TRUSTS AND NONQUALIFIED ANNUITIES:

ine the annuity contract and understand the provisions of IRC §72 and, if applicable, the Connecticut Medicaid regulations and gift tax rules, before naming a trust as the owner or beneficiary of a nonqualified annuity. Only after discussing with the client the consequences of the ownership and beneficiary designation of each annuity can the estate plan capture the client's true intent regarding those annuities. Given the complexity of trusts and annuities, the estate planner must not close the file until assured that the client and his or her financial advisor have followed the recommended approach.

CONNECTICUT GOES ROGUE
BY ELIZABETH L. LEAMON

Remarkable for a state not generally considered tax friendly and all the more remarkable given the current economic and budgetary crises, Connecticut raised its estate and gift tax exemptions and lowered both sets of tax rates for decedents dying or gifts made on or after January 1, 2010. Once in effect, Connecticut will have one of the highest estate tax exemptions and lowest estate tax rates among its neighbors in the Northeast. It will also be entirely out of step with those states with an estate tax that adopted the old Federal state death tax credit table.

Although these changes may appear of little general interest, estate planners will likely witness an impact on (1) multi-jurisdictional estates, and (2) even broader implications for the entire system of states that de-coupled from the Federal system and have their own state estate tax. Indeed, Connecticut may have inadvertently begun the process of unraveling state taxation of estates. And if other states follow the Connecticut example, the once fairly harmonious division of estate taxation among the states may come unglued.

Effective January 1, 2010, Connecticut's gift and estate tax exemptions will rise from $2 million to $3.5 million.[1] Connecticut has also lowered estate tax rates by reworking the old Section 2011 state death tax credit or pick-up table. Connecticut, like many other states, adopted the Federal state death tax credit table in 2005 in setting the rates for Connecticut's estate tax. Connecticut's new estate tax table eliminates the tax of assets below the exemption amount, the so-called cliff, and reduces the base amounts and the percentages to use in calculating the tax. As compared to the 2009 version of the tax, which used the old pick-up tax table, the estate and gift tax rates have decreased by about 25% once an estate or aggregate Connecticut taxable gifts exceed the applicable exemption.

Interesting issues created by Connecticut's new estate tax table arise in the context of the multi-jurisdictional estate. For example, consider the effect of having a taxable Connecticut estate, 10% of which consists of real estate located in another state that uses the old pick-up tax table. Because Connecticut only allows a credit for taxes paid to other states equal to the lesser of (i) the actual tax paid or (ii) the fraction of the gross estate represented by the out-of-state property multiplied by the Connecticut tax, the tax imposed by the other state will exceed the credit allowed by Connecticut. Thus, the estate will have paid more in tax to a foreign jurisdiction than it receives in credit from Connecticut.

Conversely, a non-resident Connecticut estate will pay less than the allocation made by the domiciliary state to the Connecticut property. Subject to the constitutional issue discussed below, the domiciliary state will often only give a credit equal to the Connecticut tax paid. In that case, who gets the "windfall"— the estate or the domiciliary state?

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These simple examples illustrate the unintended consequences that occur when one or more states start to play by different rules. If a Connecticut resident has out-of-state real property located in a state that uses the old death tax credit table, he or she may be well advised to convert real estate into intangible personalty, say by transferring the property into a two or more member LLC; thereby coming under the more favorable Connecticut tax umbrella. However, a Rhode Island resident owning property in Connecticut with an estate over its new exemption of $850,000 and below $3.5 million, will want to do the opposite, because a non-resident Connecticut estate worth less than $3.5 million will pay no Connecticut tax. Going forward, we could see such out-of-state residents with larger estates and Connecticut real property consciously planning to have their Connecticut property taxed by Connecticut.

The repercussions of Connecticut's break from the old Section 2011 estate tax credit table will likely be felt by neighboring states on the eastern seaboard; namely, those states that de-coupled from the Federal system and have their own state estate tax. Looking at the statutes of certain eastern commercially important states with an estate tax, namely, Delaware, Massachusetts, New Jersey, New York and Rhode Island, these states all use the old Section 2011 state death tax credit table to compute their taxes.[2] Based on a review of the statutes only, a majority of the reviewed states follow the Connecticut pattern to compute the credit for out-of-state estate tax payments, namely, the lesser of (i) the actual tax paid or (ii) the fraction of the gross estate represented by the out-of-state property multiplied by the state death tax credit table. The exceptions are Rhode Island, whose statute only taxes in-state property, and New York whose statute invariably uses the state death tax credit table to compute the credit allocable to out-of-state property.

The statutory lack of fit poses a constitutional problem as well. The issue first arose in Connecticut in 2005-2006. The Connecticut Department of Revenue Services asked the Attorney General what to do about real or tangible personal property located in states like Florida that had no state estate tax. In an opinion issued on August 1, 2006, the Connecticut Attorney General agreed with the Department that Connecticut, as a matter of Federal constitutional law, could not impose a Connecticut tax on anything other than Connecticut real property and tangible personal property and intangible personal property owned by a Connecticut resident.[3] Hence, Connecticut would not seek to impose in effect a Connecticut tax on the Florida portion of the estate, and that property would escape taxation at the state level.

The question of disparate taxes and rates was never raised in the opinion and the problem seemed largely theoretical as long as every taxing state used the same table and rates. In much the same way as the now defunct credit worked, the taxes were allocated among the states in proportion to the property located therein.

However, beginning in a few short weeks, for anyone dealing with Connecticut, either from without or within, the problem has become quite real. The reasoning in the August 1, 2006 opinion ought to result in the windfall posited above inuring to the estate; otherwise, the domiciliary state will be imposing its tax on property over which it has no constitutional taxing jurisdiction. In practice, this seems to represent the general procedure.

Connecticut has never operated as a leader in tax reduction, and the notion that it would evolve into a tax haven, relatively speaking, probably boggles the mind of most Connecticut trust and estate lawyers. Consequently, it seems unlikely that this comparative tax advantage will remain long-lived. As other states adopt their own rates and exemptions, the existing crazy quilt of state taxation of estates appears headed for increased dysfunctionality. Whether Connecticut has inadvertently started the process of pacing off the last mile of state taxation of estates remains to be seen. One can reasonably anticipate that the issues raised above will become more complex as, in all likelihood, the economy picks up steam and more states compete by abandoning the old Section 2011 table in favor of greater freedom and creativity.

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1. Assume for the moment that the 2009 Federal estate exemption is extended by Congress, the Federal system and the Connecticut system would, putting prior taxable gifts to one side, become synchronized. And if Congress maintains the gift and estate tax exemptions at that level, the Federal and Connecticut systems would generally harmonize.

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2. Del. Code Title 30, § 1501 et seq.; Mass. Gen. Laws ch. 65C § 2A ;N.J. Stat. § 54:38-1; N.Y. Tax Law § 952; R.I. Gen. Laws § 44-22-1.1.

3. Formal Opinion 2006-018, Attorney General State of Connecticut.

About the author: Elizabeth L. Leamon is an associate at the Madison, Connecticut office of Murtha Cullina LLP, where she practices in the area of wealth management, including estate planning, estate settlement and probate litigation. Her e-mail address is eleamon@murthalaw.com.

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DEFALCATION
BY ANTHONY LUDOVICO

The State Judicial Department has expressed concern about the ongoing incidence of defalcations among attorneys who act as fiduciaries for client funds or property. The State Bar Association has asked the Estates and Probate Section's Executive Committee to consider the matter and to try to develop recommendations for measures that might curtail or prevent such defalcations from occurring. The request was received with a bit of caution that, should the Section not be able to come up with viable recommendations, the Judicial Department or the Bar Association, or both, might develop and impose rules or regulations of their own making. We are told that if such rules are imposed, they might very well include a requirement that all attorneys serving as fiduciaries register as such and, perhaps, provide a bond as prerequisite to serving in such capacity.

The Section's Executive Committee gave the matter its serious attention. No fewer than 10 attorneys volunteered to serve on a subcommittee on Integrity of the Practice and studied the issue for many months during which no fewer than 12 different suggestions were explored within the subcommittee. Throughout the deliberations, the subcommittee weighed the merits of each suggestion, all the while troubled, I think, with two thoughts: that not one of the many and good suggestions (including that of registration and bonding of attorneys) would likely prevent defalcations, and that the imposition of additional regulation by the broad brush painting of all attorney-fiduciaries (and only attorney-fiduciaries) as potential evil-doers would be an unfortunate commentary upon our chosen discipline .

Defalcation, embezzlement, is a crime. There seem to be at least five ways in which we, as attorneys, might respond to a charge that portrays us as suspect for criminal activity. We could, I suppose, heed the Miranda warning. We have the right to remain silent, to say nothing in response to the request that we assist in developing recommendations to resolve the crime. Yet, we are told that silence will gain us nothing but the likelihood of regulatory expense and tedium for the area of practice to which we have dedicated our life's work.

For those of us nearing the end of our practicing lives, silence may at first blush seem like an easy approach to the matter. Certainly, the frustration of developing recommendations without receiving some acknowledgment of their usefulness is enough to make one want to remain silent. But, such a posture of non-involvement, an uncaring lack of response is not at all viable for those newly setting out as T&E attorneys. They have a significant stake in the resolution of the issue. In truth, something in our calling suggests that silence is not an acceptable option for any of us. For, upon admission to the bar, we chose to uphold the standards of the profession and to strive to improve it.

The other end of the spectrum may also seem an attractive approach to the charge. We could, for example, stop by the supermarket on the way home, pick up an empty Ivory Snow soapbox, and stand on it to assert how pure we are, and how wrong the charge is that all attorney-fiduciaries are latent predators and must register like pedophiles, be shackled and bonded. We already pay into a Client Security