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Sponge tax is the term used to describe a state death tax that maximizes the state's share of an estate's transfer taxes without increasing the estate's total transfer tax burden.

A person's estate may take a credit against federal estate tax for each dollar of state death tax paid up to certain limits. The limits are described in the State Death Tax Credit Table, including provisions for changes in this credit under the The Economic Growth and Tax Relief Reconciliation Act of 2001.

Until The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), many states imposed a sponge tax. EGTRRA included the incremental phase-out of the state death tax credit from 2002 – 2004, followed by repeal of the credit in 2005. Consequently, many states altered the calculation of their death tax so that it is not linked to a federal death tax credit schedule. In general, the new state death tax calculations yield similar death tax amounts as they did under the old “sponge” tax approach. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the suspension of the state death tax credit through 2012.

Example

Suppose you were settling a taxable estate of $2,000,000 in 2001 that had all $675,000 of its estate tax credit equivalent available. If the estate were in a state that had no death tax, the state death tax would have been $0 and the federal estate tax would have been $560,250. If the estate had been in a state that had a sponge tax, the state death tax would have been $99,600 and the federal estate tax would have been $460,650. The total of $99,600 + $460,650 is $560,250, the same total amount as the federal estate tax in the state that had no death tax.

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