Maximizing the Use of the State Death Tax Credit

The credit for state death taxes plays an important role in minimizing the overall burden of death taxes. This article examines drafting to use the credit and analyzes the best method for paying state death taxes.

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In establishing an estate plan or administering an estate, it is critical to be aware of and understand how to use the credits available to offset the Federal estate tax, including the credit for state death taxes.[1]

Background

State death tax schemes and payment provisions. States impose death taxes pursuant to one of three general death tax schemes. The dominant scheme, used by 27 states and the District of Columbia, developed in response to the state death tax credit. These states impose an estate tax equal to the maximum allowable state death tax credit on the Federal estate tax return. This taxing scheme is referred to as a "pick-up" tax because it picks up the credit for state death taxes allowed by the Federal estate tax.

The second most popular scheme, used by 18 states, involves a combination of an inheritance tax and an additional estate tax.

The typical inheritance tax statute divides beneficiaries into various classes, depending on how closely related to the decedent, and assigns different exemptions and tax rates to each class. States that have an inheritance tax also levy an additional estate tax designed to absorb the maximum state death tax credit allowed. That tax generally equals the amount, if any, by which the maximum allowable state death tax credit exceeds the state inheritance tax (and the total of estate and inheritance taxes paid to all states).

The least used tax scheme, adopted by five states, provides for an initial estate tax plus, if necessary to maximize fully the state death tax credit, an additional estate tax. Generally, the estate tax levy is similar in mechanics to the Federal estate tax, but the amount of the tax varies considerably because of different tax rate schedules and exemption amounts. The addi-

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tional estate tax is the excess, if any, of the maximum state death tax credit allowable over the initial estate tax.

Payment due dates for death taxes vary among states, but generally, the original due date is no later than the due date of the Federal estate tax return (*i.e.*, nine months after death). In addition, there are substantial differences among states regarding deferred tax payments. A few states provide no extensions for payment of death taxes. Several states tailor their laws to mirror payment extensions provided by Federal law. Yet other states allow extensions if certain conditions or requirements are met (*e.g.*, "good cause shown" or "undue hardship").

State laws regarding payment of state death taxes are important for two reasons. First, the timing of state death tax payments may have an impact on the availability of the state death tax credit. Second, to the extent a state permits (*e.g.*, pursuant to discretion granted by statute) or provides alternative payment methods, an issue arises as to whether it is more advantageous to pay state death taxes in a lump sum or by the installment method. (These topics are discussed in more detail later.)

State death tax laws have not remained static. The most dramatic recent change has been the shift to a pick-up tax scheme. Because this trend is likely to continue and because of the ambulatory nature of clients and their changes in domicile, practitioners should be aware of the status of the death tax laws in various states.

Credit for state death taxes. Section 2011(a) provides that the gross estate tax calculated to be due (line 10 on the current edition of Form 706) is credited with any estate, inheritance, legacy, or succession taxes actually paid to any state or the District of Columbia with respect to property included in the gross estate. There is a limit, however, on the maximum amount of the credit. To calculate the limit, one must first arrive at the "taxable estate," which is the gross estate minus allowable deductions. From the taxable estate, $60,000 is deducted, and then the table set forth in Section 2011(b) is used to arrive at the maximum credit allowed.

In addition to a tax credit for a portion (or all) of the state death taxes paid, Section 2053(d) also allows an executor to elect under certain circumstances to take a deduction for state death taxes charged to charitable transfers. To the extent so used, the estate is not entitled to a credit for the state death taxes deducted.[2]

Drafting suggestions

Marital deduction/credit shelter formulas. One would expect that in drafting for the state death tax credit, a will or trust would provide that the fiduciary should maximize the use and availability of the credit. This is not necessarily correct. Instead, caution should be used when reference is made to the state death tax credit, particularly in credit shelter/marital deduction strategies. In most situations, a credit shelter/marital deduction plan will take advantage of the unlimited marital deduction to avoid any estate tax at the first spouse's death. (Where couples have large estates, it may be worthwhile to incur some estate tax at the first spouse's death to take advantage of the graduated effect of the 37% to 55% rates.) In addition, a share will be carved out at the first spouse's death to take advantage of that spouse's unified credit (the credit shelter share).

The particular formula used for calculating the credit shelter share must be careful in its reference, actual or by omission, to the state death tax credit. Sample formula clauses include: "the maximum amount of property that will result in no increase in estate tax payable because of credits allowed to my estate," "the amount necessary to increase my taxable estate to the largest amount that will result in no (or the smallest) payment of estate tax," and "the residue after distributing the smallest amount that will produce a marital deduction resulting in no or the minimum Federal estate tax payable by reason of my death." Calculating the credit shelter share by reference to not only the unified credit but also the state death tax credit may unintentionally increase the state death taxes paid.

Example. The decedent died in Illinois owning property only in Illinois. Currently, Illinois estate taxes are tied to the maximum amount

allowable as a credit against the Federal estate tax (a pick-up tax). Assume the decedent left all her property to her husband, outright and in trust, via a formula provision that provided that the credit shelter share (the trust) was to be the largest amount of property that would result in no increase in Federal estate tax payable because of the unified credit and credit for state death taxes allowable to the decedent's estate. The decedent made no lifetime taxable gifts, and all debts and expenses are taken and allowed as deductions on the estate tax return. If the credit shelter share were funded with $600,000, the tax on this amount would be $192,800 and there would be no tax due (and hence "no increase in Federal estate tax payable") because of the unified credit. If the credit shelter share were increased by $42,425, this would increase the Federal estate tax by $15,697, to $208,497. The unified credit would shield $192,800 of this amount. The state death credit for a taxable estate of $642,425 is $15,697. Accordingly, the state death tax credit would shield the remaining $15,697 and no Federal estate tax would be required to be paid.

Under the above formula, the credit shelter share would be $642,425 rather than the traditional $600,000. The unintended result, however, is that state death taxes of $15,697 now must be paid; that is, the credit for state death taxes is not available if these taxes are not paid, and the formula mandates that this amount of property pass to the credit shelter share because this is the largest amount that will not increase the Federal estate tax payable. Thus, the decedent has increased the credit shelter share at the cost of incurring state death tax. The payment of the state death tax must be from the credit shelter share and reduces such share from $642,425 to $626,728. Payment of the state death tax must not be from the marital share since it would decrease the amount of the marital share qualifying for the marital deduction, thereby resulting in additional Federal estate tax. (If the taxable estate were in excess of $642,425, the increase in the gross estate taxes owed, at a marginal 37% rate, cannot be offset by the increase in the state death tax credit then available, at a 4.8% marginal rate.)

The net effect of the formula in this example in states that impose a pick-up estate tax is that (1) the marital share is decreased by $42,425, thereby preventing the future payment of estate tax on this amount, (2) state death taxes of $15,697 are incurred, and (3) the credit shelter share is increased by $26,728, which, together with any appreciation on and income from that amount, can escape transfer taxation at the surviving spouse's death. But what is the real cost? A state death tax of $15,697 is paid, which could have been deferred, decreased, and potentially eliminated if the formula clause had required merely that the credit shelter share be $600,000 and not $642,425. If the surviving spouse has no taxable estate, the payment of state death taxes at the first spouse's death is a waste. Different conclusions result, however, where the surviving spouse has a taxable estate.

If the surviving spouse's maximum marginal estate tax rate is 37%, the payment of state death taxes at the first spouse's death is a wash for transfer tax purposes. If the surviving spouse has a taxable estate subject to an estate tax rate in excess of 37%, the payment at the death of the first spouse of state death taxes equal to $15,697 will decrease the overall Federal estate taxes payable at the death of the surviving spouse.

Example. If $15,697 is paid in state death tax at the first spouse's death, then an extra $26,728 ($42,425 − $15,697) passes to the credit shelter share. The credit shelter share, plus appreciation and income, could pass at the surviving spouse's death free of additional estate tax. Thus, if the credit shelter share earns 10% on the fund and the surviving spouse dies at the beginning of the second year after the first spouse's death, an additional $29,401 ($26,728 + $2,673) passes free of estate tax at the surviving spouse's death. Had no state death tax been paid at the first spouse's death, the surviving spouse would have had an extra $42,425 plus $4,242 (the assumed 10% rate of return) in his or her estate, or $46,667. At a 55% marginal tax rate, the additional tax is $25,667, leaving only $21,000 rather than $29,401 to pass to the beneficiaries. Therefore, a tax savings of $8,401 is generated by the pay-

ment of state death taxes at the first spouse's death.

Nevertheless, the tax savings are not substantial and practitioners must be cognizant of the psychological effect that the payment of estate taxes at the first spouse's death will have on the family. As a result, in states that have a pick-up tax, practitioners generally will use a formula that allows the credit shelter share to be calculated based on factors that include the available state death tax credit, "but provided use of the credit does not increase or cause the payment of state death taxes."

In nonpick-up tax states where a state death tax may be imposed even if there is no Federal estate tax, 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. In that event, the increase in, or acceleration of, state death taxes must be compared with the anticipated decrease in Federal estate taxes at the surviving spouse's death. Depending on the results of this comparison, estate planners should consider not using the phrase "provided use of the credit does not increase or cause the payment of state death taxes" in the formula's reference to the state death tax credit.

Installment payments

Practitioners should be aware of the interplay between the timing of state death tax payments and the use of the state death tax credit. As discussed earlier, certain states permit extensions, typically via installments, for payment of death taxes. Although such extensions may have surface appeal, they may negatively affect the timing and amount of the state death tax credit (and consequently, the timing and amount of Federal estate tax payments), as illustrated in TAM 8947005.

There, pursuant to the percentage limitations of Section 2011(b), the estate's maximum allowable credit for state death taxes was limited to $15.32 million even though there was 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, on a return that was timely filed in July 1987, despite the fact that only $4.96 million of the state death tax had been paid as of the filing date of the Federal estate tax return. The remaining $15.18 million of state death tax was to be paid in October 1990 in accordance with a 3½-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 for Section 2011(a) and judicial decisions, the Service concluded that the state death tax credit was intended to be effective only as of the date the state death taxes are paid. The Service ruled 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 after this time, the state death tax credit will be allowed if the payment is within the applicable statute of limitations, but the credit is effective only as of the date of payment of the state death taxes. That is, the allowable credit does not relate back retroactively to the filing due date of the Federal estate tax return.

Based on the facts of TAM 8947005, the Service ruled that the remaining $10.36 million 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, as of the date of the extended payment in October 1990.

A significant undesirable consequence flows from the Service's holding. Because the $10.36 million state death tax credit relating to the $15.18 million extended payment was disallowed as of the Federal return due date, there was an underpayment of Federal estate tax. Thus, the Service would assess interest on the unpaid estate tax from the due date until the underpayment is eliminated.

Despite this adverse result, TAM 8947005 produced one positive outcome for the estate:

the state death 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 3½-year extension payment fell within the Federal time limit for claiming the state death tax credit. Had it not, the $10.36 million state death tax credit related to the extended $15.18 million payment would have been denied. Therefore, it is imperative that care be taken when obtaining and using payment extensions for state death taxes that exceed the period of limitations on the state death tax credit established by Federal law.

Section 2011(c) provides the general rule that the state death tax credit is limited to state death taxes actually paid and claimed as a credit within four years after filing the Federal estate tax return. The following five exceptions modify this general rule.

1. ***Tax Court litigation.***[3] If a Tax Court petition is timely filed, the time for claiming the state death tax credit is extended up to 60 days after the Tax Court decision becomes final. Within this 60-day period, a claim for refund may be filed if the Federal estate taxes were paid without fully using the state death tax credit.

2. ***Extended Federal estate tax payments.***[4] If an estate obtains an extension of time for payment of the tax shown on the Federal return or a deficiency, state death taxes may be paid and state death tax credit claimed within the extension period.

3. ***Refund claims.***[5] If a timely Federal refund claim is filed, or a timely suit on the claim instituted, the time for claiming the state death tax credit is extended until the later of: (1) 60 days after the mailing date of a disallowance notice denying any part of a refund claim; or (2) 60 days after a court decision becomes final in a timely instituted suit on a refund claim.

4. ***Remainder or reversionary interests.***[6] Section 6163(a) provides that if the decedent's gross estate includes a remainder or reversionary interest, the executor may elect to postpone payment of the Federal estate tax attributable to that interest until six months after the precedent interest terminates. At the end of the six-month period, the Service may extend the time for payment for a reasonable period not exceeding three years. The state death taxes may be paid and the state death tax credit claimed within the six-month postponement period or any Service-approved extension period. Since it is not usual to find a remainder or reversionary interest as part of a gross estate, this exception is unlikely to arise.

5. ***The Code's general provision governing credits or refunds.*** Section 6511 provides that a claim for credit or refund of any tax may be filed within two years from the time that tax was paid. As a result, a state death tax credit is allowed for state death taxes paid within two years after payment of the Federal estate tax, even though the four-year general rule limitations period may have expired.[7] For example, assume the executor filed the Federal estate tax return in June 1986. In August 1988, the Service determined an additional Federal estate tax due, which the executor paid immediately. The state also assessed a deficiency (based on the Service's determination), and in July 1990, the executor made payment. Based on the additional state death taxes paid, the executor claimed a state death tax credit and filed for a refund of Federal estate tax. Because this claim was made no later than two years after payment of the additional Federal estate tax, it is allowable.

Unless one of these exceptions exists, state death taxes paid beyond the normal four-year limitations period are not eligible for the state death tax credit. *Revenue Ruling* 86-38[8] illustrates this principle in the context of installment payments. Two situations are addressed in the Ruling. The first arises when an estate elects to pay both Federal and state estate taxes in installments. In this situation, the Service concluded that the second exception above applies, and therefore, the state death tax credit is allowed for state death taxes paid within the Federal extension period.

In the second situation of the Ruling, the estate elects to pay only its state death taxes in installments that extend beyond four years after

the filing of the Federal estate tax return. The Service determined that the Federal credit was allowed only for state death taxes paid within the usual four-year limitations period because none of the exceptions applied.

The reasoning of *Rev. Rul.* 86-38 extends to any case in which state death tax payments are deferred more than four years after the Federal estate tax return filing date. Absent one of the exceptions, such payments produce no state death tax credit. Caution must be exercised, therefore, in using the payment deferral provisions in some states' laws that allow extensions exceeding four years irrespective of the presence of one of the Federal exceptions.

Planning strategies

Deferral of payment of state death taxes vs. accelerated payment. In most situations, whether to pay state death taxes in one lump sum or to elect deferred payments (if available) is a straightforward issue. For example, to the extent state death taxes paid can be used as a credit on the Federal estate tax return (*i.e.*, Federal taxes are owed) and Federal estate taxes are paid in one lump sum, it will be desirable to pay those state death taxes on or before the filing of the Federal estate tax return (or on the first date prescribed for the payment of state death taxes, if later)—rather than pay the state death tax in installments—and use the credit as an offset against Federal estate taxes then owed. If state death taxes are paid in installments, the same amount of initial estate taxes must be paid, and the state may impose interest on the state death taxes paid in installments. Therefore, by using the installment method to pay state death taxes in this situation, the estate could pay more in total taxes.

Example. If the taxable estate is $700,000, the total Federal estate taxes owed are $37,000 (before use of the state death tax credit but after use of the unified credit). The maximum state death tax credit available is $18,000. Assume the state imposes a pick-up tax so that the state death tax equals $18,000, and the state allows for payment in ten equal installments. If the full state death tax is paid by the last date for filing the Federal estate tax return, the total tax burden will equal $37,000, comprising the following: $19,000 in Federal estate taxes ($37,000 minus the $18,000 state death tax credit) and $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) must be paid by the deadline 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 death taxes are actually paid in installments, this refund carries no interest, according to Section 2011(c). In effect, the estate would annually pay, exclusive of interest, $1,800 in state death taxes and receive back $1,800 from the Federal estate taxes previously paid. But the overall tax burden remains at $37,000, and this tax burden is increased if the state imposes interest on the unpaid balance. Although that interest is deductible from the gross estate if paid within the pertinent limitations period,[9] at most only 55% (37% in this example) of the interest paid can be saved because of the reduction in the taxable estate.

To the extent the state death taxes owed exceed the available state death tax credit, or if there is no Federal estate tax owed (such as with a formula credit shelter/marital deduction bequest), the amount in excess of the available, usable credit should be paid in installments, if that treatment is allowable under state law and to the extent desirable in light of the interest charges imposed by the state on the unpaid balance.

If the Federal estate taxes are paid in install-

Citations

1 For a discussion of methods to reduce state death taxes, see Riedel, *State death taxes can have an adverse impact on an otherwise well-planned estate*, 16 EP 350 (Nov/Dec 1989).
2 Section 2011(e).
3 Section 2011(c)(1); Reg. 20.2011-1(c).
4 Section 2011(c)(2); Reg. 20.2011-1(c). See also Sections 6161 and 6166.
5 Section 2011(c)(3); Reg. 20.2011-1(c).
6 Section 2015; Reg. 20.2015-1(a).
7 See *Rev. Rul.* 81-263, 1981-2 CB 169.
8 1986-1 CB 296. See also *Estate of Spillar*, TCM 1985-529.
9 *Rev. Rul.* 81-256, 1981-2 CB 183.
10 See, *e.g.*, *Rev. Rul.* 80-250, 1980-2 CB 278.

ments, then, depending on state interest charges, it may also be economically favorable to pay in installments all state death taxes, including that portion that generates a credit against the Federal estate tax. Moreover, as a practical matter this may be the only feasible approach. There are complex variables to this comparison and care must be taken when making this analysis. The practitioner must initially compare the rate of return that can be received on the unused amounts retained for the remaining state death tax installment payments versus the Federal interest that is in effect charged on this unpaid portion.

Example. If the estate defers $100,000 in state death taxes over a ten-year period, a comparison must initially be made between two amounts: (1) the rate of return experienced by the $100,000 (or such amount each year that remains after the payment of an installment) during the deferral period versus (2) the Federal interest charged as a result of the unpaid state death taxes (*i.e.*, had state death taxes been paid in year one, there would have been a corresponding reduction in Federal estate tax liability and hence no interest charged on that portion of the reduced Federal estate tax liability).

That comparison becomes more complicated when one considers that the Federal interest paid is an estate tax deduction.[10] That deduction decreases both the taxable estate and the interest that has accrued to that point, and hence the remaining installment payment obligation. As a result, a 10% interest charge to the estate on the deferred portion of the Federal estate tax liability does not cost the estate 10% times the amount of the deferred Federal estate tax. Rather, ignoring any adjustment to account for the interest previously paid, it costs the estate 10% times such deferred tax (the interest payment) minus that interest payment times the highest marginal estate tax rate to which the estate is subject (the estate tax saved by the deduction generated).

The above comparison may be further complicated by the effect, if any, that the nonuse of the full state death tax credit on the initial Federal estate tax return will have on the maximum available state death tax credit. As interest accrues on the portion of the Federal estate tax that could have otherwise been shielded by the nondeferral of the payment of the state death taxes, the taxable estate is reduced. In states that impose a nonpick-up tax that exceeds the maximum state death tax credit initially calculated, the effect is to reduce further the maximum state death tax credit available. This reduction should not be an economic factor in states that have a pick-up tax because even though the maximum available state death tax credit is reduced by a reduction in the taxable estate, the amount then paid to the state should correspondingly be reduced.

Although the above variables are complex and interrelated, one rule of thumb is that deferral of the payment of state death taxes (when payment of Federal estate taxes is likewise deferred) is advantageous if no interest is owed on the unpaid state death tax obligations and if the executor can invest the deferred amounts (that will be used to make state death tax payments) so as to achieve a reasonable return and growth rate.

If a state imposes interest on its unpaid death tax obligations paid in installments, it is difficult without a computer program to compare the economic benefits of deferral versus lump-sum payment of state death taxes. At a basic level, it is still useful to compare the true rate of interest charged on the combined state and Federal extended payments (after decreasing the interest payments by the tax gain generated by the reduction in the taxable estate) with the growth and return rate of the property used to make the deferred payments. In addition, a pragmatic approach may be desirable, and the executor may choose the method that facilitates overall estate administration and decreases the costs of completing and filing multiple state and Federal death tax returns.

Conclusion

Where the estate planning objective is to minimize the overall death tax burden of a married couple, practitioners should be alert to the impact of the state death tax credit. Moreover, the timing of state death tax payments may affect the availability of the state death tax credit and the amount of the Federal taxable estate. ◆