

Connecticut Tax Study Panel Briefing Note The Estate and Gift Tax

Summary

Connecticut Estate and Gift Taxation

1. *A Brief History.* The passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRCA), and the American Taxpayer Relief Act of 2012 (ATRA) fundamentally altered the structure of the federal estate tax. Gone was the state pick-up tax, which allowed for a federal tax credit for state Estate, Inheritance and Gift (EIG) taxes paid. The federal estate tax exemption has been raised from \$675,000 to \$5.43 million, and is now indexed to inflation. The federal estate tax and gift tax are now unified, so that any gifts given beyond the annual limit (currently \$14,000 per recipient) count against the exemption. *Portability*, which allows a spouse to use any unclaimed exemption by his/her deceased spouse, is now a permanent feature of the tax code.

For the states, the immediate effect of the loss of the pick-up tax was a loss in revenues. Some states responded by decoupling their EIG tax from the federal code in order to maintain the tax; by not decoupling, other states effectively let their EIG tax fade away. Other states went one step further by officially eliminating their EIG tax altogether. At present, 20 states, including Connecticut, impose some sort of EIG tax.

2. *Estate and Gift & Connecticut as a Gift Tax Outlier.* With the elimination of Minnesota's gift tax in 2014, Connecticut is the only state imposing a stand-alone gift tax. Similar to federal law, Connecticut's gift tax is a unified tax; all gifts that exceed the annual tax-free limit count against the amount that is exempt from eventual estate taxation. The current estate exemption level of 2 million dollars places Connecticut in the middle of all states nationally. Its highest tax rate of 12% is the second lowest in the nation. Connecticut has one of the lowest tax impacts in the Northeast for large estates.
3. *High Degree of Revenue Uncertainty* EIG tax revenue is notoriously volatile and hard to predict. Not only does the tax depend on people dying, but it also can be paid many years later than the year death occurs. This means that in a given year, EIG revenue is raised from both the estates of recently deceased, as well as those who deceased in years past, which can span numerous years. Since 2001, Connecticut's EIG tax revenue as a share of total tax revenues has exhibited a decreasing trend, from a high of 2.5% to currently below 1%. Only in 2013 is there a significant departure from this trend path.
4. *Size of Connecticut estates are similar to the average State.* Despite anecdotal perspectives on the Connecticut Estate Tax that there are many very high income persons dominating the CT EIG, the data show that for estate tax purposes, the state is not markedly different than the average state (Wallace, October 13) As seen in Table 1, the average gross estate for Connecticut residents is very similar to the simple average across the U.S. Moreover, there is no evidence of Connecticut trending higher or lower than the U.S. average from 2000 to 2013.

Table 1. Federal Estate Tax Returns Average Gross Estate for Tax Purposes (000's)			
Year:	2000	2010	2013
Connecticut	\$1,978	\$7,737	\$13,893
U.S.	\$2,007	\$8,571	\$13,125

Source: IRS Statistics of Income, Tax Stats: <http://www.irs.gov/uac/SOI-Tax-Stats-Estate-Tax-Statistics-Filing-Year-Table-2> Notes: Gross estate is the value of the estate before any deductions or exemptions.

5. *Migration effect.* The Panel's research (Conway and Rork, October 27) further addressed the conventional wisdom that the EIG tax is causing the elderly to leave the state. Though there may be some cases in which this is true, the data again reveals no such systematic net out migration effect. Data from the Census and the American Community Survey (ACS) shows that Connecticut has experienced a fairly steady net-outflow of elderly migrants since 1980. Moreover, the states that Connecticut loses migrants to have also remained stable over this time. Given that EIG tax policies have changed a great deal during this period, the stability of these migration patterns suggest they are influenced little by EIG taxes.

These findings along with IRS data that show that the migration behavior of high income elderly migrants (those most likely to face EIG taxes) have been similar to the general elderly migrant population (see Conway and Rork, 2015). This finding is consistent with the established broader state tax literature that shows little to no migration effects from EIG taxes. The Panel's research further shows no evidence of migration effects from data on federal estate tax returns or Connecticut personal income tax filings.

6. *Effect on Economic Growth.* Connecticut's EIG tax also appears to have limited impact on annual economic growth in the state, regardless of how growth is measured. Connecticut growth falls in line with all its neighboring states and does not appear affected by changes in its EIG tax policy. Even in comparison to Southern states that have experienced large amounts of population growth over the last 30 years, Connecticut's per capita growth rate would not be considered an outlier. A similar pattern emerges when Connecticut is compared to Midwestern states without EIG taxes. Connecticut's growth appears to be more volatile than some states, but that pattern has been consistent since 1978, making it implausible to assign blame EIG taxation for any growth pattern we witness.

Probate Fees

7. *Background.* The state budget for fiscal years 2015-16 and 2016-17 brought about two significant changes in the manner that Connecticut funds the Probate Courts. First, the budget eliminated all general fund support for the Probate Courts. Second, probate fees were increased significantly as a substitute for an appropriation from the State General Fund general fund.
8. *Method of Calculation* Fees on decedents' estates, which are calculated as a percentage of all of the decedent's assets, changed most dramatically. The new fee structure doubles the rate on estates larger than \$2 million and eliminates the fee cap (previously a maximum fee of \$12,500). As a result, Connecticut's probate fees are now the highest in the nation. The new budget also

puts the state in the unusual position of having a court that must operate exclusively on fee revenue. This outlier status when compared to other states raise concerns that if there is any significant migration effect associated with settling a Connecticut Estate, the problem will stem from the probate fee structure and level, and not the EIG.

9. *Full Cost of Recovery (?)*. The underlying premise of a user fee is that it seeks to recover the cost of providing the service from those who benefit from it. Yet the current Connecticut arrangement relating to Probate Fees fails this test. This is true for two primary reasons:

- The percentage rate of estate calculation of the fee based on (most states have a flat fee system) makes no connection between the judicial resources that an individual estate consumes and the fee.¹ Moreover, there is no evidence that larger estates are more demanding of the Probate Courts. Indeed, large estates are typically less problematic than smaller estates because they are professionally planned.
- Then there is the matter of presence net positive externalities (“spillover benefits) that to the have a fair and open state judicial systems that all citizens can access, there should be general taxpayer support for such services This is true even if though all citizens use the same types of court that make up a state/local judicial system.

10. *Financial Management*. As Conway and Rork (November 2015) point out in their Panel research paper on the Connecticut Estate and Gift Tax (and which has been noted above in this Briefing Note), estate tax revenue is notoriously volatile. Very large estates from time to time boost tax revenue for a given year, but are neither regular nor predictable occurrences.² . Moreover, this uncertainty leads to further a perverse outcome if the Court faces an operating deficit in any given year it must engage in inter-agency borrowing to cover its deficit. This is not good financial practice.

¹ Knierim and Russo, Nov 17, p 10 &11

² Probate fees can be expected to be similarly volatile under the new structure. While the now-repealed \$12,500 cap on fees meant that no single estate had very large impact on overall revenues, fees from large estates are now projected to contribute a large proportion of overall probate fee revenue. A comparison of fiscal years 2013-14 and 2014-15 is telling in this regard. Had the new fee structure applied to those periods, two estates would each have paid fees in excess of \$1 million in fiscal year 2013-14 for a total of \$3.7 million in revenue. In fiscal year 2014-15, no estates would have paid seven figure fees and total revenue would have been \$2.7 million less than the prior year (Knierim and Russo, 2015).

Connecticut Estate and Gift Tax and Probate Revenue Neutrality. All base broadening (narrowing) is understood to be made with the hard budget constraint of revenue neutrality. There are two ways to accomplish this: (1) Estate and Gift tax broadening (narrowing,) that captures (loses) new revenue triggers a reduction (increase) in the general statutory rate. And/or (2) a revenue gain (loss) can be offset by a change in the rate and/or base of another type of revenue that is part of the Connecticut State/Local tax system.

Policy Option	Description and Impact	Evaluative Criteria and Comments
Estate and Gift Taxation		
Status Quo: Retain the Current EIG Tax.	While only 20 states impose an EIG tax, nearly all of the states in the region do so and Connecticut’s tax is near the bottom in terms of tax liability; however, this policy is in flux and so the landscape could	The EIG tax is only one of two progressive taxes in the Connecticut tax system and the total (federal + Connecticut) tax on estates is lower currently than it has been at any time in recent history. Connecticut has already enacted (in 2009) the critical reform of removing the ‘cliff,’ whereby estates just exceeding the exemption faced a disproportionately large tax burden.
Allow for a state-specific QTIP election.	At present Connecticut does not allow for a state specific QTIP election. For situations where the value of the estate is more than the Connecticut exemption but less than the federal exemption, the lack of a state specific QTIP election prevents married couples from deferring state taxes without forgoing the full federal exemption when the first spouse dies.	Allowing a state specific QTIP will simplify estate planning for Connecticut residents.
More fully conform to the Federal Estate Tax.	Connecticut already conforms to the federal unified gift tax in several ways. Two other ways to conform include: i) Increase the exemption level to the federal limit (currently \$5.43 million, indexed to inflation), and, (ii) adopt the ‘portability’ feature in which one spouse may claim the unused exemption of a deceased spouse.	Conforming to the federal estate tax would simplify estate tax planning, fully exempt from taxation the large number of currently-taxable, smaller estates, and lower significantly the tax burden on all estates. These changes would also substantially reduce EIG tax revenues.
Increase the Marginal Tax Rate on Federally Taxable Estates.	The deductibility of state EIG taxes from the federally taxable estate affords the state the opportunity to capture a portion of federal revenues, as it did under the ‘pickup’ tax. Estates below the federal threshold do not enjoy this benefit and so, despite an increasing <i>statutory</i> marginal tax rate, Connecticut’s <i>effective</i> marginal tax rate actually declines (and is sometime negative) for medium to large estates.	This option is the only one considered that could increase revenues. It could therefore be considered in combination with other reforms in an effort to be revenue neutral on balance.

Policy Option	Description and Impact	Evaluative Criteria and Comments
<i>Eliminate the Gift Tax.</i>	The gift tax generates a relatively small amount of revenue (about 4% of all EIG tax revenues in 2013-14).	Eliminating the gift tax increases the opportunity for ‘deathbed’ gift planning, in which large transfers are made in contemplation of death to avoid the estate tax, although the federal unified gift tax law would still apply to larger estates.
Eliminate the Estate and Gift Tax	Connecticut EIG taxes are a relatively small portion of total tax revenues (<2%), with revenues equaling \$207 million in 2013-14.	Connecticut would join the majority of other states without EIG taxes and be the only state in the region besides New Hampshire without one. Connecticut state tax progressivity would be decreased, but the flow of revenue is small enough that there will not be a discernible effect overtime. To maintain system vertical equity there are much better tools (e.g. personal income tax base, rates, EITC, income/means tested sales tax credits and property tax credits for residential properties).
Probate Fees		
Maintain the Status Quo	The status quo violates two key principles of good state public finance: (i) failing to recognize that some (indeed most) state/ local services have net positive externalities (spillover benefits) to citizens who may not use a specific services, but who nonetheless indirectly benefit from such services. And, (ii) failing to account provide some form budget reserve system to address the high degree of revenue volatility, especially for an institution (e.g., the Probate Court) that relies fully (or nearly so) on one type of revenue.	
Overhaul Fees on Decedents’ Estates; Return to a combination of direct user charges for cost of administration and General Fund Finance.	The proposed overhaul of the fees on decedents’ estates would transition probate fees in Connecticut from the current tax-like structure to a genuine user fee. The amount and rates of the fees and accounting fees are therefore of parts of such a reform the utmost importance.	This option would (i) replace the current fee structure for decedents’ estates with one that directly parallels the fees for all other Probate Court cases’ (ii) recognize that while there certainly should be probate fees, that such fees should be set at realistic level of recovery for administrative cost in combination with the General Fund support that is associated with the public benefits that flow to society as a whole.