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HOUSE RESEARCH

Policy Brief

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The Minnesota Estate Tax after the 2001 Federal Tax Act

In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 or EGTRRA. EGTRRA eliminates the dollar-for-dollar credit against the federal estate tax for state death taxes. This policy brief discusses the impact of EGTRRA on the Minnesota estate tax and options for adapting the Minnesota tax to the federal estate tax changes.

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Summary

Since 1985 Minnesota's only estate tax has been a "pick-up" tax. A pick-up tax equals the credit under the federal estate tax for state death taxes. Because the federal credit is a dollar-for-dollar credit, a state pick-up tax results in no additional tax to the estate. The Minnesota estate tax raises about $65 million per year or slightly more than 0.5 percent of state tax revenues. Revenues can vary significantly from year to year. Only the largest estates, about 2 percent of Minnesota estates, pay the estate tax. Although the incidence of the tax is not included in the Department of Revenue's incidence study, a reasonable inference is that the estate tax is the most progressive of the major state and local taxes in Minnesota.

The 2001 federal tax act, the Economic Growth and Tax Relief and Reconciliation Act (EGTRRA), eliminated over a four-year period the credit against the federal estate tax for state death taxes. Elimination of the credit ends the ability of states to impose estate taxes that do not increase combined federal and state taxes on estates. EGTRRA also significantly increased the number of estates that are exempt from the estate tax and reduced the estate tax rates. For one year (individuals dying in 2010), EGTRRA completely eliminates the estate tax. EGTRRA was generally billed as a major reduction in the estate tax, but a substantial portion of its relief was offset by the repeal of the credit for state death taxes. Whether the reductions in federal tax rates and increases in exemptions that were "financed" by Congress in this fashion will actually flow through to estates now depends upon the actions by the state legislatures.

The 2001 Legislature responded to EGTRRA by allowing the Minnesota estate tax to "decouple" from the federal estate tax. The legislature updated the rest of the Minnesota tax system to EGTRRA's changes but did not do so for the estate tax. Updating to or adopting these changes would have phased out the Minnesota estate tax over a four-year period. The failure to update, in effect, adopted a stand-alone Minnesota estate tax that is based on pre-EGTRRA federal law. This legislation will continue Minnesota estate tax obligations as if EGTRRA had not been enacted. The exemption/unified credit amount will rise gradually to $1 million in 2006 (from $700,000 for individuals dying in 2002) and the tax rates will remain unchanged. The net effect will be that most estates will receive a reduction in combined federal and state estate tax liabilities as a result of the federal and state changes. However, this will not be true for all estates for all years. For example, estates larger than $10 million of decedents dying in 2004 will have increases.

Most states impose only pick-up estate taxes. It is unclear how other states will respond to EGTRRA. Two other states (Wisconsin and Rhode Island), like Minnesota, have decoupled their pick-up taxes from the federal law. The constitutions of two states (Florida and Nevada) prohibit them from imposing death taxes in excess of a federal credit. For most states, EGTRRA will result in elimination of the state pick-up tax automatically, unless legislation imposes a stand-alone death tax. Some initial evidence suggests many states will allow elimination of the federal credit to flow through in reduced state tax, although this may change if state budgets remain tight as a result of the recession.

The legislature may wish to consider modifying the Minnesota estate tax, in light of the effects of EGTRRA on state estate taxation. Since the federal government no longer will bear the full burden of the tax, reconsideration of the public policy bases for the estate seems appropriate. A variety of options for modifying or replacing the estate tax could be considered. Each of them has advantages and disadvantages. The options discussed in this policy brief include:

- Phasing out the tax as the federal credit is reduced
- Adopting the governor's supplemental budget recommendations, i.e., exempting estates with no federal filing obligations during calendar years 2002 and 2003 from Minnesota tax
- Conforming to the new federal exemption/unified credit amounts (i.e., exempting any estate that pays no federal tax from Minnesota tax)
- Adopt the Rhode Island and Wisconsin approach by freezing the estate tax at its 2001 level, rather than allowing the exemption/unified credit to increase, as scheduled under pre-EGTRRA federal law
- Replace the estate tax with an inheritance tax
- Tax bequests and gifts under the Minnesota income tax
- Tax capital gains at death to the decedent (a "deemed realization" tax)

The standard tax policy principles should be used to analyze the estate tax and options for modifying it:

- Horizontal and vertical equity
- Efficiency or neutrality
- Ease of administration and compliance
- Revenue adequacy

Further reductions in the estate tax will reduce the progressivity of the Minnesota tax system and could increase horizontal inequity as the estate tax's role as a backstop to the income tax is reduced. A primary concern must be whether, in the absence of the federal credit, maintaining the estate tax at its current level will cause affluent elderly individuals to move out of Minnesota or to change their domiciles to states without estate taxes, such as Florida. There is little empirical evidence of these potential effects, but common sense suggests that repeal of the credit is likely to cause some migration and/or domicile shifting.

Introduction

2001 federal tax legislation eliminated the ability of states to impose estate taxes that do not increase the combined federal and state tax burden on estates. The 2001 Minnesota Legislature chose not to phase out the Minnesota estate tax by updating to this new federal law.

Since 1985, Minnesota has imposed only a "pick-up" estate tax. A traditional pick-up tax equals the credit for state death taxes under the federal estate tax. Because the federal credit is a dollar-for-dollar credit against federal tax, a state pick-up tax does not increase the total (combined state and federal) tax obligation of an estate. Rather the pick-up tax, in effect, redirects money from the federal treasury to the state treasury.

This happy arrangement for the states, however, came to an end with Congress's enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). EGTRRA changed the landscape dramatically for state estate and inheritance taxation by phasing out the federal credit for state death taxes and replacing it with a deduction for these state taxes. Starting in 2005, it will no longer be possible for a state to impose a pick-up estate tax that does not increase tax burdens on estates. Updating Minnesota law to EGTRRA would essentially have meant gradually repealing the Minnesota estate tax. The 2001 Legislature responded instead by choosing not to update to EGTRRA and by retaining an estate tax that is equal to what a pick-up tax would have been under pre-EGTRRA federal law. In effect, this created a stand-alone Minnesota estate tax based on the credit amounts under prior federal law, starting for decedents dying after December 31, 2001. As discussed later, there is some question as to whether the actual legislation accomplished that result, but this was clearly the intent.[1]

Future Minnesota Legislatures may wish to consider modifying this arrangement to achieve various tax policy objectives. This policy brief provides some background information that may be useful in considering such decisions. It consists of four parts:

1. Some basic information about the Minnesota estate tax
2. A summary of the estate tax provisions of EGTRRA and their effects on the Minnesota estate tax
3. A discussion of policy considerations relevant to modifying the estate tax
4. A list of options for restructuring the Minnesota estate tax after EGTRRA

[1] See the discussion below in footnotes 26 and 27.

Part 1: Background on the Minnesota Estate Tax

The Minnesota estate tax is a pick-up estate tax that equals the amount of the dollar-for-dollar federal credit for state death taxes.

Minnesota's "Pick-up Estate Tax"

Since 1985, Minnesota has imposed only a "pick-up" or "soak-up" estate tax.[2] Under a pick-up estate tax, the state imposes an estate tax that is exactly equal to the amount of the credit allowed for state death taxes under the federal estate tax.[3] This credit is a dollar-for-dollar credit. Thus, any state tax up to the amount of the maximum credit is exactly offset by a corresponding reduction in federal estate tax. In effect, from the point this federal credit was adopted in 1924 through its elimination at the end of 2004, this credit allowed states to capture money that otherwise would be paid as estate tax to the federal government.[4]

The federal credit for state death taxes was intended to provide a form of implicit federal aid to states. It was enacted in response to concerns in the early 20th century that the federal government by imposing a federal estate tax was impinging on a traditional state revenue source, inheritance and other death taxes.[5] Second, it was intended to discourage interstate competition among the states for affluent residents.[6] State pick-up taxes started to become the norm for state taxes, beginning in the late 1970s. By 2001, only 12 states imposed taxes in excess of the federal pick-up tax and two of those (Connecticut and New Hampshire) were phasing out their taxes.[7]

The Minnesota estate tax yields a relatively small share of the state's revenues. In fiscal year 2001, it provided about 0.55 percent of all nondedicated state tax revenues.[8] Table A below

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[2] Repeal was effective for estates of decedents dying after December 31, 1985. 1985 Minn. Laws 2602, 1st spec. sess., ch. 14, art. 13, §§ 14, 15.

[3] I.R.C. § 2011 (2000).

[4] The credit was enacted in 1924 and increased in 1926. It has not changed since 1926 and is set as a graduated rate with 20 separate brackets, depending upon the value of the taxable estate. See Appendix A for the credit table.

[5] David Joulfaian, "The Federal Estate and Gift Tax," OTA Paper 80, U.S. Dept. of Treasury, 12-13 (December 1998).

[6] One of the precipitating events leading to the credit was Florida's repeal of its inheritance tax in 1924 (via a constitutional amendment prohibiting it) apparently to attract affluent residents. Nevada similarly amended its constitution in 1925. David Joulfaian, "The Federal Estate and Gift Tax," OTA Paper 80, U.S. Dept. of Treasury, 30 (December 1998). A brief history is outlined in Eugene Oakes, "The Federal Offset and the American Death Tax System," 54 Q. J. of Econ. 566, 567-72 (1940).

[7] *See* Appendix B for a breakdown of the estate and inheritance taxes of the 50 states.

[8] In the past, the tax has generated a larger share of Minnesota tax revenues. For example, during the early 1950s the inheritance and estate taxes generated between 1.2 percent and 1.6 percent of state tax revenues. *Report of the Governor's Tax Study Commission* 356 (1956). The repeal of the inheritance tax, increases in the individual income tax, and enactment of the sales tax have all played a role in diminishing the relative importance of the estate tax.

shows the collections and estimates for fiscal years 1997 through 2002. Since most Minnesota estate tax revenues are derived from a handful of large estates, year-to-year revenues can fluctuate quite a bit. This is illustrated by the variation between 2000 and 2001 (2000 revenues were about 55 percent higher than 2001 revenues), despite no significant changes in the tax or economic environment. The Department of Finance is forecasting that $65 million will be derived each year from the tax in fiscal years 2002 through 2005.

Table A

Minnesota Estate Tax Revenues FY 1997-2002 (millions)	
1997	$48.9
1998	61.6
1999	58.1
2000	83.9
2001	54.2
2002 (estimated)	65.0

FY1997-2000 amounts are actual collections from Dept. of Revenue; FY2001 are actual collections as of November 2001 from Dept. of Finance; FY 2002 are Dept. of Finance estimates, 2/25/02 revenue forecast.

Distribution of Tax Burden by Size of Estate

The Minnesota estate tax affects relatively few estates. Much of the tax is paid by the largest of the estates. Table B provides information on the number of Minnesota estate tax returns by size and tax liability for the 12-month period ended on August 31, 2001. As can be seen from Table B, most of the estates with tax and filing obligations[9] are under $1 million in size. However, these estates pay less than 20 percent of the tax. By contrast, estates larger than $3.5 million comprised about 4 percent of the estates with tax liability, but paid over one-third of the tax.

[9] The table is limited to estates with tax liability. In addition, about 800 estates filed returns but had no tax liability. In many instances, these estates had no liability through the use of the marital deduction. Since this deduction is unlimited, no inference should be made about the size of these estates.

Table B

Minnesota Estate Tax Returns (for 12-month period ending August 31, 2001)				
Size of taxable estate	**# of returns**	**% of total**	**Tax liability**	**% of total**
$650,000 - 750,000	254	31.0%	$2,796,713	6.1%
$750,000 - 1,000,000	240	29.3%	6,198,395	13.5%
$1,000,000 - 1,500,000	188	22.9%	8,538,530	18.5%
$1,500,000 - 2,000,000	50	6.1%	3,884,579	8.4%
$2,000,000 - 3,500,000	58	7.1%	9,067,155	19.7%
Over $3,500,000	30	3.7%	15,587,097	33.8%
Total	**820**		**$46,072,469**	

Source: Minnesota Department of Revenue

Prior Minnesota Death Taxes

After four unsuccessful attempts, Minnesota enacted a valid inheritance tax in 1905.[10] A pick-up estate tax was added in 1931 (retroactive to 1926). The inheritance tax continued in effect until 1979 when it was replaced by an estate tax that fairly closely followed federal law, but supplemented the pick-up tax.[11] This stand-alone estate tax was repealed by the 1985

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[10] The Minnesota legislative attempts to enact a death tax in the late 19th and early 20th century is a long saga of legislative efforts that were frustrated by the courts. The legislature first enacted, in essence, an estate tax (a fee levied relative to the size of the probate estate) in 1878. The Minnesota Supreme Court held this tax unconstitutional on the basis that its progressive rate structure violated the constitutional requirement of uniformity. *State ex rel. Davidson v. Gorman*, 40 Minn. 232, 41 N.W. 948 (1899). In 1894, the Minnesota Constitution was amended to permit imposition of a graduated inheritance tax. The legislature's first attempt to enact an inheritance tax under this authority was held unconstitutional because, among other things, the court concluded the amendment did not permit taxing real and personal property differentially. 1897 Minn. Laws, ch. 293; *Drew v. Tifft*, 79 Minn. 175, 81 N.W. 839 (1900). The legislature made a second effort to enact an inheritance tax under the constitutional authorization in 1901. 1901 Minn. Laws, ch. 225. The court held that the tax violated the requirement of uniformity because it imposed a higher tax on collateral, as compared with lineal, descendants and essentially had a cliff exemption. Once the exemption amount was reached, the entire estate became taxable. The court invalidated the entire tax. *State ex rel. Frye v. Bazille*, 87 Minn. 500, 92 N.W. 415 (1902). (This cliff bears some remarkable similarities to the proposal in Governor Ventura's 2001 Supplemental Budget. *See* text on page 22.) Proving three is not necessarily a charm, the legislature's third effort to enact an inheritance under the 1894 amendment was also invalidated on the grounds that the maximum tax rate exceeded the constitutional limit. *State ex rel. Russell v. Harvey*, 90 Minn. 180, 95 N.W. 764 (1903). The court again invalidated the entire tax. *Id.* at 182, 95 N.W. 765. The legislature finally succeeded in enacting a death tax that the Minnesota Supreme Court upheld in 1904, 27 years after its first attempt. *State ex rel. Foot v. Bazille,* 97 Minn. 11, 106 N.W. 93 (1905).

[11] An inheritance or succession tax imposes taxes on successions to property from the estate. By contrast, an

Legislature, effective for decedents dying after December 31, 1985. When it was repealed, the separate tax was estimated to raise only about $300,000 over the fiscal years 1986-87 biennium.[12]

Part 2: EGTRRA and 2001 State Legislative Responses

EGTRRA, the 2001 federal tax legislation, makes four major types of changes in the federal estate tax. EGTRRA:

1. Increases the exemption/unified credit amount in a number of steps between 2002 and 2009
2. Reduces the rates that apply to larger estates
3. Repeals the federal estate tax for one year (2010)
4. Phases down and repeals the credit for state death taxes

This section describes the changes by type of change, but does not show (in all cases) the detail of when the reductions take effect.[13] The reductions in the federal estate tax are phased in over a nine-year period. The exact provisions (rates, unified credit amounts) vary by year and, as a result, are somewhat confusing. Various published sources have provided breakdowns that show the provisions that are in effect for each calendar year.[14] All of the changes are repealed, effective for decedents dying after December 31, 2010.

Increase in Exemption/Unified Credit Amount

EGTRRA increases the amount of the unified credit against estate and gift taxes, beginning for decedents dying after December 31, 2001.[15]

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estate tax is imposed on the value of the estate that is distributed. The rates of an inheritance tax typically vary based on the relationship of the recipient to the decedent. For example, lower rates or exemptions may be provided to surviving spouses or children, with higher rates for recipients who are more distant relations or who are unrelated to the decedent. Exemptions for specific types of property (e.g., homesteads) may also be provided.

[12] Dept. of Revenue Research Division, "Final Compromise Agreement" (unpublished estimate for the 1985 omnibus tax bill, dated June 14, 1985, in author's files). *Cf* Raymond A. Reister, "Minnesota Transfer Taxes" in 2 *Final Report of the Tax Study Commission* 147 (Staff Paper, 1986) ($1.3 million estimate).

[13] In addition to the four major changes noted in the text, EGTRRA also made a number of more minor changes in estate and gift taxes. For example, the availability of conservation easements was expanded to a wider geographic area and a variety of changes were made to the generation skipping tax.

[14] *See* Beth Shapiro Kaufman, "The Estate and Gift Tax Implications of the 2001 Tax Act," 92 Tax Notes 949 (Aug. 13, 2001) for a year-by-year summary of when these provisions take effect.

[15] The unified credit is frequently reported (as in the table in the text) as an exemption equivalent amount. This shows the maximum value of an estate that it shields or exempts from taxation. It is worth noting, however, that as a credit it has a constant value to all taxable estates and, unlike a true exemption, does not vary in value by the

The gift tax exemption amount stays at $1 million over the entire period until the entire bill expires. The scheduled increases are shown in Table C.

Table C

Unified Credit* – Effective Exemption Amount EGTRRA Compared with Prior Law		
Decedents dying during CY	**Prior Law**	**EGTRRA**
2002	$700,000	$1,000,000
2003	700,000	1,000,000
2004	850,000	1,500,000
2005	950,000	1,500,000
2006	1,000,000	2,000,000
2007	1,000,000	2,000,000
2008	1,000,000	2,000,000
2009	1,000,000	3,500,000
2010	1,000,000	Tax repealed
2011**	1,000,000	1,000,000

* For EGTRRA, this is the estate tax credit. EGTRRA sets the gift tax credit permanently at $1 million.

** Assumes EGTRRA's "sunset" provision takes effect and tax returns to its pre-EGTRRA version.

Rate Reduction

EGTRRA also reduces the rates that apply to larger estates. Under prior law, a top rate of 55 percent applied. In addition, a 5 percent "surtax" applied to estates of over $10 million. This surtax had the effect of taking away the benefit of the lower graduated rates, so that estates over $17,184,000 are subject to a flat rate of 55 percent. EGTRRA repealed the surtax and reduced the top rate to 50 percent, effective for decedents dying in 2002. The top rate is further reduced in annual one-percentage point steps to 45 percent in 2007. It remains at that level until repeal of the tax in 2010.

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marginal tax rate to which the estate is subject. Also, EGTRRA decouples the estate tax and gift tax, so it is no longer a "unified" credit against lifetime taxable gifts and the value of the estate. EGTRRA permanently sets the gift tax exemption at $1 million, even when the estate tax exemption increases.

Repeal of State Death Tax Credit

EGTRRA repeals over a four-year period the federal credit for state death taxes. Table D displays the phase-out schedule for the credit.

Table D

Phase-out of State Death Tax Credit Under EGTRRA	
Calendar Year	**% allowed**
2002	75%
2003	50%
2004	25%
2005–2010	No credit

Repeal of the credit for state death taxes means that states will no longer be able to impose "pick-up" estate taxes, the entire cost of which is borne by the federal treasury. During the phase-out period, pure pick-up taxes will continue to provide state revenue, but at a reduced level (25 percent less in 2002, and so forth). In 2005 through 2010, the credit is replaced by a deduction for state death taxes. The value of this deduction to an estate will depend upon the marginal tax rate that applies to the estate. If the estate is, for example, in the top 47 percent bracket in 2005, a dollar of state estate or inheritance tax will reduce the federal tax obligation by 47 cents.

Repeal of the Estate Tax

EGTRRA repeals the estate tax in 2010. The gift tax, however, remains in place with a tax rate equal to the top income tax rate and, as noted above, a lifetime exemption of $1 million.[16] This repeal is in effect for one year only, since the sunset provision of EGTRRA will cause all of its changes to expire on December 31, 2010.

EGTRRA financed a significant share of its federal estate tax relief with repeal of the state death tax credit, leaving to the states whether or not this change ultimately results in tax reductions or offsetting increases in state estate or other death taxes.

EGTRRA financed a good deal of the reductions in the federal estate tax by repealing the credit for state death taxes. Estimates of the cost of the estate tax changes prepared by the Joint

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[16] This was done to prevent the use of gifts to avoid income tax (e.g., by shifting income to lower bracket taxpayers by giving income producing or appreciated property to them).

Committee on Taxation do not separately report this cost. But a comparison of the estimates for EGTRRA with similar bills that did not include credit repeal strongly suggest that in the initial years of the phase-out of the federal tax, the repeal of the credit financed the cost of the increases in the exemption, as well as part of the rate reductions.[17] In some years, it seems clear that over half of the cost of the increases in the exemption and the rate cuts were financed with the savings from the credit reductions.[18]

This leaves to the states whether these reductions will actually pass through to estates or will be offset by increases in "real" state taxes which can no longer be offset or shielded by the federal credit.

Five states have either enacted legislation (Minnesota, Rhode Island, and Wisconsin) or are constitutionally prohibited from doing so (Florida and Nevada). It is difficult to predict how political bodies, such as state legislatures, will react to the change in the credit. Two states have enacted legislation to prevent the federal credit repeal to flow through in lower state estate taxes. Both of these states froze their taxes at the level of the old federal credit. Rhode Island set its estate tax to equal the amount that the pick-up tax would have been under the federal law in effect on January 1, 2001.[19] Wisconsin similarly set its estate tax to equal the amount of the federal credit "in effect on" December 31, 2000.[20] Wisconsin limits this freezing of the tax to decedents dying after December 31, 2000, and before January 1, 2008. Thus, if no further action

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[17] As noted in the text, the Joint Committee on Taxation's published estimates combined the effects of the estate tax rate cuts, increases in the unified credit, and reduction and repeal of the state death tax credit in one estimate. However, by comparing the Joint Committee's estimates of the cost of H.R. 8, the Death Tax Elimination Act, with the estimates for EGTRRA, one can get an impression of the impact of the credit changes. H.R. 8 did not include repeal of the credit or an increase in the exemption amount, but essentially reduced the top rates until the tax was repealed. Despite H.R. 8 having smaller rate cuts and no change in the unified credit, EGTRRA's annual costs throughout the period are lower than that of H.R. 8. For example, in 2002 H.R. 8 had a top rate of 53 percent and no increase in the unified credit-exemption equivalent amount (i.e., it would have been $700,000), while EGTRRA has a top rate of 50 percent and a unified credit-exemption equivalent of $1,000,000. Nevertheless, H.R. 8 had a fiscal year 2003 (very roughly the fiscal year affected by calendar year 2002 deaths) cost of $6.7 billion and EGTRRA of $6.4 billion. The difference for the more generous EGTRRA provisions must largely be explained by the reduction in the state death tax credit in EGTRRA (H.R. 8 proportionately reduced the credit, while EGTRRA reduced it by 25 percent in 2002). H.R. 8 also converted the unified credit to a true exemption, while EGTRRA does not. This feature of H.R. 8 adds to its costs.

[18] The state death tax credit equals about 25.5 percent to 27.5 percent of federal estate tax collections. Joint Committee on Taxation, "Description and Analysis of Present Law and Proposals Relating to Federal Estate and Gift Taxation," 41 (March 14, 2001). If one uses this benchmark in the year the repeal of the credit is fully phased in, compared with CBO's estimates for estate tax collections before EGTRRA, the credit repeal would save about $7.8 billion in fiscal year 2006. The Joint Committee's estimates of the cost of EGTRRA's estate tax rate, exemption, and credit changes for fiscal year 2006 is $4.1 billion. Thus, one can infer that the combined cost of the rate cuts and exemption increase is about $11.9 billion (i.e., $7.8 billion + $4.1 billion). Following this logic, repeal of the state death tax credit financed about 65 percent of the total cost of the rate cuts and exemption increases in fiscal year 2005.

[19] R.I. Gen. Laws § 44.22-1.1 (2000), as amended by R.I. Pub. Laws, ch. 77, art. 7 § 3.

[20] 2001 Wis. Act No. 16 § 2000d. This change takes effect for decedents dying after September 30, 2002. The federal $1 million exemption and reduced tax applies from January 1 to September 30, 2002.

is taken by either Congress (on the state death tax credit) or by the Wisconsin Legislature, the Wisconsin estate tax will disappear starting in calendar year 2008.[21]

In Minnesota, the pick-up estate tax is tied to federal law as amended through a specific date.[22] Thus, the reduction and repeal of the credit for state death taxes would not have automatically flowed through as lower state estate taxes. Moreover, and perhaps more importantly, the 2001 Minnesota Legislature did not update to the estate tax changes made by EGTRRA, while doing so for individual income, corporate income, and other tax types.[23] The legislative intent of this action was to leave to later legislatures the question of how to respond to the repeal of the federal credit for state death taxes.[24] Until further action was taken, it was intended that Minnesota impose a stand-alone estate tax based on federal law, as amended through December 31, 2000.[25] However, there is some question as to whether the 2001 changes actually accomplished this. In particular, the 2001 legislation updated the general filing requirements, including those of the estate tax, for EGTRRA's changes. This may create an inference that only taxpayers who are required to file a federal return must also file a Minnesota estate tax return.[26] In addition, some probate lawyers have argued that the 2001 legislative changes somehow adopted EGTRRA's changes for purposes of the Minnesota estate tax or failed to prevent them from occurring

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[21] I assume that this choice of a delayed effective date must have been done because it was outside the window in which the cost of tax changes are scored for budget bill purposes, but do not know.

[22] This appears to be the case in nine other states. *See* Appendix B. The Minnesota Supreme Court has held that the Minnesota Legislature may not, as a general matter, constitutionally provide that state laws automatically adopt future federal legislative changes, such as changes in the definition of the basic tax base. *Wallace v. Commissioner of Taxation*, 289 Minn. 220, 184 N.W.2d 588 (1971) (definition of federal adjusted gross income).

[23] 2001 Minn. Laws 1653-62, 1st spec. sess. ch. 5, art. 10 §§ 1, 6, 9, 10 (estate tax updated through December 31, 2000, while other taxes through June 15, 2001, or after EGTRRA's enactment).

[24] This intent is inferred from the revenue estimates for the 2001 update to EGTRRA, which assumed that the state would not lose revenue from EGTRRA's estate tax changes and from discussions between the Department of Revenue staff and key legislators when the provisions were under consideration in June 2001.

[25] Note how the similar Rhode Island and Wisconsin provisions differ from Minnesota law. Under the Rhode Island and Wisconsin provisions, the exemption will remain at $675,000 despite the increases that were scheduled under federal law as amended through January 1, 2001. The key language is treating federal law *as it was in effect* on January 1, 2001 (December 31, 2000, for Wisconsin). By contrast, Minnesota's tax is whatever the federal credit would have been under the law *as amended* through December 31, 2000. Thus, estates that are subject to the Minnesota estate tax will benefit from the increases in the unified credit-exemption equivalent to $1 million.

[26] 2001 Minn. Laws 1653, 1st spec. sess. ch. 5, art. 10 § 1, codified as Minn. Stat. § 289A.02, subd. 7 (2001 Suppl.). This provision adopted EGTRRA for purposes of chapter 289A. Section 289A.10, subdivision 1, requires a personal representative to file an estate tax return "in instances when a federal estate tax return is required to be filed." Since chapter 289A was updated for EGTRRA's changes, one could argue that no filing obligation applies if the estate is exempt from filing a federal return under EGTRRA. However, section 289A.10, subdivision 3, provides that the definitions contained in section 291.005 apply to the section. Section 291.005 also contains a definition of the Internal Revenue Code. Minn. Stat. § 291.005, subd. 1(8) (2001 Suppl.). This definition was updated only through December 31, 2000, and, thus, does not include EGTRRA. This creates an ambiguity as to whether the filing requirements are determined under chapter 289A's update or chapter 291's. One could argue that the 2001 tax bill, in effect, adopted the equivalent of the estate tax proposal contained in the governor's supplemental budget, described in the text, page 22.

automatically. These arguments appear weak.[27] The likely effect of the 2001 tax bill is that the Minnesota estate tax must be computed as if EGTRRA had not been enacted.

Two states, Florida and Nevada, have constitutional provisions that prohibit imposition of estate taxes that exceed the dollar-for-dollar federal credit.

The remaining states can be divided into three groups:

- **In most states, repeal of the federal credit will flow through as tax reductions *unless the legislature takes action* to impose an estate or inheritance tax.**

  In many states with only pick-up taxes, these federal changes will flow through as tax reductions unless the law is changed to impose a stand-alone death tax. These states have open-ended references to the federal credit (e.g., "section 2011 of Internal Revenue Code, as amended") that appear intended to automatically adopt changes in the federal credit. It appears that this is the case in most states (perhaps in 28 of the states).

- **In a few states, similar to Minnesota law, the pick-up tax is tied to federal law as of a date before EGTRRA's enactment. For these states, the legislature must take action to allow EGTRRA's changes in the credit to flow through as state estate tax reductions.**

  States in the second group have pick-up taxes tied to federal law as of a specific date. For these states, the legislature will need to adopt EGTRRA's credit provisions, if all of the federal changes are to flow through as reductions in tax. The details for the states are shown in Appendix B.

- **Other states have stand-alone inheritance or estate taxes, in addition to pick-up taxes. For these states, repeal's effects will be offset by increases in these taxes.**

  Twelve states have stand-alone death taxes, in addition to pick-up taxes. The effective

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[27] The essence of this argument is that the Minnesota estate tax is imposed on the federal credit amount which is determined under federal law and is, therefore, limited to the amount of the federal tax. The 2001 tax act tied the Internal Revenue Code references to pre-EGTRRA law. But neither the prior statute nor the 2001 changes explicitly tie the Minnesota tax to the federal tax as determined under a specific section of the Internal Revenue Code. Thus, under this argument the 2001 tax act's changes did not limit EGTRRA's effect of reducing the underlying tax (by increasing the unified credit and exemption amounts). This argument seems implausible. It is contrary to the actual intent of the 2001 changes. It is difficult to infer that the 2001 Legislature intended anything other than preventing EGTRRA's changes from flowing through to the Minnesota tax. Moreover, the argument seems to prove too much. It implies that the legislature could provide for automatic updates, if it avoids specific references to the Internal Revenue Code. This seems contrary to the holding of the *Wallace* case. *Wallace v. Commissioner of Taxation,* 289 Minn. 220, 228 184 N.W. 2d 588, 592 (1971) ("The legislature did not, or could not, grant to Congress the right to make future modifications or changes in Minnesota law.") One could argue the estate tax is different than the reference to federal adjusted gross income in Wallace because the state tax base actually is the federal tax. However, that would still seem contrary to the basic constitutional principle that underlies *Wallace.*

burden of these taxes will increase automatically as the federal credit and the pick up taxes disappear in these states, if the state law automatically adopts EGTRRA's changes. Some estates will have pick-up taxes that are higher than these stand-alone taxes. These estates will realize some relief as a result of EGTRRA, unless the state acts to increase the stand-alone or another death tax.

Minnesota's adoption of a stand-alone estate tax will negate a good portion of the estate tax reductions provided in EGTRRA.

As described above, the 2001 Minnesota Legislature, in effect, chose to continue imposing a Minnesota estate tax equal to the pre-EGTRRA state death tax credit. This decision in combination with EGTRRA's repeal of the state credit will prevent much of the nominal federal tax cuts from actually flowing through to estates. Table E illustrates this effect by comparing the reductions that would occur if a state conforms to EGTRRA (or if this happens automatically in states with automatic updating provisions) with the effect under the law adopted by the 2001 Minnesota Legislature. The table shows the changes in federal and state tax for sample estates of \$1.5 million, \$5 million, \$10 million, \$20 million, and \$50 million for:

- The first year EGTRRA's estate tax changes are effective (2002),
- The last year in which a state death tax credit is allowed (2004), and
- The year in which the state death tax credit phase-out is fully effective (2005).

In Table E, the "Combined tax pre-EGTRRA" rows are the amounts of federal estate tax and the Minnesota pick-up tax before the enactment of EGTRRA. These amounts include the phased-in increases in the unified credit/exemption amount that were enacted by Congress in 1997 and adopted by the 1998 Minnesota Legislature. The "Federal tax under EGTRRA" rows are the amounts of the federal estate tax, net of the state death tax credit after EGTRRA (for years in which it is allowed). The Minnesota tax line is the amount of pick-up tax under pre-EGTRRA law, also including the phased-in increases in the unified credit/exemption amount enacted in 1997.

Row #5 shows the actual reduction in combined federal and Minnesota tax for each estate for the three years. Row #7 shows the additional tax that results from the loss of the federal credit for state death taxes. Put another way, the amounts in row #7 are the additional tax that a Minnesota domiciled decedent would pay as compared to a decedent domiciled in a state that fully conforms to the EGTRRA's provisions (such as Florida and Nevada). Row #7 represents the estate tax benefit of shifting one's domicile from Minnesota to a state without an estate tax.

Table E

Effects of EGTRRA on Estate Tax Liabilities* for Five Sample Estates					
Value of Estate**	**$1,500,000**	**$5,000,000**	**$10,000,000**	**$20,000,000**	**$50,000,000**
Decedents dying during calendar year 2002					
1. Combined tax pre-EGTRRA	$326,000	$2,161,000	$4,911,000	$10,770,200	$27,270,200
2. Federal tax under EGTRRA	161,700	1,611,300	3,554,300	7,254,900	18,354,900
3. Minnesota tax*	64,400	391,600	1,067,600	2,666,800	7,466,800
4. Total federal & MN tax (2 + 3)	226,100	2,002,900	4,621,900	9,921,700	25,821,700
5. Change in total tax (1 - 4)	(99,900)	(158,100)	(289,100)	(848,500)	(1,448,500)
6. Pct decrease (increase) (5 ÷ 1)	-30.6%	-7.3%	-5.9%	-7.9%	-5.3%
7. Comparison to full conformity***	16,100	97,900	266,900	666,700	1,866,700
Decedents dying during calendar year 2004					
1. Combined tax pre-EGTRRA	268,500	2,103,500	4,853,500	10,712,700	27,212,700
2. Federal tax under EGTRRA	0	1,567,100	3,789,100	8,198,300	21,398,300
3. Minnesota tax*	64,400	391,600	1,067,600	2,666,800	7,466,800
4. Total federal & MN tax (2 + 3)	64,400	1,958,700	4,865,700	10,865,100	28,865,100
5. Change in total tax (1 - 4)	(204,100)	(144,800)	12,200	152,400	1,652,400
6. Pct decrease (increase) (5 ÷ 1)	-76.0	-6.9%	0.3%	1.4%	6.1%
7. Comparison to full conformity***	48,300	293,700	800,700	2,000,100	5,600,100
Decedents dying during calendar year 2005					
1. Combined tax pre-EGTRRA	229,500	2,064,500	4,814,500	10,673,700	27,173,700
2. Federal tax under EGTRRA	0	1,450,948	3,483,228	7,431,604	19,275,604
3. Minnesota tax*	64,400	391,600	1,067,600	2,666,800	7,466,800
4. Total federal & MN tax (2 + 3)	64,400	1,842,548	4,550,828	10,098,404	26,742,404
5. Change in total tax (1 - 4)	(165,100)	(221,952)	(263,672)	(575,296)	(431,296)
6. Pct decrease (increase) (5 ÷ 1)	-71.9%	-6.9%	-5.5%	-5.4%	-1.6%
7. Comparison to full conformity***	64,400	207,548	565,828	1,413,404	3,957,404

* Minnesota tax is based on pick-up tax tied to the Internal Revenue Code, as amended through December 31, 2001 (i.e., before the amendments contained in EGTRRA), as per the actions of the 2001 Minnesota Legislature.

** Before reduction for the exemption amount

*** Total federal and Minnesota tax minus federal and state tax in state adopting full conformity (e.g., Florida)

In general, Table E shows that most of the sample estates have tax cuts after netting out the combined effects of the federal and Minnesota changes. These reductions are larger in percentage terms for the smaller estates with larger dollar amounts for the bigger estates. The largest net effects of state estate taxes are for decedents dying in 2004. The three largest sample estates ($10 million, $20 million, and $50 million) all have increases. This results because the tax benefit of the reduced (25 percent) federal death tax credit is less than allowing the deduction for state taxes paid that applies beginning for decedents dying in 2005.[28] After the federal credit for state death taxes is phased out in 2005, all of these estates have reductions in combined federal and state taxes compared with pre-EGTRRA law.[29] The federal reductions from the higher exemptions, the repeal of the surtax, and the reduction in the top rate all are more than offset by the loss of the state death tax credit.

Also it is worth noting that some estates (e.g., the $1.5 million example) will have no federal tax obligation, but will continue to have Minnesota filing and tax obligations. This effect will become more pronounced with the increases in the credit/exemption amount to $2 million (in calendar year 2006) and $3.5 million (in calendar year 2009). Estates with values that exceed the $1 million exemption amount under pre-EGTRRA law but are smaller than the new federal exemption amounts would continue to be obligated to pay Minnesota tax, even though they would have no federal tax or filing obligation.

Part 3: Policy Considerations

This section lists and briefly discusses some policy concerns that the legislature may wish to consider in evaluating whether or how to modify the Minnesota estate tax. The basic considerations that underlie this discussion are the standard tax policy principles used to evaluate taxes:

- Equity—both horizontal and vertical
- Efficiency and neutrality
- Revenue adequacy
- Ease of administration and compliance

Equity considerations

There are two components to the equity principle: vertical equity or the progressivity or regressivity of the tax and horizontal equity or equal treatment of equals.

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[28] The deduction provides a tax benefit equal to the state tax multiplied by the marginal rate. The applicable marginal rates (45 percent or 48 percent) are higher than a credit equal to 25 percent of the old state death tax credit.

[29] Some very large estates (e.g., $500 million) would still have tax increases in 2005, as the loss of the federal credit for state death taxes continues to be larger than the benefit of the increases in the federal exemption and the reductions in the tax rates. After that increases in the exemption (in 2006 and 2009) and the additional reductions in the top tax rate, these increases disappear.

Vertical Equity

The vertical equity principle evaluates the tax relative to the income distribution, i.e., its progressivity or regressivity. With regard to vertical equity it seems likely that the estate tax is the most progressive of the major Minnesota taxes. The Department of Revenue's incidence study does not analyze the estate tax.[30] Thus, specific data or analysis of income distribution of the Minnesota tax is not available.[31] However, common sense and analyses done of the federal estate tax make it clear that this is a very progressive source of revenue. The tax applies to fewer than the top 2 percent of estates[32] and, then, applies a progressive rate structure to the small group of estates that are subject to tax. If one assumes the tax is borne by the recipients of bequests, the tax still appears very progressive. Children of wealthy parents tend to have high incomes.[33] Given all of this, it is likely that the tax is the most progressive state tax.

Horizontal Equity

Is the appropriate reference unit the estate or the beneficiary of the estate? The horizontal equity principle provides that equals should be treated equally. In the context of the estate tax, a key threshold question is what the benchmark should be in judging the horizontal equity of the tax—is it the estate (i.e., the decedent) or the beneficiaries of the tax? The answer to this question will affect whether one prefers an estate tax, an inheritance tax, or taxing bequests under the income tax. Since the estate tax is levied on the estate, it taxes estates of equal size equally. By contrast, an inheritance tax adjusts the tax based on the recipient of the bequest.[34] Finally, the income tax adjusts the tax based on the income of the recipient beneficiary.

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[30] Minn. Dept. of Revenue, *2001 Minnesota Tax Incidence Study* 2 (March 2001).

[31] Indeed, in the past regime of a pick-up tax, there are some conceptual questions about whether the tax is really simply a federal aid program that is borne by federal taxpayers generally or should be allocated to the decedents or beneficiaries. This is similar to the question of how to handle the partial federal offset for federal itemized deductions of individual income and property taxes. It would likely be handled in the same way, i.e., by ignoring the federal offset. *See Id.* at 27-28.

[32] From 1990 through 1997, the percentage of deaths nationally with taxable estates ranged from 1.08 percent to 1.85 percent. Table 17 in Joint Committee on Taxation, *Present Law and Background on Federal Tax Provisions Relating to Retirement Savings Incentives, Health and Long-Term Care, and Estate and Gift Taxes* (June 15, 1999). The percentage of taxable estates increased across the period with the economic and stock market boom and the unindexed exemption amount. The unlimited marital deduction, however, tends to understate the number of estates subject to tax, since the deduction frequently is used to defer the tax on the estate of the first spouse to die.

[33] *See* David Joulfaian, *The Federal Estate and Gift Tax: Description, Profile of Taxpayers, and Economic Consequences*, OTA Paper 80 (Dec. 1998). Roughly 35 percent of the recipients of the largest taxable estates were in the highest income strata ($200,000+ of adjusted gross income in 1982), while less than 1 percent of the recipients of smallest taxable estates (i.e., estates of $300,000 to $500,000) were. *Id.* Table 12A.

[34] Many inheritance taxes, including the old Minnesota inheritance tax, adjusted the tax based on the degree of the relationship to the decedent. Tax was generally lower on surviving spouses and minor children, higher on adult children, and higher still on collateral or unrelated heirs.

Consider two $1 million estates; one is passed to a single child ($1 million bequest); the other to two children ($500,000 bequest to each). If the benchmark is the decedent or the estate, the two estates should pay the same tax and the estate tax is the appropriate vehicle. However, if the equity benchmark is the recipient, it may be appropriate for the tax to be lower (as a proportion of the bequest) for the second estate with its two heirs. After all, these beneficiaries got only half as much as the beneficiary of the first estate. From this perspective, the "correct" answer may be an inheritance tax. Assume further that the two heirs to the second estate differ considerably in their incomes and asset holdings; one may be low-income with little wealth and the other high-income with substantial holdings. If the appropriate equity benchmark is the recipient, then the low-income and low-wealth recipient perhaps should pay less than the high-income sibling. In this case, the more appropriate approach may be to tax the bequest under the income tax, rather than the estate tax.

The estate tax helps to fill in gaps in the individual income tax, enhancing horizontal equity. The estate tax ensures that individuals with large unrealized capital gains pay some tax on these gains. A commonly cited justification for the estate tax is to act as a backstop to the income tax.[35] A fair amount of capital income escapes income taxation. A primary example of this is the step-up in basis at death that can shelter capital gain and recapture of depreciation (in excess of economic depreciation) from taxation. For individuals with substantial assets, the estate tax can ensure that this unrealized capital appreciation yields some tax. In this role, the estate tax may promote horizontal equity. Absent the estate tax, an individual who realizes most of his income through wages, salaries, interest, and dividends can pay considerably more lifetime tax than an individual who accrues most of her income as unrealized capital gains.

Efficiency or Neutrality

It is unclear to what extent state estate taxes, after repeal of the federal credit, will affect migration decisions by affluent individuals. The neutrality, or efficiency principle, suggests that taxes should interfere as little as possible with private market behavior. All taxes, of course, have negative efficiency effects; they inevitably affect private decision-making. Thus, the efficiency principle argues for minimizing these effects as much as possible. Various efficiency concerns have been expressed and analyzed about the federal estate tax, such as the potential effects on savings, charitable giving, capital gains realizations, and labor supply.[36] There is little consensus among economists on the existence or extent of these effects. State estate and inheritance taxes with their much lower rates seem less likely to have these effects.

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[35] *See e.g.,*David Joulfaian, *The Federal Estate and Gift Tax: Description, Profile of Taxpayers, and Economic Consequences*, pp. 30-31, OTA Paper 80 (Dec. 1998). Joulfaian's numbers show a declining ratio of capital income (reported on income tax returns in the year before death) to the size of the estate. This, of course, strongly implies that the wealthy individuals have relatively larger amounts of unrealized capital gains.

[36] *See e.g.,*David Joulfaian, *The Federal Estate and Gift Tax: Description, Profile of Taxpayers, and Economic Consequences*, OTA Paper 80 (Dec. 1998) for a discussion of these issues.

However, a principal concern to states must be whether state estate and inheritance taxes will affect migration or domicile planning decisions by affluent residents.[37] If imposing an estate tax after repeal of the federal credit has this effect, the net result may be counter productive. Imposition of the tax may not generate the expected estate tax revenues because it may cause wealthy individuals to move out-of-state. Moreover, domicile planning or migration induced by a state estate tax may actually cause a reduction in individual income tax receipts, if older affluent resident abandon Minnesota as their domicile and residence to avoid the estate or inheritance tax.[38]

Unfortunately, there is little good empirical evidence on the potential effects of state death taxes on migration and domicile planning. The few studies that have been done have shown little or no effect.[39] But these studies use relatively unsophisticated methodologies and, more importantly, EGTRRA and repeal of the state death tax credit likely has changed the environment considerably. The federal credit for state death taxes essentially masked much of the burden of state death taxes, particularly as they applied to larger estates. The burden of stand-alone state death taxes (i.e., liability in excess of the federal credit) appears to be quite modest and largely affects more modest size estates that are not required to pay large amounts of federal estate tax. Furthermore, only a few states imposed stand-alone state death taxes of any significance. Therefore, one would expect pre-EGTRRA data to show little, if any, effect on migration or change of domicile.

It is certainly possible that after EGTRRA, affluent individuals will be more willing to change their domiciles if the pay-off is avoiding a multi-million state estate tax liability. This seems particularly true, since the no-tax states will include Sunbelt states, such as Florida and Nevada, that are attractive locations to retirees. Adding to this potential is the fact that many of these affluent individuals already have second homes in these states. Changing their domiciles may require making a number of fairly modest adjustments in

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[37] A state generally has the authority to impose a death tax (estate, inheritance, or accessions tax) on tangible property within the state and the intangibles of individuals domiciled in the state on their deaths. Residence coupled with the intent to make the place one's home is the general test of domicile. *See, e.g.,Texas v. Florida*, 306 U.S. 398 (1939) for a colorful case on domicile that illustrates the basic principles. *Texas v. Florida* was an interpleader action filed under the Supreme Court's original jurisdiction with four states each claiming to be the domicile of a very wealthy decedent. (The sum of the federal estate tax and the four states' taxes would have exceeded the value of the estate; as a result, interpleader was granted.) The decedent had lived in each state and had homes in three of the states and apparently used domicile planning during his lifetime to successfully avoid the personal income and intangible taxes of all of the states. Texas had neither tax, but Texas was also the one state in which he did not have a dwelling unit and in which he had not lived for more than 20 years before his death.

[38] This has been an underlying theme of policy discussions of state death taxes probably since their inceptions. For example, the 1956 *Governor's Tax Study Report* extensively discusses this issue with regard to the portion of the old inheritance tax that exceeded the federal credit. *Report of the Governor's Minnesota Tax Study Committee*, pp. 357-67 (1956).

[39] *See, e.g.,* Dennis Prouty, *The Iowa Inheritance Tax and Elderly Migration*, Iowa Legislative Fiscal Bureau (Jan. 16, 1997) (regression analysis of factors affecting elderly migration, finding the Iowa inheritance tax to be statistically insignificant).

their lives.[40] Changing their domiciles has the added attraction to these individuals of avoiding the Minnesota income tax Given the lack of empirical evidence, the best one can do is hazard a guess based on intuition and anecdotes. It certainly seems possible that state death taxes, if they are imposed at substantial levels (e.g., comparable to the old federal credit for state death taxes), will have some effect on migration and domicile planning decisions.

Revenue Adequacy

The estate tax provides a small and volatile source of state revenues.

The primary purpose of all taxes is, of course, to provide revenue to the government. Ideally, revenues should be stable and should grow as the state's economy grows and as demands for public services grow. Estate tax revenues are based on asset values of affluent individuals. As a result, they tend to keep pace with growth in the economy. During the stock market boom of the 1990s, they grew somewhat faster than overall state revenues.[41] In a relatively small state such as Minnesota and over short time periods (e.g., a fiscal year or biennium), estate tax revenues tend to be fairly volatile because they depend on the vagaries of the deaths of a handful of individuals. This volatility can be readily seen in the tax collections reported in Table A on page 6.

Ease of Administration and Compliance

Tying a state tax closely to the federal estate tax, especially limiting it to estates with a federal tax obligation, will make administration and compliance easier. This principle provides that taxes should be relatively easy for the government to administer and for taxpayers to comply with. Holding down administrative and compliance costs reduces the negative social costs of a tax. The costs of administering the tax by the government seem clear and straightforward. There are (at least) two components of the taxpayers' costs of complying with the estate tax: (1) estate planning and rearranging of

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[40] This certainly would seem to be the case for individuals who already spend a good part of the year at a second home in a low-tax state, such as Florida. Various steps can be taken to move one's domicile. *See, e.g.,* King, *Taking It With Them the Dynamics of Changing a State Income Tax Residence,* 24 Akron L. Rev. 321, 338-43 (1990) (checklist of actions to take to change domicile). Some forms of wealth—e.g., holding appreciated land—make it more difficult to avoid a state death tax, since selling the land will result in a federal and Minnesota capital gain tax. This is not inevitable, if one is sufficiently determined and the tax is high enough to justify some planning or effort. For example, tax-free like-kind exchanges under section 1031 can be made. Or the land could be contributed to a newly formed (or existing) corporate entity in return for stock. The stock would be passed on to the heirs at death with a stepped-up basis and, then, sold. Since the stock is an intangible, it likely would not have a Minnesota situs if the owner is a nonresident. There are, of course, ways that the state could attempt to prevent these types of arrangements. But they would complicate the income tax or estate tax or both and it is not clear whether they would be effective.

[41] For example, in fiscal years 1991-92, the estate tax raised 0.33 percent of all state taxes, while for fiscal years 2000-01 it raised 0.56 percent or about a 70 percent increase over the decade. Revenues from the tax are volatile and it can be misleading to compare two years. But this trend generally persisted through the 1990s.

financial affairs to avoid or reduce the tax and (2) the usual costs of appraising assets, preparing returns and so forth. It seems likely that the first category is more important than the second, i.e., more resources are spent on planning (especially since it typically is done several times) and there are social and economic costs of the techniques used to avoid the taxes.

Extravagant claims have been made about the cost of complying with the federal estate tax.[42] Regardless of the merits of these claims, it seems clear that the estate tax imposes substantial compliance and administrative costs. By contrast, a state pick-up tax imposed relatively few compliance costs. Taxpayers incurred the costs to comply with the federal tax; because the state tax so closely followed the federal, it added only a few costs. After EGTRRA, the costs of complying with state taxes will loom larger.[43] Some of these costs —particularly domicile planning—appear unavoidable. They are an inherent part of a federal system of states with divergent tax systems. But compliance and administrative costs can be minimized by restricting a state tax (1) to the federal tax base (i.e., imposing it on the federal taxable estate) and (2) to estates that are taxable under federal law.

Part 4: Options for Modifying the Minnesota Estate Tax

This section discusses several options for modifying the Minnesota estate tax in response to EGTRRA. The options selected are those likely to be discussed by the legislature, adopted by other states, or that have been proposed by various academic or other policy experts.[44]

Option 1: Phase-out the Tax as the Federal Credit Phases Out

This is the approach that most of the states with pick-up taxes seem likely to adopt.[45] It will reduce the estate tax revenues in steps beginning in fiscal year 2003 until the tax is eliminated in fiscal year 2006.

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[42] The cost of compliance and studies done of these costs are discussed in Charles Davenport and Jay A. Soled, "Enlivening the Death Tax-Death-Talk," 84 Tax Notes 591, 618-25 (July 26, 1999). Davenport and Soled cite claims by others that the cost of compliance with the federal tax exceed 65 percent of the revenues from the tax. Their own estimates are much more modest, ranging from about 6 percent to 9 percent of revenues.

[43] *See* Carolyn Joy Lee, "The Unfortunate State Tax Side Effects of Federal Death Tax 'Repeal'," 22 State Tax Notes 935 (Dec. 17, 2001).

[44] For example, see the options discussed in Leonard E. Burman and William G. Gale, "The Estate Tax Is Down But Not Out," Urban Institute, Tax Policy Issues and Options No. 2, pp. 5-6 (Dec. 2001).

[45] This conclusion is based on anecdotal evidence from e-mail responses to questions posted on list-serves maintained by the Federation of Tax Administrators and National Conference of State Legislatures. *See also* "House Speaker: Tax System Must Roll With Big Federal Changes," 22 State Tax Notes 994-95 (Dec. 24, 2001) (Speaker of Vermont House speculating tax would be eliminated altogether in Vermont to keep affluent residents from changing their residence). As noted above, the Florida and Nevada constitutions mandate this for their states.

Revenue effects. The fully phased-in cost of a full conformity in Minnesota is approximately $65 million per year, based on the February 2002 Department of Finance forecast. This fully phased-in cost would occur in fiscal year 2006. The costs before fiscal year 2006 are detailed in the table below. The costs per fiscal year as the federal credit phases out are listed in the table below.

Cost of full conformity to EGTRRA (in thousands)		
FY2003	**FY2004**	**FY2005**
$15,200	$32,000	$46,500

Source: Minnesota Dept. of Revenue (4/5/2002)

Advantages

- It prevents the estate tax from causing affluent residents to relocate to states without state death taxes, such as Florida and Nevada.
- It is simple and easy to comply with, since the estate tax would completely disappear for individuals dying after December 31, 2004.

Disadvantages

- It would result in the loss of significant amounts of state revenue when the state is in tight fiscal times.
- It would eliminate what is likely the most progressive state tax.
- Total elimination of the estate tax would increase horizontal inequity to the extent that the tax acts as a backstop to the income tax for individuals with large holdings of unrealized capital gains.

Option 2: Adopt the Governor's Supplemental Budget Proposal

The governor's supplemental budget proposes to continue imposing a Minnesota estate tax. This tax would be a modified version of the current pick-up tax. It would impose tax only on estates that are subject to a federal filing requirement (as of January 1, 2002). Thus, gross estates smaller than $1 million would be exempt from taxation. However, the tax would be computed as under present law. For example, for decedents dying during calendar year 2002, a $700,000 exemption would apply and the state death tax credit would not be reduced by 25 percent.

Revenue effects. The Department of Revenue estimates the cost to be $3.5 million in fiscal year 2003. The costs per year are shown in the table below. The costs decline in fiscal year 2005, as the estimated cost of the increase in the exemption to $1 million dollar is offset by the fact that the underlying forecast also included the cost of phasing up the exemption/unified credit amount to $1 million.[46]

Cost of governor's estate tax proposal (in thousands)		
FY2003	**FY2004**	**FY2005**
$3,500	$5,300	$2,800

Source: Minnesota Dept. of Revenue (4/5/2002)

Advantages

- It would reduce compliance and administrative costs. For decedents dying before January 1, 2004, no estate would be required to file a Minnesota estate tax return unless the estate had an obligation to file a federal estate tax return. The planning benefits would be more modest; individuals would need to take into account the state tax in deciding how to minimize combined federal and state taxes.

- It would minimize the revenue loss to the state budget, as compared with either full conformity (repeal) or conforming to the federal exemption amount as it rises to $3.5 million.

- It could be viewed as a temporary measure to preserve most of the revenues until the budget situation improves and it is clear what direction other states and Congress will take in developing a more permanent structure for the estate tax.

Disadvantages

- The structure of a higher filing requirement than the tax threshold will lead to some anomalous results—e.g., two estates with the same federal taxable estate, one of which is exempt from taxation (because the gross estate was under the $1 million filing requirement) and the other which pays tax. An example would be a gross estate of $1.1 million with a charitable bequest of $200,000 as compared to a gross estate of $900,000. Both estates have net estates of $900,000, but only the former estate pays tax. This aspect would disappear when the exemption phases up to $1 million by calendar year 2006.

- The compliance and administrative benefits are temporary. The proposal was designed principally to prevent estates from being required to file, if they have no federal filing requirement. This benefit disappears in two years (decedents dying after December 31, 2003), when EGTRRA increases the unified credit/exemption amount to $1.5 million. At

[46] This was done in the 1998 federal update provisions of the 1998 omnibus tax act, which adopted the provisions of the federal Taxpayer Relief Act of 1997. 1998 Minn. Laws 1071, ch. 389, art. 7 § 11.

that point, some estates with no federal filing obligation (those larger than $1 million but not more than $1.5 million) will be required to file a Minnesota return.

- As compared with full conformity to the federal changes, this option may induce relocations or changes in domicile by older affluent individuals. If so, this could cause an unexpected loss of both estate and income tax revenues. The DOR estimates do not take into account any potential domicile changing effects of a stand-alone estate tax.

Option 3: Adopt a Variant on the Governor's Proposal

Variants could include:

- **Adopting a true $1 million exemption**
- **Setting the exemption at the EGTRRA exemption amount or**
- **Exempting estates from Minnesota tax if they have no federal tax obligation**

These options could be done in combination with raising the rates on taxable estates to hold revenues constant with the governor's proposal, or the rates could be adjusted to yield a larger (or smaller) revenue loss. To conform to EGTRRA's exemption and hold revenues constant with the governor's proposal would require an across the board rate increase of about 6 percent. Larger rate increases would be required in later years, as the credit/exemption amounts under EGTRRA increase.

Revenue effects. Table F shows the estimated costs of the three alternatives, broken down by fiscal year. The cost of conforming to the federal exemption amount option will increase in later years, as EGTRRA increases the exemption amount to $3.5 million. By contrast, the cost of the a true $1 million exemption will decline, since this cost is already reflected in the underlying forecast, effective for individuals dying after December 31, 2005.

Table F

General Fund Cost of Various Estate Tax Options
(in thousands)

	FY2003	FY2004	FY2005
Conform to EGTRRA's exemption	$ 4,900	$ 7,300	$ 9,900
$1 million exemption	4,900	7,300	4,500
Exempt unless federal tax obligation	4,400	6,500	9,000

Source: Minnesota Dept. of Revenue (3/8/2002)

Advantages

- As compared with the governor's budget proposal, providing a true exemption of $1 million would eliminate the anomalous effects of taxing some estates that have no federal tax obligation simply because they have a federal filing obligation. However, the option of exempting all estates without a federal tax obligation would create its own "cliff." A small federal tax obligation could generate an even larger state obligation, since the tax would apply based on the pre-EGTRRA exemption/unified credit amount.

- Compliance and administration would be easier. By tying the exemption to the federal amount, this option would have a big advantage in terms of simplicity and costs of compliance. Estates that are exempt from federal filing when the unified credit/exemption amount increases would also be exempt from Minnesota tax.

- The reduced estate tax burdens under this approach should help mitigate adverse migration or domicile planning by individuals with estates near to the taxable thresholds.

Disadvantages

- This option has a substantially higher revenue loss than the governor's proposal. This cost increases if the exemption amount is tied to the federal amount in 2004 and later years, when the unified credit/exemption amount is scheduled to increase.

- It modestly increases the regressivity of the state tax system, but much less than full conformity since the largest estates continue to pay substantial tax.

- Although it reduces the tax quite significantly on estates that are near the tax thresholds, it provides proportionately smaller reduction to the largest estates. Thus, it may do little to mitigate the potential for migration or domicile shifting by the owners of these large estates.

Option 4: Follow Rhode Island and Wisconsin in Freezing the Estate Tax at the 2001 Levels

This approach would freeze the unified credit/exemption amount at $675,000 and would raise additional revenues as compared with the baseline February 2002 forecast.

Revenue effects. The Department of Revenue has not prepared an estimate of how much revenue would be raised by this option, as compared with current law. In 1998, DOR estimated the fiscal year 2001 revenue loss of adopting the higher exemption/credit amounts to be approximately $1.5 million. If these increases in the exemption are repealed, the revenue raised would likely be somewhat higher than the 1998 estimates, reflecting the phasing up of the exemption amount after calendar year 2000 (roughly the last year included in 1998 estimate) and the overall increase in estate tax collections since 1998.

Advantages

- This option's main advantage is that it provides additional revenue from a progressive tax source.

- It could reduce the potential for domicile shifting or migration, if the additional revenues are used to reduce the estate tax rates, if the concern is that owners of large estates will move out of Minnesota to avoid the tax.

Disadvantages

- This option will increase complexity, compliance, and administrative costs. Estates that are exempt from federal tax will be required to file and pay state tax. DOR will not be able to rely primarily on enforcement of the tax by the federal government.

- As compared with full conformity to the federal changes, this option may induce relocations or changes in domicile by older affluent individuals. If so, this could cause an unexpected loss of both estate and income tax revenues. The DOR estimates do not take into account any potential domicile changing effects of a stand-alone estate tax. The potential effects seem likely to be on the same order as the two preceding options. The increases (as compared with Options 2 and 3) will tend to impose the most significant percentage increases on estates near the exemption amount.

Option 5: Replace the Estate Tax with An Inheritance Tax

This could be dubbed the back-to-the-future option, since it would return Minnesota to the tax system it had before 1980. A variety of different structures for the tax could be developed. A common one would be to totally exempt bequests to surviving spouses, impose a lower rate tax on bequests over an exemption amount to surviving children (one variant is lower rates for minor children), and impose higher tax rates on bequests over an exemption amount to collateral heirs. The tax would still be paid by and collected from the estate, so administration would parallel the estate tax, although the tax obligation would vary depending upon to whom the estate devolves.

Advantages

- An inheritance tax may be attractive if the policy goals are to (1) retain something like the current method of administering and collecting the death tax (i.e., from the administrator of the estate) and (2) vary the tax depending upon the closeness of the relationship with the decedent and the amount an individual recipient receives.

- An inheritance tax can provide a viable state revenue source. The amount of revenue will depend upon the exemption amount(s) and tax rates.

- To reduce the potential for the state death tax causing domicile shifting or migration, an inheritance tax could be used to impose a small tax on most estates to (partially) offset tax reductions for large estates. This makes sense, if the primary concern is that high state death taxes on large estates after elimination of the federal credit will cause older, affluent individuals to change their domiciles from Minnesota. This could also be done with a lower rate estate tax on all but the smallest estates.

- Inheritance taxes are the most common death tax structures in other countries and in states with stand-alone death taxes.[47]

Disadvantages

- This option will increase complexity, compliance, and administrative costs. Estates that are exempt from federal tax will be required to file and pay state tax. This approach is more complex than an estate tax that follows federal concepts. This is true particularly for estates that are subject to the federal tax; for these estates, an estate tax that follows the federal tax base (even with a smaller exemption) would be simpler. DOR will not be able to rely primarily on federal enforcement and administration of the tax. Larger numbers of returns will need to be processed, compared with current law.

- It goes against the trend across the country and likely would be unpopular.

- Depending upon the rates and exemptions, it would likely reduce the progressivity of the estate tax somewhat.

- Most policy experts would likely argue that either an estate tax or income taxation of bequests is preferable from an equity perspective. An inheritance tax varies tax liability based on the number of recipients of bequests from the estate (and possibly their relationships to the decedent), but does not take into account the resources or incomes of the recipients. Thus, it does not satisfy equity norms either from the perspective of the decedent or the beneficiaries, as well as an estate tax or income taxation of recipients would.

Option 6: Tax Bequests to the Recipient Under the Income Tax

Various academics and other policy experts have suggested this approach.[48] Under this approach, heirs would report bequests as income on their state income tax returns. Some threshold exclusion amount could be provided, probably tied, at least, to the annual gift tax exclusion (currently $11,000). Gifts and bequests to surviving spouses and minor children could be allowed larger exemptions to continue the estate tax (and old inheritance tax) policies in this regard.

Various design issues would need to be addressed: To avoid distinguishing between *inter vivos* gifts and bequests, should recipients of gifts over the exemption amount be required to include the portion of the gift over the exemption in income? If they are, should basis differences be permitted for Minnesota tax purpose, since gifts carry over the donor's basis?[49] Should the

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[47] Ten states with stand-alone death taxes have inheritance taxes; two states have estate taxes. *See* Appendix B.

[48] *See, e.g.,* Joseph M. Dodge, "Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income," 91 Harv. L. Rev. 1177 (1978).

[49] I.R.C. § 1015 (2001).

proceeds of life insurance (which are commonly includible in the taxable estate) be included? Doing so would avoid favoring one form of investment over another. How should transfers into trusts be treated?[50]

Advantages

- This option would allow elimination of the estate tax with its attendant administrative and compliance costs.

- To the extent that one's equity benchmark is measured relative to the recipients of bequests (and gifts), this option will tend to treat all recipients more nearly alike. It more closely mirrors an inheritance tax type approach by varying the tax based on the amount of the bequest to the individual, rather than the size of the overall estate.

- Taxing bequests and gifts is consistent with income tax policy principles, both for those who prefer a comprehensive income tax or a consumption type tax.[51]

- It may reduce the potential for the death tax to induce relocation or domicile changes. It seems more likely that the typical decedent in the years before death would change his or her domicile to avoid a state estate tax, than a potential heir would to avoid income taxation of the bequest. The decedent-owner will likely be older, retired, and more affluent. A retired individual may already spend a good share of the year at a second home in a Sunbelt state, such as Florida or Nevada. Furthermore, relocation avoids the tax for the entire estate, i.e., for all of the heirs. By contrast, recipients of bequests are more likely to be younger and employed and, as a result, more closely bound to Minnesota. The decedent-owner has a larger incentive to move and it will be easier for her to do so.

- This option would shift some of the burden of Minnesota death taxes to the estates of nonresident decedents who make bequests to Minnesota residents. Of course, this comes at the expense of the Minnesota recipient. In a world in which Minnesota has an estate tax and other states do not, it would equalize the death taxes imposed on all Minnesota heirs. By contrast, under an estate or inheritance tax, a resident beneficiary of an estate in a state without a death tax would receive a larger inheritance than a beneficiary of an in-state estate, everything else being equal.

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[50] One possibility would be to treat distributions from trusts as includible in taxable income. This raises questions as to the income taxation of trusts and estates. For simplicity they could be exempted from state tax, since the tax will be paid when distributions are made. Since this deviates from the federal tax rules, it would complicate the state income tax.

[51] David F. Bradford and U.S. Treasury Tax Policy Staff, Blueprints for Basic Tax Reform 29-31 (2d ed. Revised, 1984).

Disadvantages

- Although it reduces the compliance and administration costs associated with the estate tax, it shifts some of those (or perhaps even more) problems to the state income tax. There is no federal reporting obligation for bequests; estates do not issue 1099s or K-1 forms to recipients of bequests. Minnesota could impose such an obligation on Minnesota estates, but this would be a burden on administrators and the Department of Revenue (and potentially probate courts and registrars, if they were expected to have a role in enforcement). It could complicate the ability to use quick, simple, and inexpensive probate processes. Depending upon how large the exemption amount is, the tax could apply to many more estates than the estate tax now applies to. The state could not impose a reporting obligation on out-of-state estates that pay bequests to Minnesota residents. Compliance would likely be spotty for bequests to Minnesota residents from estates domiciled in another state.[52]

- This option could complicate the state income tax quite a bit. Some of these issues are noted above as design issues. This would particularly be the case if it is considered necessary to provide basis differences from federal law or different fiduciary tax rules.

- This option could substantially change who bears the burden of the state death tax. Out-of-state recipients of bequests from Minnesota domiciled estates would escape taxation.[53] Depending upon what exemptions are provided, beneficiaries of more modest sized estates would likely pay more. Beneficiaries of very large estates would pay less than the estate pays in estate tax under present law, since the top income tax rate is 7.85 percent while the estate tax rate can be as high as 16 percent.

- For estates subject to the federal estate tax, this option will reduce the federal tax benefits of the deductibility of state taxes. An income tax on the recipient of a bequest would likely not be deductible from the federal estate tax.[54] The recipient could deduct the

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[52] There is not much experience with compliance with reporting types of income that are not taxable for federal purposes. One example is interest on out-of-state municipal bonds, but this is a common provision in most state income taxes and information is also reported on federal tax returns. Compliance might be similar to the very low compliance with the consumer use tax on purchases made from remote sellers. One would normally expect somewhat better experience, since individuals regularly file state income tax returns, but are not expected to do so for use tax returns. For estates that have a federal estate tax filing obligations, recipients of bequests (with taxpayers identification numbers and estimated amounts) are reported on the Form 706, the federal estate tax return. However, the federal government likely does not enter these amounts electronically and, thus, they would be of little use for state compliance efforts. Even if this data were readily available from the Internal Revenue Service, it would not help with the many estates that have no estate tax filing obligation. Of course, if the federal estate tax disappears as scheduled, this source of data for compliance and enforcement also disappears.

[53] It may be possible to impose an income tax on these individuals on the theory that the situs of the income is in Minnesota. This seems contrary to the likely notion that this is income from an intangible that could only be taxed to a domiciliary or resident.

[54] The deduction is allowed for "any estate, succession, legacy, or inheritance tax imposed by a State[.]" I.R.C. § 2053(d)(1)(A) (2001). It seems unlikely that a state income tax on bequests would qualify. If it did, this tax would

income tax paid as an itemized deduction from the income tax. But since the federal estate tax is imposed at higher rates than the income tax, this would result in a net reduction of the federal tax benefit.

- Taxing bequests could create some problems of coordination with other states' death taxes. Bequests to Minnesota residents from estates in states with stand-alone death taxes could be perceived as being subject to "double taxation." The estate in the state of domicile would pay an estate or inheritance tax and the Minnesota recipient would pay the Minnesota income tax on the bequest. Allowing a credit against the Minnesota income tax for the state inheritance or estate tax paid in the other state could solve this problem. Such a credit would likely be complicated to calculate, since it would need to allocate a state estate tax to the recipient. The out-of-state administrator of an estate would have no reason to make these calculations or necessarily to provide the information needed to make them.

Option 7: Tax Capital Gains on Death

Some academics and policy experts have also suggested taxing the decedent on unrealized capital gains at death, often referred to as deemed realization on death.[55] Both Canada and New Zealand have repealed their estate and transfer taxes and replaced them with deemed realization systems. Under a deemed realization system, the decedent is "deemed" to realize capital gains upon death. This essentially elevates the function of the estate tax to that of a pure "backstop" to the income tax. This is the mirror of Option 6, but instead of taxing the bequest to the recipient, the unrealized gain is taxed to the decedent. More importantly, the tax is limited to the unrealized capital gain, whereas income taxation of bequests would not be limited to the unrealized capital gains.

Advantages

- A deemed realization tax would increase horizontal equity, if the equity benchmark is the decedent/estate. The principal theoretical advantage of this approach is that it prevents "double taxing" of income. Under an estate or inheritance tax, much income is subject to taxation to the decedent under both the individual income tax and the estate tax. This is true for wages, salaries, interest, dividends, and realized capital gains. By contrast, unrealized capital gains may be subject to one tax, the estate tax, for a small percentage of estates (about 2 percent), but escape taxation altogether because of the step-up in basis.[56] A deemed realization tax eliminates the double taxing of income and ensures that all income (perhaps above an exemption amount) is subject to one tax, the income tax.

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be deductible under both the federal estate tax and the income tax, an unlikely result.

[55] *See, e.g.,* Joseph M. Dodge, "A Deemed Realization Approach is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)," 54 Tax Law Rev. 421 (2001).

[56] I.R.C. § 1014 (2001).

- The tax would be administered and paid by the personal representative of the estate. In some ways it would be similar to the estate tax and could be administered similarly to the estate tax. No new tax return would need to be filed, since it could be paid on filing a final income tax return for the decedent.

- The tax would likely generate significant revenue. It has been estimated that unrealized gains are about 35 percent of the value of all estates.[57] The income tax rate is considerably lower than the typical estate tax rate, but the tax could be justified in applying to more estates as a supplement to the income tax.

Disadvantages

- As with the estate tax, a deemed realization system would present valuation problems. A fair market value would need to be assigned to all property (personal use property would likely be exempted) to determine if there are unrealized capital gains.

- In addition to the valuation problems, the tax presents the same problems as a carryover basis system. In many cases, the personal representative may have difficulty determining what the decedent's basis was in the assets because of poor or nonexistent records. These problems doomed the federal efforts to adopt a carryover basis regime in the 1970s and led to its repeal. Canada addressed these issues by allowing a step-up in basis to fair market value on a "national valuation date." This sort of approach obviously could not be adopted by an individual state, given the migration of residents from state to state.

- The tax would create administrative difficulties, since the state cannot rely upon the federal tax for help in enforcement or easing the compliance burden on taxpayers. If it applies to a much larger proportion of estates than are subject to the current estate tax, it could bog down and complicate the probate process.

- If no exemptions are provided or the exemption amounts are small, liquidity objections will be raised by farmers and small business owners. Although the tax will be modest (less than 8 percent of the value of the assets), it may require liquidating or borrowing against assets to pay the tax. The estate tax now provides a variety of provisions, aside from the generous exemptions, to ease these concerns. Layering them onto a deemed realization tax would complicate the tax considerably.

- This tax could reduce the federal tax benefits of deductibility, since the tax likely would be deductible from the federal income tax, rather than the estate tax.

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[57] James M. Poterba and Scott Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death," in *Rethinking Estate and Gift Taxes* 439 (2001) (estimate of unrealized capital gains at death of 36 percent of the value of all estates, excluding the Forbes 400). They found a "weak association" between the size of the estate and its share of its value in unrealized capital gains. At the highest level (estates over $10 million), unrealized gains constituted 56 percent of the estates' value.

Appendix A
Amount of Federal Credit for State Death Taxes

The following table displays the credit for state death taxes under the law before the phase-down and elimination of the credit under EGTRRA. The adjusted estate is the amount of the taxable estate reduced by $60,000 (i.e., before the unified credit/exemption amount).

If the adjusted taxable estate is:	The maximum tax credit is:
Not over $90,000	0.8% of the amount by which the taxable estate exceeds $40,000
Over $90,000 but not over $140,000	$400 plus 1.6% of the excess over $90,000
Over $140,000 but not over $240,000	$1,200 plus 2.4% of the excess over $140,000
Over $240,000 but not over $440,000	$3,600 plus 3.2% of the excess over $240,000
Over $440,000 but not over $640,000	$10,000 plus 4% of the excess over $440,000
Over $640,000 but not over $840,000	$18,000 plus 4.8% of the excess over $640,000
Over $840,000 but not over $1,040,000	$27,600 plus 5.6% of the excess over $840,000
Over $1,040,000 but not over $1,540,000	$38,800 plus 6.4% of the excess over $1,040,000
Over $1,540,000 but not over $2,040,000	$70,800 plus 7.2% of the excess over $1,540,000
Over $2,040,000 but not over $2,540,000	$106,800 plus 8% of the excess over $2,040,000
Over $2,540,000 but not over $3,040,000	$146,800 plus 8.8% of the excess over $2,540,000
Over $3,040,000 but not over $3,540,000	$190,800 plus 9.6% of the excess over $3,040,000
Over $3,540,000 but not over $4,040,000	$238,800 plus 10.4% of the excess over $3,540,000
Over $4,040,000 but not over $5,040,000	$290,800 plus 11.2% of the excess over $4,040,000
Over $5,040,000 but not over $6,040,000	$402,800 plus 12% of the excess over $5,040,000
Over $6,040,000 but not over $7,040,000	$522,800 plus 12.8% of the excess over $6,040,000
Over $7,040,000 but not over $8,040,000	$650,800 plus 13.6% of the excess over $7,040,000
Over $8,040,000 but not over $9,040,000	$786,800 plus 14.4% of the excess over $8,040,000
Over $9,040,000 but not over $10,040,000	$930,800 plus 15.2% of the excess over $9,040,000
Over $10,040,000	$1,082,800 plus 16% of the excess over $10,040,000

Appendix B
State Death Taxes and EGTRRA: Will EGTRRA Automatically Reduce State Taxes?

State-by-State Comparison				
	Pick-up tax			
State	With automatic update to federal changes	Tied to federal law as of a specific date*	Stand-alone state death tax before EGTRRA	Stand-alone state tax enacted in reponse to EGTRRA
Alabama	Yes[1]			
Alaska	Yes[2]			
Arizona	Yes[3]			
Arkansas		1/1/1999[4]		
California	Yes[5]			
Colorado	Yes[6]			
Connecticut	Yes[7]		Inheritance[8]	
Delaware	Yes[9]			
District of Columbia		1/1/1986[10]		
Florida	Yes[11]			
Georgia	Yes[12]			
Hawaii	Yes[13]			
Idaho	Yes[14]			
Illinois	Yes[15]			
Indiana	Yes[16]		Inheritance[17]	
Iowa	Yes[18]		Inheritance[19]	
Kansas		12/31/1997[20]		
Kentucky	Yes[21]		Inheritance[22]	
Louisiana	Yes[23]		Inheritance[24]	
Maine	Yes[25]			
Maryland	Yes[26]		Inheritance[27]	
Massachusetts	Yes[28]			
Michigan	Yes[29]			
Minnesota		12/31/2000[30]		
Mississippi	Yes[31]			
Missouri	Yes[32]			
Montana	Yes[33]			
Nebraska	Yes[34]			
Nevada	Yes[35]			
New Hampshire	Yes[36]		Inheritance[37]	

State-by-State Comparison				
	Pick-up tax		Stand-alone state death tax before EGTRRA	Stand-alone state tax enacted in reponse to EGTRRA
State	**With automatic update to federal changes**	**Tied to federal law as of a specific date***		
New Jersey	Yes[38]		Inheritance[39]	
New Mexico	Yes[40]			
New York		7/27/1998[41]		
North Carolina	Yes[42]			
North Dakota	Yes[43]			
Ohio	Yes[44]		Estate[45]	
Oklahoma	Yes[46]		Estate[47]	
Oregon		1997[48]		
Pennsylvania	Yes[49]		Inheritance[50]	
Rhode Island	Yes[51]			Estate tax credit for state death taxes under federal estate tax, in effect as of 1/1/2001.[52]
South Carolina		12/31/2000[53]		
South Dakota		1/1/2001[54]		
Tennessee	Yes[55]		Inheritance[56]	
Texas	Yes[57]			
Utah	Yes[58]			
Vermont	Yes[59]			
Virginia		1/1/1978[60]		
Washington		1/1/2001[61]		
West Virginia	Yes[62]			
Wisconsin	Yes[63]			Estate tax equal to credit for state death taxes under federal estate tax in effect on 12/31/00. Applies to decedents dying between 9/30/02 and before 1/1/08.[64]
Wyoming	Yes[65]			

* Unless otherwise noted, refers to the date through which the Internal Revenue Code was amended.

Notes to Table:

1. Ala. Code § 40-15-2.
2. Alaska Stat. § 43.31.011.
3. Ariz. Rev. Stat. §§ 42-4001; 42-4051.
4. Ark. Code Ann. § 26-59-106, but Arkansas law provides the estate tax "shall cease to be operative when the United States Government ceases to impose any estate tax of the United States." Ark. Code Ann. § 26-59-103. Even though Arkansas ties its pick-up tax to the Internal Revenue Code as January 1, 1999, this provision would appear to result in no Arkansas tax if the actual repeal of the federal tax ever takes effect.
5. Cal. Rev. & Tax. Code § 13302.
6. Colo. Rev. Stat. §§ 39-23.5-102(9.5); 39-23-103.
7. Conn. Gen. Stat. § 217-12-319 (2001). The tax also provides it is void, if the federal estate tax is repealed. Conn. Gen. Stat. § 217-12-399.
8. Connecticut is phasing out its inheritance tax. The tax will be eliminated for deaths occurring on or after January 1, 2005. *See* Conn. Gen. Stat. § 216-12-344(e) (2001). In a special session in November 2001, Connecticut delayed by a year the phase-out of its inheritance tax. 2001 Conn. Acts 01-1 (Nov. Spec. Sess.).
9. Del. Code Ann. tit. 30 §§ 15-1501(2); 15-1502.
10. D.C. Code Ann. §§ 47-3701(4) and (6); 47-3702.
11. Fla. Stat. § 198.02 (2001). The Florida Constitution prohibits levying an estate tax that exceeds the federal credit. Fla. Const. art. VII § 5 ("No tax upon estates or inheritances or upon the income of natural persons who are residents or citizens of the state shall be levied by the state, or under its authority, in excess of the aggregate of amounts which may be allowed to be credited upon or deducted from any similar tax levied by the United States or any state.")
12. Ga. Code Ann. § 48-12-2(b).
13. Haw. Rev. Stat. §§ 236D-2; 236D-3 (2001).
14. Idaho Code § 14-402(3).
15. 35 Ill. Comp. Stat. §§ 405/2 - 405/4.
16. Ind. Code §§ 6-4.1-1-4; 6-4.1-11.1; 6-4.1-11-2 (2001).
17. Ind. Code §§ 6-4.1-2-1 (2001).
18. Iowa Code §§ 451.1 - 451.2.
19. Iowa Code § 450.3.
20. Kan. Stat. § 79-15,101(a).
21. Ky. Rev. Stat. § 140.130 (2001).
22. Ky. Rev. Stat. § 140.01 (2001).
23. La. Rev. Stat. §§ 47.2431; 47.2432.
24. La. Rev. Stat. § 47.2403 (2001). The Louisiana inheritance tax is being phased down (but not eliminated) over several years. For deaths occurring after June 30, 2003, it will be 80 percent of the level imposed for deaths occurring before July 1, 1998.

25. Me. Rev. Stat. tit. 36 § 4063.

26. Md. Code Tax-Gen. §§ 7-304; 7-309 which provides:

    If Congress passes an act that repeals the federal credit under § 2011 of the Internal Revenue Code and does not enact a similar statute as a substitute:

    > (1) the provisions of this subtitle that are in effect before the passage of the Act of Congress shall apply with respect to a decedent who died before the end of the period covered by a budget bill that the General Assembly passed before the effective date of the Act of Congress; and
    >
    > (2) this subtitle is void with respect to a decedent who dies after the effective date of the Act of Congress.

27. Md. Code Ann. Tax-Gen. § 7-202.

28. Mass. Ann. Laws ch. 65C, §§ 2A (2001).

29. Mich. Comp. Laws § 205.202a.

30. Minn. Stat. § 291.005, subd. 1 (8) (2000), as amended by 2001 Minn. Laws, 1st spec. sess. Ch. 5 art. 10, § 10.

31. Miss. Code Ann. § 27-9-5.

32. Mo. Rev. Stat. § 145-011.

33. Mont. Code Ann. § 72-16-904 (2001).

34. Neb. Rev. Stat. § 77-2101.01.

35. Nevada is constitutionally limited to a pure pick-up tax. Nev. Const. art. 10 § 4 provides:

    The legislature may provide by law for the taxation of estates taxed by the United States, but only to the extent of any credit allowed by federal law for the payment of the state tax and only for the purpose of education, to be divided between the common schools and the state university for their support and maintenance. The combined amount of these federal and state taxes may not exceed the estate tax which would be imposed by federal law alone.

36. N.H. Rev. Stat. § 87.1.

37. N.H. Rev. Stat. § 86.6. The New Hampshire inheritance tax is scheduled to be eliminated January 1, 2003.

38. N.J. Rev. Stat. §§ 54:38-1.

39. N.J. Rev. Stat. §§ 54:34-1 *et seq.*

40. N.M. Stat. Ann. §§ 7-7-2; 7-7-3.

41. N.Y. Tax Law § 951. The statute provides that "Notwithstanding the foregoing [the date reference to July 27, 1998], the unified credit against the estate tax provided in section two thousand ten of the internal revenue code shall, for purposes of this article, be the amount allowed by such section under the applicable federal law in effect on the decedent's date of death. Provided, however, the amount of such credit allowable for purposes of this article shall not exceed the amount allowable as if the federal unified credit did not exceed the tax due under section two thousand one of the internal revenue code on a federal taxable estate of one million dollars." This appears to cap the unified credit at its pre-EGTRRA level.

42. N.C. Gen. Stat. § 105-32.2.

43. N.D. Cent. Code § 57-37.1-04.

44. Ohio Rev. Code Ann. § 2113.85.

45. Ohio Rev. Code Ann. § 5731.02.

46. Okla. Stat. tit. 68 § 8-804 (2001).

47. Okla. Stat. tit. 68 § 8-802 (2001).

48. Or. Rev. Stat. § 118.010. Statute contains an open-ended reference to federal law, but the Department of Revenue has apparently taken the position that the Oregon constitution prohibits adoption of future federal changes. *Cf. State v. Charlesworth*, 151 Or. App. 100, 951 P.2d 951 (1997) (*dicta* that it is unconstitutional delegation of legislative power for legislation to adopt subsequent amendments to a federal statute).

49. 72 Pa. Cons. Stat. § 9117 contains an open-ended reference to the amount of the federal credit, but the reference refers to the public law that enacted the Tax Reform Act of 1986. I presume, however, that the state treats the reference as automatically updating to later changes.

50. 72 Pa. Cons. Stat. § 9106.

51. R.I. Gen. Laws § 44.22-1.1 (2000).

52. R.I. Gen. Laws § 44.22-1.1 (2000), as amended by 2001 R.I. Pub. Laws, ch. 77, art. 7 § 3.

53. S.C. Code Ann. §§ 12-6-40(A); 12-6-20(2) and (5); 12-16-510(A), as amended by 2000 S.C. Acts, Act 89 § 6.

54. S.D. Codified Laws §§ 10-40A-1; 10-40A-2 (2001).

55. Tenn. Code Ann. §§ 67-8-202; 67-8-204.

56. Tenn. Code Ann. §§ 67-8-301 *et seq.*

57. Tex. Tax Code Ann. §§ 211.003; 211.051.

58. Utah Code Ann. §§ 59-11-102(9); 59-11-103 (2001).

59. Vt. Stat. Ann. tit. 33 §§ 7402; 7442a(a).

60. Va. Code Ann. §§ 58.1-901; 58-1.-902 (2001) ("In no event, however, shall such amount [the amount of the federal credit for state death taxes under I.R.C. § 2011] be less than the federal credit allowable by § 2011 of the Internal Revenue Code as it existed on January 1, 1978.")

61. Wash. Rev. Code § 83.100.020(15), as amended by 2001 Wash. Laws ch. 320 § 15, Wash. Adv. Legis. Serv.

62. W. Va. Code §§ 11-11-2(b)(5); 11-11-3 (2000).

63. Wis. Stat. § 72.02 (2000).

64. 2001 Wis. Act No. 16 § 2000d.

65. Wyo. Stat. Ann. §§ 39-19-101; 39-19-103; 39-19-104.