



Why the \$3.5 Million Federal Estate Tax Exemption Could Increase State Death Taxes

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Here is some good news for being a Michigander.

The Michigan estate tax is designed to absorb the federal estate tax credit for state death taxes. No additional estate tax is imposed in the State of Michigan.

Generally, each individual is allowed an exemption from the federal estate tax. That amount increased from \$2 million to \$3.5 million on January 1, 2009. This should be great news, but for some married couples, it could actually mean an increase in state death taxes.

Here's why:

Not only does the federal government impose an estate tax, but each state imposes some type of death tax as well. In order to avoid double taxation, the federal estate tax system used to allow a credit for state death taxes paid, which was calculated using a table, similar to the federal income tax tables. Many of the states imposed a state death tax equal to the federal credit that was allowed. In 2001, however, a law was passed that repealed the federal tax credit and replaced it with a deduction. In response, many states "decoupled" from the federal system, and began to impose a stand-alone death tax. Many of these states now only allow an exemption of \$1 million or less.

Many married couples plan their estates to postpone the payment of estate taxes until the death of the second spouse. For example, a couple's will might provide that an amount equal to the federal exemption passes to children (or first to a trust that benefits the surviving spouse), and the remainder passes to the surviving spouse free from estate taxes (both federal and state) under the unlimited marital deduction. This formula works fine as long as the federal exemption amount and the state exemption amount are the same. However, if the federal exemption amount is greater than the state exemption amount (as it is in 2009), the difference between the two may become subject to state death taxation.

Unless a married couple's estate plan has been updated, one or both estates may owe state death taxes even though one or both estates may pass free from federal estate tax. Deciding how to address this complication can be difficult. Your financial professional can help you understand your options.

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