

# *Estate Tax*



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## **Introduction**

Wisconsin imposes an estate tax based on the federal estate tax credit allowed for state death taxes paid. Wisconsin's law was revised under 2001 Wisconsin Act 16, the 2001-03 biennial budget act, in response to federal law changes under the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA). This paper outlines current federal and state estate tax provisions, including a description of these recent law changes

The paper begins by providing general information regarding death and gift taxes, followed by a summary of federal transfer tax provisions in 2002 and the time frame for the gradual repeal of the federal estate tax. A description of the state estate tax is then provided, along with examples of estate tax computations for deaths occurring in 2002, and information on historical state transfer tax collections. Transfer taxes in other states are reviewed next, followed by a discussion of the arguments for and against death and gift taxation.

Information about the Wisconsin inheritance and gift taxes, which were imposed prior to 1992, is presented in the Appendix.

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## **Structure of Death and Gift Taxes**

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Estate, inheritance, and gift taxes are taxes on accumulated wealth that are imposed at the time

property is transferred. Estate and inheritance taxes are imposed on transfers at death and represent differing approaches to the taxation of such transfers. The estate tax is a tax on the right to transfer wealth. It is based on the value of the estate, without consideration for the amount received by any beneficiary or the relationship between the deceased and the beneficiary (although transfers to a surviving spouse may be exempt from an estate tax). The federal death tax is an estate tax.

In contrast, an inheritance tax is a tax on the right to receive property. The amount of wealth transferred to each heir and the relationship of the beneficiary to the deceased are considered in imposing the tax. Gift taxes are imposed on transfers of property during life to provide a neutral tax treatment of wealth transfers and to minimize incentives to avoid the taxation of transfers at death.

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## **Federal Transfer Taxes on Estates and Gifts**

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The federal government imposes an estate tax on the privilege of transferring property at death and a gift tax on the privilege of transferring property during life. Under EGTRRA, significant changes were made to these taxes, starting in 2002 and ending with complete elimination of the estate tax in 2010. [However, in order to comply with the Congressional Budget Act of 1974, all of the provisions under EGTRRA will sunset after 2010 in

the absence of federal legislation to extend them.]

Prior to 2002, a single, unified transfer tax applied to estates and gifts under federal law. EGTRRA separated the two taxes. EGTRRA also increased the amounts excluded for the purpose of each tax, and decreased the top tax rates. Specific features of the estate and gift taxes are described below.

### **Estate Tax**

The federal government imposes an estate tax on the cumulative value of transfers during life and at death. To determine the tax, the value of taxable gifts made by the decedent in prior years is first added to the value of the taxable estate. A tentative tax on this cumulative value is computed, based on a progressive rate schedule. Gift taxes previously paid are then subtracted to arrive at the gross estate tax. Subsequently, additional credits are applied to arrive at the net estate tax.

Federal estate taxes and returns are generally due nine months after the date of a decedent's death. The Internal Revenue Service (IRS) may grant an extension of up to six months to the time for filing a return, which would mean that an executor would have up to 15 months after the date of a decedent's death to file the return. With some exceptions, in response to a timely application for a six-month extension, the IRS grants the extension automatically. However, interest is generally still due on the amount of tax that is not paid by the original due date.

### ***Gross Estate***

Under federal law, the gross estate is composed of the value of all property in which the decedent has a beneficial interest at the time of death. Examples of such assets include real estate, stock, cash, bonds, and life insurance proceeds from the decedent. The extent to which property is included in a decedent's gross estate is generally determined under state statutory and case law. Deductions are

allowed for certain funeral and administrative expenses, charitable transfers, debts, and taxes.

Although specific classes of distributees are generally not recognized, unlimited marital deductions are provided for transfers of assets to a spouse.

### ***Estate Tax Rates***

While EGTRRA technically separated the federal estate and gift taxes, a single, unified tax rate schedule continues to apply for purposes of the two taxes until the estate tax is repealed in 2010. For deaths occurring from 1987 through 2001, the graduated tax rates ranged from 18% to 55%. Under EGTRRA, all of the rates except those at the top remain the same as they were under prior law. However, the top graduated tax rate was reduced to 50% for 2002, and then declines 1% each year through 2007. The top marginal rate remains at 45% for 2007 through 2009.

EGTRRA eliminated a prior-law phase-out of the graduated rates that had applied to taxable estates exceeding \$10 million. For taxes due because of deaths prior to 1998, the benefits of the graduated rates and the \$192,800 unified credit had been phased out for such estates. With taxes due because of deaths occurring in 1998 through 2001, this phase-out had applied to the graduated rates only. Effective with 2002, there is no longer a phase-out of the graduated rates for large estates.

The unified transfer tax graduated rate schedule that applied prior to EGTRRA (and that will, under current federal law, apply again for deaths occurring after 2010) is shown in Table 1. The changes in the top tax rates under EGTRRA are outlined at the bottom of the table.

### ***Estate Tax Applicable Exclusion Amount***

In place of an exemption from the estate tax based on each donee or heir, federal law provides an "applicable credit" against the tax imposed on

**Table 1: Federal Unified Transfer Tax Rate Schedule (1987 through 2001)\***

Value of Taxable Estate		Tax on	Rate of Tax
Column A	Column B	Amount in Column A	on Excess Over Amount in Column A
0	\$10,000	0	18%
\$10,000	20,000	\$1,800	20
20,000	40,000	3,800	22
40,000	60,000	8,200	24
60,000	80,000	13,000	26
80,000	100,000	18,200	28
100,000	150,000	23,800	30
150,000	250,000	38,800	32
250,000	500,000	70,800	34
500,000	750,000	155,800	37
750,000	1,000,000	248,300	39
1,000,000	1,250,000	345,800	41
1,250,000	1,500,000	448,300	43
1,500,000	2,000,000	555,800	45
2,000,000	2,500,000	780,800	49
2,500,000	3,000,000	1,025,800	53
3,000,000	---	1,290,800	55

\*Except for the top tax rates, the same rates apply after 2001. However, the top tax rate drops to 50% for 2002, and then decreases 1% each year through 2007. The rate remains at 45% for 2007 through 2009. For 2010, the estate tax is repealed.

lifetime transfers of assets. The credit is associated with an "applicable exclusion amount," representing the value of the estate that is effectively excluded from taxation once the credit is applied. For ease of discussion, this paper generally refers to the applicable exclusion amount associated with the applicable credit, even though the tax reduction is actually achieved with a tax credit rather than an exclusion.

EGTRRA provided an applicable exclusion of \$1 million for deaths in 2002 and 2003. For decedents dying in 2002 and 2003, therefore, there is no estate tax if the value of the estate plus the value of cumulative taxable gifts is less than \$1 million. Under EGTRRA, the applicable exclusion increases in subsequent years as follows: (a) to \$1.5 million for deaths in 2004 and 2005; (b) to \$2 million for deaths in 2006, 2007, and 2008; and (c) to \$3.5 million for deaths in 2009. The schedule of

applicable exclusion amounts and associated applicable credits for deaths occurring in 2000 through 2009 is shown in Table 2. As described above, the federal estate tax is repealed for deaths in 2010.

**Table 2: Schedule of Federal Estate Tax Applicable Exclusion Amount and Applicable Credit**

Year of Gift Or Death	Applicable Exclusion Amount	Applicable Credit
2000 & 2001	\$675,000	\$220,550
2002 & 2003	1,000,000	345,800
2004 & 2005	1,500,000	555,800
2006 -- 2008	2,000,000	780,800
2009	3,500,000	1,515,800
2010	Repeal of Estate Tax	

Historically, the applicable exclusion had been increased over time, to a maximum exclusion of \$600,000 (actually a \$192,800 tax credit) between 1986 and 1997. Under prior federal law, beginning in 1998, increases in the exclusion were being phased in over a nine-year period. For 2000 and 2001, the applicable exclusion was \$675,000 (the applicable credit was \$220,550), with a phased-in increase to \$1 million (a \$345,800 tax credit) scheduled for 2006 and thereafter.

***Exclusion for Family-Owned Business Assets***

Since 1998, an additional exclusion from the estate tax has been available for certain qualified family-owned business assets. The maximum exclusion amount for decedents with a qualified family-owned business is \$1.3 million. This maximum includes the applicable exclusion amount available to all decedents, plus an additional exclusion for qualifying business owners. The additional exclusion is the lesser of: (a) the adjusted value of the qualified family-owned business interests of the decedent otherwise includible in the estate; and (b) the difference between \$1.3 million and the applicable exclusion amount.

For 2000 and 2001, with an applicable exclusion amount of \$675,000, the maximum additional family-owned business exclusion was \$625,000 (\$1.3 million less \$675,000). With the increase in the applicable exclusion to \$1.0 million for 2002 and 2003, the maximum additional family-owned business exclusion is reduced to \$300,000. The additional exclusion for family-owned businesses was repealed under EGTRRA for deaths after December 31, 2002. [For deaths after this date, the general applicable exclusion exceeds \$1.3 million, so there would be no additional exclusion for family-owned business interests even if the \$1.3 million family-owned business exclusion had been retained.]

### **State Death Tax Credit**

As noted, a credit is provided against federal estate taxes for death taxes paid to a state government. Prior to 2002, the credit was equal to state death taxes paid, up to a maximum of 80% of the federal estate tax liability as defined in 1926 federal law. The state death tax credit was based on the schedule shown in Table 3.

Under EGTRRA, the schedule in Table 3 remains the starting point for determining the state death tax credit. However, the amounts in Table 3 are then reduced as follows: (a) by 25% for deaths in 2002; (b) by 50% for deaths in 2003; and (c) by 75% for deaths in 2004. The state death tax credit is eliminated for deaths in 2005 and thereafter (subject to the 2011 sunset provision), and replaced with a deduction against the gross estate for estate or inheritance taxes paid to any state or the District of Columbia with respect to property included in the decedent's gross estate.

### **Gift Tax**

Like the estate tax, the gift tax is a tax on the transfer of property. The tax is levied during the transferor's lifetime and is cumulative in nature. The gift tax is paid annually, with tax returns due

**Table 3: Federal Credit for State Death Taxes Prior to 2002\* -- Computation of Maximum Credit for State Death Taxes (Based on Federal Adjusted Taxable Estate, Which is the Federal Taxable Estate Reduced by \$60,000)**

Adjusted Taxable Estate Equal to or More Than (1)	Adjusted Taxable Estate Less Than (2)	Credit on Amount in Column 1 (3)	Rate of Credit on Excess Over Amount in Column 1 (4)
0	\$40,000	0	0.0
\$40,000	90,000	0	0.8%
90,000	140,000	\$400	1.6
140,000	240,000	1,200	2.4
240,000	440,000	3,600	3.2
440,000	640,000	10,000	4.0
640,000	840,000	18,000	4.8
840,000	1,040,000	27,600	5.6
1,040,000	1,540,000	38,800	6.4
1,540,000	2,040,000	70,800	7.2
2,040,000	2,540,000	106,800	8.0
2,540,000	3,040,000	146,800	8.8
3,040,000	3,540,000	190,800	9.6
3,540,000	4,040,000	238,800	10.4
4,040,000	5,040,000	290,800	11.2
5,040,000	6,040,000	402,800	12.0
6,040,000	7,040,000	522,800	12.8
7,040,000	8,040,000	650,800	13.6
8,040,000	9,040,000	786,800	14.4
9,040,000	10,040,000	930,800	15.2
10,040,000		1,082,800	16.0

\* For years after 2001, the credit is reduced as follows: (a) by 25% for 2002; (b) by 50% for 2003; and (c) by 75% for 2004. The state death tax credit is eliminated starting with deaths in 2005.

on April 15 following the calendar year in which a gift is given.

### **Gift Tax Rates**

As described previously, a unified transfer tax rate schedule applies for both estate and gift tax purposes until the estate tax is repealed in 2010. At that time, the gift tax rate schedule will remain the same as the existing unified rate schedule, as long as cumulated taxable gifts are less than \$500,000 (see Table 1 for the graduated rates). The tax rate on cumulated taxable gifts exceeding the \$500,000 threshold will be a flat 35% in 2010. In the absence of legislation to extend the provisions of EGTRRA, the gift tax will revert to prior law for 2011 and thereafter.

### ***Gift Tax Deductions and Annual Exclusion***

As with the estate tax, there is an unlimited marital deduction for transfers to spouses and for charitable purposes. Certain exemptions also apply in the case of gifts for tuition and medical expenses.

Federal law provides an exclusion for the first \$11,000 of gifts made to any one donee in 2002. Prior to 1998, the annual gift tax exclusion was for the first \$10,000 in gifts to a donee. Starting in 1998, the \$10,000 annual exemption for gifts is indexed for inflation. The indexing adjustment is in multiples of \$1,000, rounded down to the next lowest multiple thereof. The first inflationary adjustment in the annual exclusion was made for tax year 2002, when the exclusion was adjusted to \$11,000.

A married donor may elect to treat all gifts made by either spouse as being made one-half from each. This "gift-splitting" right has the effect of doubling the annual exclusion for each donee, while allowing each spouse's applicable exclusion for cumulated gifts to be utilized.

### ***Applicable Exclusion for Cumulated Gifts***

As provided under EGTRRA, the applicable exclusion for gift tax purposes is \$1 million, effective with gifts given in 2002. This exclusion amount corresponds to an applicable credit of \$345,800.

While EGTRRA provides phased-in increases in the applicable exclusion for the estate tax, there is no corresponding increase in the applicable exclusion for gift tax purposes. Prior to 2002, there was a single, unified applicable exclusion amount and associated credit for estate and gift taxes.

### ***Gift Tax Computation***

To determine the annual gift tax, a tentative tax is first determined on cumulative transfers of gifts by a donor (after subtracting the deductions and annual exclusions). The next step is to subtract gift taxes previously paid by the donor. Finally, the

"applicable credit" is applied to the remaining balance. If the tentative tax before applying the credit is less than the applicable credit amount, then there is no gift tax liability.

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## **Wisconsin Estate Tax**

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### **General Provisions**

A state estate tax is imposed upon transfers of property at death by Wisconsin residents. However, transfers of real or personal property located outside Wisconsin are not taxable, unless the property is located in a state that does not impose an estate tax. Nonresidents are subject to the Wisconsin estate tax for transfers of property located in the state. If only a portion of the decedent's property has taxable situs in Wisconsin, the tax is prorated based on the share of property located in this state. Transfers of intangible personal property (such as securities) owned by nonresidents are not taxable in Wisconsin if the decedent's state of residence provides a reciprocal exemption for Wisconsin residents.

The estate tax is due and payable nine months after the date of the decedent's death, but may be paid in advance on an estimated basis. If the tax is not paid within nine months, interest is charged at a rate of 12%, computed from the date of death.

If the IRS has granted an extension in the due date of the federal return, the extended due date applies to the state return as well. If the return is filed after the extended due date, a penalty is imposed equal to 5% of the tax due, with a minimum penalty of \$25 and a maximum of \$500. Interest is also due on any amount of tax not paid by the original due date of the return.

Beginning with taxes due because of deaths occurring on July 29, 1995, installment payments may be made if the estate consists largely of an interest in a closely-held business, if installment

payments are allowed for federal estate tax purposes, and if written notice is given to the Department of Revenue within nine months. Interest is imposed on installment payments at the rate of 12%, calculated from the date of death.

### **The Gap Tax**

For deaths occurring from January 1, 1992, through September 30, 2002, Wisconsin's sole transfer tax was an estate tax equal to the federal credit for death taxes paid to a state government. Under this type of tax, commonly known as a "gap" or "pick-up" tax, the state death tax results in a dollar-for-dollar reduction of federal estate tax liability and does not lead to an increase in total taxes due on an estate. Prior to 1992, the state also imposed separate inheritance and gift taxes.

Under current federal law, the federal credit for state death taxes paid is being phased out, starting with deaths in 2002. For states with a gap tax, estate tax collections will be reduced along with the federal credit. Starting with deaths in 2005, the state estate tax will be eliminated for any state relying solely on the gap tax.

### **Wisconsin Estate Tax Revisions**

In order to avoid some of the loss in state tax revenue that would have otherwise occurred as a result of EGTRRA, the state estate tax was modified under Act 16. For a specified period, the provisions of Act 16 decouple the state estate tax from the current federal credit for state death taxes paid and link, instead, to the federal credit as computed prior to the EGTRRA changes.

Specifically, Act 16 provides that, for deaths occurring on or after October 1, 2002, and before January 1, 2008, the state estate tax is equal to the federal credit allowed for state death taxes paid as computed under federal estate tax law in effect on December 31, 2000. For deaths occurring on or after January 1, 2008, state estate taxes will be based on federal law in effect at the time. Based on current

federal law, the provisions of Act 16 will result in the elimination of state estate tax revenues for deaths occurring in 2008 and thereafter. However, if the federal law were to sunset at the end of 2010, federal estate taxes would again be imposed and the state would receive estate tax revenues based on the federal credit for state death taxes prior to the EGTRRA changes.

For the period during which the state estate tax is decoupled from federal credit for state death taxes paid under current federal law (deaths from October 1, 2002, through December 31, 2007), the state estate tax is determined as follows:

*Step 1.* The value of the estate to which the tax rates and credits are applied is determined as under current federal law. Federal law prohibits states from imposing an estate tax on the transfer of insurance and pension benefits from a government employee retirement plan. Therefore, for state tax purposes, the value of such nontaxable transfers is subtracted from the value of the estate as it would be determined for federal purposes.

*Step 2.* The state estate tax on the value determined in Step 1 is computed using the tax rates, applicable exclusion, and federal credit for state death taxes paid under federal law in effect on December 31, 2000.

For the estates of decedents dying from October 1, 2002, through December 31, 2007, the effects of Act 16 are as follows:

a. For state estate tax purposes, the applicable exclusion is limited to \$675,000, which was the exclusion under federal law in effect on December 31, 2000. Neither the increases in the exclusion that had been scheduled under prior federal law nor the increases in the exclusion as provided under current federal law apply for state estate tax purposes.

b. The state estate tax does not incorporate the new federal reductions in the top tax rates.



c. As the starting point for determining the state estate tax is the value of the estate as provided under current federal law, the additional exclusion for qualified family-owned business assets is eliminated after 2003 for state purposes as well as for federal purposes.

d. As the state estate tax is no longer a gap tax, it no longer leads to a dollar-for-dollar reduction of federal estate tax liability. Therefore, unlike the gap tax, the current state estate tax may lead to an increase in total taxes due on an estate.

Under prior law, no Wisconsin estate tax return was required if an estate was not required to file for federal purposes. However, for estates of decedents dying from October 1, 2002, through December 31, 2007, a state estate tax return may be required even if a federal return is not. For example, for a decedent dying in 2003, no federal return would be required if the estate were valued at less than the applicable exclusion amount of \$1.0 million. However, if the value of such an estate were above the Wisconsin threshold of \$675,000, a state estate tax return would still be required.

As previously noted, for estates for which both a federal and state return are filed, if the IRS has granted an extension in the due date of the federal return, the extended due date applies to the state return as well. In cases in which only a state return is required, an extension in the due date of the return may be obtained by applying to the Department of Revenue.

## Examples

Figure 1 presents simplified examples of the federal and state estate taxes for two hypothetical estates in 2002. In each case, the value of the estate has been selected to exceed the \$1 million applicable exclusion amount. For estates below this threshold, no estate tax would apply. However, as noted, if the estate was valued between \$675,000 and \$1.0 million, a return would still be required for Wisconsin.

Each example first shows the calculation of the federal estate tax, followed by: (a) the calculation of the state estate tax for deaths from January 1 to September 30, 2002; and (b) the calculation of the state estate tax for deaths from October 1 through December 31, 2002 (to reflect the law changes under Act 16). The taxable estate is the basis for calculating both state and federal estate tax liabilities.

### *Example "A"*

In Example "A" a gross estate of \$1,200,000, less funeral and administrative expenses of \$85,000, is transferred to one daughter of the decedent. The taxable estate is equal to \$1,115,000 (the gross estate less the funeral and administrative expenses). The federal estate tax, before credits are applied, is equal to \$392,950, which is calculated according to Table 1. Once the \$345,800 unified credit is subtracted, the federal tax before the credit for state death taxes due is \$47,150.

The federal credit for state death taxes is calculated according to Table 3. Using the schedule in Table 3, the initial calculation on the adjusted taxable estate of \$1,055,000 (\$1,115,000 less \$60,000) yields a figure of \$39,760. However, as provided by EGTRRA, this figure is reduced by 25% for deaths during 2002, resulting in an allowable state death tax credit of \$29,820 under Example "A." After the credit, the federal estate tax liability is \$17,330.

For deaths from January 1 through September 30, 2002, Wisconsin's estate tax is based on the allowable federal credit for state death taxes paid. Therefore, for deaths during this time period, under Example "A," the state estate tax liability is \$29,820 (75% of the amount first computed following Table 3). The total estate tax liability is \$47,150 (the net federal tax of \$17,330 plus the state estate tax of \$29,820).

For deaths from October 1 through December 31, 2002, Wisconsin's estate tax is based on the federal credit that would have been computed

**Figure 1: Federal and State Estate Taxes -- Computations for Deaths Occurring in 2002**

	EXAMPLE A	EXAMPLE B
<b>FEDERAL ESTATE TAX</b>		
Gross Estate	\$1,200,000	\$6,200,000
Less: Funeral and administrative expenses	<u>-85,000</u>	<u>-125,000</u>
Adjusted Gross Estate	\$1,115,000	\$6,075,000
Less: Marital deduction	<u>0</u>	<u>-3,500,000</u>
Taxable Estate	\$1,115,000	\$2,575,000
Federal Tax Before Applicable Credit (see Table 1)	\$392,950	\$1,063,300
Less: Applicable Credit (see Table 2)	<u>-345,800</u>	<u>-345,800</u>
Federal Tax Before Credit for State Death Tax	\$47,150	\$717,500
Less: Federal Credit for State Death Taxes (from "Allowable Federal Credit," below)	<u>-29,820</u>	<u>-108,600</u>
<b>Net Federal Tax Due</b>	<b>\$17,330</b>	<b>\$608,900</b>
<b>FEDERAL CREDIT FOR STATE DEATH TAXES</b>		
Federal Taxable Estate	\$1,115,000	\$2,575,000
Less: \$60,000	<u>-60,000</u>	<u>-60,000</u>
Federal Adjusted Taxable Estate	\$1,055,000	\$2,515,000
State Death Tax Credit Computed from Table 3	\$39,760	\$144,800
Allowable Federal Credit (75% of Table 3 Amount)	\$29,820	\$108,600
<b>STATE ESTATE TAX*</b>		
Deaths Occurring <u>January 1 through September 30, 2002</u> (Based on allowable federal credit for state death taxes paid, which is generally 75% of the credit under prior federal law.)	\$29,820	\$108,600
Deaths Occurring <u>October 1 through December 31, 2002</u> (Based on allowable federal credit for state death taxes paid under prior federal law.)	\$39,760	\$144,800
<b>TOTAL ESTATE TAX</b>		
Deaths Occurring <u>January 1 through September 30, 2002</u>		
Net Federal Tax	\$17,330	\$608,900
State Estate Tax	<u>29,820</u>	<u>108,600</u>
Total Estate Tax	\$47,150	\$717,500
Deaths Occurring <u>October 1 through December 31, 2002</u>		
Net Federal Tax	\$17,330	\$608,900
State Estate Tax	<u>39,760</u>	<u>144,800</u>
Total Estate Tax	\$57,090	\$753,700

\* Under Act 16, the state estate tax is equal to the allowable federal credit for death taxes paid for deaths from January 1 through September 30, 2002. However, for deaths from October 1, 2002, through December 31, 2007, the state estate tax is computed under federal law in effect on December 31, 2000.

under prior federal law (which, in this instance, is equal to the state death tax credit before making the adjustment to 25% of the amount first computed following Table 3). Therefore, for deaths during this time period, under Example "A," the state estate tax liability is \$39,760. The total estate tax liability is \$57,090 (the net federal tax of \$17,330 plus the state estate tax of \$39,760).

### ***Example "B"***

In Example "B" a gross estate of \$6,200,000, less funeral and administrative expenses of \$125,000, is transferred as follows: (a) \$3,500,000 to the spouse; and (b) the remainder to a son. The taxable estate is equal to \$2,575,000 (the gross estate less the funeral and administrative expenses and deduction for the transfer to the spouse). Under this example, the federal net tax due is \$608,900. The state estate tax for deaths from January through September 30, 2002, is \$108,600, for a total estate tax liability of \$717,500. The state estate tax for deaths from October 1 through December 31, 2002, is \$144,800, for a total estate tax liability of \$753,700.

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### **Transfer Taxes in Other States**

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In calendar year 2002, 10 states levied an inheritance tax and three imposed a stand-alone estate tax. Each of these 13 states also imposed a tax based on the federal credit for death taxes paid (as either a minimum tax or a supplemental tax). Eight of the 13 states based the additional tax on the federal credit under current federal law, incorporating the reductions in the federal credit for state death taxes provided under EGTRRA. These states include: Connecticut, Indiana, Iowa, Kentucky, Louisiana, New Hampshire, Oklahoma,

and Tennessee. Kansas and Ohio provided the federal credit without the EGTRRA phase-out, but required no law change to do so. The three remaining states, Maryland, New Jersey, and Pennsylvania revised their tax laws to link to the federal credit under prior federal law.

For deaths during 2002, 10 states, plus the District of Columbia, imposed only an estate tax based on the federal credit under a prior version of federal law. [However, as noted, the Wisconsin estate tax was linked to the federal credit under current federal law for deaths prior to October 1, 2002.] Six of the 10 states, plus the District of Columbia, took legislative action to decouple from current federal law in order to reduce or eliminate revenue losses that would otherwise have occurred following EGTRRA. The other four states were already linked to earlier versions of federal law.

For deaths occurring in 2002, the remaining 27 states imposed only a tax based on the current law federal credit for state death taxes paid. However, two of these states (Massachusetts and Nebraska), modified state statutes to decouple from current federal law for deaths in 2003 and thereafter.

The information about transfer taxes in the states is outlined in Table 4. The entries that are underlined indicate the 11 states, plus the District of Columbia, that have modified state tax statutes in order to avoid or reduce state tax revenue losses from the phase-out of the federal credit under EGTRRA. Footnotes indicate states with law changes that take effect after 2002.

In addition to the transfer taxes described above, four states (Connecticut, Louisiana, North Carolina, and Tennessee) imposed a gift tax during 2002.

**Table 4: 2002 Transfer Taxes in Other States\******Inheritance Tax***

Connecticut <sup>1</sup>	Louisiana <sup>2</sup>	<u>New Jersey</u>
Indiana	<u>Maryland</u>	<u>Pennsylvania</u>
Iowa	New Hampshire <sup>3</sup>	Tennessee
Kentucky		

***Stand Alone Estate Tax***

Kansas	Ohio	Oklahoma
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***Estate Tax Based on Federal Credit Under a Prior Federal Law***

<u>Dist. Of Columbia</u>	<u>North Carolina</u> <sup>5</sup>	Virginia
<u>Maine</u> <sup>4</sup>	Oregon	Washington
<u>Minnesota</u>	<u>Rhode Island</u>	<u>Wisconsin</u> <sup>6</sup>
New York	<u>Vermont</u>	

***Estate Tax Based on Federal Credit Under Current Federal Law***

Alabama	Hawaii	<u>Nebraska</u> <sup>8</sup>
Alaska	Idaho	Nevada
Arizona	Illinois	New Mexico
Arkansas	<u>Massachusetts</u> <sup>7</sup>	South Carolina
California	Michigan	South Dakota
Colorado	Mississippi	Texas
Delaware	Missouri	Utah
Florida	Montana	West Virginia
Georgia	North Dakota	Wyoming

<sup>1</sup>Connecticut: inheritance tax is repealed after 2005.<sup>2</sup>Louisiana: inheritance tax is being phased out and is completely eliminated for deaths after 6/30/04.<sup>3</sup>New Hampshire: starting with 2003, the inheritance tax is repealed.<sup>4</sup>Maine: effective with 2003, links with current law federal credit.<sup>5</sup>North Carolina: links back to the current federal credit starting in 2004.<sup>6</sup>Wisconsin: federal credit as of 12/31/00 for deaths from 10/1/02 through 12/31/07. For 2008 and thereafter, current federal credit.<sup>7</sup>Massachusetts: starting with 2003, links to credit under 12/31/00 federal law.<sup>8</sup>Nebraska: effective with 2003, Nebraska will have a free-standing estate tax tied to federal definitions of the estate tax base, a \$1 million exemption, and a rate schedule tied to the federal credit for state death taxes (without the percentage decreases under EGTRRA). Nebraska also has an inheritance tax that is collected and administered at the county level.

\*States that are underlined passed legislation to reduce revenue losses following EGTRRA.

**Estate, Inheritance and Gift Tax Collections**

A breakdown of estate, inheritance and gift tax revenues collected in Wisconsin for the past 11 years is shown in Table 5. As Table 5 illustrates, tax collections may vary significantly from year to year. After several years of declining revenues, transfer tax collections increased annually from 1995-96 through 1999-00, before decreasing 42.2% from 1999-00 to 2000-01. In 2001-02 tax collections again increased, at a rate of 7.2%. It is expected that tax collections will decrease for 2002-03, due to the reduction in the federal credit for state death taxes paid (which the state conforms to for deaths from January through September, 2002, for which returns are generally filed from October, 2002, through June, 2003.) However, starting in 2003-04, the reduced federal credit for state death taxes will not affect state estate tax collections.

**Table 5: Wisconsin Estate, Inheritance and Gift Tax Collections (In Millions)**

Fiscal Year	Estate and Inheritance Taxes		Gift Taxes		Estate, Inheritance & Gift	
	Amount	Percent Change	Amount	Percent Change	Amount	Percent Change
1991-92	\$55.9	-21.8%	\$1.7	-58.4%	\$57.6	-23.8%
1992-93	53.1	-5.0	0.7	-60.9	53.7	-6.8
1993-94	52.2	-1.6	1.0	42.7	53.2	-1.0
1994-95	39.7	-23.9	1.1	10.1	40.8	-23.3
1995-96	45.4	14.3	0.2	-80.0	45.6	11.8
1996-97	50.6	11.6	0.2	-24.2	50.8	11.5
1997-98	80.0	58.0	0.1	-59.4	80.1	57.6
1998-99	116.8	45.9	0.1	20.2	116.9	45.9
1999-00	133.3	14.1	0.0	-100.0	133.3	14.0
2000-01	77.1	-42.2	0.0	0	77.1	-42.2
2001-02	82.6	7.2	0.0	0	82.6	7.2

Estate and gift tax revenues typically comprise less than 1% of total state general fund tax revenues. Historically, estate tax collections have been affected not only by year-to-year changes in the value of transfers subject to tax, but also by changes in both state and federal tax laws and in general economic conditions.

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### **Arguments Relating to Death and Gift Taxes**

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A primary argument for inheritance, estate, and gift taxes relates to the government's role in property ownership. Because the government contributes to the accumulation of wealth by defining and protecting property rights, taxes on the transfer of this property at death or during life have been viewed as appropriate. Such taxes have also been argued as fair because they are based on the ability to pay, reduce the amount of wealth permanently held by a few individuals in society and foster economic growth by circulating property and wealth among individuals. Also, because certain income from unrealized capital gains, interest, or investments is not taxed under

the income tax, transfer taxes sometimes apply to income that would otherwise escape taxation. Along with an inheritance or estate tax, the gift tax provides a neutral treatment of transfers during life and at death, thereby lessening the incentive to avoid taxes at death.

Opponents argue that death and gift taxes represent a form of double taxation, as the taxes may be an additional levy on income that has previously been taxed under the income tax. In addition, such taxes are seen as placing hardship on heirs, creating cash flow problems for some farms and small, closely-held businesses that may have to take on debt or be sold in order to pay the tax. Taxes on inheritances and gifts are also said to alter economic incentives to save and invest.

In Wisconsin, prior to the phase-out of the state inheritance and gift taxes, it was also argued that inheritance and gift taxes provided incentives for wealthy individuals to move out of the state to states with lower inheritance taxes. The migration of these taxpayers was believed to lead to lower revenues from other state taxes, fewer donations to charities in Wisconsin, and the loss of social, occupational, and educational activities of such individuals within the state.



## APPENDIX

### Wisconsin Inheritance and Gift Taxes Under Prior Law

Prior to 1992, Wisconsin imposed an inheritance tax and a gift tax in addition to the current estate tax. Under 1987 Wisconsin Act 27, the state inheritance and gift taxes were phased out over a five-year period that began in 1988. The state retained an estate tax equal to the state death tax credit provided under federal law (the "gap" or "pick-up" tax) during the phase-out period and after repeal of the inheritance and gift taxes. The phase-out was implemented by reducing the tax liability from previous law by 20% in 1988, 40% in 1989, 60% in 1990, and 80% in 1991. On January 1, 1992, the state inheritance and gift taxes were completely repealed, with only the gap tax collected for deaths occurring in 1992 and thereafter. The following sections describe the Wisconsin inheritance and gift taxes that were in effect before the phase-out.

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#### Wisconsin Inheritance Tax

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Under previous state law, the inheritance tax was imposed upon transfers of property at death by Wisconsin residents. However, transfers of real property or tangible personal property located outside Wisconsin were not taxable, unless located in a state that did not impose an estate tax. Nonresidents were subject to the Wisconsin inheritance tax for transfers of real and tangible personal property located in the state. The net taxable estate was the gross estate reduced by a number of exemptions and deductions. The gross estate consisted of:

- All property owned by the decedent at death including both real property (land and buildings)

and personal property (household goods, cash, stocks, bonds, savings accounts);

- Transfers made in contemplation of death;
- Decedent's interest in partnerships and businesses;
- Annuities and death benefits;
- Value of transfers to take effect after death;
- Insurance, if the decedent retained any ownership or if it was paid to the estate or to a named beneficiary; and
- The appropriate share of property owned jointly by the decedent. For property held as a joint tenancy completed transfer, in which the signatures of all of the joint tenants are required to transfer the property (real estate, stocks, or bonds), only the share of the property attributable to the deceased based on the proportion of the property owned by the decedent was included in the estate. For property held as a joint tenancy incomplete transfer, in which one owner may withdraw all the funds without the signature or consent of other joint owners (savings and checking accounts), only the portion contributed by the decedent was taxable.

The value of the gross estate was determined as of the date of the decedent's death. Exemptions from tax were provided for: (a) the value of property passing to qualified charities or governmental units; (b) certain death benefits paid to a surviving spouse; (c) property transferred to a spouse; and (d) the value of household furnishings and tangible personal property, except money, up to \$10,000. In addition, the gross estate was reduced by several

deductions: (1) funeral and burial expenses; (2) the decedent's liabilities such as debts, mortgages, and liens; (3) expenses of administering the estate; (4) federal estate taxes paid; and (5) property taxes accrued prior to death along with state and federal income taxes on income earned prior to death. If the decedent owned out-of-state property not subject to the Wisconsin inheritance tax, the deductions were prorated.

Under certain conditions, a tax credit was available for property transferred to children (and grandchildren) if the property transferred from the parents (or grandparents) was subject to the state inheritance tax more than once within a six-year period. In addition, property transferred from a decedent who was missing in action during the Vietnam era and declared dead by the federal government was exempt from state inheritance taxes.

The inheritance tax was not applied directly to the value of the net taxable estate but, rather, upon each distributee's share of the estate. The classes of distributees, exemptions, and tax rates in effect prior to Act 27 are shown in Table 6. [Table 6 also includes this information for the state gift tax.] Depending on the class of distributee, inheritance tax rates on bequests ranged from 2.5% to 20%. Within each category, a progressive tax rate structure applied. Beginning in 1988, the tax liability was reduced over a five-year period to phase out the state inheritance tax.

The inheritance tax was due and payable upon the date of the decedent's death but could be paid at any time within one year after the date of death without penalty. After that time, interest at a rate of 12% was charged, computed from the date of death. For certain farms and closely-held businesses, inheritance taxes could be paid on an installment basis over a period of 15 years.

**Table 6: Wisconsin Inheritance and Gift Tax Rates and Exemptions Prior to 1987 Act 27\***

	Class A** Lineal Issue, Lineal Ancestor	Class B Brother, Sister or Descendant of	Class C Uncle, Aunt or Descendant of	Class D All Others
<b>Personal Exemptions</b>				
Inheritance Tax	\$50,000	\$1,000	\$1,000	\$500
Gift Tax-Annual Exemption	10,000	10,000	10,000	10,000
Gift Tax-Lifetime Exemption	50,000	None	None	None
<b>Inheritance &amp; Gift Tax Rates</b> (All exemptions taken from the lowest bracket***)				
\$25,000 or less	2.5%	5.0%	7.5%	10.0%
25,000 to 50,000	5.0	10.0	15.0	20.0
50,000 to 100,000	7.5	15.0	20.0	20.0
100,000 to 500,000	10.0	20.0	20.0	20.0
Over 500,000	12.5	20.0	20.0	20.0

\*Under 1987 Wisconsin Act 27, the tax liability was reduced by 20% for deaths or transfers occurring in 1988, 40% in 1989, 60% in 1990 and 80% in 1991. On January 1, 1992, the inheritance and gift taxes were repealed with only the gap tax collected for transfers due to deaths occurring in that year and thereafter.

\*\*A total exemption was provided for transfers to spouses.

\*\*\*For example, the tax on a \$100,000 transfer to a Class B beneficiary was \$11,200, calculated as follows: (a) first \$25,000 minus \$1,000 exemption multiplied by 5%; plus (b) next \$25,000 multiplied by 10%; plus (c) last \$50,000 multiplied by 15%.

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## Wisconsin Gift Tax

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The Wisconsin gift tax, which complemented the state inheritance tax, was imposed upon transfers of property during life. During the phase-out, the gift tax liability, like that of the inheritance tax, was calculated based on pre-Act 27 law. The tax liability was then reduced by the phase-out percentages of 20% for gifts occurring in 1988, 40% in 1989, 60% in 1990, and 80% in 1991. The state gift tax was repealed in 1992. However, gift tax collections continued past 1992 as a result of audits and delinquent payments. Transfers which were taxable under the gift tax included:



- Gifts by a donor who was a Wisconsin resident, except for gifts of real estate or tangible personal property located outside Wisconsin;

- Gifts of real estate and tangible or intangible personal property located in Wisconsin regardless of the residency of the donor or donee;

- Forgiveness of a debt;

- The sale or exchange of property for less than market value;

- Funds withdrawn from a joint bank account by a joint tenant who was not the original owner of the funds;

- Property transferred to a completed joint tenancy to the extent the contribution of all joint tenants was not equal.

Exemptions from the gift tax were provided for: (a) transfers of out-of-state real estate or of personal property permanently located outside Wis-

consin by a nonresident to a Wisconsin donee; (b) employer-financed benefits for sickness, retirement or death annuities; (c) amounts to cover the current maintenance, support, or education of a dependent; (d) gifts to qualified charities or governmental units; and (e) gifts to a spouse.

Classes of distributees and rates of tax were comparable to provisions used under the inheritance tax. As illustrated in Table 6, two exemptions were provided under the gift tax: a noncumulative exemption of \$10,000 annually between each donor and donee and an additional \$50,000 lifetime exemption for certain closely-related donees.

If the total value of gifts between a donor and donee exceeded the annual exemption of \$10,000 in a calendar year, both persons were required to file a gift tax return. The donee was liable for the tax; however, the donor could pay the tax without incurring an additional tax. Interest accrued at 12% per year for taxes not paid by the April 15 due date for gift tax returns.