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Support Decoupling CT's Estate Tax From Federal Estate Tax Changes: sSB 592¹

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What does sSB592 do? The bill decouples CT's estate tax from federal estate tax changes resulting in a *revenue gain of \$158M in FY 06 (10 months) and \$190M in FY 07 and each year thereafter.*²

Why is decoupling necessary to preserve CT's estate tax? The federal estate tax has provided taxpayers with a dollar-for-dollar credit against their federal estate tax liability for state estate and inheritance tax payments, up to a specified amount. Like many other states, CT levied an estate tax equal to the maximum credit that could be taken against the federal estate tax. In this way, states were able to raise additional revenue without increasing taxes beyond that which individuals would otherwise be required to pay by the federal estate tax.

However, in June 2001 the federal government adopted a tax cut package that included a gradual phasing down of the federal estate tax by the year 2010, and a more rapid phasing down of the federal credit by the year 2005. As a result, states like Connecticut that continue to tie their estate tax to the federal credit have seen and will continue to see their estate tax revenues decline.

Why should Connecticut decouple to preserve its estate tax?

- Connecticut's estate tax is an important source of state revenue.
- Allowing Connecticut's estate tax to disappear will make the state's overall tax structure more regressive.
- The estate tax is a means of taxing income that might otherwise evade taxation, such as unrealized capital gains.

What is the current status of CT's estate tax? Current Connecticut law imposes a temporary estate tax, payable in lieu of the regular estate tax, on estates valued at over \$1 million of people who die between July 1, 2004 and January 1, 2005. For these estates, the tax is 1.3 times the maximum federal estate tax credit, excluding the 75% federal tax reduction applicable in 2004. This temporary tax is *not* to apply if, by July 1, 2004, the Secretary of the Office of Policy and Management certifies that CT will receive at least \$110 million in extra federal financial assistance in FY 05. There is no decoupling after January 1, 2005.

Are other states decoupled from the federal estate tax changes? Yes. Seventeen states, including our neighboring states, and the District of Columbia are currently decoupled from the federal changes: Massachusetts, New Jersey, New York, Rhode Island, Vermont, Maine, Kansas, Illinois, Maryland, Minnesota, Nebraska, North Carolina, Ohio, Oregon, Virginia, Washington, and Wisconsin. Of these states, eleven acted to decouple from the federal changes and six (plus the District of Columbia) will remain decoupled unless they take legislative action.

¹ This fact sheet deals only with the estate tax provision of sSB 592.

² More specifically, the bill increases the estate and generation-skipping tax rates by decoupling the state taxes from federal estate tax changes and setting the state tax at the amount of the federal estate tax credit as of 1/1/01. It also lowers the threshold of taxable estates and transfers from \$1.5M to \$1M.

Who pays the estate tax? Nationwide, only the *largest estates* – those of the wealthiest 2% -- face estate tax liability. Because Connecticut has such great wealth, the rate is somewhat higher – approximately 3.7% of CT estates face estate tax liability. Stated another way, over 96% of estates are entirely unaffected by the tax. *Moreover, because of changes in the federal estate tax, even if a state delinks its estate tax, each estate, no matter how large, will pay less in combined state and federal estate taxes in 2005 than would have been due previously.*³

Is there evidence that the estate tax will cause wealthy residents to leave Connecticut? No. On the contrary, studies show that most people choose their residence based on proximity to a good job and family and availability of services such as health care.⁴ Estate taxes are an important revenue source for states, enabling them to provide health care, public safety and education – all of which are important to the state’s residents.

What about retirees? State tax systems have only minimal effects on retirees’ choice of where to live. The authors of a recent study concluded that “states should focus on marketing their amenities, rather than using fiscal policy to recruit retirees.”⁵

Does the estate tax force families to liquidate family-owned farms and small businesses? No.

- The reasons family businesses are sometimes not passed to the next generation have very little to do with estate taxes.⁶
- The American Farm Bureau Federation, one of the leading advocates for repeal of estate taxes, admitted that it could not cite a single example of a farm lost because of estate taxes.⁷

Does the estate tax result in unfair double taxation? No. A major portion of most large estates consists of assets that have never been taxed. A primary example of untaxed assets is unrealized capital gains. According to one study, unrealized capital gains make up about 37% of the value of estates worth more than \$1 million and about 56% of estates worth more than \$10 million.⁸ In the absence of an estate tax, the appreciation in these assets would entirely escape taxation since they receive a stepped-up basis when bequeathed.

Is the estate tax different from the inheritance tax? Yes. The estate tax is levied on the estate and collected from the assets of the estate before they are transferred to the heirs. An inheritance tax is a tax on the amount of the estate inherited by each heir and is levied on and collected from the heirs. sSB 592 deals only with Connecticut’s estate tax. Connecticut’s inheritance tax is in the process of being phased out.⁹

³ Center on Budget and Policy Priorities, “Assessing the Impact of State Estate Taxes,” (2004), available at <http://www.cbpp.org/2-18-04sfp.htm> (accessed 04/13/04).

⁴ Id.

⁵ William Duncombe, Mark Robbins, and Douglas Wolf, “Chasing the Elderly: Can State and Local Governments Attract Recent Retirees?,” Aging Studies Program Paper No. 22, Center for Policy Research, Maxwell School of Citizenship and Public Affairs, Syracuse University, September 2000 quoted in Center on Budget and Policy Priorities, “Why States Should Act Now to Preserve Their Estate and Inheritance Taxes,” (2003), FN6, available at <http://www.cbpp.org/12-20-02sfp.htm> (accessed 04/13/04).

⁶ David Cay Johnston, “Study Contradicts Foes of Estate Tax,” *NY Times*, July 25 1999.

⁷ David Cay Johnston, “Talk of Lost Farms Reflects Muddle of Estate Tax Debate,” *NY Times*, April 8, 2001.

⁸ OMB watch, “Frequently Asked Questions about the Estate Tax,” 2002, available at <http://www.ombwatch.org/article/articleview/749/1/119/> (accessed 04/03/02).

⁹ CT’s inheritance tax now applies only to estates of more than \$1.5 million passing to Class B heirs (collateral relatives such as brothers, sisters, nephews, cousins) and to estates over \$400,000 if passing to Class C heirs (persons unrelated to the deceased). Estates of any size that pass to spouses, parents, children, and grandchildren are totally exempt from CT’s inheritance tax now. [See OLR, *Succession and Estate Taxes* (2003-R-0572)(August 7, 2003).