Tax Notes

The Michigan Estate Tax: Effective Drafting and Payment Techniques©

By John M. Janiga and Louis S. Harrison

The Michigan estate tax[1] imposes a tax on the transfer of the estate of both residents and nonresidents.[2] 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 Michigan 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 Michigan Estate Tax Works

The key feature of the Michigan estate tax is that it is determined by reference to the maximum allowable federal credit, under Section 2011 of the Internal Revenue Code (the "Code").[3] 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..." (emphasis added).[4]

Importantly, the credit will be allowed only to a specified limit, and then only to the extent that Michigan 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):[5]

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

Although the Michigan estate tax can never exceed the maximum allowable state death credit amount, it may in certain cases be less. This depends on several factors including the decedent's residency at time of death and the *situs* of the decedent's property.

If the decedent was a resident of Michigan at the time of death and died owning property located only in Michigan, the Michigan estate tax would equal the maximum state death tax credit allowable. If, however, the decedent also owned property with a *situs* outside of Michigan (such as real estate in Florida) then the Michigan estate tax is reduced. The amount of the Michigan estate tax would then be the maximum state death tax credit allowable, but reduced by the lesser of:

1. The amount of the estate tax paid to the other state(s), or

2. the amount of the state death tax credit multiplied by a fraction, the numerator of which is the value of all real and tangible personal property with a *situs* outside of Michigan and the denominator of which is the gross value of the decedent's gross estate.[6]

If the decedent was not a resident of Michigan at the time of death, the Michigan estate tax would equal the maximum state death tax credit allowable multiplied by a fraction, the numerator of which is the value of all real and tangible personal property with a *situs* in Michigan and the denominator of which is the gross value of the decedent's gross estate.[7]

Drafting Estate Planning Documents Based on the Michigan 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[8] 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.[9]

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The typical plan focuses on eliminating federal estate tax at the first spouse's death[10] by: (1) carving out of the 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.[11]

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 formula determines the amount of property that 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 must 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 that are not taken or allowed as deductions for federal estate tax purposes.

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 million, 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 million 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 million 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 Michigan 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 Michigan estate tax. In this regard, because the amount of the Michigan 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 Michigan estate taxes paid.

The following example illustrates this situation. Assume these facts: (1) Decedent Jane Adams died a resident of Michigan owning property with only a Michigan *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.[12] 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.[13] 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.[14]

The state death tax credit, however, will be available only 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,[15] 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 paid then, 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. Different conclusions may be obtained in the case of a surviving spouse with a taxable estate.

If the surviving spouse's maximum marginal federal estate tax rate is 37 percent, then the payment at the first spouse's passing of state death taxes results in no overall death tax savings.[16] In contrast, if the surviving spouse has a taxable estate subject to federal estate tax at a rate in excess of 37 percent, then the payment at the first spouse's passing of state death taxes equal to $15,697 decreases the federal estate tax payable at the surviving spouse's death.[17] Nevertheless, the tax savings are not substantial.

As a result, when drafting under the Michigan 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 that the clients own property or die in a state other than Michigan 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 Michigan, the practitioner should review the new state's death tax laws. For example, in states that 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. In that event, the above *proviso* should not be included in the credit shelter formula.

In making that determination, the increase in state death taxes must be compared to 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 Michigan Estate Tax

Payment of the Michigan estate tax and filing of the return is coordinated with payment and filing of the federal tax and return. Accordingly, because the federal return and payment is due nine months after the date of death (assuming no extension),[18] the Michigan estate tax return and payment is also due at that point.[19] If an extension is granted to file the federal return, the Michigan return need not be filed until that extended date.[20] Similarly, if an extension of time is granted to pay the tax by the Internal Revenue Service ("Service"), the time to pay the Michigan estate tax is also extended.[21] With an extension of time to pay, interest is charged on the unpaid Michigan estate tax at the prescribed rate.[22] Michigan estate tax paid after the due date, including extensions, may also be subject to penalties.[23]

In planning the payment of Michigan estate tax, 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 § 2011(b), the estate's maximum allowable credit for state death tax 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 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 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 to Section 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 actually been paid by the later of: (1) the filing 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. (Note: When the October 1990 payment is made, the federal estate tax becomes overpaid, but pursuant to Section 2011(c), the overpayment is refunded without interest).

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 due. Underlying this positive result was the fact that the 3½-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

The appropriate payment strategy for Michigan estate tax will depend on the underlying facts. One fact pattern involves situations in which the federal estate tax is paid in one lump-sum (rather than in installments under Code § 6166) either by the original due date of the federal return, or within 12 months of the original due date, in accordance with the extension provisions contained in Code § 6161. In these situations, the Michigan estate tax is required to be paid—and should be paid—by the same date as the federal payment so that the state death tax credit can be used as an offset against federal estate tax then owed. Late payment of the Michigan estate tax would not change the combined state death tax and federal estate tax burden, but the estate may be unnecessarily depleted if interest and penalties are imposed. 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; and (4) The decedent died in Michigan owning only property with a Michigan *situs*, so that the state death tax equals $18,000.

If the entire Michigan estate tax is 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 Michigan estate tax.

In contrast, if the estate pays the Michigan estate tax late, 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 Michigan estate tax is paid. Although the estate would get a refund of its federal tax paid as Michigan tax is actually paid, this refund carries with it no interest. *See* IRC § 2011(c).

In effect, as the estate would pay tax, it would receive an equal amount back 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 Michigan imposes interest and penalties on the unpaid state death tax balance. Although such interest is deductible from the gross estate, Rev. Rul. 81-256, at most 55 percent (37 percent in this example) of the interest paid results in a federal estate tax savings. The penalties produce no federal estate tax savings because they are not deductible.

Installments

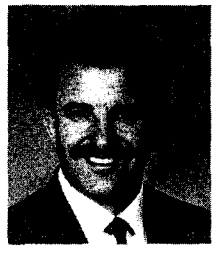
A second fact pattern involves situations in which the estate elects installment treatment under the extension provisions contained in Code § 6166 (which applies only if the estate consists largely of an interest in a closely held business). Installment payments would then also be allowed (not required) with regard to Michigan estate tax payments.

Although seemingly straightforward, these situations add substantial complication to calculation of both the federal and Michigan estate tax. Consider, for example, what happens each year as installment payments are made on the federal estate tax. Under Code § 6166, interest is paid on the federal unpaid balance. The interest generates a deduction, which reduces the taxable estate.[24]

Because the taxable estate is reduced, so is the amount of the state death tax credit. Assuming that Michigan estate tax is also being paid in installments, this means that future installments owed to the state of Michigan, as well as past interest paid on the unpaid balance, must be changed. This then has an impact on the federal estate tax due.

These situations require a complex analysis to determine whether it is economically desirable to pay Michigan estate tax in installments. This analysis requires a comparison between the rate of return that can be received on the unused amounts necessary to make the remaining Michigan estate tax installment payments and the federal interest that is in effect, charged on this unpaid portion.

Although these variables are complex and interrelated, one rule of thumb is that deferral of the payment of state death taxes



John M. Janiga is an associate professor at Loyola University Chicago and is a consultant on federal and state tax matters. He holds B.B.A., M.B.A., *and* J.D. *degrees from Loyola University Chicago, an* L.L.M. *from DePaul University College of Law, and is a* CPA.

Louis S. Harrison is a partner, specializing in estate planning, with Lord, Bissell & Brook in Chicago, Illinois and is an adjunct professor at DePaul University College of Law. He holds a B.A. *from Colgate University and a* J.D. *from Duke University School of Law.*