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TAXES TAXES TAXES

What a year we are having. Congress is spending money like the proverbial drunken sailor to stimulate the national economy. Meanwhile the economic downturn has stretched state budgets to the limit.

In the face of the most difficult budget year within memory, the Rhode Island General Assembly somehow managed to up the Rhode Island estate tax exemption amount to \$850,000.

Now is an opportune time to take a look at what this change really means. We will also review the news and rumor from Washington regarding possible changes in store for the federal estate tax.

- **Rhode Island Estate Tax**

Since 2001 the Rhode Island estate tax exemption amount has been \$675,000. But on January 1, 2010, the exemption amount will rise to \$850,000. And in future years the exemption amount will be indexed for inflation based on the Consumer Price Index.

Rhode Island legislators and Governor Carcieri have touted the increase as an important first step in moving Rhode Island toward estate tax parity with Massachusetts which has an estate tax exemption amount of \$1,000,000.

Let's take a closer look at what upping the exemption amount really means. The most obvious winners are taxable estates which exceed \$675,000 but do not exceed \$850,000. Under present law, a taxable estate of \$850,000 would incur a Rhode Island estate tax of \$25,200. But under the new law, no Rhode Island estate tax will be due.

In addition to saving taxes, estates of up to \$850,000 will not have to file a Rhode Island estate tax return. An estate realizes a significant benefit if it can avoid the time and expense of having to prepare and file a return.

For taxable estates above the \$850,000 threshold, the tax benefit of the new law quickly fades away. For a taxable estate of \$900,000, the Rhode Island estate tax under present law is \$27,600, and under the new law the tax will be \$19,500. And for taxable estates of \$924,250 and up, the Rhode Island estate tax under present law and under the new law will be exactly the same.

How can this be? Just as a rising tide lifts all boats, our intuition tells us that a rising exemption amount should benefit all estates. But in this case intuition is wrong. In short, raising the exemption amount to \$850,000 brings welcome relief, but only for taxable estates in the window from \$675,000 to \$924,250.

- **Massachusetts Estate Tax**

One of the reasons given for raising the Rhode Island estate tax exemption amount was to narrow any perceived advantage Massachusetts might have in attracting businesses and jobs.

As noted above, “running the numbers” shows that the benefit from raising the Rhode Island exemption amount only benefits taxable estates in a narrow range, and there is no benefit for taxable estates in excess of \$924,250. Does the benefit of the \$1,000,000 Massachusetts exemption also disappear for larger estates? And if it does, at what level does this occur?

As it turns out, the benefit of the higher Massachusetts estate tax exemption amount does disappear for taxable estates of \$1,093,785 and up. A taxable estate of this size would generate an estate tax of \$38,452 under both Massachusetts and Rhode Island law, and for taxable estates in excess of this amount the marginal rate structure in the two states is identical, beginning at 5.6% and rising in modest increments until it tops out at 16% for taxable estates in excess of \$10,100,000.

Whatever you may think of the tax competitiveness argument, the estate tax laws of Rhode Island and Massachusetts have been in equilibrium for taxable estates of less than \$675,000 and more than \$1,100,000. Only for estates in the window was Massachusetts law more favorable. Next January the window will narrow.

- **Federal Estate Tax**

There is a general consensus among politicians, commentators and professionals that Congress must address the federal estate tax law this year.

Consider the following:

- For deaths in 2009 each decedent's estate is entitled to an exemption of \$3.5 Million with a top tax rate of 45%.
- In 2010, the federal estate tax is scheduled to be REPEALED! There will be no federal estate tax as such. The estate tax is supposed to be replaced by a complicated carry-over basis regime for large estates that promises to be an administrative nightmare for the public and the IRS alike.
- Then in 2011, the federal estate tax is scheduled to return with a vengeance. The law in effect in 2001 will be reinstated. This means an exemption amount of \$1.0 Million per person and a top tax rate of 55% for taxable estates over \$3.0 Million!

In short, we will move from high exemption/low rates, to no tax, to low exemption/high rates in the space of just over a year. It is enough to give the taxpaying public a bad case of "tax whiplash". Tax whiplash makes for unhappy taxpayers. Since unhappy taxpayers make unhappy voters, most commentators think Congress will act.

If Congress does act, what is it likely to do? On January 12, 2009 the Wall Street Journal predicted that we will see a "permanent" \$3.5 Million exemption and a top rate of 45% effective for 2010 and future years.

Since then the Journal's prediction has been confirmed by some significant legislative actions, *e.g.* a joint budget resolution passed in April directs Senate and House of Representatives conferees to use the above exemption amount (indexed for inflation) and rate in developing a budget for fiscal year 2010.

If Congress does pass such a law, President Obama is likely to sign it.

Stay tuned.