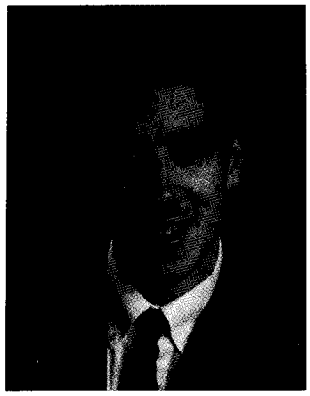
An Examination of the Fully Phased-in Massachusetts Estate Tax: Drafting and Payment Techniques

BY JOHN M. JANIGA AND LOUIS S. HARRISON

John M. Janiga is an associate professor of taxation at Loyola University Chicago and a consultant on federal tax matters.



Louis S. Harrison is a partner with Lord, Bissell & Brook in Chicago, where he practices estate planning, and is an adjunct professor of law at DePaul University College of Law.

I. Introduction

The phase in of the Massachusetts estate tax[1] to a "pickup" tax system was completed in 1997. Under this system, each estate pays a state death tax in an amount equal to the maximum state death tax credit allowable for federal estate tax purposes. This so-called pickup tax reduces the federal estate tax by an equivalent amount; thus, there is no increase in the overall death taxes paid by the estate.

Generally, the objective of a shift to a pickup estate tax is to effect a more fair and straightforward death tax approach.[2] Although the Massachusetts estate tax should meet this objective, it nevertheless contains unexpected nuances that impact drafting of estate planning documents and payment of Massachusetts estate tax.

Section II of this article provides an overview of Massachusetts estate tax mechanics. Section III then explores drafting techniques that effectively address the Massachusetts estate tax. Finally, Section IV explains why the timing of Massachusetts estate tax payments is crucial, and provides effective payment strategies.

II. How the Massachusetts Estate Tax Works

The key feature of the new Massachusetts 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 Massachusetts estate tax has actually been paid.[5] The starting point for computing the limit is the "taxable estate," which is the federal gross estate minus allowable deductions.[6] From the taxable estate, $60,000 is then deducted to arrive at the "adjusted taxable estate."[7] Finally, based on this amount, the table set forth in Code section 2011(b) is used to arrive at what is known as the "maximum credit amount" allowed.

1. G.L.M. c.65C (1998). The Massachusetts estate tax provisions include two types of tax, an estate tax and a generation-skipping transfer tax. This article examines only the estate tax. Additionally, this article focuses on the application of the Massachusetts estate tax to estates of residents and nonresidents dying on or after January 1, 1997. *Id.* § 2A. The estates of residents or nonresidents dying on or before December 31, 1996 were subject to the "old" Massachusetts estate tax (i.e., prior to complete phase-in to a pickup tax system). *Id.* § 2.

2. For example, it eliminates the bizarre and unpleasant consequences of non-domiciliaries who died owning property in Massachusetts. Massachusetts joins the vast majority of states that now have adopted a pickup estate tax to achieve equity and simplicity. For examples of other pickup tax systems, *see* Fla. Stat. Ann. § 198.01 et. seq. and Ill. Rev. Stat. Ch 120, ¶ 375 to 404.

3. *See* G.L.M. c.65C, § 2A.

4. 26 U.S.C. § 2011(a) (1998).

5. *Id.*

6. *See* 26 U.S.C. § 2051 (1998).

7. 26 U.S.C. § 2011(b) (1998) (last sentence).

The following schedule illustrates the computation of the maximum state death tax credit amount under Code section 2011(b) (note: the taxable estate amount is assumed):[8]

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

Although the Massachusetts estate tax can never exceed the maximum allowable state death credit amount, it may in certain cases be less.[9] 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 Massachusetts at the time of death and died owning property located only in Massachusetts, the Massachusetts estate tax would equal the maximum state death tax credit allowable.[10] If, however, the decedent also owned property with a situs outside of Massachusetts (such as real estate in Florida) then the Massachusetts estate tax is reduced. The amount of the Massachusetts estate tax would then be the maximum state death tax credit allowable but reduced by the lesser of:

1. The amount of the estate, inheritance, legacy and succession taxes 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 property taxable by the other state(s) and the denominator of which is the entire value of the decedent's federal gross estate.[11]

If the decedent was not a resident of Massachusetts at time of death, the Massachusetts 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 Massachusetts and the denominator of which is the entire value of the decedent's federal gross estate.[12]

III. Drafting Estate Planning Documents Based on the Massachusetts 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.

A. 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. 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.

In the majority of situations, the plan includes consideration of a federal estate tax credit known as the "applicable credit amount" or "unified credit," and the marital deduction. The unified credit for 1998 of $202,050[13] effectively shields transfers on up to $625,000 from federal estate tax;[14] the marital deduction allows a decedent to transfer an unlimited amount of property to a surviving spouse free of federal estate tax.[15]

8. *See* 26 U.S.C.§ 2011(b) (1998) (the table appears as Exhibit I to this article).

9. *See* G.L.M. c.65, §2A(a).

10. *Id.*

11. *Id.*

12. *Id.*,§ 2A(b).

13. 26 U.S.C.§ 2010(a) (1998).

14. The Taxpayer Relief Act of 1997 (P.L. 105-34, 8/5/97) increased the unified credit from $192,800 for 1997 to $345,800 for 2006 and thereafter. The increase in the unified credit increases the amount of transfers shielded from the federal estate tax, previously referred to as the "exemption equivalent" and now as the "applicable exclusion amount." The phase in of the credit and the corresponding exclusion amounts follow:

For Deaths in	Unified Credit	Applicable Exclusion Amount
1997	$192,800	$600,000
1998	$202,050	$625,000
1999	$211,300	$650,000
2000 and 2001	$220,550	$675,000
2002 and 2003	$229,800	$700,000
2004	$287,300	$850,000
2005	$326,300	$950,000
2006/thereafter	$345,800	$1,000,000

There is no provision to adjust the unified credit for inflation after 2006.

All of the examples in this article assume a decedent dying in 1998.

15. 26 U.S.C.§ 2056(a) (1998).

The typical plan focuses on eliminating federal estate tax at the first spouse's death[16] 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.[17]

As most estate planners know, the unified credit effectively shields transfers of up to $625,000 from federal estate tax; however, that does not mean that the credit shelter share formula should be drafted to automatically equal $625,000. Rather, the formula must take into account that this $625,000 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.

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 $2.025 million, administration expenses of $100,000, and made lifetime taxable gifts of $300,000; (2) under the terms of the decedent's will, $625,000 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 $1.3 million, which is the $2.025 million gross estate minus $725,000, the portion of the gross estate that does not pass to the surviving spouse (the $625,000 credit shelter share plus the $100,000 of administration expenses). Subtracting the allowable deductions of $1.4 million (the marital deduction of $1.3 million plus the administration expenses of $100,000) from the gross estate of $2.025 million produces a taxable estate of $625,000. Adding the taxable estate, $625,000, to the lifetime taxable gifts, $300,000, results in a federal estate tax base of $925,000. The tentative federal estate tax on this amount is $316,550.[18]

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 $202,050, the unified credit amount, results in a negative number. The unified credit, $202,050, when subtracted from the tentative tax of $316,550, results in a federal estate tax due of $114,500.

The reason that there is a tax due stems from the fact that the credit shelter share should not have been fixed at $625,000. 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 $625,000 to $325,000. A reduction in the credit shelter share to $325,000 would have correspondingly increased the share qualifying for the marital deduction to $1.6 million. The federal estate tax base then would have been $625,000 ($325,000 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, $202,050.[19]

16. In large estate situations, it may be worthwhile to incur some federal estate tax at the first spouse's passing in order to take advantage of the graduated federal estate tax rates. Also, the family owned business (partial) deduction under Code section 2057 can be carved out at the first spouse's passing and would increase the credit shelter share.

17. A plan which left all of a decedent's estate to the surviving spouse would also eliminate federal estate tax at the first spouse's death due to the unlimited marital deduction. Such a plan, however, would fail to minimize the couple's overall death taxes because it would waste one spouse's unified credit. Under that plan, no federal estate tax is due at the first spouse's passing. At the surviving spouse's death, a maximum of $625,000 passes to non-charitable beneficiaries free of estate tax as the result of the surviving spouse's unified credit.

Under a combination credit shelter/marital deduction plan, at the first spouse's death a credit shelter share is established to pass property to either nonspousal, noncharitable beneficiaries or to a trust in which the surviving spouse is a beneficiary (and may even be a trustee if the trust is properly drafted) but which is not includable in the surviving spouse's gross estate for federal estate tax purposes. The credit shelter share produces three benefits: (1) it passes free of federal estate tax because of the unified credit (the marital deduction is not applicable to the credit shelter share because the property does not "pass" to the surviving spouse); (2) at the surviving spouse's death, the then value of the credit shelter share passes to the designated beneficiaries free of estate tax (the credit shelter share is not includable in the surviving spouse's gross estate for federal estate tax purposes); and (3) the surviving spouse is able to pass additional property free of estate tax to the extent of the surviving spouse's unified credit. Thus, at the surviving spouse's death a maximum of $1.25 million (plus appreciation and income earned on the credit shelter share created at the first spouse's death) passes to the beneficiaries free of estate tax.

18. The tentative tax on $925,000 equals $248,300, plus 39 percent of $175,000 (the excess of such amount over $750,000), or $316,550. *See* 26 U.S.C.§ 2001(b),(c) (1998).

19. The tentative tax on $625,000 equals $155,800, plus 37 percent of $125,000 (the excess of such amount over $500,000), or $202,050. *See* 26 U.S.C.§ 2001(b) (1998).

B. Reference to the Massachusetts 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 Massachusetts estate tax. In this regard, because the amount of the Massachusetts estate tax generally will equal the state death tax credit, any such reference will actually be to the state death tax credit. Some frequently used 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 and deductions (other than the marital deduction) 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 Massachusetts estate taxes paid. The following example illustrates this problem.

Assume these facts: (1) decedent Jane Adams died a resident of Massachusetts owning property with only a Massachusetts 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 which would result in no increase in federal estate tax payable? On these facts, if the credit shelter share were funded with $625,000, the tentative federal estate tax on this amount would be $202,050.[20] Because of the $202,050 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 $670,455. This would increase the tentative federal estate tax by $16,818, to $218,868.[21] 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 $202,050, the unified credit, and $16,818, the state death tax credit on $670,455.[22]

The state death tax credit, however, will be available only if the $16,818 of state death taxes are actually paid. Because payment of the state death taxes must be from the credit shelter share,[23] the credit shelter share would need to be adjusted from $670,455 to account for $16,818 of state death taxes paid.

Jane's formula, therefore, results ultimately in a $653,637 credit shelter share. This produces the following positive effects: (1) the marital share is decreased by $45,455 ($670,455 less $625,000), thereby preventing the future payment of federal estate tax on this amount, and (2) the credit shelter share is increased by $28,637 ($653,637 less $625,000). That amount, plus any appreciation and income, escapes federal estate tax at Jack's death.

A negative effect is that state death taxes of $16,818 must be paid which otherwise 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 obtain 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.[24] In contrast, if the sur-

20. The tentative tax on $625,000 equals $155,800, plus 37 percent of $125,000 (the excess of such amount over $500,000), or $202,050. *See* 26 U.S.C.§ 2001(b) (1998).

21. The tentative tax on $670,455 equals $155,800, plus 37 percent of $170,455 (the excess of such amount over $500,000) or $218,868. *See* 26 U.S.C.§ 2001(b) (1998).

22. If the credit shelter share, and therefore the taxable estate, were in excess of $670,455, the increase in the federal estate taxes owed, at a marginal 37 percent rate, would not offset the increase in the state death tax credit then available, at a 4.8 percent rate (refer to Exhibit I). Thus, if the credit shelter share exceeded $670,455, federal estate tax would be due. Since the formula requires that no federal estate tax be due, the formula prevents the credit shelter share from exceeding $670,455.

23. Payment of the state death taxes cannot come from the marital share because that would decrease the amount of the marital share qualifying for the marital deduction, thereby resulting in federal estate tax, which would violate the mandate of the formula that no federal estate tax be due.

24. The $16,818 of state death taxes paid in year one allows an extra $28,637 to pass to the credit shelter share ($45,455 minus the state death taxes owed, $16,818). Even if the $28,637 experiences no appreciation between the first and second spouse's death, this means that a minimum of $28,637 will pass free of estate tax at the surviving spouse's death. If the state death taxes had not been paid, then an extra $45,455 would be included in the surviving spouse's gross estate. The federal estate tax on $45,455 at a marginal tax rate of 37 percent is $16,818, leaving a net to the beneficiaries of $28,637.

viving 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 $16,818 decreases the federal estate tax payable at the surviving spouse's death.[25] Nevertheless, the tax savings are not substantial. As a result, when drafting under the Massachusetts estate tax scheme, estate planners should reference in the formula that determines the credit shelter share all available credits, but should also 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 italic above) will protect the draftsperson in the event the clients own property or die in a state other than Massachusetts, 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 Massachusetts, the practitioner should review the new domicile'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. 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 with the anticipated decrease in federal estate tax at the surviving spouse's death. Based on this analysis, estate planners can determine the appropriateness of the above proviso in the credit shelter share formula.

IV. Payment of Massachusetts Estate Tax

Payment of the Massachusetts estate tax and filing of the return is consistent with payment and filing of the federal tax and return.[26] Thus, the Massachusetts estate tax return and payment is due nine months after date of death (assuming no extension).[27] A six-month extension to file is available by filing Form M-4768 on or before the original due date of the return.[28] Similarly, an extension of time to pay the Massachusetts estate tax may be requested on Form M-4768A on or before the due date for payment. The commissioner may extend the time for payment of the tax for a reasonable period not to exceed six months from the due date. However, if the commissioner finds that payment of any part of the tax would result in undue hardship, the Massachusetts Department of Revenue may extend the time for payment for a reasonable period not to exceed three years from the date fixed for payment of the tax.[29] With an extension of time to pay, interest is charged on the unpaid Massachusetts estate tax at the prescribed rate.[30] Massachusetts estate tax paid after the due date, including extensions, may also be subject to penalties.[31]

In planning the payment of Massachusetts estate tax, the practitioner should consider that the timing of state death tax payments will impact the availability of the state death tax credit. A relevant IRS pronouncement (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 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 3-1/2 year extension obtained by the executor from the state. Consequently, the state death tax credit claimed on the federal return exceeded by $10.36 million the state death tax actually paid as of the federal return filing date.

25. If, for example, state death taxes of $16,818 are paid in year one, then an extra $28,637 ($45,455 minus $16,818) passes to the credit shelter share. The credit shelter share, plus appreciation and income thereon, will pass at the surviving spouse's death free of additional federal estate tax. Thus, if the credit shelter share earns 10 percent and the surviving spouse dies at the beginning of the second year following the first spouse's death, an additional $31,501 ($28,637 plus $2,864) passes free of federal estate tax at the death of the surviving spouse. Had there been no state death taxes paid at the first spouse's death, the surviving spouse would have had an extra $45,455 plus $4,546 in his or her estate, or $50,001. At a 55 percent marginal federal estate tax rate, the additional federal estate tax is $27,501, leaving only $22,500 — rather than $31,501 — to pass to the beneficiaries. Therefore, a tax savings of $9,001 is generated by the payment of state death taxes at the first spouse's death.

26. The federal estate payment and filing requirements are contained in 26 U.S.C. §§ 6075(a), 6151(a), respectively.

27. G.L.M. c.62C, §§ 17, 32.

28. *See* G.L.M. c.62C, §19. A six-month automatic extension is deemed void, however, if 80 percent of the total tax liability is not paid on or before the original due date of the return.

29. *See* G.L.M. c.65C, §10(a).

30. *See* G.L.M. c.62C, §32(a).

31. *Id.* §33(b)(c).

Relying on the legislative history to section 2011(a) and judicial decisions, the IRS 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 IRS 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 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 on the date of payment.

Based on the facts of TAM 8947005, the IRS 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 IRS'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 IRS 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 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.

A. Lump Sum Payments

The appropriate payment strategy for Massachusetts estate tax will depend on the underlying facts. If the federal estate tax is paid in one lump sum (not in installments) it will be advantageous to pay Massachusetts estate tax on or before the filing of the federal estate tax return and use the credit as an offset against federal estate tax then owed. This course is advisable because Massachusetts imposes interest on extended state death tax payments. Late payment of the Massachusetts estate tax would not change the combined state death tax and federal estate tax burden, but the estate will be unnecessarily depleted to the extent that 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 $27,750; (3) the adjusted taxable estate is $640,000 ($700,000 minus $60,000) which, under Code section 2011(b) yields a maximum state death tax credit of $18,000; and (4) the decedent died in Massachusetts owning only property with a Massachusetts situs, so that the state death tax equals $18,000.

If the entire Massachusetts estate tax is paid on or before the last date for filing the federal estate tax return, the total tax burden will equal $27,750. This represents $9,750 in federal estate taxes ($27,750 minus the $18,000 state death tax credit) plus $18,000 in Massachusetts estate tax.

In contrast, if the estate pays the Massachusetts estate tax late the same amount of total taxes, $27,750, 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 $27,750 owed in federal estate tax until the Massachusetts estate tax is paid. Although the estate would get a refund of its federal tax paid as Massachusetts tax is actually paid, this refund carries with it no interest.[32] 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 $27,750, the estate suffers economically because Massachusetts imposes interest and penalties on the unpaid state death tax balance. Although such interest is deductible from the gross estate,[33] at most 55 percent (37 perent 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.

B. Installments

The most difficult interplay between federal estate tax payments and Massachusetts estate tax payments occurs if the estate elects installment treatment under Code section 6166. These situations potentially require a complex analysis to determine whether it is economically desirable to request an extension (either the normal six-month extension or an "undue hardship "extension up to three years) to pay Massachusetts estate tax. This analysis requires a comparison between the rate of return that can be received on the unused amounts necessary to make the remaining Massachusetts estate tax payments and the federal interest which is in effect charged on this unpaid portion.

32. *See* 26 U.S.C.§ 2011(c) (1998).

33. *See* Rev. Rul. 81-256, 1981-2 C.B. 183.

34. This section of the Code applies only if the estate consists largely of an interest in a closely held business.

If, for example, the estate defers $100,000 in Massachusetts estate tax over a three-year period (under the undue hardship provision), a comparison needs to be made between the rate of return experienced by the $100,000 (or such amount each year that remains after a payment) during the deferral period versus the federal interest charged as a result of the unpaid Massachusetts estate tax (i.e., had Massachusetts estate tax been paid in year one, there would have been a corresponding reduction in federal estate tax liability and, hence, no interest would have been charged on this portion of the reduced federal estate tax liability).

For estates of decedents dying prior to 1998, a further complication arose. Consider, for example, what happened each year as installment payments were made on the federal estate tax. Under Code section 6166, interest is payable on any federal unpaid balance. Under prior law, the interest was deductible either for income tax purposes or estate tax purposes. In the latter case, the deduction reduced the taxable estate.[35] Because the taxable estate was reduced, so was the amount of the state death tax credit. This meant that future payments owed to the state of Massachusetts, as well as past interest paid on the unpaid balance, had to be changed. This then had an impact on the federal estate tax due.

For decedents dying after 1997, this complication has been eliminated. Section 503(b) of the Tax Relief Act of 1997 (P.L. 105-34, 8/5/97) denies both an income tax deduction and an estate tax deduction for federal interest paid.

One rule of thumb is that deferring state death tax payments will make economic sense if there is no interest owed on the unpaid state death tax balance and if the deferred amounts (which will be used to make state death tax payments) can be invested in a vehicle which will experience a reasonable return and growth rate. Because Massachusetts imposes interest on its unpaid estate tax balance, it is difficult without a computer program to compare the economic benefits of deferral versus lump-sum payment of Massachusetts estate tax, although lump sum payment certainly will be administratively more convenient.[36]

VI. Conclusion

The effects of the new Massachusetts estate tax must be considered when drafting estate planning documents. 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. Generally, when drafting the credit shelter formula for clients domiciled in Massachusetts, practitioners should make reference to all available credits, with the proviso that consideration of the state death tax credit should not increase or cause the payment of state death taxes. Depending on the underlying facts, such a proviso may or may not be appropriate for clients who are not domiciled in Massachusetts.

The timing of Massachusetts estate tax payments must also be considered. Practitioners should be alert to the fact that improperly timed payments could result in a denial of the state death tax credit. Moreover, the appropriate payment strategy for Massachusetts estate tax will vary depending on the circumstances. If the federal estate tax is paid in one lump sum, it will be financially advantageous to pay Massachusetts estate tax on or before the filing of the federal estate tax return. If the federal estate tax is paid in installments, the determination of whether it is better economically to immediately pay or to defer Massachusetts estate tax requires a more sophisticated financial analysis.

35. *See, e.g.*, Rev. Rul. 80-250, 1980-2 C.B. 278.

36. A pragmatic approach is to choose the payment method which facilitates overall estate administration and decreases the costs associated with completing and filing multiple state death tax returns and a federal estate tax return, or filing for or preserving state death tax refunds.

EXHIBIT 1

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 adjusted taxable estate exceeds $40,000.00
Over $90,000 but not over $140,000	$400 plus 1.6% of the excess over $90,000.00
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% 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% 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 plus 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% 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 $10,040,00	$930,800 plus 15.2% of the excess over $9,040,000
Over $10,040,000	$1,082,800 plus 16% of the excess over $10,040,000