Drafting and Payment Considerations Under the South Carolina Estate Tax

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The South Carolina estate tax, S.C. Code Ann. § 12-16-10 et seq, imposes a tax on the transfer of the estate of both residents and nonresidents. Id., § 12-16-510, 520. (The South Carolina Estate Tax Act also imposes a tax on the transfer of the estate of aliens and includes a generation-skipping transfer tax. This article does not address these issues.) On its face, the tax appears straightforward and, in effect, represents a relatively fair death tax approach. Nevertheless, it contains unexpected nuances.

This article initially provides an overview of South Carolina estate tax mechanics. Then, it examines the need for sensitivity to the tax in drafting estate planning documents and paying the tax due.

How the South Carolina Estate Tax Works

The key feature of the South Carolina estate tax is that it is determined by reference to Internal Revenue Code (Code) § 2011. That section provides a credit in determining federal estate tax due for "the amount of any estate, inheritance, legacy, or succession taxes *actually paid* to any State or the District of Columbia, in respect of any property included in the gross estate . . ." Code § 2011(a).

Importantly, the credit will be allowed only to a specified limit, and then only to the extent that South Carolina estate tax has actually been paid. The starting point for computing the limit is the "taxable estate," which is the federal gross estate minus allowable deductions. From the taxable estate, $60,000 is then deducted to arrive at the "adjusted taxable estate." Finally, based on this amount, the table set forth in Code § 2011(b) is used to arrive at what is known as the "maximum credit amount" allowed.

The following schedule illustrates the computation of the maximum state death tax credit amount under Code § 2011(b) (note: the taxable estate amount is assumed):

	Taxable estate	$2,100,000
	Reduction amount	60,000
=	Adjusted taxable estate	$2,040,000
	Maximum credit amount based on table (which appears on page 36) in Code § 2011(b):	$ 106,800

The determination of the South Carolina estate tax depends on several underlying factors, including the decedent's residency at the time of death and the tax situs of the decedent's property.

If the decedent was a resident of South Carolina at the time of death, the South Carolina estate tax would equal the maximum state death tax credit allowable but reduced by the lesser of:

1. The amount of the estate tax paid to any other state and credited against the federal estate tax, or

2. the amount of the death tax credit multiplied by a fraction, the numerator of which is the value of the property having a tax situs outside of South Carolina and the denominator of which is the value of the decedent's gross estate. Id., § 12-16-510.

If the decedent was not a resident of South Carolina at time of death, the South Carolina estate tax would equal the maximum state death tax credit allowable multiplied by a fraction, the numerator of which is the value of the property having a tax situs in South Carolina and the denominator of which is the value of the decedent's gross estate. Id., § 12-16-520.

Drafting Estate Planning Documents Based on the South Carolina Estate Tax

One objective of estate planning is to reduce a married couple's overall exposure to federal and state death taxes. Given this objective, estate planners have developed

drafting strategies based on the state death tax credit. These strategies revolve around the interplay between state death taxes and credit shelter/marital deduction formulae.

Credit Shelter/Marital Deduction Formulae. Credit shelter/marital deduction formulae provide the vehicle by which estate planners can implement a married couple's objective of minimizing death taxes. The formulae represent the critical aspect of a tax minimization plan which examines the death taxes which will be due at two future points in time, initially at the first spouse's death and subsequently at the surviving spouse's death.

In the majority of situations, the plan includes consideration of a federal estate tax credit known as the "unified credit," and the marital deduction. The unified credit of $192,800, Code § 2010(a), effectively shields transfers on up to $600,000 from federal estate tax; the marital deduction allows a decedent to transfer an unlimited amount of property to a surviving spouse free of federal estate tax. Code § 2056(a).

The typical plan focuses on eliminating federal estate tax at the first spouse's death by: (1) carving out of such decedent's estate a "credit shelter share" to take advantage of the unified credit, and (2) leaving the remaining share of the estate to the decedent's surviving spouse to qualify for the marital deduction.

Thus, the critical aspect for successful implementation of a tax minimization plan focuses on the credit shelter share—and the formula used to determine it—established under the estate planning documents. It is the formula which determines the amount of property which will pass to the credit shelter share.

Significantly, although the unified credit effectively shields transfers of up to $600,000 from federal estate tax, that does not mean that the credit shelter share formula should be drafted to automatically equal $600,000. Rather, the credit shelter share formula has to take into account that this $600,000 amount may be reduced or increased based on several variables, including the state death tax credit, adjusted taxable gifts, other property included in the gross estate passing to beneficiaries which does not qualify for the unlimited marital or charitable deductions, and expenditures which are not taken or allowed as deductions for federal estate tax purposes.

Thus, the critical aspect for successful implementation of a tax minimization plan focuses on the credit shelter share—and the formula used to determine it—established under the estate planning documents.

The following example illustrates how one of these variables, prior adjusted taxable gifts, might impact the credit shelter share. Assume the following facts: (1) the decedent has a gross estate of $2,000,000, administration expenses of $100,000, and made lifetime taxable gifts of $300,000; (2) under the terms of the decedent's will, $600,000 of the decedent's estate was specifically bequeathed to the credit shelter share and the remainder was given outright to the surviving spouse; and (3) the administration expenses are taken as deductions on the federal estate tax return and not as income tax deductions.

Based on these facts, the marital deduction equals $1,300,000, which is the $2,000,000 gross estate minus the portion of the gross estate that does not pass to the surviving spouse, $700,000 (the $600,000 credit shelter share plus the $100,000 of administration expenses). Subtracting the allowable deductions of $1,400,000 (the marital deduction of $1,300,000 plus the administration expenses of $100,000) from the gross estate of $2,000,000 produces a taxable estate of $600,000. Adding the taxable estate, $600,000, to the lifetime taxable gifts, $300,000, results in a federal estate tax base of $900,000. The tentative federal estate tax on this amount is $306,800.

To arrive at federal estate tax due, this amount is reduced by the amount of total gift taxes "which would have been payable" with respect to lifetime gifts made by the decedent. In this case, the total gift taxes payable are zero: the transfer tax on $300,000, $87,800, minus $192,800, the unified credit amount, results in a negative number. The unified credit, $192,800, when subtracted from the tentative tax of $306,800, results in a federal estate tax due of $114,000.

The reason that this situation results in a tax due stems from the fact that the credit shelter share should not have been fixed at $600,000. A portion of the unified credit, $87,800, was used to prevent gift tax from being payable on the $300,000 lifetime taxable gifts. Accordingly, the credit shelter share should have been reduced from $600,000 to $300,000. A reduction in the credit shelter share to $300,000 would have correspondingly increased the share qualifying for the marital deduction to $1,600,000. The federal estate tax base then would have been $600,000 ($300,000 taxable estate plus $300,000 in lifetime taxable gifts). No federal estate tax would have been due because the unified credit would fully offset the tentative tax on this amount, $192,800.

Reference to the South Carolina Estate Tax in Credit Shelter/Marital Deduction Formulae. The practitioner should consider whether the

particular formula used for calculating the credit shelter share should reference the South Carolina estate tax. In this regard, because the amount of the South Carolina estate tax generally will equal the state death tax credit, any such reference will actually be to the state death tax credit.

Sample credit shelter formulae include: 1. "the maximum amount of property that will result in no increase in federal estate tax payable because of credits and deductions (other than the marital deduction) allowed to my estate," 2. "after considering all deductions and credits available to my estate, the amount necessary to increase my taxable estate to the largest amount that will result in no (or the minimal) payment of federal estate tax," and 3. "the largest amount that can pass free of the payment of any estate tax by reason of credits allowable to my estate." Since the term "credit" as used in these formulae includes not only the unified credit but also the state death tax credit, that reference may unintentionally increase the South Carolina estate taxes paid.

The following example illustrates this situation. Assume these facts: 1. decedent Jane Adams died a resident of South Carolina owning property with only a South Carolina situs; 2. Jane's will left all of her property to her husband, Jack Adams, via a formula provision which provided that the credit shelter share was to be the largest amount of property which would result in no increase in federal estate tax payable because of the unified credit and *the state death tax credit allowable* to Jane's estate; 3. Jane made no lifetime taxable gifts; and 4. all debts and expenses of Jane's estate are taken and allowed as deductions on the federal estate tax return.

What is the largest amount of property that would result in no increase in federal estate tax payable? On these facts, if the credit shelter share were funded with $600,000, the tentative federal estate tax on this amount would be $192,800. Because of the $192,800 unified credit, no tax would be payable. This result ignores, however, the mandate of the formula to consider not only the unified credit but also the state death tax credit. To account for the state death tax credit, the credit shelter share initially would need to be increased to $642,425. This would increase the tentative federal estate tax by $15,697, to $208,497. Despite the increase, there still would be no federal estate tax payable (and, accordingly, "no increase in federal estate tax payable"). The tentative tax would be offset by $192,800, the unified credit, and $15,697, the state death tax credit on $642,425.

Table 1: I.R.C. § 2011(b)

Amount of credit. The credit allowed by this section shall not exceed the appropriate amount stated in the following table:

If the adjusted taxable estate is:	**The maximum tax credit shall be:**
Not over $90,000	8/10ths of 1% of the amount by which the taxable estate exceeds $40,000
Over $90,000 but not over $140,000	$400 plus 1.6% of the excess over $90,000
Over $140,000 but not over $240,000	$1,200 plus 2.4% of the excess over $140,000
Over $240,000 but not over $440,000	$3,600 plus 3.2% of the excess over $240,000
Over $440,000 but not over $640,000	$10,000 plus 4.0% of the excess over $440,000
Over $640,000 but not over $840,000	$18,000 plus 4.8% of the excess over $640,000
Over $840,000 but not over $1,040,000	$27,600 plus 5.6% of the excess over $840,000
Over $1,040,000 but not over $1,540,000	$38,800 plus 6.4% of the excess over $1,040,000
Over $1,540,000 but not over $2,040,000	$70,800 plus 7.2% of the excess over $1,540,000
Over $2,040,000 but not over $2,540,000	$106,800 plus 8.0% of the excess over $2,040,000
Over $2,540,000 but not over $3,040,000	$146,800 plus 8.8% of the excess over $2,540,000
Over $3,040,000 but not over $3,540,000	$190,800 plus 9.6% of the excess over $3,040,000
Over $3,540,000 but not over $4,040,000	$238,800 ptus 10.4% of the excess over $3,540,000
Over $4,040,000 but not over $5,040,000	$290,800 plus 11.2% of the excess over $4,040,000
Over $5,040,000 but not over $6,040,000	$402,800 plus 12.0% of the excess over $5,040,000
Over $6,040,000 but not over $7,040,000	$522,800 plus 12.8% of the excess over $6,040,000
Over $7,040,000 but not over $8,040,000	$650,800 plus 13.6% of the excess over $7,040,000
Over $8,040,000 but not over $9,040,000	$786,800 plus 14.4% of the excess over $8,040,000
Over $9,040,000 but not over $10,040,000	$930,800 plus 15.2% of the excess over $9,040,000
Over $10,040,000	$1,082,800 plus 16.0% of the excess over $10,040,000

The state death tax credit, however, will only be available if the $15,697 of state death taxes are actually paid. Because payment of the state death taxes must be from the credit shelter share, the credit shelter share would need to be adjusted from $642,425 to account for $15,697 of state death taxes paid.

Jane's formula, therefore, results ultimately in a $626,728 credit shelter share. This produces the following positive effect: the credit shelter share is increased by $26,728; that amount, plus any appreciation and income, escapes federal estate tax at Jack's death.

A negative effect is that state death taxes of $15,697 must be paid at Jane's death. Importantly, these state death taxes, if not then paid, might have been potentially eliminated, decreased, or at minimum, deferred, had the credit shelter share not required consideration of the state death tax credit. For example, in the case of a surviving spouse with no taxable estate, no state or federal death taxes would have to be paid. Accordingly, payment of state death taxes at the first spouse's death is unnecessary.

As a result, when drafting under the South Carolina estate tax scheme, estate planners may reference in the formula that determines the credit shelter share all available credits, but should add the following type of clause: *"provided, however, that consideration of the state death tax credit does not increase or cause the payment of state death taxes."* The reference to all available credits, including the state death tax credit (with the proviso in italics above) will protect the draftsperson in the event the clients own property or die in a state other than South Carolina and those other states impose an estate tax not tied solely to the state death tax credit.

Nevertheless, in those cases where clients do change domicile from South Carolina, the practitioner should review the new state's death tax laws. For example, in states which impose state death taxes even if there is no federal estate tax due, the estate of the first spouse to die may want to take advantage of the maximum state death tax credit that will result in the payment of no federal estate tax, even though this may increase state death taxes paid. By so doing, the increase in the credit shelter share, which will be exempt from all future death taxes, may be so significant as to justify a small, up front increase in state death taxes paid. In that event, the above-bolded proviso should not be included in the credit shelter formula. In making that determination, the increase in state death taxes must be compared with the anticipated decrease in federal estate tax at the surviving spouse's death. Based on this analysis, planners can determine the appropriateness of the above proviso in the credit shelter share formula.

Payment of South Carolina Estate Tax

Extensions. Generally, the payment of South Carolina estate tax and the filing of the South Carolina estate tax return must occur concurrently. An extension, however, can be granted for one and not the other.

The filing of the South Carolina estate tax return is coordinated with filing of the federal tax return. S.C. Code Ann. § 12-16-1110(B). Accordingly, because the federal return is due nine months after date of death (assuming no extensions), the South Carolina estate tax return is also due at that point. If an extension is granted to file a federal return, the South Carolina return need not be filed until that extended date. Further time for filing the return may be granted "for good cause" pursuant to S.C. Code Ann. § 12-54-70.

The tax due must be paid not later than the date when the return is

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required to be filed. S.C. Code Ann. § 12-16-1110(C). Accordingly, if an extension of time is granted to file the federal return by the Internal Revenue Service (Service), an extension of time to pay the South Carolina estate tax is allowed. Id. With an extension of time to pay, interest is charged on the unpaid South Carolina estate tax amount at the prescribed rate. See Id., § 12-54-20.

In addition, the South Carolina Department of Revenue (Department) may extend the time for the payment of tax for up to 12 additional months, unless it finds that payment may result in "undue hardship," in which event payment may be extended for up to 5 years. Id., §12-16-1140. Prior to making an extension request, the practitioner should consider that the timing of state death tax payments will impact the availability of the state death tax credit. Technical Advice Memorandum (TAM) 8947005 highlights the importance of the timing of state death tax payments on the state death tax credit.

In TAM 8947005, the decedent's federal estate tax return was timely filed in July 1987. Pursuant to the percentage limitations of Code section 2011(b), the estate's maximum allowable credit for state death taxes was $15.32 million, based on a state death tax payable of $20.14 million. The executor deducted the entire $15.32 million as a credit in computing the federal estate tax due, even though only $4.96 million of the state death tax had been paid as of

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the date of the filing of the federal estate tax return. The remaining $15.18 million of the state death tax was to be paid in October 1990 in accordance with a 3 1/2 year extension obtained by the executor from the state. Consequently, the state death tax credit claimed on the federal return exceeded the state death tax actually paid as of the federal return filing date by $10.36 million.

Relying on the legislative history to § 2011(a) and judicial decisions, the Service determined that the state death tax credit was intended to be effective only as of the date that the state death taxes are paid. Specifically, the Service held that the state death tax credit may be properly claimed on the federal estate tax return only if the state death taxes have been actually paid by the later of: (1) the filing due date for the federal estate tax return, or (2) the first date prescribed for payment of death taxes under state law, excluding extensions. If state death taxes are paid beyond this time constraint, the state death tax credit will be allowed, but is first effective the date of payment.

Based on the facts of TAM 8947005, the Service concluded that the state death tax credit was not allowable with respect to the $15.18 million of state death taxes unpaid as of the due date of the federal estate tax return. Such credit was allowable, however, effective as of the date of the extended payment in October 1990.

A significant undesirable consequence flows from the Service's holding. Because the credit related to the $15.18 million extended payment was disallowed as of the federal return due date, the federal estate tax was in an underpayment situation. Thus, the Service would assess interest on the unpaid estate tax from the due date until the tax was paid in October 1990.

Despite this adverse result, TAM 8947005 produced one major positive for the estate: the estate tax credit with regard to the $15.18 million October 1990 payment was allowable, albeit as of the payment date. Underlying this positive result was the fact that the 3 1/2 year extension payment fell within the federal time frame for claiming the state death tax credit. Had it not, the state death tax credit related to the extended $15.18 million payment would have been denied.

Lump sum payments. If the federal estate tax is paid in one lump-sum (not in installments), it will be advantageous to pay South Carolina state death taxes on or before the filing of the federal estate tax return—rather than pay the state death taxes pursuant to an extension—and use the credit as an offset against federal estate tax then owed. This result occurs because South Carolina will impose interest on the state death taxes paid late. The following example illustrates this point. Assume these facts: 1. the taxable estate equals $700,000; 2. the total federal estate tax on a taxable estate of $700,000 equals $229,800 which, after use of the unified credit, results in a tax owed of $37,000; 3. the adjusted taxable estate is $640,000 ($700,000 minus $60,000) which, under the Code § 2011(b) table yields a maximum state death tax credit of $18,000; 4. the decedent died in South Carolina, so that the state death tax equals $18,000; and 5. the Department allows for payment of the state death tax in five equal installments.

If the entire state death taxes are paid on or before the last date for filing the federal estate tax return, the total tax burden will equal $37,000. This represents $19,000 in federal estate taxes ($37,000 minus the $18,000 state death tax credit) plus $18,000 in state death taxes.

In contrast, if the estate pays the state death taxes in installments the same amount of total taxes, $37,000, needs to be paid on or before the time prescribed for filing the federal estate tax return. In that event, there is no reduction in the $37,000 owed in federal estate tax until the state death taxes are paid. Although the estate would get a refund of its federal tax paid as state taxes are actually paid in installments, this refund carries with it no interest. See Code § 2011(c). In effect, the estate would annually pay $3,600 in state death taxes and receive back $3,600 from the federal estate taxes previously paid. Despite the fact that the overall tax burden remains at $37,000, the estate will be unnecessarily depleted because South Carolina imposes interest on the unpaid state death tax balance. Although such interest is deductible from the gross estate, Rev. Rul. 81-256, at most 55% (37% in this example) of the interest paid results in a federal estate tax savings. Accordingly, the practitioner would not ordinarily request that the Department exercise its discretionary authority to grant a payment extension.

Installments. The most difficult interplay between the federal estate tax payments and South Carolina estate tax payments occurs if the

estate elects installment treatment under Code § 6166. That section provides that federal estate taxes can be paid over a fifteen year period. Installment payments are not expressly permitted with regard to South Carolina state death tax payments. Accordingly, the practitioner may have a situation in which the South Carolina payments have been paid in full while the federal estate tax payments are being made on installments.

Although seemingly straightforward, this situation adds substantial complication to payment of the federal death tax each year. Consider, for example, what happens each year as installment payments are made on the federal estate tax. Under federal law, interest is paid on the unpaid balance. The interest generates a deduction, which reduces the taxable estate.

Because the taxable estate is reduced, so is the amount of the state death tax credit. This means that the previous amount paid to the State of South Carolina was excessive. The practitioner should then apply to the department for a refund for the overpayment and interest pursuant to § 12-47-440.

However, claims for refunds under § 12-47-440 must be made within three years from the date the tax was due to be paid, or, if later, one year of payment if additional tax is assessed. This creates a problem because the refund claim could occur later than the three years. For example, each time there is a federal estate tax installment payment the taxable estate will be decreased. As a result, the state death tax credit will be reduced. If the full fifteen year period for payment of the federal estate tax is used, a claim for refund under § 12-47-440 could occur later than the allowed three years.

The department has not taken a position on whether it will allow protective refund claims to be made for future years before this time period runs or if it would agree to extend the period. Nevertheless, a claim for a protective refund or request for an extension should be filed before the running of the limitations period under § 12-47-440.

> The most difficult interplay between the federal estate tax payments and South Carolina estate tax payments occurs if the estate elects installment treatment under Code § 6166.

Conclusion

Practitioners must consider the South Carolina estate tax in drafting estate planning documents. Moreover, practitioners should understand the complex interplay between payment of the federal tax in installments and the amounts previously paid to the state of South Carolina.

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