HOUSE RESEARCH
Bill Summary

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Subject: Estate tax - allowing Minnesota QTIP elections

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Overview

This bill allows a Minnesota Qualified Terminable Interest Property (QTIP) election under the estate tax and clarifies that state death taxes (including the Minnesota estate tax itself) are not deductible in computing the Minnesota tax.

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1 **Definition of taxable estate.** Provides that state death taxes area not deducted from the gross estate in computing Minnesota estate taxes. Minnesota law indirectly defines the taxable estate by reference to computations under the federal estate tax. Starting for decedents dying after December 31, 2004, the federal tax will allow state death taxes to be deducted in computing the amount of the taxable estate. (This deduction replaces the federal credit for state death taxes.) This likely means that the Minnesota tax itself will be deductible in computing the tax base subject to Minnesota tax, essentially a circular computation. The bill resolves this by providing state death taxes are not taken into account in determining the taxable estate for Minnesota estate tax purposes.

QTIP. This section also allows a Minnesota QTIP election that differs from the federal election. This will allow electing differing state and federal amounts to qualify for the full exemption under both taxes.

Background information. As a result decoupling from the federal estate tax, Minnesota's exemption amount differs from the exemption under the federal estate tax. For decedents dying in the 2004, for example, the Minnesota exemption amount is $850,000 and the federal

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exemption is $1,500,000. These differences create difficult choices for married couples who are subject to the estate tax. A standard planning strategy for married couples is to fund a tax credit shelter trust up to the federal and state exemption amount on the death of the first spouse with the remainder of the estate passing to the surviving spouse and qualifying for the marital deduction. Before decoupling, this approach avoided both federal and state estate tax on the first death and avoided wasting any of the first spouse's exemption (which would have occurred if the whole estate simply passed to the surviving spouse). However, now the survivor must chose whether to avoid paying Minnesota tax by funding the family or credit shelter trust only up to the Minnesota exemption and, thereby, potentially "wasting" some of the federal exemption. This strategy may result in paying significantly higher federal tax on the death of the second spouse. The other option is to fund the family or credit shelter trust up to the federal exemption and pay higher Minnesota estate tax now, so that lower federal tax can be paid on the death of the second spouse.

QTIP trusts are a standard estate planning tool for married couples. They allow an election of the amount of the trust that will qualify for the marital deduction. The rest or non-elected part of the QTIP trust can be used to remove property from the estate of the surviving spouse for estate tax purposes, while still providing income to the surviving spouse and limiting to whom the property will ultimately go. By allowing a different QTIP amount for state and federal tax purposes, the full exemption amounts for both taxes can be claimed, while deferring tax under both taxes. As a general matter to be a QTIP, a trust must: (1) be the property of the decedent; (2) the surviving spouse must have a right to all of its income, payable at least annually, for life; (3) no one else may have a power of appointment over the property until the surviving spouse dies; (4) a QTIP election must be made; and (5) the surviving spouse's right to invade principal must satisfy IRS rules.

Effective date: Decedents dying after June 30, 2004.