A R T I C L E

The Case of the Disappearing Inheritance Tax

By Dan W. Holbrook

Look for a new column, "Where There's a Will," in the *Tennessee Bar Journal,* beginning in January. The column, by Dan W. Holbrook, will be published every other month.

These are interesting times for estate planners.

Congress has repealed the gift and estate tax (with a nine-year phaseout), although President Clinton has vowed a veto, meaning any real reform will probably come only next year. Several states are actively recruiting trust business by, *inter alia*, abolishing the Rule Against Perpetuities, adopting an "optional" community property system, offering exemption from creditors for trusts created by foreigners ("on-shore trusts"), and even (horrors!) allowing domestic self-settled trusts to be exempt from claims of creditors. Several states, including Tennessee, now allow "income" to be whatever the Trustee says it is, analogous to asking what "is" is. The use of limited partnerships and LLCs has exploded in the estate planning context, with significant taxpayer victories in the courts offset by ever greater IRS determination to stanch the fiscal bleeding. Multidisciplinary practices (MDPs) seem just around the corner.

Midst all these other changes, it may surprise many to know that our Tennessee Inheritance Tax will soon disappear. No, the statute is not being repealed, it's just becoming obsolete.

Remember that in Tennessee there are really two "death" taxes: an "estate" tax and an "inheritance" tax, and the tax due at death is the greater of the two.

The estate tax is tied to the federal estate tax, which allows a credit for taxes paid to a state. No fools, the states all enacted taxes equal to whatever the federal credit allowed. The taxpayer pays no more total tax; Uncle Sam just shares part of the tax with the state. Even states that promote themselves as tax havens, such as Florida, have this "pickup" tax, to absorb the free money.

The inheritance tax, on the other hand, is a separate tax, with language similar to, but not identical to, the federal estate tax. It has a separate set of tax rates and exemptions. Tennessee is one of only about 14 states with a separate inheritance tax (and one of only four with a gift tax!).

So if the actual death tax paid is the greater of the two taxes, which one is greater? Easy to calculate, and the results are surprising. Tennessee inheritance tax rates begin on estates above the exemption (currently $675,000), while the federal credit is calculated beginning on the first dollar of estate. Therefore, for estates barely above the exemption, Tennessee's inheritance tax rates haven't had a chance to cause much tax, and the federal credit (the pickup tax) will be substantial. The inheritance tax rates are larger at that point, however, so with larger estates, the inheritance tax catches up and eventually becomes greater. But not forever. The rates for the federal credit finally grow beyond the inheritance tax rates, and eventually, the credit overtakes the inheritance tax again. A rough graph might look like the graph at right.

The two crossover points define the taxable "gap" during which the Tennessee inheritance tax

dominates over the federal credit. In other words, this is the "gap" over which an estate in Tennessee will pay more total death taxes than in states without an inheritance tax. From 1987 through 1997, the gap was from $1,193,549 to $5,624,000. So for those with very large estates, there was no advantage in moving to Florida. Those with moderately taxable estates were at a continuing disadvantage if they died in Tennessee.

In 1998, Congress increased the federal estate tax exemption, which had been $600,000 for many years, to $625,000 for 1998, $650,000 for 1999, etc., reaching $1 million by 2006 in a series of unevenly spaced increases. Tennessee amended the inheritance tax exemption to follow suit. The effect of these changes on the "gap" was surprising: the gap narrows as the exemption increases. And in the year 2006, like the Cheshire cat, it simply disappears.

So for those clients who expect to live beyond the year 2006, Tennessee will soon be a death-tax free state to live and die in, joining the growing number of states that have abolished their separate inheritance tax. On the other hand, one doubts whether the Department of Revenue intended this effect and willingly acquiesced. Perhaps it is time to consider repeal of the gift tax too?

Here are the future gaps, which will of course be subject to further revision if or when Congress really does modify our federal estate tax system:

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