



# Revenue and Transportation Interim Committee

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## 59th Montana Legislature

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September 30, 2005

TO: Revenue and Transportation Interim Committee

FROM: Jeff Martin, *Legislative Research Analyst*

SUBJECT: Federal and State Estate Taxes

This memo is written in response to Sen. Toole's request that the estate tax be included on the Revenue and Transportation Committee agenda. It briefly summarizes: federal changes to the estate tax, other states' legislative responses to the federal changes, trends in estate tax and inheritance tax collections in Montana, and provisions that apply to farms and small businesses. It does not address related matters such as the gift tax, the generation-skipping tax, or capital gains implications.

In 2001, Congress passed and the president signed the Economic Growth and Tax Relief Reconciliation Act of 2001 (Act). Among other provisions, the Act reduced individual marginal income tax rates, reduced marriage penalties, expanded the child care tax credit, expanded tax-preferred retirement savings programs, and revised estate taxes. The major provisions of the Act are phased in over several years and the Act, because of federal budget rules, "sunsets" on January 1, 2011.

The federal estate tax is phased out over a ten-year period, with full repeal in 2010. However, because of the sunset provision, the tax will be reinstated in 2011.<sup>1</sup> The Act reduced the top tax rate applied to taxable estates from 55 percent to 45 percent by 2009. The taxable estate is determined by subtracting from the value of the gross estate allowable deductions, such as the full exemption of transfers to the surviving spouse (the largest deduction), contributions to qualifying charities (the second largest deduction), and other costs (e.g., funeral expenses, debts, mortgages, and administrative costs).

The Act phased in increases to the unified credit that exempts a portion of the estate from taxation. Application of the unified credit will effectively exempt estates of up to \$3.5 million by 2009. A federal estate tax return must be filed for estates that are valued in excess of the

<sup>1</sup>On April 13, 2005, the U.S. House of Representatives passed H.R. 8 (272 to 162) to permanently repeal the estate tax. The U.S. Senate was scheduled to vote on repeal of the tax in early-September but Senate Majority Leader Bill Frist postponed the vote indefinitely because of Hurricane Katrina.

exemption amount, but not all estates owe the tax. Based on Internal Revenue Service *Statistics of Income*, about 108,300 federal estate tax returns were filed in 2000 with 52,000 owing taxes. A little over 66,000 estate tax returns were filed in 2003, with about 30,600 owing taxes.

A significant provision of the Act was the phase-out of the state tax credit from 2002 to 2005. The credit was reduced by 25 percent in 2002, by 50 percent in 2003, and by 75 percent in 2004. In 2005, the state tax credit is eliminated and is replaced by a deduction for state estate taxes paid.

Table 1 compares exemption amounts for estates under current law with prior law and shows the phase-out of the state tax credit.

Decedents dying during calendar year	Prior Law	Current Law	Unified Credit	Percent of State Credit Allowed
2002	\$700,000	\$1,000,000	\$345,800	75%
2003	\$700,000	\$1,000,000	\$345,800	50%
2004	\$850,000	\$1,500,000	\$555,800	25%
2005	\$950,000	\$1,500,000	\$555,800	State estate tax credit repealed; estates allowed deduction for state estate taxes paid
2006 through 2008	\$1,000,000	\$2,000,000	\$780,800	NA
2009	\$1,000,000	\$3,500,000	\$1,455,800	NA
2010	\$1,000,000	Tax repealed	NA	NA
2011	\$1,000,000	\$1,000,000	\$345,800	100%

The federal estate tax was enacted in 1916. Many states had already adopted their own inheritance and estate taxes. Because the federal tax and state taxes were imposed on the same tax base, Congress provided for a federal credit for state taxes paid (1926). Taxpayers are allowed a dollar-for-dollar credit against the federal estate tax for state estate and inheritance taxes, up to a maximum amount. The state tax credit is determined by multiplying the value of adjusted taxable estate<sup>2</sup> brackets by graduated tax rates ranging from 0.8 percent to 16 percent. The effect of the credit, in general, allowed state governments and the federal government to share estate tax revenue without imposing an additional burden on taxable estates. The credit is referred to as a "pickup" tax on the federal estate tax. In 1980, 37 states imposed a separate estate tax or inheritance tax plus the pickup tax, while 12 states imposed a pickup tax exactly equal to

<sup>2</sup>The adjusted taxable estate is the taxable estate reduced by \$60,000.

the state tax credit. Until recently, 13 states imposed a separate estate tax or inheritance tax plus the pickup tax, while 37 states, including Montana<sup>3</sup> imposed the pickup tax only.<sup>4</sup>

Eighteen states have decoupled from changes in federal estate tax laws. Several states (Illinois, Maine, Maryland, Massachusetts, New Jersey, Rhode Island, and Vermont) linked their estate taxes to the federal estate tax that was in effect before the 2001 tax bill. Minnesota, which enacts federal tax conformity legislation each year, did not conform to the federal changes. North Carolina and Wisconsin decoupled through 2005 and 2007, respectively. Connecticut, Nebraska, and Washington enacted separate estate taxes. Estate tax laws in Kansas, New York, Ohio, Oregon, and Virginia do not conform to federal legislation unless specific state legislation is enacted.<sup>5</sup>

Changes in the federal estate tax and the repeal of inheritance taxes has affected tax collections from those sources in Montana. Table 2 shows state inheritance and estate collections since fiscal year 1999. The estimates for estate tax collection in House Joint Resolution 2 are \$1.95 million in fiscal year 2006 and just under \$1 million in fiscal year 2007.

Fiscal Year	Collections in Millions	Percent of State General Fund
1999	\$18.30	1.71
2000	\$19.39	1.64
2001	\$20.29	1.60
2002	\$13.82	1.09
2003	\$13.31	1.04
2004	\$11.43	0.83
2005	\$4.19	0.27

Source: Revenue collections derived from various Montana Legislative Fiscal Division reports.

<sup>3</sup>On November 7, 2000, Montana voters approved Legislative Referendum No. 116 to repeal the state inheritance tax. The repeal applied to deaths occurring after December 31, 2000. The estate tax in Montana is imposed under 72-16-905, MCA).

<sup>4</sup>Daphne A. Kenyon, "You Can't Take It With You--Increase Wealth Transfer Taxes", *State Tax Notes*, Vol. 36, No. 6, May 9, 2005, p. 449.

<sup>5</sup>Elizabeth C. McNichol, "Many State Are Decoupling from the Federal Estate Tax Cut", Center on Budget and Policy Priorities, Revised June 19, 2005. Retrieved September 21, 2005, from the WWW: <http://www.cbpp.org/5-23-02sfp.htm>.

The revenue amounts shown in the table include both estate taxes and inheritance taxes. Taxes are generally due within 18 months of the death of the decedent. However, it may take a number of years before an estate to be settled. As a result, collections will be realized from each source for several more years.

Federal law previously allowed family-owned businesses an additional qualified family-owned business interest deduction in addition to the general estate tax deduction. The Act effectively repealed the extra exclusion amount in 2004 because the \$1.5 million exemption in that year exceeded the combined exemption of \$1.3 million.<sup>6</sup> However, farms and small businesses are still allowed to take advantage of special valuation methods and tax deferrals and installment payments. Family farms and closely-held businesses are allowed to value the real property of the estate at the farm or business value (with limitations) rather than at market value, provided the heirs continue the current use of the property for 10 years. A recapture tax is imposed if this requirement is not met. The estate tax on a family farm or business (under certain conditions) may be deferred up to 5 years and then may be paid in installments over 10 years.<sup>7</sup>

One of the criticisms of the estate tax is that part or all of a farm or small business may have to be sold to pay the tax. A Congressional Budget Office Report indicated that in 1999 and 2000, about 5 percent of estates that owed estate taxes had a tax liability that exceeded their liquid assets, while about 12 percent, in 1999, and 8 percent, in 2000, of farmers' estates that owed taxes had a liability greater than their liquid assets. For estates claiming the QFOBI deduction, about 34 percent of the estates that owed taxes in 2000 had a liability greater than liquid assets.<sup>8</sup> The report does not discuss the magnitude of the insufficiency in liquid assets. The report also estimated the number of farm estates and that would owe taxes in 2000 under various exemption amounts with a top tax rate of 48% and the number of estates with insufficient liquid assets to pay the tax (a list of liquid assets is included in the table). See the attached table.

Using a different set of assumptions, a Congressional Research Service Report to Congress, estimated that "3 to 4% of family farms and businesses would potentially be at risk" of having insufficient liquid assets to cover the estate tax liability. The report further suggests that taking into account nonbusiness assets, partial sale of assets, or loans would reduce the risk to 1 percent.<sup>9</sup>

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<sup>6</sup>Robert McClelland, "Effects of the Federal Estate Tax on Farms and Small Businesses", Congressional Budget Office, July 2005.

<sup>7</sup>Jane G. Gravelle and Steven Maguire, "Estate and Gift Taxes Economic Issues", Congressional Research Service Report for Congress, Updated January 3, 2005, p. CRS-5.

<sup>8</sup>McClelland, *op. cit.*, p. 12.

<sup>9</sup>Gravelle and Maguire. *op. cit.*, p. CRS-14.

**Table 8.**

**Number of Estates Filing Returns and Number with Insufficient Liquidity to Pay the Estate Tax in 2000, Under Various Exemption Levels**

Exemption Amount	Estates Filing Tax Returns	Estates Owning Estate Tax	Estates with Insufficient Liquid Assets to Pay Estate Tax Liability <sup>a</sup>
		<b>All Estates</b>	
Actual <sup>b</sup>	108,322	52,000	2,834
\$1.5 Million	33,685	13,771	740
\$2.0 Million	20,997	6,337	366
\$3.5 Million	9,210	3,676	182
		<b>Estates of Farmers<sup>c</sup></b>	
Actual <sup>b</sup>	4,641	1,659	138
\$1.5 Million	1,005	300	27
\$2.0 Million	578	123	15
\$3.5 Million	187	65	13
		<b>Estates Claiming Qualified Family-Owned Business-Interest Deduction</b>	
Actual <sup>b</sup>	1,470	485	164
\$1.5 Million	692	223	82
\$2.0 Million	440	135	62
\$3.5 Million	223	94	41

Source: Congressional Budget Office based on data from the Internal Revenue Service's Statistics of Income files.

- a. Liquid assets include government and private-sector bonds, bond funds, corporate stock, cash and cash management accounts, and insurance. The number of estates with insufficient liquidity is an upper bound on the actual number because estimates of liquidity do not include money held in some trusts, which could also be used to pay estate taxes.
- b. Estate tax returns filed in 2000 could be for people who died in either the last nine months of 1999 or in 2000. The actual estate tax exemption was that in effect on the date of death: \$650,000 in 1999 or \$675,000 in 2000.
- c. Using the narrow sample discussed in Box 3.