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As a result of the American Taxpayer Relief Act of 2012, an estimated 99.87% of Americans will die without their estates being subject to federal estate tax. At the state level, however, the situation can be quite a bit different. Accordingly, in appropriate circumstances gift planners should alert donors to the possibility that a state estate tax or inheritance tax – or both – may apply, while pointing out as well ways to reduce or eliminate such taxes by making charitable gifts.

Types of Taxation Occasioned by Death

Before considering state estate and inheritance taxes in particular, it can be helpful to take note of other ways death can be a taxable event, whether for the individual in question, for his or her estate, or for beneficiaries of the estate. This is especially so in an era when lawmakers are open to embracing fundamental changes in how governments obtain revenue.

One option is to apply income tax law. To an extent, this already occurs at the federal level (and, as a result, at the state level as well, in those states that have income taxes) in connection with "income in respect of a decedent." Such income is earned, and is therefore taxable, when an individual or an entity, such as an heir or the decedent's estate, receives money on which the decedent would have had to pay income tax had the decedent continued to live.

A variation on this approach has long been taken in Canada in connection with income taxed as capital gain. With a few exceptions, such as those for assets given directly to or placed in trust for a surviving spouse, when an individual dies, assets he or she owned that grew in value between the time they were acquired and the date of death are deemed to be sold, with the capital gain taxed on the individual's final income tax return (and the assets thereby receiving a step-up in their cost basis).

A different approach is, in effect, to tax an individual *in anticipation of* his or her death. This is essentially the role played by a gift tax in any jurisdiction that also has an estate tax. If an individual is wealthy enough and makes enough transfers of that wealth to certain other individuals and entities during life, then upon death his or her estate may no longer have enough wealth to be subject to the jurisdiction's

estate tax. If the jurisdiction also has a gift tax, however, transfers that would have been taxable had they been made upon death become taxable when made during life, with the giver of the gift paying the tax.

Apart from the federal gift tax, relatively few states have had their own gift tax over the years. By the beginning of 2013 only one state, Connecticut, still had one. Nevertheless, just in recent months the number of states with a gift tax has begun to grow. Minnesota's new gift tax took effect in July, and changes to Washington's estate tax law create a *de facto* gift tax in specific situations. Indeed, in some cases a jurisdiction's estate tax will apply not only to wealth owned upon death, but also to wealth transferred prior to death, typically within a certain period.

How an Estate Tax Differs from an Inheritance Tax

Conceptually, an estate tax is levied on an individual's right to transfer wealth upon his or her death. Because the individual has died, the tax falls on the individual's entire estate, for it is the estate that makes (or, in selected instances, is deemed to make) the actual transfers.

Yet as a practical matter, the estate often passes the estate tax burden – whether federal, state, or both – along to some or even all of the estate's beneficiaries by first deducting any applicable estate tax from what a beneficiary receives. Who ends up paying how much is mostly a function of what the deceased individual's will and/or living trust agreement says. Beyond that, state law regarding what's known as "estate tax apportionment" comes into play.

In unusual situations, the IRS or a state revenue agency may need to collect unpaid estate tax from the personal representative (referred to as the executor in some states) or from one or more beneficiaries of the estate if administration of the estate was not carried out properly with regard to the payment of estate taxes. Likewise, a donor who has not exercised sufficient care can make a charitable bequest that nonetheless results in the charity's share of the estate being reduced by estate tax. Despite the fact that the overall estate tax owed may be reduced by virtue of a deduction for charitable gifts, inattention to detail in drafting estate planning documents will occasionally result in the charity having to pay a portion of any tax still owed by the estate. Fortunately, this is a rare occurrence.

By contrast, an inheritance tax burden falls directly on a beneficiary of the estate unless his, her, or its inheritance is exempted from the tax (although in practice the

tax will sometimes be paid by the estate, with a net inheritance amount then distributed to a beneficiary). Moreover, some beneficiaries pay inheritance tax at higher rates than other beneficiaries. Typically, this will be a function both of the size of an inheritance and of how closely related a beneficiary is to the individual who has died.

Currently, only seven states (Iowa, Kentucky, Maryland, Nebraska, New Jersey, Pennsylvania, and Tennessee) have an inheritance tax. Tennessee's tax is due to be phased out, ceasing entirely in 2016. Maryland and New Jersey have both an inheritance tax and an estate tax. Because significantly more states (14, counting Maryland and New Jersey, along with the District of Columbia) have estate taxes than have inheritance taxes, the balance of this article will concentrate on state estate taxes. Moreover, even though at present the majority of states – 31 in all – have neither an estate tax nor an inheritance tax, and even though there is something of a trend toward states eliminating such taxes, what the future holds is by no means clear.

State Estate Tax Basics

The following jurisdictions have some form of estate tax: Connecticut, District of Columbia, Delaware, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oregon, Rhode Island, Vermont, and Washington.

State estate taxes feature both what is fundamentally an exemption (i.e., an overall estate value below which no tax applies) and a graduated set of tax rates that apply to whatever portion of the estate's value exceeds the exemption. From state to state, the exemption, the top marginal tax rate, and the different levels of estate value at which different rates apply differ considerably. Exemptions range from $675,000 to $5.25 million (which, of course, matches the federal exemption for 2013), with those between $1 million and $2 million prevailing in about half of the states. Top marginal rates range from 12% to 19%, although all but three states have a top rate of 16%. As noted above, however, that top rate is reached at estate values that vary from one state to another.

For donors in a state with an estate tax, the size of the exemption is ultimately going to be more important than different estate tax rates or the estate values at which they apply. This is because the higher the exemption, the lower the number of individuals who will need to concern themselves with state estate tax as they do

their estate planning.

Still, the sorts of assets included in determining the value of an individual's estate can differ from state to state as well. Furthermore, a state's estate tax laws can apply to the estate of an individual who was not living in the state at the time of his or her death. For example, this can be the case with regard to real estate a person owned – whether outright or sometimes even through an entity such as a limited liability company – in another state at the time he or she died.

Happily for gift planners, an unlimited state estate tax deduction is generally available for charitable gifts made upon death. Thus, the effect of a charitable bequest will be that the gift will "cost" noncharitable beneficiaries somewhat less than the full amount of the bequest. If, for example, a donor makes a $100,000 bequest to ABC Charity and the applicable state estate tax rate is, say, 12%, an heir of the donor who might otherwise have received the $100,000 ends up foregoing only $88,000 on an after-tax basis.

Of course, the impact of a state estate tax charitable deduction will not be as great as that of the federal estate tax charitable deduction because state estate tax rates are lower than the flat federal estate tax rate of 40%. Accordingly, the federal estate tax benefit of the $100,000 bequest in the example immediately above is that the gift costs noncharitable beneficiaries only $60,000.

Interplay Between Federal and State Taxes

If the value of an individual's estate upon death is such that both federal and state estate tax (or federal estate tax and state inheritance tax, for that matter) will apply, the amount of the state estate or inheritance tax paid can be deducted from the value of the estate subject to federal estate tax. This means that, on an after tax basis, the impact of a state estate or inheritance tax will be only 60% of what it otherwise would be, given the federal estate tax flat rate of 40%. For example, if an estate pays state estate tax at a rate of 15%, once the tax paid is deducted from the federal estate, the net rate of the state estate tax declines to only 9%.

Even though for the largest of estates the cost of paying state estate or inheritance tax is lessened somewhat by the existence of the federal estate tax deduction for such taxes, the benefit of the deduction is not as great as was the case when the federal tax law provided for a fixed *credit* for either type of state tax. Such a credit was available up through 2001, and it had the effect of costing the estate not a

penny extra to pay state estate or inheritance tax, so long as the amount of the tax was less than or equal to the federal credit. Accordingly, many states had so-called "pick-up taxes" that allowed estates to take full advantage of the federal credit. Between 2002 and 2004, however, the federal credit was phased out, leading certain states to repeal their pick-up taxes, in some cases replacing the lost revenue with new estate taxes and/or with other types of taxes.

Marketing Implications

In the last decade or so, as the federal estate tax exemption has grown ever higher, charities have wisely downplayed potential estate tax savings as a benefit for donors to take into account when deciding whether to make a charitable bequest or other testamentary charitable gift. Yet in so doing, they may have neglected the more modest tax savings that may exist by virtue of state estate or inheritance taxes.

True, if a charity is located in a state without either type of tax and if substantially all its donors live in that state, there is very little value in drawing attention to the dynamics of such state taxes. By contrast, while a charity that enjoys nationwide support should mention the fact that some states impose estate or inheritance taxes and that making charitable gifts upon death can decrease the tax owed by the estates of wealthier donors in those states, few specifics can be cited.

The charities perhaps most able to profit by bringing state estate and/or inheritance tax considerations to the attention of their donors are those located in a state with such a tax when a significant number of donors also live in that state. It then becomes realistic for gift planners at such organizations to deepen their knowledge about how the relevant tax(es) operate(s), in the process drawing on the expertise of highly-regarded local estate planning advisors. These gift planners will then be in a position to acquaint their supporters with some of the details, whether in marketing materials (ideally, materials targeted to wealthier donors) or simply in one-on-one conversations. So long as the charity ultimately just raises the issue and refers donors to their own tax counsel for a determination of how either type of tax will affect them, they will have done donors a service.

Conclusion

Plainly, state taxes applicable upon death will be relevant in a relatively limited number of donor situations, both because most states have no such taxes and because they typically affect only a charity's more affluent supporters. Still, gift

planners who understand the fundamentals of such taxes, as well as the modest incentive they can provide donors who are thinking of making charitable bequests or other testamentary gifts, will be able to bring that understanding to bear when appropriate.

Furthermore, the current tax environment remains fairly "fluid." On the one hand, North Carolina repealed its estate tax in recent months. In Delaware, on the other hand, an estate tax that was to have been repealed as of July 1, 2013 was instead retained. These and similar developments make it advisable for gift planners not only to tune in to what's going on at the state level, but also to stay tuned.

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