent's taxable estate,[viii] that an estate incurs by virtue of being located in an estate tax jurisdiction (after accounting for the federal estate tax deduction). This article refers to this amount as "additional estate tax." A $200 million taxable estate in Maryland would incur $18.72 million of additional estate tax liability, an amount equal to 9.36% of the taxable estate's pre-tax value. Note that in most estate tax jurisdictions, taxable estates in the $50 million range and up will owe an additional estate tax liability equal to about 9% of their pre-tax values.

		Size of Taxable Estate				
		$10,000,000	**$12,000,000**	**$50,000,000**	**$200,000,000**	**$1,000,000,000**
State of Domicile	**Connecticut**	6.51%	5.43%	6.54%	4.50%	0.90%
	District of Columbia	5.98%	5.65%	8.40%	9.30%	9.54%
	Hawaii	5.31%	4.98%	8.16%	9.11%	9.36%
	Illinois	9.27%	7.96%	7.72%	8.14%	8.25%
	Maine	3.70%	2.88%	6.16%	6.94%	7.15%
	Maryland	8.00%	7.33%	8.64%	9.36%	9.56%
	Massachusetts	10.68%	9.56%	8.96%	9.44%	9.57%
	Minnesota	9.50%	8.28%	8.77%	9.39%	9.56%
	New York	10.68%	9.56%	8.96%	9.44%	9.57%
	Oregon	11.03%	9.85%	9.00%	9.45%	9.57%
	Rhode Island	9.99%	8.99%	8.88%	9.42%	9.57%
	Vermont	11.60%	10.33%	9.07%	9.47%	9.58%
	Washington	12.57%	11.76%	11.10%	11.78%	11.96%
	Average Rate	8.83%	7.89%	8.49%	8.90%	8.78%

Table 2: Additional State Estate Tax as a Percentage of Decedent's Taxable Estate, Assuming Full Federal Exclusion (2019)

High-Estate-Tax States, Low-Estate-Tax States, and No-Estate-Tax States

Individuals who are considering moving from one state to another often take taxes into account. For high-net-worth individuals, estate taxes are a matter of particular concern. Often, people distinguish between states that impose an estate tax and those that do not. This dichotomy, though sometimes useful, ignores the significant variation between modern state estate tax systems. Some states impose fairly light estate taxes. Others impose more burdensome ones. High-net-worth individuals and their advisers should take differences between state estate tax systems seriously.

For example, from a billionaire’s perspective, Connecticut’s estate tax climate is much closer to no-estate-tax New Hampshire’s than it is to high-estate-tax Vermont’s. A $1 billion taxable estate (with a fully intact federal exclusion) would owe approximately $491 million of total state and federal estate tax in Vermont, $404 million of estate tax in Connecticut, and $395 million of estate tax in New Hampshire.

These distinctions matter to non-billionaires, too. Setting aside Connecticut's estate tax system, which is an outlier, the variation between state estate tax systems is at its greatest for taxable estates in the $1 million to $50 million range. Take, for example, an individual with a $10 million taxable estate and a full federal exclusion who is considering establishing domicile in either Massachusetts or Maine. If she dies domiciled in Maine, her heirs will save about $700,000 in state estate tax, enough money to buy a small house on Penobscot Bay. Likewise, an individual could save her heirs a substantial amount of money by establishing domicile in Greenwich instead of New York City or Honolulu instead of Seattle.

These distinctions also matter to high-net-worth individuals who live in states that do not have estate taxes. Since a nonresident's real property and tangible property are generally subject to estate tax in the state where the property is located, a nonresident decedent's vacation home and its contents may be subject to state estate tax. (A certain amount of a nonresident decedent's property, though not necessarily the jurisdiction's exclusion amount, will be exempt from estate tax.) In some states, a $5 million vacation home owned by a nonresident decedent could trigger hundreds of thousands of dollars of state estate tax.

Lifetime Gifts Can Reduce Future State Estate Tax

States differ considerably in how they apply their estate taxes to lifetime gifts. New York and Minnesota include in their estate tax bases federal taxable gifts (lifetime gifts above the federal gift tax exclusion amount) made within three years of a decedent's death.[ix] Vermont includes federal taxable gifts made within two years of a decedent's death. Maine includes federal taxable gifts made within one year of a decedent's death. Connecticut includes lifetime gifts made after January 1, 2005 and gift taxes paid within three years of a decedent's death.[x] Illinois and Massachusetts do not include a decedent's lifetime gifts in their estate tax bases but do reduce an estate's available exclusion amount to the extent of any federal taxable gifts. In the remaining states, gifts are excluded from the estate tax base and from calculations of an estate's available exclusion amount.

The upshot is that high-net-worth individuals in estate tax jurisdictions other than Connecticut can reduce their state estate tax exposure by making lifetime gifts. Of course, to the extent these gifts exceed the federal gift tax annual exclusion amount, they will be subject to federal gift tax or consume a portion of the donor's unused federal gift and estate tax exclusion. But the transferred amounts will not be subject to state gift tax and will escape state estate tax unless the donor lives in New York, Minnesota, Maine, or Vermont and makes the gifts shortly before his death.

For example, imagine Z has a net worth of $6 million and lives in Washington State (which has a $2.19 million exclusion amount). If he does not make any lifetime gifts, he can expect his estate to face about $519,000 of Washington estate tax upon his death. But if he makes lifetime gifts, he can reduce—or even eliminate—that projected tax liability. Under current law, if Z has at least $6 million of unused federal exclusion, he can make a $3.81 million gift without incurring any federal gift tax and, upon his death, his estate will not owe any state or federal estate tax. Z's estate tax savings may exceed $519,000 if the transferred property appreciates after the transfer but before Z's death. If Z has no remaining federal exclusion, a $3.81 million gift will eliminate his future Washington estate tax liability but Z will owe federal gift tax on the gift.[xi] Keep in mind, however, that if Z does not make the $3.81 million gift, his estate will owe federal estate tax on that amount (or, if the property appreciates before his death, a larger amount).

A potential downside to making lifetime gifts is that the donees will receive the donor's basis rather than the stepped-up basis that they would have received if the property had passed at the donor's death. The tax liability that would result from a donee selling a low-basis asset would likely swamp any state estate tax savings. For that reason, high-net-worth individuals should be careful to gift only high-basis assets. In the above example, Z might consider making a $2 million gift of high-basis assets rather than a $3.81 million gift that includes a mix of high- and low-basis assets. By making a $2 million gift, Z would reduce, though not eliminate, his estate's future Washington estate tax liability.

Idiosyncratic Provisions

Some jurisdictions have idiosyncratic provisions. Hawaii and Maryland are the only states that allow surviving spouses to "port" a decedent's unused state exclusion amount. In Connecticut, the only state that imposes a gift tax, a taxpayer's combined state gift and estate tax liability is capped at $15 million.[xii] Maryland exempts from its estate tax up to $5 million of "qualified agricultural property," while Oregon exempts from its estate tax the full value of certain farms, forests, and fisheries. In Illinois, Massachusetts, and New York, estates that exceed the exclusion amount, following a brief period where the exclusion phases out, are taxed on their full values, not just to the extent they exceed the exclusion amount. As a result, the top state estate tax marginal rates in Illinois, Massachusetts, and New York are 28.6%, 41%, and 240%, respectively. Notably, Massachusetts and New York impose the same rates on large estates. A few of these idiosyncrasies are discussed in more depth below.

Connecticut's Estate Tax is Regressive

All state estate taxes are progressive in the sense that they fall mostly on the wealthy, but recent changes to the Connecticut estate tax have caused that state's ultra-wealthy to face lower effective state estate tax rates than the merely rich. Since 2016, Connecticut has capped taxpayers' cumulative Connecticut gift and estate tax liability. The cap was originally $20 million, but last fall the state legislature lowered the cap to $15 million, effective January 1, 2019. As a result, a $1 billion taxable estate will owe the same amount of state estate tax as a $130 million taxable estate.

While a $10 million Connecticut taxable estate (with a full federal exclusion) will face an additional estate tax rate of 6.51%, a $1 billion Connecticut taxable estate will face an additional estate tax rate of just 0.90%. If our hypothetical Connecticut billionaire decedent paid Connecticut gift tax during her lifetime, her effective state estate tax rate would be even lower. Note that after taking into account the federal deduction for state estate taxes, Connecticut estates owe, at most, $9 million more estate tax than similarly situated estates in jurisdictions without an estate tax.

Interestingly, as Table 2 shows, even though states' statutory estate tax rates (outside of Maryland and Vermont) are graduated, additional estate tax rates are often higher on $10 million taxable estates than on $1 billion taxable estates. This is a consequence of the way the federal estate tax deduction and the generous federal exclusion interact with state estate taxes. Under Section 2058 of the Code, estates can deduct state estate tax against federal estate tax. Since the federal estate tax is imposed at a flat 40% rate on estates that exceed the federal exclusion amount (currently, $11.4 million), the effect of the federal deduction is to reduce a state's effective estate tax rate by 40%. Thus, Oregon's 16% top statutory rate is reduced to an effective rate of, at most, 9.6% for estates exceeding the federal exclusion amount. For estates that exceed the federal exclusion amount by just a few million dollars, the effect is even more dramatic: In many cases, the deduction will reduce an estate's federal estate tax liability to zero. These effects exist only when a taxpayer's unused federal exclusion amount exceeds her state exclusion amount.

New York's Estate Tax Cliff

As noted above, the application of the Illinois, Massachusetts, and New York estate taxes to a decedent's full taxable estate creates high marginal rates just above the state exclusion amounts. In New York, this effect is particularly extreme. New York provides a tax credit to estates that are under its exclusion amount, but the credit phases out for estates between 100% and 105% of the exclusion amount before disappearing entirely. As a result of the credit's rapid phase-out, marginal rates just above the exclusion amount can easily exceed 100%. In 2019, the top marginal rate is 240%. If New York's estate tax statute is not reformed, the top rate will eventually exceed 300%.[xiii]

New Yorkers should consider including a "cliff bequest" in their wills or revocable trusts. A cliff bequest is a charitable bequest equal to the excess of an estate's taxable value over the exclusion amount. (Cliff bequests apply only if an estate is facing a marginal rate greater than 100%.) The effect is to eliminate the estate's tax liability while increasing the amount of assets that pass to charitable and non-charitable beneficiaries.

Imagine that a New Yorker dies in 2019 with a $5.9 million taxable estate. In the absence of a cliff bequest, the estate will owe $357,000 in estate tax despite being just $160,000 over the $5.74 million exclusion amount. However, if the decedent makes a cliff bequest for the benefit of Charity X, the estate will owe no estate tax, Charity X will receive a $160,000 bequest, and the estate's other beneficiaries will receive an additional $197,000.

Massachusetts and New York Tax Impose the Same Rates on Large Estates

Even though Massachusetts and New York have slightly different rate structures, for large estates, the two states' rate structures are identical in practice.[xiv] Massachusetts and New York impose the same rates on taxable estates that exceed $2.10 million and impose the same aggregate estate tax burden on estates below that level. Moreover, both tax estates that exceed $6.03 million[xv] in value to their full extent, not just to the extent their values exceed the exclusion amount.

That said, there are some key differences between the two states' estate tax systems. Taxpayers who are deciding whether to settle in one state or the other should take these differences into account. For example, Massachusetts's lower exclusion amount is important for relatively small estates. Further, New York taxes gifts made within three years of a decedent's death while Massachusetts does not, making deathbed planning much more attractive in the Bay State than in the Empire State.

A New Equilibrium?

State estate tax policy has been in flux for almost two decades. In the past five years alone, Delaware and New Jersey have repealed their estate taxes and Connecticut, the District of Columbia, Hawaii, Maine, Maryland, Minnesota, New York, Rhode Island, and Vermont have made major changes to theirs.[xvi] The past two years have seen a flurry of state legislative activity in this area as a number of states have decoupled their exclusion amounts from the federal exclusion amount, which was doubled by the Tax Cuts and Jobs Act (the "TCJA").

It is possible, however, that we are entering a period of relative stability in state estate tax policy. The states where estate taxes are the least popular no longer have them, while many of the remaining estate tax jurisdictions have increased their exclusion amounts to levels that exempt the vast majority of residents. The only state that has not decoupled from the federal exclusion amount is Connecticut, which responded to the TCJA by stretching out the time period during which the federal exclusion amount will be phased in.[xvii] Meanwhile, concerns about socioeconomic inequality and a sense among some lawmakers that previous reforms have gone too far seem to have slowed the trend toward further liberalization of state estate tax laws.

If a period of policy stability does materialize, it will be a welcome development for tax planners, who will finally be able to plan with some degree of certainty about the future of state estate taxes.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Peter Tucci

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[i] This change took effect on January 1, 2005.

[ii] In addition, six states impose inheritance taxes: Iowa, Kentucky, Maryland, Nebraska, New Jersey, and Pennsylvania. State inheritance taxes, which raise less revenue and are generally less burdensome than state estate taxes, are beyond the scope of this article.

[iii] In lieu of exclusion amounts, some states have “zero brackets” that subject estates with between $0 and $X to no estate tax. Since zero brackets are the functional equivalent of exclusion amounts, I use the term “exclusion amount” to describe both arrangements.

[iv] On January 1, 2020, Minnesota’s exclusion amount will increase to $3 million, Vermont’s will increase to $4.25 million, and Connecticut’s will increase to $5.1 million.

[v] During the federal tax credit era, states set their estate tax brackets to maximize the value of the credit. As a result, the states had fairly uniform estate tax systems. Today, there is much more variation, though vestiges of the old system remain.

[vi] In addition, on January 1, 2020, Hawaii’s top rate will increase from 15.7% to 20%.

[vii] Table 2 assumes that the decedent did not use up his or her federal exclusion by making lifetime gifts and did not "inherit" any unused exclusion from a predeceased spouse.

[viii] States define "taxable estate" differently. To avoid confusion, this article uses "taxable estate" as the term is defined in Section 2051 of the Internal Revenue Code of 1986 (the "Code").

[ix] New York excludes gifts made between January 1, 2019 and January 15, 2019 as well as gifts of real or tangible property that had a tax situs outside of New York at the time of the gift.

[x] The federal deduction under Section 2058 of the Code is not available for state gift taxes paid within three years of death, since those taxes are not paid on the "gross estate." *See* PMTA 2019-03.

[xi] Once Z pays the federal gift tax due, the size of his estate will be well under Washington's $2.19 million exclusion. If Z dies within three years of making the gift, the value of the federal gift tax paid will be pulled back into his estate for federal and Washington State purposes. *See Estate of Ackerley v. Dep't of Revenue*, No. 92791-0 (Wash. 2017).

[xii] Only gifts made on or after January 1, 2016 count toward the $15 million cap.

[xiii] The marginal rate increases over time as the exclusion amount, which is adjusted for inflation, increases. As the exclusion amount increases, estates are pushed into higher statutory estate tax brackets, increasing the effective marginal rates as the tax credit phases out.

[xiv] At first glance, New York and Massachusetts appear to have slightly staggered estate tax brackets: New York's kick in at $X million + $100,000 while Massachusetts's begin at $X million + $40,000. But after accounting for Massachusetts's definition of "adjusted taxable estate" (drawn from Section 2011 of the Internal Revenue Code as it existed on December 31, 2000), which is equal to the "taxable estate" less $60,000, this discrepancy disappears.

[xv] This is the amount at which, in 2019, New York's exclusion is completely phased out.

[xvi] In addition, as part of legislation enacted in 2012, Tennessee's estate tax was repealed effective January 1, 2016.

[xvii] In October 2017, Connecticut enacted legislation that would have phased in the federal exclusion amount by 2020. In May 2018, Connecticut enacted legislation that gradually increases the state's exclusion amount each year until 2023, when it will match the federal exclusion amount.