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A Primer on the Massachusetts Estate Tax

By Harry S. Margolis

While very few estates are subject to a federal estate tax, which only applies to those exceeding $11.2 million (in 2018), many more are subject to the Massachusetts estate tax for which the threshold is $1 million. While the Massachusetts estate tax rate is not nearly as high as the federal rate, which is 40%, many clients still prefer to take steps to reduce or eliminate the estate tax their heirs will have to pay.

The Massachusetts estate tax rate starts at .8% of assets over $40,000 and goes up to 16% of assets over $10 million. The reader may well wonder why there's any tax on estates of $40,000 and above when estates of less than $1 million are not taxed. The answer is that once the tax is triggered, Massachusetts estates are taxed back to the first dollar. This will become relevant when we discuss methods of reducing the estate tax below.

The Amount

A few examples of Massachusetts estate taxes:

Size of Taxable Estate	Approximate Tax	Effective Rate
$400,000	$10,000	2.5%
$800,000	$25,000	3.125%
$1,000,000	$35,000	3.5%
$1,500,000	$70,000	4.7%
$2,000,000	$100,000	5.0%
$3,000,000	$180,000	6.0%

Interestingly, while the difference in the tax between an estate of $1.5 million and $1,000,001 million is about $35,000, reflecting a 7.2% marginal tax rate, reducing a $1.5 million estate to $999,999 saves approximately $70,000 in taxes if done correctly, meaning that the effective tax rate is really closer to 14%. The effect is event greater for estates closer to $1 million. A $1.2 million estate faces a tax of about $50,000, meaning that the effective tax rate on the $200,000 above the threshold is about 25%. In effect, this means that the balance over $1 million is taxed at a rate of 25%, even though the marginal rate is still only 7.2%, since reducing the value of the estate by $200,001 to bring it below the $1 million threshold would eliminate the tax entirely.

The Structure

To understand the Massachusetts estate tax, it helps to understand its structure. Like many other states, before the phase out of the federal estate tax enacted under President George W. Bush, Massachusetts pegged its tax to the amount permitted as a credit for state estate taxes under the federal estate tax. This way, estates did not owe more due to the state tax; it just diverted some of the taxes from the federal government to the state coffers.

When Congress voted to phase out the estate tax it also phased out the state estate tax credit. The result for many states was a significant loss of revenue, even though the states had made no change in their own tax laws. Massachusetts chose to prevent this loss of revenue by freezing its estate tax as it was in 2001. As a result, in order to determine the federal tax credit available then, executors today must complete a 2001 federal estate tax return. (This gets a bit more odd with every passing year.)

In determining whether an estate is taxable, prior taxable gifts (those over $15,000) are added back into the estate. However, they are not included when determining the amount of tax. (More on this below.)

Out-of-State Property and Non-Resident Decedents

Out-of-state or out-of-country property is not taxable in Massachusetts. On the other hand, property owned by non-Massachusetts residents will be taxed if their entire estate exceeds $1 million, in the proportion of the Massachusetts property to the entire estate. Here's how this works in practice:

Let's assume that the decedent lived in Florida, he had an estate of $1.5 million which included a house in Massachusetts valued at $500,000. The tax on a $1.5 million estate would be about $70,000. Since the Massachusetts property consisted of a third of the estate, it would pay a third of this tax, or about $23,000. It the decedent had a $3 million estate, the tax would be about $30,000, reflecting the higher tax rate on larger estates. The Massachusetts property would be just a sixth of this larger estate, but the total tax on a $3 million estate is about $180,000, resulting in the higher tax amount ($180,000 ÷ 6 = $30,000).

Reducing the Tax

For those Massachusetts resident individuals or couples with estates totaling more than $1 million, there are essentially three ways to reduce or eliminate estate taxes: reducing one's assets through gifts and spending, planning for couples to both give away up to $1 million tax free, and making large taxable gifts.

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Gifting and Spending

One way to lower or eliminate one's estate tax is to reduce one's taxable estate, hopefully below $1 million. This can be done by spending or by making gifts either to charity or to individuals in amounts of up to $15,000 each per year (in 2018).

A taxpayer with an estate of $1.2 million may be reluctant to make gifts or to overspend, especially if a significant part of the estate consists of a home. For instance, a taxpayer, who we will call "Jane," may have a home worth $600,000, $300,000 in savings and investments and $300,000 in an IRA. Jane may be comfortable living off of her Social Security, investment income and annual IRA withdrawals, and be legitimately fearful of the effect on her financial security of transferring out $200,000 of her savings.

Two alternatives are available to Jane. One would be to transfer to her children a one-third interest in her home (in $15,000 increments). This would have the advantage of eliminating the estate tax. But if she has owned the home for a long time and it has a low basis (the amount she paid for it plus the cost of improvements), the lifetime gift to her children would cause a higher tax on capital gains on the sale of the house after Jane's death. Such a capital gains consequence could significantly undercut the estate tax benefit of the gifts, or even cost more.

Jane also has the option of accelerating her IRA distributions in order to make the annual gifts. All withdrawals from IRAs constitute taxable income. To the extent Jane does not completely use up her IRA funds during her life, they will pass to her children who will have to begin taking withdrawals based on their life expectancies. They may well be in a higher tax bracket than Jane, meaning that it would be cheaper for Jane to withdraw the funds than for them to do so. In addition, to the extent that Jane reduces her estate by paying the taxes on the IRA withdrawals, that saves an additional 7% in estate taxes, which grows to a 25% savings if she can lower her estate below the $1 million threshold. (This analysis does not factor in the lost earnings on the funds Jane uses to pay taxes early, but they might be ameliorated to some extent if she converts from a standard IRA to a Roth IRA.)

Another option for Jane would be to take a home equity loan on her home and make gifts from those funds, in effect transferring equity in her home without any adverse capital gain consequences. Of course, there's the cost of interest payments on the loan.

If an estate cannot be lowered below $1 million through gifts and spending, reducing its size stills saves heirs some estate taxes, but not nearly as much as reducing it below $1 million. Every $100 of spending or gifting for estates between $1 million and $2 million in size reduces estate taxes by $7 or $8.

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Planning for Couples

The first fact to know about planning for couples is that there is no tax on funds passing to the surviving spouse, no matter how much. However, if the surviving spouse does not need the funds and they remain in her estate when she dies, they will be taxed at that time. As we discussed above, the effective tax rate on these funds can be high if they are the amount that pushes her estate over $1 million.

There are a few planning techniques that can reduce or eliminate estate taxes when the second spouse passes away. First, each spouse can set up his or her assets so that enough passes directly to the next generation instead of to the surviving spouse so that the surviving spouse's estate is below $1 million. This only makes sense if the couple determines that the surviving spouse doesn't need those funds. Also, don't go overboard. If the first spouse who dies gives away more than $1 million to people other than his spouse, his estate will have to pay a tax at that point.

Second, the surviving spouse can disclaim some or all of the funds coming to her from the deceased spouse. This causes her be treated as having predeceased her spouse and the property will pass as if that were the case, usually directly to children. This allows for what is called "post mortem" estate planning, to make adjustments based on the situation after the death of the first spouse to pass away, but the result can be the same as in disinheriting the surviving spouse – leaving her at financial risk.

The third option, which most clients prefer, is for the estate to be structured so that the assets of the first spouse to die pass into a trust for the benefit of the surviving spouse. The trust can be structured so that it can be used for the surviving spouse's benefit, without it being taxed at her death.

By way of example, assume a couple has a total estate of $1.8 million. If everything passes to the surviving spouse, at her death the estate will owe a tax of approximately $90,000. If instead, upon the death of the first spouse to pass away $900,000 passed into a trust for the benefit of the surviving spouse, she would be left with $900,000 in her own name, less than the $1 million threshold for Massachusetts estate taxes. This means that there would be no estate tax on the surviving spouse's estate, saving $90,000 (assuming her estate does not grow beyond $1 million). And this is true even if the value of the trust grows above $1 million.

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Making Large Gifts

A third method of reducing estate taxes is less effective than those described above, but may be used in certain circumstances. Above, we discussed taxpayers making gifts of up to $15,000 per recipient per year. This amount is excluded from gift tax reporting.

Contrary to popular belief, there is no legal bar to giving away more. There is just a requirement that the taxpayer report larger gifts on a gift tax return to be filed with his annual income tax return. Under current law, he has to pay a gift tax only when his accumulated taxable gifts exceed $11.2 million. (Only once have we had a case in which someone actually paid a gift tax. Our client was receiving a gift from a movie star friend who had to pay a gift tax because he had exceeded the much lower gift tax limit in place at that time.)

While few taxpayers ever pay gift taxes, the filing of the return affects their estate taxes when they die. For federal estate tax purposes, in effect, the amount of taxable gifts made during a decedent's life gets added to her taxable estate when she dies. This is not the case for Massachusetts, which has no gift tax. If a Massachusetts taxpayer gives property to someone else before he dies, it's out of his estate immediately.

However, given the interplay of the 2001 federal estate tax and the Massachusetts estate tax described above, the gift does come back into the Massachusetts estate just for the purpose of determining whether it exceeds the $1 million threshold and must pay an estate tax.

In an example above, the taxpayer had an estate of $1.2 million which would be subject to a tax of approximately $50,000. We discussed how this tax could be completely eliminated by lowering her estate by $200,001 to $999,999. The taxpayer could also reduce the size of her estate below $1 million by giving away $200,001 all at once. However, this would not eliminate the estate tax, since the larger gift would be included back in her estate for purposes of determining whether it is subject to tax. The large gift, however, would save the estate about $15,000, reducing the tax to about $35,000 from the $50,000 it would otherwise have had to pay.

This strategy is most often used as part of "deathbed" planning. While it's always better to reduce the size of an estate by making smaller gifts that do not have to be reported, in some instances where a taxpayer is gravely ill and it's too late to reduce an estate below $1 million through small gifts, it can make sense to make larger gifts. It's important in such instances, however, to consider other repercussions, such as the effect on taxes on capital gain.

As the reader can see, this is complicated material and there is considerable interplay between estate, income and capital gains tax rules. Tax planning should always be carried out with the guidance of a qualified professional.

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