The Quarterly Counselor October 2008

WealthCounsel®

LEADING PROVIDER OF TOOLS & INTELLIGENCE TO THE ESTATE PLANNING COMMUNITY VOLUME 2 NO. 4

Decoupling Dilemma: Planning Pitfalls and Solutions for Decoupled State Planning

By: Gary B. Garland, Esq.

New York, New Jersey, and 18 other states have decoupled from the federal government when it comes to estate taxes - meaning clients (and advisors) who read trade journals or lay publications may not realize there is an exposure well below the current $2,000,000 (and forthcoming in 2009 $3.5M) estate tax exemption - creating the need for advisors to guide their clients through the quagmire which can otherwise trap the unwary. While much ballyhoo has been written and discussed about the federal estate tax marginal rate of 45%, one should not be quick to ignore the state level estate tax which can zap the unwary at roughly 10% (or more).

Perhaps the best way to proceed is to start with the worst case scenario - what are the potential ramifications for doing nothing? In New Jersey, for example, the state estate tax starts at $675k - about the price of a middle class home depending upon locale within the state. A single decedent with a $675k estate will barely escape estate taxes; a $1M estate in NJ will be exposed to $33,200 in state level estate taxes, a $1.5M estate in NJ is exposed to $64,400, and a $2M estate is exposed to $99,600 – not a small chunk of change! (Beyond $2M this year, NJ will impose no additional tax as it will receive a share of the federal tax imposed [sponge tax/pick up tax]. Next year, with a $3.5M exemption, New Yorkers and New Jersians may face as high as $229,000 of state level estate taxes on a $3.5M estate.). As a general rule, for New York ($1M exemption) and NJ, the state level estate tax is ROUGHLY 10% of the excess above the state estate tax exemption. Other states that have decoupled have other rules and rates.

For a married couple with a federally taxable estate, the state estate tax is something that has to be swallowed to take advantage of fully funding a credit shelter trust – at which point the state level estate tax will be due after the death of the first spouse – to do otherwise would be to waste the first spouse's federal estate tax exemption.

The unwary advisor who sells an insurance policy outside of a trust may be contributing to a state level estate tax – while the same advisor would hopefully know to structure a new policy used to pay federal estate taxes inside of an Irrevocable Life Insurance Trust (ILIT), the same advisor may completely miss the ball on the state level estate tax. The question of whether to fund an ILIT for a state taxable estate versus when there is a federal concern is one that should be explored by the advisor, estate planner, and hopefully the client's accountant.

When faced with a potential estate tax of the numbers above, many clients (and advisors) will opt for the relatively low cost of insurance of that amount, and the cost to implement via an ILIT – even permanent insurance of $100,000 is substantially less expensive than insurance to protect against Federal Estate taxes, and as several pontiffs have stated, the costs against estate taxes are not actually costs, but investments – is it worth a thousand or two for a trust and a fraction of the $100k for the benefit of saving the beneficiaries $100k or more? That is a decision a family must decide, but it may well be a far better return on the dollar than other investments – and far better than the returns in a declining stock market! Further, even for affluent, and following federal tax planning, a policy held in an ILIT for state estate taxes bring necessary liquidity and certainty without the need to sell income producing assets to raise funds to cover state level estate taxes.

The draftsperson must be aware of the client in or neighboring a decoupled state if there is a chance the client will relocate and be subject to state estate taxes – the undersigned routinely prefers drafting with the Clayton Election to provide maximum disclaimer planning and flexibility which can encompass state estate tax disclaimers; other colleagues prefer multiple trusts including QTIP trusts which can then be treated as a marital or bypass trust.

As an absolutely honest true anecdote, earlier today (yes, the date of drafting this article) the undersigned received a phone call from an insurance/investment advisor he met last Thursday (today is the following Monday) – among other things on the call, he mentioned words to the effect of, “you’ve convinced me of the need for planning for state level estate taxes.” – the advisor, technically savvy, devoted most of his time to asset management, and had not given much thought to state level estate taxes. Now, as a “value added” service, he can speak with his clients and ensure (and possibly insure) their protection against state level taxes that otherwise would have hit.

Space concerns prohibit a larger treatment, but in conclusion the practitioners must be aware of the state level estate tax – while it can bite the backside of an unwary client, it can be dealt with via appropriate drafting, possibly including an Irrevocable Trust and an insurance policy within to handle the tax hit.

Gary B. Garland, Esq. practices in New York and New Jersey. He is the author of the CPA’s Guide to Life Insurance and CPA’s Guide to Federal and Estate Gift Taxation. He is also the creator of the Maturity Trust℠ and Toggle Trust℠ and has written for CCH’s Journal of Practical Estate Planning. He can be reached via gary@estateattorney.info.