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YOUR MONEY

## Cold Facts About Estate Taxes

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Wealth Matters

By PAUL SULLIVAN

For most of the United States, the estate tax is now something only the very wealthy have to plan for. The federal exemption for an individual this year is now \$5.34 million, or \$10.68 million for a married couple. And that amount is indexed to inflation, so it will continue to rise.

The exception is in the 16 states, mostly in the North, where state estate taxes remain and ensnare middle- and upper-middle-class residents — the very people the high federal exemption was supposed to protect.

The worst for taxpayers is New Jersey, with the lowest exemption in the country, \$675,000 per person, and a rate that tops out at 16 percent. (Rhode Island is second.) New Jersey also has an inheritance tax — for bequests to, say, a niece or friend — which starts to be applied at \$500. The rate is 15 percent until the amount reaches \$700,000 and then it rises to 16 percent. (One concession: The estate pays the higher of the two taxes, not both.)

This week, New York's governor, Andrew M. Cuomo, took a step toward bringing the state's estate tax in line with the federal one. And he is not alone among governors of cold-weather states (along with the District of Columbia) that have realized affluent residents are moving to states without estate taxes (and in some cases, income taxes) and in doing so, depriving their old state of the other taxes they paid, like property, sales and income tax.

"We have a lot of people moving out of these jurisdictions to avoid the state estate tax entirely," said Samuel Weiner, co-chairman of the tax, trusts and estates department at Cole Schotz, which has offices in New York and New Jersey. "I have

people all over Florida. We even wrote a book on how to establish a residency in Florida.”

New York’s current exemption is \$1 million per person with a top rate of 16 percent. Governor Cuomo proposed raising the exemption to \$5.25 million by 2019, index that to inflation and lower the top rate to 10 percent. (That tax is still in addition to the 40 percent federal estate tax rate.)

New York is not alone in re-evaluating this. Indiana repealed its inheritance tax, and Ohio ended its estate tax. Tennessee is in the process of phasing out its inheritance tax, and Maryland and the District of Columbia are reviewing their estate taxes.

“There is a strong possibility that the gap is going to be closed over a few years,” said Jamie C. Yesnowitz, a principal at Grant Thornton and chairman of the American Institute of Certified Public Accountant’s state and local tax technical resource panel. “Once some of these other states see New York and D.C. are doing this, I would find it unsurprising if some of these other states join the bandwagon.”

Until — or if — that happens, people who have more money than their state’s exemption but less than the federal exemption generally have three options: set up trusts to reduce or defer the tax, start making gifts to reduce the estate or move. All have complications and pitfalls.

Sharon L. Klein, managing director of family office services and wealth strategies at Wilmington Trust, said a married couple could set up a credit shelter trust for state estate taxes. When the first spouse dies, the amount of the state’s exemption would go into a trust. The remainder would pass free of tax to the surviving spouse and any additional tax owed would be assessed when that spouse died.

Such trusts were commonly used as the federal estate tax exemption rose over the past decade. What complicates this for state estate planning is that the legislation that set the federal estate tax exemption and rate last year included a provision, called portability, that allows surviving spouses to use their deceased spouses’ exemption even if they did not set up a credit shelter trust.

This means that a married couple today would have an exemption of \$10.68 million without much planning at all. Not so with states like New York and New Jersey that do not have portability.

In New Jersey, a couple with \$1.35 million would owe no estate tax when the first spouse died. If the second spouse died with that same amount, the estate would owe \$55,000 in New Jersey tax.

“It’s ironic because you’d think families with smaller estates don’t need a complicated estate plan,” said Laura A. Kelly, a partner at McCarter & English in Newark. “But these are the families that can least afford to pay the tax. If you have a credit shelter trust to get the New Jersey exemption, the surviving spouse can have access to it and get the rest.”

Whereas such estate planning is standard for people worth tens of millions of dollars, it is less common for affluent couples worth several million dollars because of the cost and time needed to set them up. But it is worth it.

Consider a couple in New York with \$5 million in assets. They would owe no federal estate tax. But what they would owe to New York would depend on their planning, said Ita M. Rahilly, a partner at the accounting firm Vanacore, DeBenedictus, DiGovanni & Weddell.

If each spouse had \$2.5 million in his or her name, \$1 million would go into a credit shelter trust upon death and the marginal estate tax rate on the remaining \$1.5 million would be 8 percent, she said. If the spouse who died second had all \$5 million in her name, that marginal rate would be 11.2 percent on the amount over the exemption.

“This requires a whole rethink,” Ms. Rahilly said.

One upside: People who bought life insurance to cover federal estate taxes could use that policy to pay state estate taxes.

Another option is to give away money while you are still alive. Only Connecticut and Minnesota have state gift taxes that are applied below the federal gift tax exemption, which is the same as the federal estate tax exemption. (This is separate from the annual gift exclusion of \$14,000.) Some states, however, consider gifts made close to death for estate tax purposes.

But when you give heirs a gift of, say, appreciated stock, you are also giving them all the unrealized gains the stock has from when you purchased it — known as your cost basis. When they sell that gift, they are going to have to pay capital gains on it.

This is where people need to make a calculation. Depending on the recipient’s tax bracket, that rate could be lower than the state estate tax or it could be much

higher. (When someone dies, the cost basis goes to what it was on the date of death, called a step-up in basis, and essentially erases all of the embedded gains.)

In Massachusetts, for example, anyone who received an asset with embedded gains and sold it would also be subject to the state's 5 percent capital gains tax, which is on top of the federal rates, said Beth C. Gamel, managing director at Argent Wealth Management. A person in the highest tax bracket for capital gains and subject to the 3.8 percent Medicare tax would pay a capital-gains tax of 28.8 percent on that asset. The highest rate for Massachusetts's estate tax is 16 percent, with an exemption of \$1 million.

Ms. Gamel added that Massachusetts, unlike many other states and the federal government, allowed people to make large gifts on their deathbed and not have those assets counted for estate tax. This kind of gifting would work if the person had a lot of cash to give. It would also work if the recipient was in a lower tax bracket in a state like New Hampshire, which doesn't have its own capital gains tax.

None of this is terribly difficult for experts to figure out, but it is time-consuming and requires paying lawyers and accountants for advice. The headache factor is high, particularly when in most states a simple will would do the trick for federal estate taxes. For those dispirited by this, Mr. Weiner of Cole Schotz had simple advice: "Move to Florida."

But the risk is that people won't really move: They will spend the winter there and the rest of the year at their home in the Northeast. For the move not to be challenged, they have to establish residency there, with proof like drivers' licenses, voter registration, country club memberships and church affiliations.

"People want to straddle this gray line," Mr. Yesnowitz of Grant Thornton said. "But states are looking for that. New York is a hotbed for that kind of litigation because of the stakes involved."

The trouble could be worth the tax savings — and warmer winters.