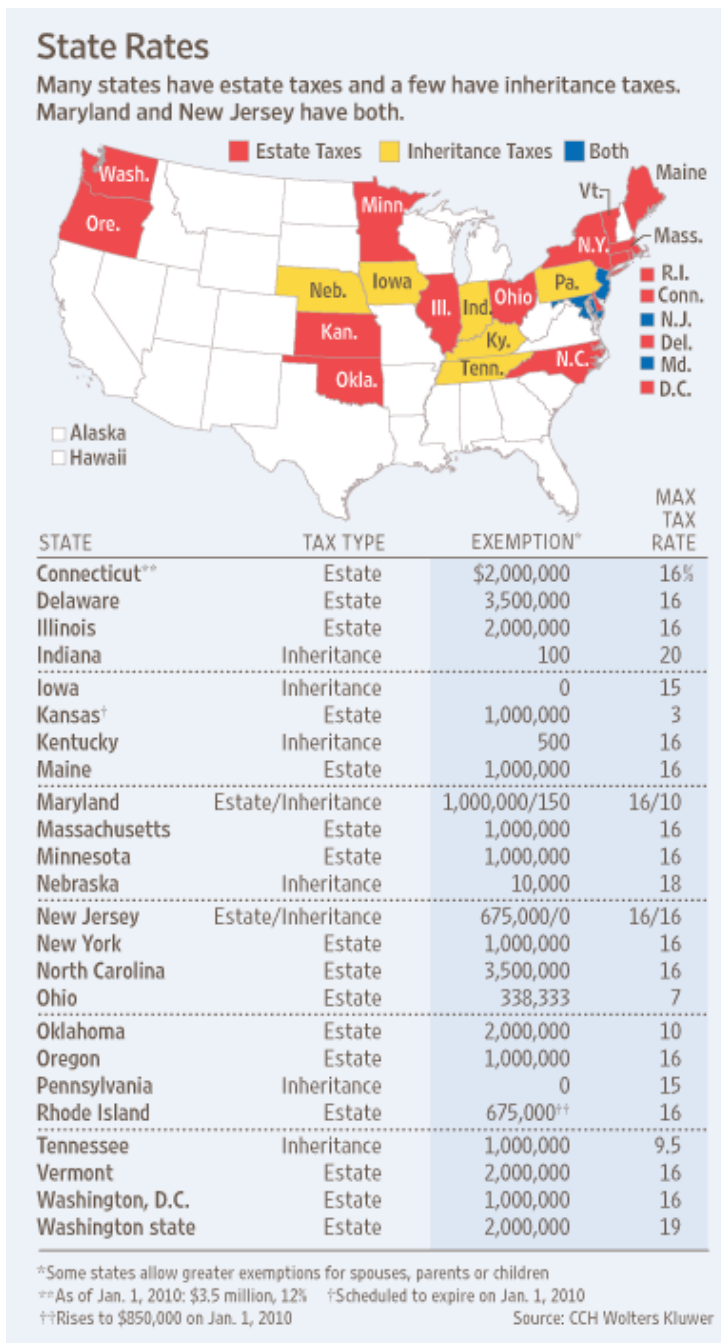


State Death Taxes Are the Latest Worry



With the federal estate tax disappearing for most people, state death taxes have emerged as a surprise new worry.

This year, the federal exemption rose to \$3.5 million per individual, or as much as \$7 million per married couple. At the current level, only 5,500 estates a year are federally taxable.

That is down from the 17,500 estates that would have faced death taxes under the previous \$2 million limit, the Urban-Brookings Tax Policy Center estimates.

The problem is that most states with estate or inheritance taxes haven't raised exemptions to match the federal limits. That means thousands of taxpayers who now escape the federal levy could still get hit with a state death tax.

As a result, tax advisers are tweaking bypass trusts that allow married couples to maximize exemptions from state taxes. They are advising taxpayers where to retire in order to pare or eliminate estate taxes. And they are counseling out-of-state taxpayers so that they don't get dinged for property they own in a state with a tough death tax.

"In the past, many people hardly gave state death taxes a thought," says veteran estate attorney Sidney Kess in New York. "Now they are shocked at how expensive mistakes can be."

Adding insult to injury, Congress is talking about eliminating the federal deduction for state estate taxes. That would affect only wealthy taxpayers whose estates still exceed \$3.5 million per individual.

Keeping track of the constantly changing landscape in state death taxes can be tricky. Delaware just added an estate tax this year, while the estate taxes in Kansas and Illinois are scheduled to disappear at the end of 2009.

Connecticut, meanwhile, will raise its exemption to \$3.5 million from \$2 million in January. There are only three states that have same exemption as the federal estate tax.

"States are in such dire straits that most without these taxes would like to have one, and nobody who has one will let it go," says David Brunori, a state tax expert with Tax Analysts in Falls Church, Va.

He believes that both Illinois and Kansas will end up retaining their taxes, even though they are supposed to go away at the end of the year. "They need the money."

Seventeen states and the District of Columbia currently impose estate taxes, according to CCH Wolters Kluwer. Eight states have inheritance taxes, which are levied on heirs, not estates. Maryland and New Jersey have both.

Compared to the uniform federal tax, state taxes are a crazy quilt. In many states with inheritance taxes, rates are tied to how closely the heir is related to the late donor. Iowa and Kentucky exempt both spouses and children who inherit property, while Nebraska treats only transfers to spouses as tax-free.

Rates and exemptions vary widely. Washington state's top tax rate is 19%, but it applies only to estates over \$2 million. Pennsylvania, by contrast, taxes children and grandchildren of an heir at an almost-flat rate of 4.5%. More-distant heirs pay up to 15%.

Advisers say taxpayers are most likely to be tripped up by states that used to conform to the federal exemption but haven't raised it at the same rate.

As a result, married couples in states with lower exemptions -- such as New York, Oregon, Minnesota and Massachusetts (all \$1 million) or Illinois (\$2 million) -- are setting up "bypass" trusts in wills even if they no longer need them for federal taxes.

Here's how bypass trusts work: At the death of the first spouse, assets go into a trust that the survivor can draw on if necessary. When the second spouse dies, the remaining assets in the bypass trust pass tax-free to heirs, preserving the value of both individual exemptions.

Put another way, if a married couple lives in a state with a \$1 million individual exemption, a bypass trust would let them to pass as much as \$2 million tax-free to heirs.

"Without the proper trusts," says Eric Hager, an attorney at Davidson, Dawson & Clark in New York, "a couple in New York with \$2 million in assets might pay an unnecessary \$100,000."

Others warn that even taxpayers who live in states without estate taxes, such as Florida or California, risk unpleasant surprises if they also own property in a state that does have one.

The issue is figuring out the "domicile" of a taxpayer. Domicile is a much broader idea than the mere residency test that often determines where someone pays income tax.

Although one determinant of domicile is the amount of time spent in a state, it also may look at where a taxpayer votes, has church and club memberships, registers a car or even has a burial plot.

This means that a taxpayer could live in estate-tax-free Florida, California or Texas and even spend most of his time there. But if he keeps an apartment in New York or a summer home on Cape Cod and has other ties to the area, he might be considered to be domiciled there.

"The issue of domicile used to come up only once in a blue moon," says Daniel Daniels, an attorney at Wiggin & Dana in Stamford, Conn. "Now we have to think about it all the time."

In the worst case, a taxpayer could be domiciled in more than one state and owe taxes to each. There is a famous precedent: After the 1930 death of Campbell Soup magnate John Dorrance, both New Jersey and Pennsylvania claimed he was domiciled there. Each billed his estate about \$15 million.

Twice, the U.S. Supreme Court refused to break the deadlock. After a six-year battle, the Dorrance estate paid tax to both states.

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