

Probate & Trust Law Newsletter

A Publication of the Probate & Trust Law Section of the Minnesota State Bar Association

A Word From the Chair

After a long hiatus, the *Probate & Trust Law Newsletter* is again being published. The purpose of the newsletter is to serve as a medium through which the Probate & Trust Law Section and the Minnesota estate planning bar can communicate. It is anticipated that the newsletter will be published semi-annually, once in the winter and once in the summer, and that the newsletter will consist of articles on legal developments and legislative updates, announcements of Section activities and events, and information regarding Section contacts. We welcome your comments and the submission of articles or announcements for future newsletters.

Important Numbers for 2005

<u>Federal Estate/GST Tax Exemption</u>	\$1,500,000
<u>Federal Gift Tax Exemption</u>	\$1,000,000
<u>Minnesota Estate Tax Exemption</u>	\$950,000
<u>Annual Gift Tax Exclusion</u>	\$11,000
<u>Maximum Federal Gift/Estate Tax Rate</u>	47%
<u>GST Tax Rate</u>	47%
<u>Maximum Minnesota Estate Tax Rate</u>	16%
<u>Maximum Federal Income Tax Rate</u>	35%

The Unintended Consequences of Decoupling

(Peter S. Hatinen)

In 2001, the United States Congress passed and the President signed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA). EGTRRA gradually reduces marginal estate tax rates, increases the applicable credit amount, and

phases out the credit for state estate taxes and replaces it with a deduction for such taxes.

The Minnesota Department of Revenue recently convened an *ad hoc* committee to examine the effects of EGTRRA and the decoupling of the Minnesota estate tax from the federal estate tax. The committee includes Section Council member, Dale J. Schoonover, and former Section Council chair, Terry L. Slye. Among the issues being considered are the apparently circular calculation necessary to determine the Minnesota estate tax liability for decedents dying in 2005 and thereafter and the consequences of the increasing difference between the Minnesota and federal estate tax exemptions.

Circularity

Because Minnesota's estate tax was calculated based upon the federal credit for state estate taxes, the phase out of the state estate tax credit under EGTRRA would have effectively eliminated the Minnesota estate tax. Recognizing this, the Minnesota Legislature amended Minnesota Statutes § 291.03, subdivision 1 to provide that the Minnesota estate tax is calculated based upon the federal credit as it existed on December 31, 2000.

As amended, Minnesota Statutes § 291.03, subdivision 1 provides that the Minnesota estate tax is the "amount equal to the proportion of the maximum credit computed under section 2011 of the Internal Revenue Code, as amended through December 31, 2000, for state death taxes as the Minnesota gross estate bears to the value of the federal gross estate."

Minnesota Statutes § 291.005, subdivision 1 defines federal gross estate as "the gross estate of a decedent as valued and otherwise determined for federal estate tax purposes by federal taxing authorities pursuant to the provisions of the Internal Revenue Code," and it defines the Minnesota gross estate as "the

federal gross estate of a decedent after (a) excluding therefrom any property included therein which has its situs outside Minnesota, and (b) including therein any property omitted from the federal gross estate which is includable therein, has its situs in Minnesota, and was not disclosed to federal taxing authorities.” Curiously, Minnesota Statutes § 291.005, subdivision 1 defines Internal Revenue Code (IRC) as the IRC as amended through December 31, 2002, and thus incorporates the EGTRRA amendments.

EGTRRA eliminates the credit for state estate taxes and replaces it with a deduction for state estate taxes in 2005. Under present Minnesota law, this shift from a credit to a deduction at the federal level may lead to a circular calculation when determining Minnesota estate taxes for decedents dying in 2005 because a decedent’s Minnesota estate tax liability is based upon the decedent’s federal taxable estate, which is the decedent’s gross estate reduced by, among other things, state estate taxes.

Minnesota Statutes § 291.03, subdivision 1 bases the Minnesota estate tax on IRC § 2011 as it existed on December 31, 2000. At that time, IRC § 2011 based the credit for state estate taxes upon a decedent’s adjusted taxable estate, which is defined as the decedent’s taxable estate reduced by \$60,000. IRC § 2051, in turn, defines the decedent’s taxable estate as the gross estate reduced by certain deductions.

Beginning in 2005, the reference in IRC § 2051 to deductions becomes problematic because IRC § 2058 provides for a deduction for state estate taxes for decedents dying after December 31, 2004. Therefore, under IRC § 2051, a decedent’s “taxable estate” is the gross estate reduced by various deductions, including state estate taxes. However, the calculation of Minnesota estate taxes is dependent upon the IRC § 2051 definition of the decedent’s taxable estate. Thus, the computation becomes circular for decedent’s dying in 2005 or thereafter. In short, it appears that Minnesota estate taxes are based upon a decedent’s federal taxable estate which, in turn, depends upon knowing the amount of any state estate taxes.

Minnesota Statutes § 291.03 clearly makes reference to IRC § 2011 as it existed on December 31, 2000. However, Minnesota Statutes § 291.005, subdivision 1(8) provides that, unless the context clearly requires otherwise, references to the IRC mean the IRC as amended through December 31, 2002, thereby incorporating the EGTRRA amendments and creating the ambiguity regarding possible circular calculations for the Minnesota estate tax liability of decedents dying after December 31, 2004. If Minnesota Statutes § 291.03 limited references to the IRC to the IRC as it existed on December 31, 2000, the circular calculation triggered by the IRC § 2058 deduction could be avoided. If that is what the Minnesota Legislature intended, it has been suggested that the Legislature ought to codify IRC § 2011 (as it existed on December 31, 2000) as a tax table along with a definition of “adjusted taxable estate” that excludes the IRC § 2058 deduction. If these simple steps were taken, determining a decedent’s Minnesota estate tax liability would not result in a circular calculation.

The Minnesota and Federal Estate Tax Exemption Gap

Another, perhaps more obvious, byproduct of the decoupling of the Minnesota and federal estate taxes is the divergence of the Minnesota and federal estate tax exemption amounts. This year, the Minnesota exemption amount is \$950,000 and the federal exemption amount is \$1,500,000. In 2009, the Minnesota exemption amount will be \$1,000,000 and the federal exemption amount will be \$3,500,000.

The spread between the Minnesota and federal exemption amounts, combined with the fact that there is no state statute or administrative decision permitting a personal representative to make an independent qualified terminable interest property (QTIP) election for Minnesota purposes, puts Minnesota taxpayers in a difficult tax planning position.

Taxpayers generally seek to make optimal use of their exemptions from estate taxes. Thus, prior to the enactment of EGTRRA, a common estate

planning technique for a married person was to fund a credit shelter trust with an amount equal to his or her federal estate tax exemption and to distribute the balance to his or her surviving spouse (or fund a QTIP trust with such balance). Such a plan resulted in taking full advantage of each spouse's federal estate tax exemption and deferring the payment of estate taxes until the second death, at which time estate taxes were payable to the extent that the second spouse's assets (and any assets in a QTIP trust for his or her benefit) exceeded his or her federal estate tax exemption. The decoupling of the Minnesota and federal estate taxes has complicated such planning.

The widening gap between the Minnesota and federal estate tax exemptions is now forcing Minnesota taxpayers to make unnecessarily difficult tax planning decisions. If they seek to take full advantage of their federal estate tax exemptions and fund their credit trusts up to the federal exemption amount, they must pay Minnesota estate tax on the difference between the federal and Minnesota exemption amounts. In 2005, the difference is \$550,000 and the tax is \$64,400. In 2009, the difference will be \$2,500,000 and the tax will be \$229,200. Alternatively, if taxpayers limit the funding of their credit shelter trusts to the Minnesota exemption amount, they avoid Minnesota estate taxes at the first death, but they waste a portion of their federal exemptions and risk future federal estate taxation on the difference between the Minnesota and federal exemption amount

If Minnesota permitted personal representatives to make different QTIP elections for Minnesota and federal estate tax purposes, this problem could be resolved. Some of the states that have decoupled their estate taxes from the federal estate tax have passed legislation or issued administrative decisions that authorize independent state QTIP elections. In practice, state QTIP elections work as follows: At the first spouse's death, a credit shelter trust is funded with the state estate tax exemption amount and a marital deduction trust is funded with the balance of the estate. For state estate tax purposes, the personal representative files a QTIP election as to the whole marital trust, and

for federal estate tax purposes, the personal representative files a QTIP election over a portion of the marital trust assets equal to the amount by which the federal estate tax exemption exceeds the state estate tax exemption. Thus, the decedents are each able to use their full state and federal estate tax exemptions without paying any estate tax at the first death.

If the Minnesota Legislature passed legislation permitting a Minnesota QTIP election, it would provide taxpayers with a greater degree of certainty and flexibility with respect to estate taxes. Doing so, however, would clearly cost the state some revenue. The Department of Revenue is currently studying the revenue effects of permitting a state QTIP election.

Members of the Probate & Trust Law Section with questions or comments on these or related issues are invited to contact Dale J. Schoonover or Terry L. Slye.

Save the Date

The 2005 Probate & Trust Law Section Conference has been scheduled for June 9 and 10 at the Minneapolis Convention Center.

Probate & Trust Section Council Meeting Dates

The Council is scheduled to meet on the following days:

February 17, 2005	April 21, 2005
March 17, 2005	May 19, 2005

All meetings begin at 3:30 and are held at the Minnesota State Bar Association Offices Boardroom at 600 Nicollet Mall in Minneapolis.

The Gene Daly Award

The Gene Daly Award is periodically conferred upon Section members who have made a strong, positive impact on the practice of estate planning in Minnesota. Former Section Council chair, Chris Hunt, was given the award in 2004. If you

would like to nominate someone for the award, please contact Andrea Breckner.

Probate & Trust Section Committees

Several Committees develop and implement various programs of the Probate & Trust Law Section. Volunteers interested in becoming involved in a committee are encouraged to contact the chair of the committee on which they wish to serve. Furthermore, volunteers willing to serve as the chair of the Federal Taxation committee, Greater Minnesota Involvement committee, or the Technology committee are encouraged to contact David J. Shannon. The Section committees and their chairs are as follows:

Education, Melinda K. Greer

Legislation, Mary E. Shearen and Robert A. McLeod

Newsletter, Peter S. Hatinen

Litigation Committee, Alan Silver

Federal Taxation, Open

Consumer Protection/Publications, Mavis J. Van Sambeek

Greater Minnesota Involvement, Open

Technology, Open

Gene Daly Award, Andrea Breckner

Ethics and Professional Responsibility, Susan J. Link

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