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White Paper

Understanding State Death Taxes

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Understanding State Death Taxes

What are state death taxes?

Just as the federal government can impose a federal estate tax, the individual states can impose a state estate tax. Estate taxes are imposed when property is transferred because of the property owner's death. State estate taxes are called "death taxes" because there are three types of estate tax that can be imposed: (1) an inheritance or succession tax, (2) an estate tax, or (3) a credit estate tax, also called a sponge tax or pickup tax (each type is discussed further below). All 50 states (including the District of Columbia) impose death taxes; some states impose one type only and the other states impose two. You need to be aware of state death taxes because they could be a significant liability to your estate.

Generally, states may impose state death taxes on certain property in your estate if (1) you are domiciled in that state, or (2) property you own at the time of your death is located in that state. The state in which your real estate and tangible personal property (e.g., cash, insurance proceeds, cars, furnishings, jewelry, or art objects) are located may impose state death taxes on that property. The state in which you are domiciled also may impose state death taxes on your intangible personal property (e.g., copyrights, patents, stocks, bonds, or notes).

Technical Note: "Domicile" is a legal term. It refers to the state in which you have a permanently established residence and intend for that residence to be your permanent home. It is not a mere residence (e.g., a summer home or temporary move).

Example(s): Harriet lives in New York most of the year, but she also owns a condo in Florida, where she lives during the winter. Harriet also owns a car and has \$100,000 in mutual funds in New York, \$90,000 in a New York bank, and \$25,000 in a Florida bank. Harriet dies. New York, Harriet's domicile, has the right to levy state death taxes on Harriet's New York home, furnishings, car, \$100,000 in mutual funds, and \$90,000 bank account. Florida has the right to levy state death taxes on Harriet's Florida condo, furnishings, and \$25,000 bank account.

Caution: State death tax liabilities can result in multiple states if you have any of the following situations: (1) multiple residences, (2) a business incorporated in a non-domiciliary state, (3) a company doing business in a non-domiciliary state, or (4) nonresident trusts.

Tip: Currently, Connecticut, Louisiana, North Carolina, Tennessee, and Puerto Rico impose a gift tax (tax imposed on transfers of property made during life) and some states impose a generation-skipping transfer tax (an additional tax imposed on transfers to persons who are more than one generation below you). Contact an attorney or your state's department of revenue or taxation to find out what is subject to these taxes, and when and how to file a return.

What is a state estate tax?

A state estate tax works much like the federal estate tax; it is imposed on your net taxable estate, which is the value of your property minus certain exclusions and deductions.

How is a state estate tax computed?

Determine the gross estate

Property subject to estate tax is called the gross estate. What is includable in the gross estate and how it is valued depends on the law in your state.

The gross estate generally includes both probate and non-probate assets, along with other property interests, such as life insurance and annuity death benefits, annuity contracts, other interests in property, certain transfers made within three years of death, transfers effective at death, and property over which the decedent held a general power of appointment. Please note that the above list is just to provide examples of what types of property may be subject to estate tax. You must contact a tax attorney or your state's department of revenue or taxation to find out exactly what property your state taxes.

Valuation of property is determined by state law, but is generally the property's fair market value on the date of death. Some states, but not all, follow the methods established by the IRS for federal estate tax purposes. Contact an attorney or your state's department of revenue or taxation to find out how to value property in your gross estate.

Subtract allowable exclusions and deductions

Exclusions and deductions allowed vary from state to state. Generally, charitable gifts, a family allowance, claims against the probate estate, federal estate taxes if any, marital bequests, and previously taxed property may be deducted in whole or in part from your gross estate. The result is your net taxable estate. Contact an attorney or your state's department of revenue or taxation to find out what exclusions and deductions are allowed.

Compute the tax by multiplying the appropriate tax rate by the net taxable estate

State law determines the appropriate estate tax rate. Multiply the rate by the net taxable estate. The result is the tentative tax.

Subtract any allowable credits

State law determines allowable credits. Subtract the allowable credits from the tentative tax. The result is your net tax owed. Contact an attorney or your state's department of revenue or taxation to find out what credits are allowed.

Example(s): Terry, who lives and owns property in a state that imposes an estate tax, dies. His gross estate is valued at \$700,000 (calculated according to state law), and a flat exemption of \$500,000 is allowed. Terry's other allowable deductions amount to \$150,000. Terry's net taxable estate is \$50,000 ($\$700,000 - \$500,000 - \$150,000$). The tax rate according to Terry's state's tax table is 5 percent. Terry's tentative tax is \$2,500 ($\$50,000 \times .05$). Terry's state allows a 10 percent discount for prompt payment. Terry's personal representative pays the net tax owed of \$2,250 ($\$2,500 - (\$2,500 \times .10)$).

What is a state inheritance or succession tax?

Some states impose an inheritance tax, also called a succession tax. Unlike the estate tax, inheritance tax is imposed on your beneficiaries' rights to receive property. It is imposed on each heir's share of your estate and is determined according to her or his relationship to you. Although inheritance tax is due on each heir's share of your estate, it's commonly your personal representative who writes the check from your estate to pay it.

How is inheritance tax computed?

The inheritance tax calculation is more complex than the estate tax calculation, although the first two steps are the same.

Determine the property subject to tax

Property subject to inheritance tax is called the gross estate. What is includable in the gross estate and how it is valued depends on the law in your state. The gross estate generally includes both probate and non-probate assets, along with other property interests, such as life insurance and annuity death benefits, annuity contracts, other interests in property, gifts made in contemplation of death (generally within three years of death), transfers effective at death, and powers of appointment. Please note that the preceding list is just to provide examples of what types of property may be subject to inheritance tax. You must contact a tax attorney or your state's department of revenue or taxation to find out exactly what property your state taxes.

Valuation of property is determined by state law, but is generally its fair market value on the date of death. Some states, but not all, follow the methods established by the IRS for federal estate tax purposes. Contact an attorney or your state's department of revenue or taxation to find out how to value property in your gross estate.

Caution: Some states that impose inheritance tax require that the federal valuation be used if such valuation turns out to be higher than the state valuation.

Subtract allowable exclusions and deductions

Exclusions and deductions allowed vary from state to state. Generally, charitable gifts, a family allowance, claims against the probate estate, marital bequests, and previously taxed property are allowed to be deducted from your gross estate. Unlike the estate tax, a flat exemption is usually not allowed, nor is a deduction for federal estate taxes. The result is the net taxable estate. Contact an attorney or your state's department of revenue or taxation to find out what exclusions and deductions are allowed.

Allocate shares to beneficiaries

You must divide the net taxable estate into the shares each beneficiary is entitled to receive.

Group beneficiaries into classes

Beneficiaries are classified and taxed according to their degree of relationship to you. Generally, spouses, lineal descendants, and lineal ancestors are grouped together and allowed the greatest exemption. Siblings and descendants of siblings are generally grouped at a lesser allowable exemption. All others are combined in another group at the least allowable exemption.

For example, a state's classification system may look like this:

Class	Amount of Exemption
A-Spouse, Lineal descendants, Lineal ancestors	\$50,000, \$10,000 each, and \$6,000 each
B-Brothers, sisters, and descendants thereof	\$1,000 each
C-All others	\$500 each

Calculate tax on each share

Calculate the inheritance tax using the appropriate rate. Inheritance tax rates generally vary according to both the size of the inheritance and the classification of the beneficiary.

A typical inheritance tax rate schedule might look like this:

Class A			
Shares in excess of exemption, from	Shares in excess of exemption, to	Tax on column 1	Rate on excess
\$0	\$25,000	\$0	1%
\$25,000	\$50,000	\$250	2%
\$50,000	\$200,000	\$750	3%
\$200,000	\$300,000	\$5,250	4%
Class B			
Shares in excess of exemption, from	Shares in excess of exemption, to	Tax on column 1	Rate on excess
\$0	\$100,000	\$0	7%
\$100,000	\$500,000	\$7,000	10%
\$500,000	\$1,000,000	\$47,000	12%
\$1,000,000	balance	\$107,000	15%
Class C			
Shares in excess of exemption, from	Shares in excess of exemption, to	Tax on column 1	Rate on excess
\$0	\$100,000	\$0	10%
\$100,000	\$1,000,000	\$10,000	15%
\$1,000,000	balance	\$45,000	20%

Determine total tax

Add the taxes on the individual shares to arrive at the total inheritance tax due.

Example(s): Estelle dies, leaving a net taxable estate valued at \$376,000 (according to state law). Estelle leaves \$250,000 to her husband, Marvin, \$35,000 to each of her children, Beatrice and Agnes, and \$56,000 to her mother, Wanda. Estelle's estate owes inheritance tax in the amount of \$6,500, calculated as follows (using the preceding tables):

A	B	C	D
Adjusted taxable estate, equal to or more than	Adjusted taxable estate, less than	Credit on amount in column A	Rates of credit on excess over amount in column A
\$40,000	\$90,000	\$0	0.8%
\$90,000	\$140,000	\$400	1.6%
\$140,000	\$240,000	\$1,200	2.4%
\$240,000	\$440,000	\$3,600	3.2%
\$440,000	\$640,000	\$10,000	4.0%

What is a state credit estate tax?

A credit estate tax (also referred to as a sponge tax or pickup tax) is a device that was created to divert federal estate taxes to the state by taking advantage of the federal credit allowed for state death taxes paid (the "state death tax credit"). A state that imposes a credit estate tax imposes a tax in the amount that is exactly equal to the state death tax credit allowable in the year of the decedent's death. This revenue-sharing device was created to relieve taxpayers from the burden of double taxation. However, in 2001, President Bush signed the Economic Growth and Tax Relief Reconciliation Act (the 2001 Tax Act) into law. Among other things, the 2001 Tax Act phased out the state death tax credit, reducing the credit over three years, and then fully repealing the credit in 2005. For the estates of persons dying in 2005 and thereafter, there is no state death tax credit, although a deduction is available. Faced with losing their estate tax revenue, most of the states that imposed a credit estate tax have restructured their tax systems. Generally, those states that kept their credit estate tax systems impose a tax that is based on the state death tax credit that was allowable under the federal law that was in existence prior to the credit's reduction and repeal.

How is a credit estate tax computed?

Calculate the value of your net taxable estate for federal estate tax purposes

Determine your net taxable estate for federal estate tax purposes. This figure is your adjusted gross taxable estate minus exclusions and deductions.

Subtract \$60,000

Subtract \$60,000 from your net taxable estate. The result is your adjusted taxable estate. A state death tax credit is or would have been allowed against adjusted taxable estates of \$40,000 or more.

Find the maximum state death credit allowed

Look up the amount of state death tax credit your estate is or would have been entitled to under the effective Maximum Credit Table for State Death Taxes, which is published by the IRS.

What else should you know about state death taxes?

When this debt must be paid varies from state to state. All states will impose late payment penalties and/or interest, so you should plan on adequate liquidity (ready cash) in your estate to meet this need.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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