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Re: <u>Proposal to Reinstitute the Federal Credit for State Death Taxes</u>

Ladies and Gentlemen:

We write on behalf of the Committee on Estate and Gift Taxation of the New York City Bar Association to express our concern that the tax policy justifications for the federal "credit for state death taxes" have been overlooked in the recent federal estate tax debate. As the necessity for federal estate tax reform looms in the coming months, we would like to make the case for reinstituting the state death tax credit (as defined in section 2011 of the Internal Revenue Code).

Background

One of the changes to federal estate tax law made by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") was to scale back, and ultimately repeal as of 2005, the federal credit for state death taxes. Under prior law, section 2011 of the Internal Revenue Code provided a credit, up to a certain amount, against the federal estate tax for estate or inheritance taxes actually paid to a state or the District of Columbia.[1] In essence, the state death tax credit was a revenue-sharing arrangement between the federal government and the various states, and therefore did not increase the total amount of tax paid by the estate. Because of this, states gradually enacted "pick-up" or "sop" taxes to ensure that the state collected at least the amount of the federal credit; only a handful imposed a separate estate or inheritance tax on top of the pick-up tax. Consequently, for estate tax purposes, the state in which a person died generally did not matter.

As a result of EGTRRA, the maximum state death tax credit allowable against the federal estate tax was reduced by 25% in 2002, 50% in 2003, and 75% in 2004; in 2005, the credit was eliminated, and replaced by a state death tax deduction under section 2058 of the Code.[2] States that had enacted pick-up tax regimes to collect state death tax credit dollars saw their estate tax revenues reduced, and ultimately, eliminated as a direct result of the 2001 federal legislation. Twenty-six states are currently in that predicament, with the balance of the states generally having now "decoupled" from the federal law to avoid the loss of revenue.

As a result of the repeal of the state death tax credit, the state estate tax regimes are divided into two groups: (1) "coupled" states that now have no state estate tax; and (2) "decoupled" states that impose a state estate tax even though there is no longer a federal credit for such taxes. This schism means that where a person dies has a dramatic effect on the individual's potential estate tax. For example, if a widow domiciled in New York (a "decoupled" state) dies in 2009 with a taxable estate of $5 million, her estate will owe $391,600 in New York State estate tax. If the same widow instead dies as a Florida domiciliary, she will pay no state estate tax because Florida is a coupled state.[3]

Argument in Support of Reinstituting the Federal Credit for State Death Taxes

1. Historical Justification: Decrease Forum-Shopping

To make the case for reinstituting the state death tax credit, it is worth reviewing why it was instituted in the first place. The credit was preceded, of course, by the federal estate tax, which Congress enacted in 1916 (after a number of precursors) to meet its revenue needs following the entry of the United States into World War I, and to decrease concentrations of wealth; it has been with us ever since. When the estate tax was enacted, most states already imposed some form of estate or inheritance tax. Indeed, estate taxes were considered by some to be the province of the states, not the federal government, and there was concern that the federal

[1] This credit was equal to a percentage of the taxable estate reduced by $60,000.
[2] This deduction has had the effect of making state death tax laws less uniform – see the discussion on p. 3.
[3] The §2058 deduction for state death taxes mitigates the result somewhat by reducing the federal estate taxes owed by the widow's estate. Nevertheless, the aggregate estate tax burden of dying domiciled in New York is $215,380 more than it would be if the widow had died domiciled in Florida.

estate tax would diminish state tax revenues. A growing problem with the imposition of estate taxes at the state level, however, was the stark lack of uniformity among the state death tax regimes. This lack of uniformity provided incentives for wealthy people to "forum shop" for a good state in which to die, by moving in their old age to a state with little or no death tax.

The Revenue Act of 1924 addressed the forum shopping problem by allowing a credit against the federal estate tax for death taxes paid to the states. The credit, originally 25% of the federal estate tax, was later increased to 80% of the federal estate tax by the Revenue Act of 1926, and thereby greatly leveled the playing field among the states. In addition, the credit assuaged those states rankled by the federal intrusion on their tax base.

Unfortunately, as a direct result of EGTRRA and the repeal of the federal credit for state death taxes, forum shopping for a tax-free state in which to die is now very much an issue again.

2. Complexity, Uncertainty and Inequity in Planning

The havoc caused by the enactment of EGTRRA was cogently set forth in the *Report on Reform of Federal Wealth Transfer Taxes* (hereinafter, the "Report") prepared by the Task Force on Federal Wealth Transfer Taxes and submitted to Congress in 2004.[4] The purpose of the Report was to provide expert analysis of the changes effected by EGTRRA and to assess those changes on the basis of simplicity, compliance and consistency of enforcement. As a general matter, the Report does not consider policy questions. Rather, it identifies issues and then suggests various options that Congress might consider without making recommendations.

With respect to EGTRRA's elimination of the state death tax credit, the Report notes, "[t]he operation of the credit under prior law had the salutary effect of making state death tax laws more uniform, reducing the administrative burden on states to collect and enforce state death taxes, and minimizing taxpayer compliance costs."[5] The Report goes on to describe the problems faced by taxpayers trying to engage in estate planning in an environment of uncertain tax laws.

In a non-conforming or decoupled state like New York, married couples are now forced "to decide whether to reduce their federal estate taxes by taking advantage of increases in the federal applicable exclusion amount and, thereby, potentially pay more state taxes, or to increase their marital deduction bequests to avoid state taxes and, thereby, potentially pay more federal estate taxes at the surviving spouse's death".[6] The burden caused by this "disconnect" between federal and state death taxes falls primarily on less affluent married couples, who must either forego the full benefit of the federal exclusion amount or pay a state estate tax when the first spouse dies. While more affluent couples can comfortably pay *state* estate tax at the first spouse's death, and thereby shelter more of the surviving spouse's estate from federal estate tax,

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[4] The Task Force comprised representatives from the American Bar Association's Section of Real Property, Probate and Trust Law, the American Bar Association's Section of Taxation, the American College of Tax Counsel, the American College of Trust and Estate Counsel, the American Bankers Association, and the American Institute of Certified Public Accountants.

[5] Report, at p. 8.

[6] Id. at 9.

less affluent couples may not have that luxury. Such inequity also undermines the principle that married couples are a "tax unity," and that no estate tax should be payable until both spouses have died.

3. Added Enforcement, Administrative and Compliance Costs

As stated above, the Report notes that the effect of the state death tax credit under prior law was to reduce the administrative burden on states to collect and enforce state death taxes and to reduce taxpayers' compliance costs.[7] That is, under prior law, "pick-up" tax states needed only minimal estate tax enforcement departments because they could rely on federal estate tax law to enforce and monitor the payment of state estate taxes. Proof of payment of the state estate tax was necessary to claim the federal credit. Now, however, each state with an estate tax will have to develop a separate system of administration, with its own auditors who will need to be educated on the separate state system. Moreover, separate state systems will each have separate returns, increasing compliance costs to the taxpayers.

4. Costs of Legislative Change

In addition to the planning uncertainties and costs mentioned above, the credit's elimination has caused many states to amend their state laws regarding estate taxes (sometimes more than once). The amendment process entails substantial costs and often adds further uncertainty to the planning process, especially where the state law is linked to the federal estate tax, as it most often is.

Solution

We propose reinstituting the state death tax credit at the federal level. It is our understanding that there has been little or no lobbying for such a change in the federal legislative bodies. That does not make the issue any less pressing, however: decoupled states like New York face growing resentment from taxpayers about a tax burden that exceeds that of many other states; and coupled states have watched their estate tax revenues dwindle to zero as they grapple with budget deficits. Reinstituting the federal credit will provide a cost-effective means of revenue-sharing between the federal and state governments, and will ease some of the current fiscal burden on the states. Any negative impact on the net federal revenues caused by the credit's reinstitution could be minimized by adjusting the rates applicable to the federal estate tax and the state death tax credit.

Conclusion

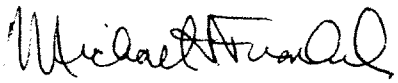
Prior to its disappearance in 2005, the state death tax credit had been part of the federal law for more than eighty years. In that time, it operated as an effective and efficient revenue-sharing arrangement between the federal government and the states. The initial justifications for the credit, including the elimination of forum shopping, still make good policy sense. The credit's loss means that states are faced with a daunting choice: either forego their estate tax revenues entirely, or maintain those revenues at the cost of increased administrative burdens and taxpayers decamping to states with no state estate tax.

[7] Report at p. 8.

The credit's elimination has spawned separate state estate tax laws and separate rules, returns and enforcement mechanisms. This is inefficient, costly and confusing for taxpayers, and creates additional burdens for states that do not necessarily translate to increased state revenue.

For these reasons, we urge the Administration and Congress to consider reinstituting the federal credit for state death taxes. We would be grateful for the opportunity to address any questions you may have and to discuss this proposal in more detail.

Respectfully,



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