The Connecticut Estate and Gift Tax

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Presentation for Connecticut State Tax Panel
October 27, 2015

Outline of Presentation

1. Background & Brief History

2. Current Situation – in CT, the region and the federal code

3. Issues to Consider & Available Evidence
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   b. Effects on Migration
   c. Effects on Economic Growth
   d. Administrative and Compliance Costs

4. Possible Options for Reform

1. Background & Brief History

Key Features of **E**state, **I**nheritance & **G**ift taxes (EIG) taxes include:

- Estate taxes are levied on the estate (on the decedent)

- Inheritance (or succession) taxes are levied on the beneficiary & the rate typically differs depending on the relationship with decedent

- Gift taxes imposed once an annual limit has been exceeded, as an effort to prevent 'deathbed' transfers that circumvent E&I taxes

- Spouses typically exempt from all three

- EIG Revenues are volatile and difficult to link to policy
  - ➤One very large estate can have a disproportionate impact
  - ➤Estates can take years to settle, so tax revenues received in a given year do not match well with the policy in place at time of death

1. Background & Brief History – continued

Prior to 2001 (and EGTRRA):

The federal credit for state EIG taxes paid meant states could 'pick up' a portion of federal revenues while not adding to the tax liability of the estate

- Every state took advantage of this 'pick-up' tax

- Alabama, Arkansas, Florida, Georgia & Nevada have had only the 'pick-up' tax since the 1950s

- Between 1976 and 2001, 30 states eliminated their incremental EIG taxes & only imposed the 'pick-up' tax
    - List includes neighbors MA, NY & RI as well as VT, ME. NH was phasing out by 2003 & CT planned to in 2005
    - About a dozen states with EIG taxes (and no law to phase out) remained

➤ State EIG taxes have changed a lot over the last 40 years – which is critical to identifying a causal effect on migration and growth

1. Background & Brief History – continued

EGTRRA changed things in 2001 by (Table 1) :

- Eliminating the 'pick-up tax' by 2005
- Making state EIG taxes paid a deduction instead
- Steadily increasing the federal exemption level from $675K to $3.5M in 2009
- Steadily lowering the top tax rate from 60% to 45%
- Eliminating the estate tax entirely in 2010, then reinstating at 2001 level in 2011

➢ All reduced the ability of the states to get a piece of federal estate revenues

➢ States responded in several different ways (Table 2) –
  - Allowing their EIG tax to become dormant
  - 'Decoupling' their EIG tax so that it would still yield revenues based on the old law
  - Enacting a stand-alone EIG tax

➢ In general, federal & state EIG tax policy was in flux until 2012

2. Current Situation – Federal law (ATRA)

ATRA 2012 made several changes (Table 1):

- Exemption $5M, indexed to inflation (currently $5.43M)

- Top rate now 40% (phased in quickly)

- *Unified gift tax*; exemption raised to that of estate tax (gifts that exceed $14K per donee per year)

- Includes *portability* = any unused portion of a deceased spouse's estate tax exclusion may be used by surviving spouse – effectively doubles the exemption for married couples

➢ As a result, far fewer estates are subject to the federal tax than in 2001 or even 2009
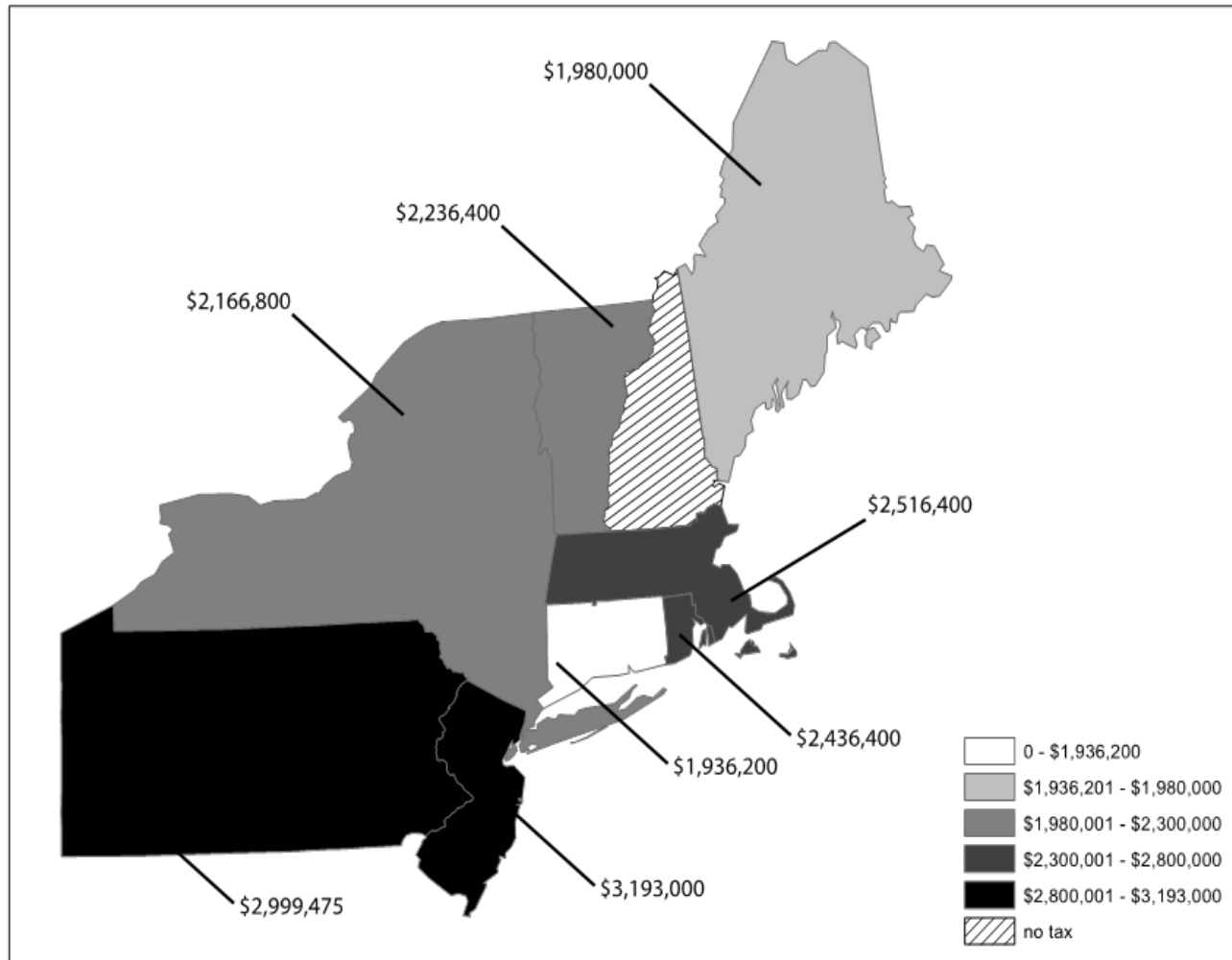
2. Current Situation – States (Figure 1 & Table 4)

Legend:
- no tax
- has tax
- exempts farms
- exempts farms and small businesses
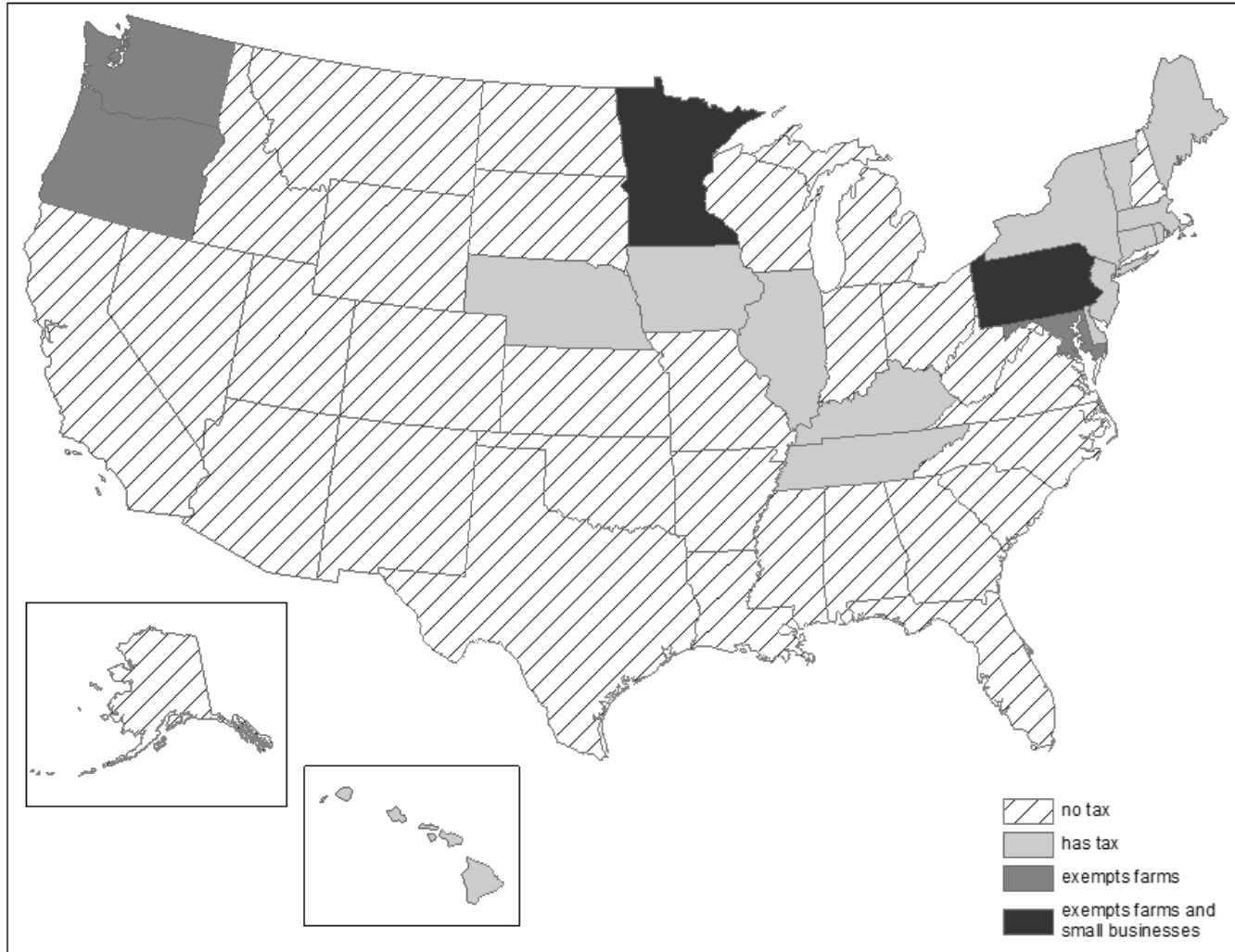
- 20 states currently have EIG taxes
- TN's expires in 2016; NE has county inheritance tax
- Exemptions range from $1000 to 5.43M (low ones inheritance)
- Top rate ranges from 9.5% to 20%

➢CT is $2M & 12%
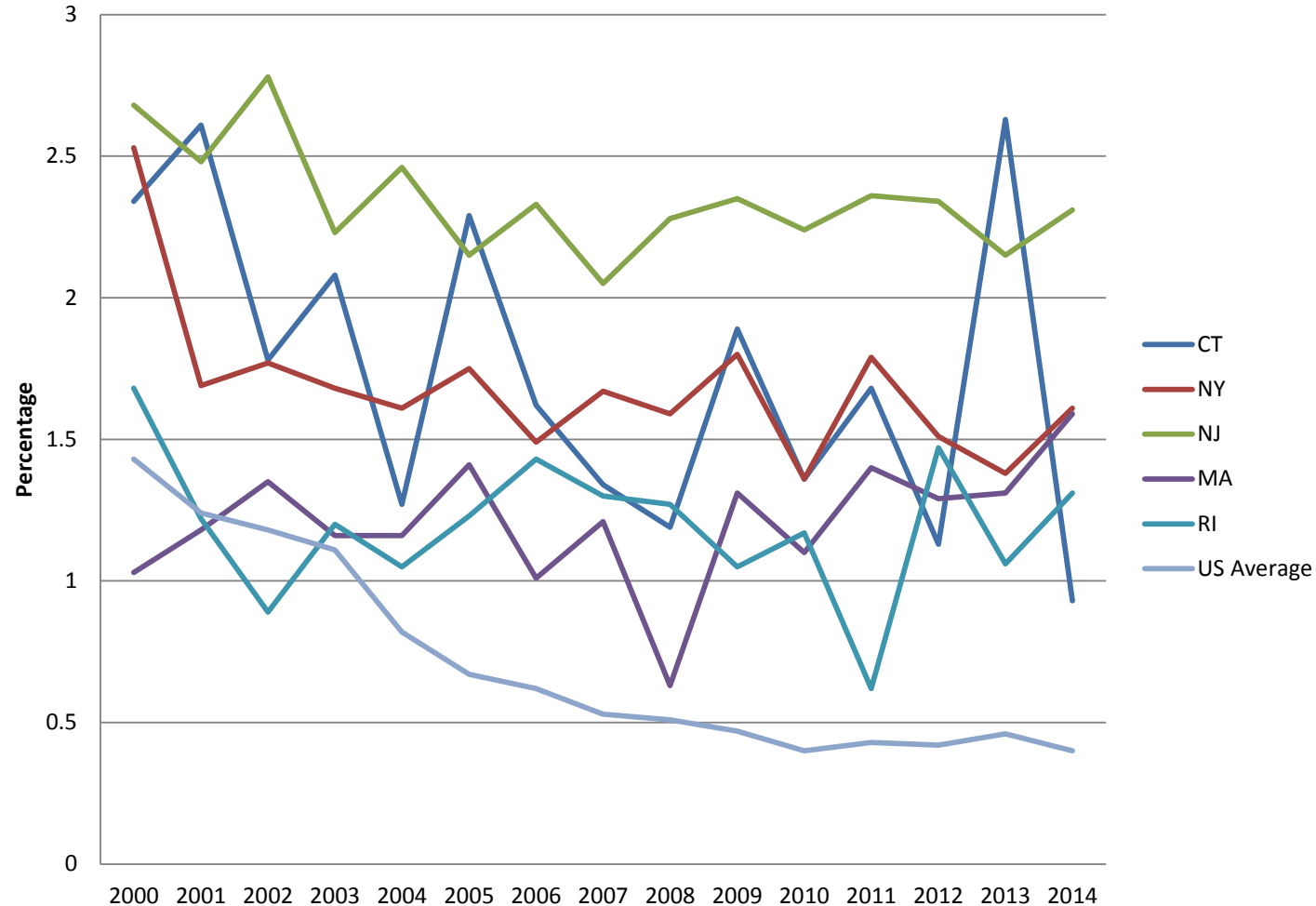
2. Current Situation – the Region (Figures 4A-C)

TAX BILL ON 20 MILLION DOLLAR ESTATE, BY STATE

- CT's is the lowest in the region other than NH (which doesn't have one)
- Exemptions range from $3500 (PA) to $3.125M (NY) Figure 4A
- Top rates are 12 (CT & ME), 15 (PA) & 16% (the rest) Figure 4B
- ➢CT is $2M & 12% & $1.9362 on $20M estate

2. Current Situation – State Revenues (Figure 2)

EIG REVENUES AS A PERCENTAGE OF TOTAL TAX
RECEIPTS, BY SELECTED STATES AND YEARS

- Shows steady decline in EIG revenues for all states – loss of pickup tax (US Average)
- Shows smaller decline in the region
- Reveals volatility of revenues
- Makes up a small portion of state revenues

2. Current Situation – Recent Actions in the Region

Maine = in 2012, created stand-alone estate tax; $2M exemption & 3 brackets (8% 2M-5M to 12% 8M+). No cliff.

New York = in 2014, began increasing exemption by $1.0625M/year until 2019 when it is set to the federal exclusion. Top rate is 16%; no cliff but a very steep hill.

Rhode Island = in 2014, increased exemption & indexed to inflation; currently $1.5M. Top rate of 16% and no cliff.

Vermont = in 2011, increased exemption to $2.75M. Has a cliff and top rate of 16%.

➢A 'cliff' or 'bubble' occurs when the *entire estate* is subject to tax once it exceeds the exemption. Example – pay no tax on 1.9999M but pay 5% or 50,000 on an estate equaling $2M + $1.

2. Current Situation -- The Case of Connecticut (Table 3)

<u>Before 2005:</u> had a succession tax that was being phased out by 2005; class A (immediate family) already exempt, class B (more distant relative) had exemption of 600K, rates of 12.8-14%, & all others had 200K exemption, rates of 14-20%

<u>2005-2009:</u> replaced with unified gift & estate tax based on dormant 'pickup tax' credit – exemption was $2M & rates ranged from 5.085% to 16%. **Had a cliff.**

<u>2010:</u> removed cliff, increased exemption to $3.5M and rates ranged from 7.2% to 12%.

<u>2011-present:</u> exemption decreased to $2M, rest unchanged

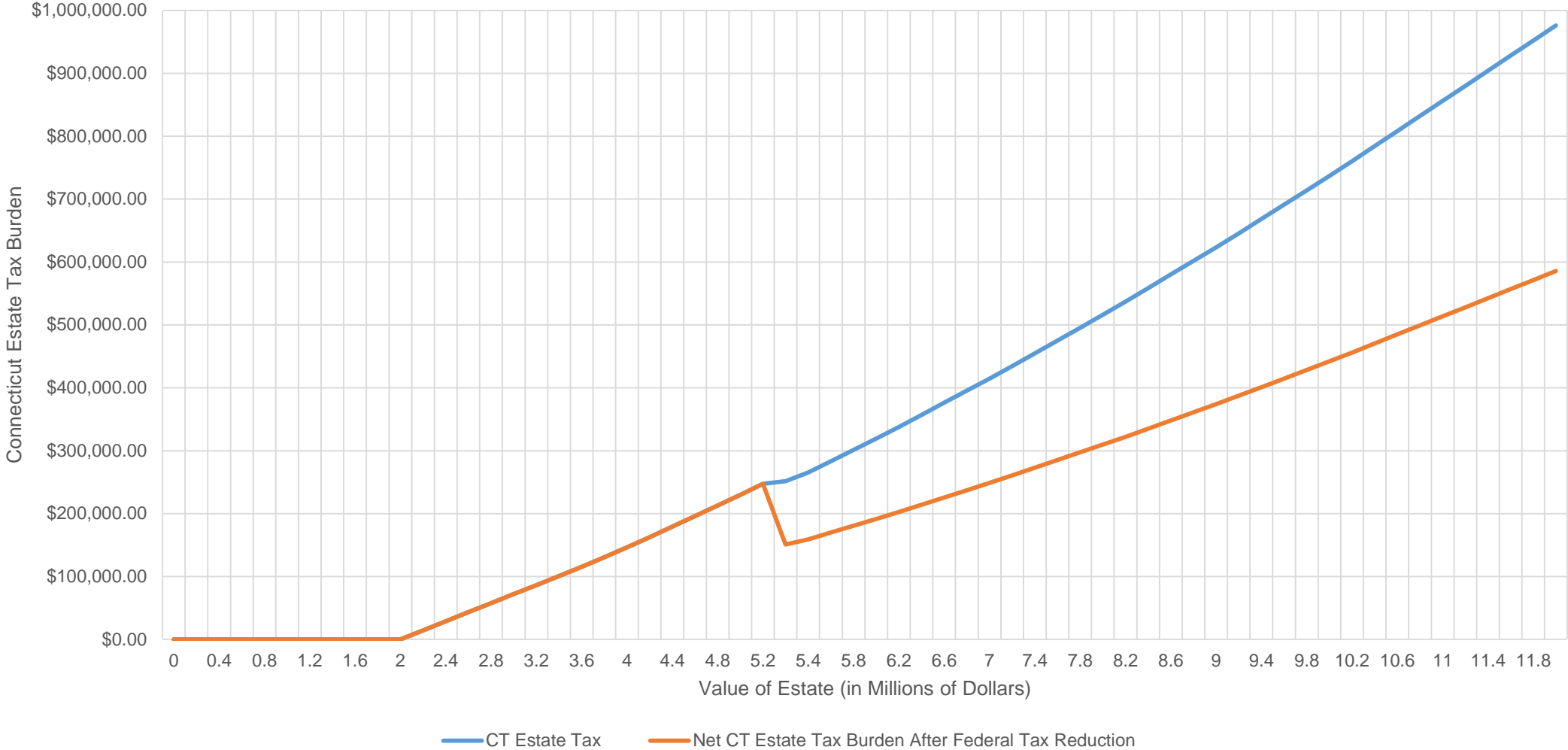# 2. Current Situation -- The Case of Connecticut

Key Features of Current Law:

- Exemption of $2M
- Rates that range from 7.2% (2M to 3.6M) to 12% for 10.1M+
- No portability (only Hawaii currently allows; Maryland in 2019)
- A unified gift tax (only state with one although many have limits); same $2M exemption and $14K annual limit per donee

Interaction with Federal Law:

- Estates large enough to face federal tax can deduct state EIG taxes paid, effectively 'pushing off' when federal taxation begins and lowers the net mtr; leads the state liability (net of federal) to actually decrease for a while.
  - For every dollar above $5.43M, the estate can deduct a dollar in state taxes paid, reducing their federal liability by the mtr (up to .4). Since the federal mtr > CT mtr, the net state liability actually declines with each additional $
  - Once estate is large enough to be able to deduct all state taxes paid, the net mtr is no longer negative but is reduced by (1-federal mtr).
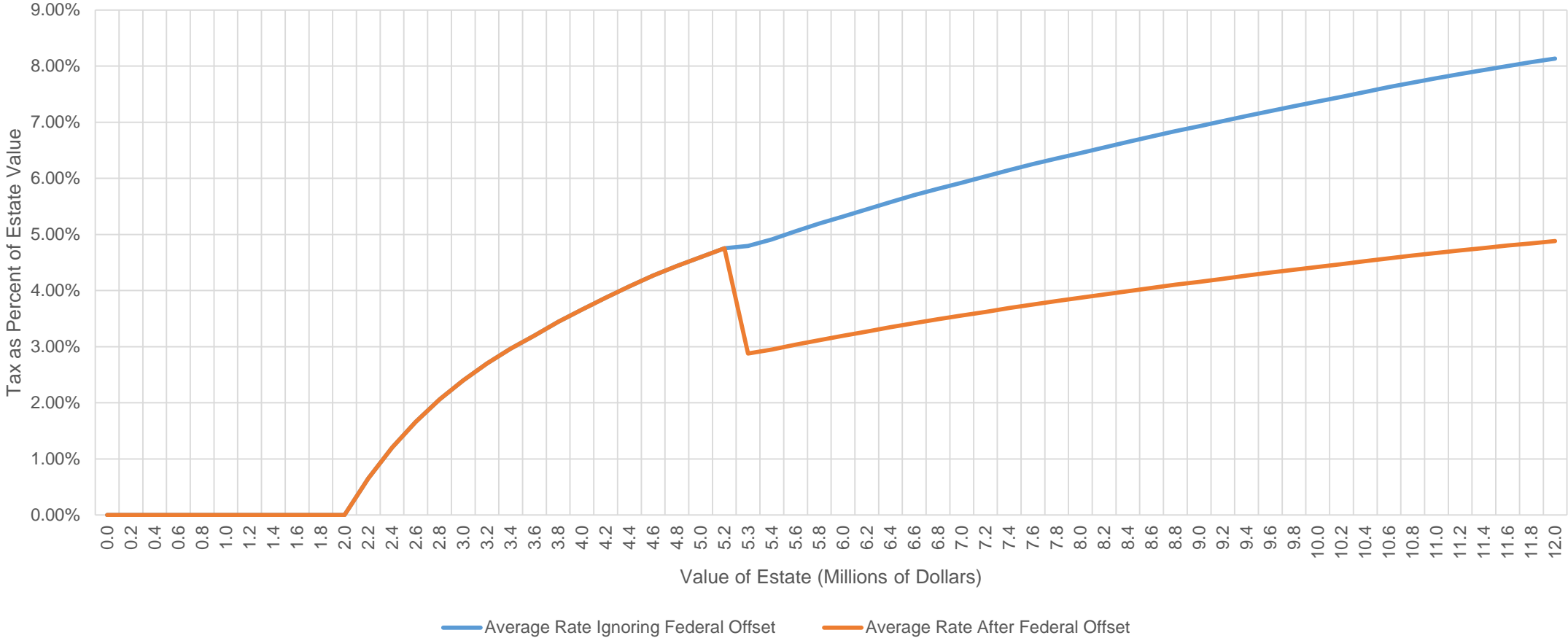
2. Current Situation -- The Case of Connecticut

NET CONNECTICUT ESTATE TAX BURDEN AFTER FEDERAL DEDUCTION OF CT'S ESTATE TAX in 2014

2. Current Situation -- The Case of Connecticut

AVERGE TAX PER DOLLAR OF CONNECTICUT ESTATE in 2014

2. Current Situation – Case of Connecticut

Another interaction with the federal law is whether the state allows a separate state **QTIP** (Qualified Terminable Interest Property).

QTIPs are a way to transfer assets to spouses while dictating who receives the assets upon the spouse's death.

- CT, along with NY, NJ, VT & DC, does not allow a separate state QTIP election
- This complicates estate planning for estates below the federal exemption because
  - If choose QTIP equal to federal exemption, it creates a tax burden at state level
  - If choose QTIP equal to lower state exemption, it may waste a portion of the decedent's federal exemption

3. Issues to Consider & Available Evidence

Distributional Considerations:

- EIG taxes are typically desirable from the 'ability to pay' criteria as they are paid by the very top of the wealth distribution
  - In 2000, 9.17% of CT deaths faced an EIG tax
  - In 2013, 1.75% of CT deaths faced an EIG tax
- 2014 CT DRS Tax Incidence report finds
  - the EIG tax is the most progressive tax
  - the EIG tax is only one of two progressive taxes out of the 9 considered
  - Paid by the top 3 deciles of the income distribution and 98% paid by top two
- A preliminary study (Brewer et al 2015) finds that
  - CT experienced the largest growth in income inequality (measured by the Gini) between 1990 & 2013 of all the US states
  - CT has the 4th highest Gini (largest inequality) in the country in 2013
  - The % of CT elderly residents in the bottom 25% of the national income distribution has grown as well – so it is not just that the top is growing.

3. Issues & Evidence – Behavioral Effects

Most concerns about EIG taxes regard possible effects on *behaviors* and *incentives* – such as work & investment/savings decisions.

Past academic research finds that

- Donor responses are complicated by the motive of the donor
  - 'Accidental' bequests may elicit no response
  - Other motives include altruism (alternative definitions) towards children or exchange (for services from children)
  - Presumes people are rational about planning for their deaths – some evidence that is not true
- Heirs' behaviors may also be affected by anticipating and receiving the bequest. (Examples – may work less in anticipation of $ or work more to gain favor…)

➢ The empirical evidence is mixed and the bottom line is that EIG taxes could have behavioral effects that are either beneficial or detrimental to economic growth

3. Issues & Evidence -- Migration

<u>For state EIG taxes,</u> the behavioral response that gets the most attention is the concern *that people may move to another state* to avoid them.

<u>The challenge</u> of these studies is to control for other state characteristics and factors that affect decisions to move (e.g., climate, cost of living, family connections, vacation habits, need for assistance)

<u>Example</u> – the southern states have no EIG taxes, but also have low cost-of-living and the onset of air conditioning has made their climate more attractive.

➤ These states have experienced strong in-migration from all age and income levels for decades. How much is due to EIG taxes?

➤ Most studies therefore focus on the elderly and try to control for other characteristics via statistical analyses.

3. Evidence for Migration Effects – past research

Some stylized facts:

- Elderly interstate migration is somewhat rare (< 1% move in any given year)
- The geographic patterns of elderly migration are very persistent over the last 30+ years -- even while EIG taxes have changed alot

Earliest studies = find some effect of EIG taxes but often in a puzzling way – it discourages people from moving in (expected) *and* from moving out (not expected).
- "Same sign" problem often present in studies that only consider one point in time.
- Studies that use only 1 point in time run the danger of attributing to EIG taxes (or any policy) the effects of other characteristics the state possesses but is not controlled for.

3. Evidence for Migration Effects – past research

<u>More recent studies</u> = examine how *changes* in tax policy lead to *changes* in migration (and EIG taxes have changed a lot).

These studies tend to find little or no effect of taxes. Some key studies:
- Our past work using census-based migration data, by age & income=finds no effect of EIG taxes or income tax breaks for the elderly
- Bakija & Slemrod (2004) use an indirect measure of migration, the # of federal estate tax returns filed in the state = finds a modest effect but not strong enough to make up for lost revenues
- Brulhart & Parchet (2014) study cantonal estate taxes in Switzerland = finds no effect
- Studies of 'millionaire taxes' by Varner & Young (2011, forthcoming) = finds little or no effect of millionaire *income taxes* on migration.
- Two studies that have found effects of *income taxes* on migration are limited to inventors (Moretti and Wilson 2015) and star athletes (Kleven et al 2010).

➢Recent research therefore provides little evidence that migration is substantially affected by EIG taxes (or millionaire taxes)

3. Evidence for Migration Effects in Connecticut

<u>Studying the current effects of EIG taxes in Connecticut presents several challenges.</u>

Migration is difficult to measure and increasingly so:

- Its rarity means that the numbers can get very small as cut by age, income, state destination or origin
- The decennial census was replaced by the American Community Survey which isn't entirely comparable and captures fewer migrants (with its shorter window)
- The EIG tax now affects a much smaller % of the population = very hard to get data on the very wealthy (their small size, top-coding of income & wealth)
- We still need to look at variation over time to isolate the effects of EIG taxes = which means the new IRS-SOI gross data that breaks down by age & income is not that much help because it is only available since 2011-12 (at most, 3 years). Also doesn't give *flow* (where people have moved from or to).

➢ We use several alternative sources of data to look for evidence that migration behaviors respond to changes in EIG taxes.

3. Evidence for Migration Effects in Connecticut

A. Direct measures of migration:

1. Many use the <u>IRS-SOI migration flow data</u>, including the 2008 Estate Tax Report by CT DRS. This data has several limitations:

- Is based on the universe of taxpayers = includes all ages & incomes, most of whom are not affected by the EIG tax. (Younger taxpayers migrate much more than older ones.)
- Excludes those who file late in the year and therefore misses late returns (often those complicated returns of high income elderly taxpayers)
- ➤For comparison, we nonetheless report annual, migration data from 2001-2013 in Table 7 and find
   - ➤similar patterns to our other measures, and
   - ➤little connection to changes in EIG taxes.

3. Evidence for Migration Effects in Connecticut

A. <u>Direct measures of migration – con't:</u>

2. We emphasize the <u>census/ACS data</u> because we can focus on the migration of the elderly and the high income (although getting enough of the top % is still difficult).

- Have migration data from 3 decennial censuses (spanning migration 1976-80, 1986-90 & 1996-2000) and two ACS samples (spanning 2006-2010 & 2011-2013)
- We look at top destinations and origins for elderly CT residents (Table 5) and find
  - ➤People come *from* NY (1st), MA, FL & NJ
  - ➤People move *to* FL (1st), NY, MA, NC & SC (used to be CA)
  - ➤More people move out than move in
  - ➤Patterns are consistent over time

➤Next we focus on *net* inflows (how many coming minus how many leaving from/to each state)

ALL ELDERLY

Net Rank	1976-1980		1986-1990		1996-2000		2006-2010		2011-2013	
1	FL	-7120	FL	-12129	FL	-6491	FL	-5570	FL	-5819
2	CA	-1120	SC	-962	NC	-989	SC	-1945	NV	-719
3	NC	-520	NC	-783	MA	-987	GA	-1410	CA	-515
4	AZ	-520	CA	-675	ME	-938	NH	-1175	MA	-472
5	GA	-440	ME	-495	SC	-668	NC	-800	SC	-387
6	NH	-360	VA	-474	CA	-648	MI	-750	RI	-356
7	ME	-320	NH	-392	AZ	-575	ME	-705	MI	-223
8	RI	-320	MD	-377	WA	-557	PA	-690	AZ	-130
9	SC	-280	AZ	-333	NH	-438	AZ	-460	NH	-122
10	TX	-240	RI	-282	TN	-374	MD	-405		
44	MO	120					MN	320		
45	IA	120	IL	123	MI	102	TN	380	WV	193
46	MA	160	MA	187	MO	134	RI	635	PA	257
47	NJ	560	NJ	634	NJ	860	MA	650	NJ	693
48	NY	4360	NY	2194	NY	4611	NY	4055	NY	2248
Net Change:		-7760		-15929		-9236		-10655		-4555

RICH ELDERLY (TOP 25% of NATIONAL INCOME)

Net Rank	1976-1980		1986-1990		1996-2000		2006-2010		2011-2013	
1	FL	-2800	FL	-8224	FL	-2885	FL	-3235	FL	-1876
2	CA	-480	NC	-701	MA	-544	SC	-915	NV	-296
3	AZ	-240	SC	-677	NC	-431	CA	-425	MI	-258
4	MA	-200	CA	-636	CA	-358	NC	-390	AZ	-241
5	ME	-160	ME	-316	ME	-293	MI	-380	NH	-173
6	GA	-160	NH	-315	AZ	-254	GA	-340	SC	-140
7	VT	-160	MD	-226	NH	-239	TX	-315		
8	NC	-120	AZ	-215	SC	-171	AZ	-205		
9	SC	-120	RI	-178	TN	-159	NV	-200		
10			PA	-171	VA	-147	NH	-150		
44							AL	150	NY	62
45							OH	235	WV	89
46	NJ	120	MA	351			MN	245	MA	198
47	PA	160	NJ	524	NJ	130	NJ	260	MD	255
48	NY	1360	NY	1132	NY	1346	NY	1565	NJ	274
Net Change:		-2880		-10761		-5132		-4335		-2236

Note how stable the patterns are across time and between the top 25% & all elderly

CT was actually losing the most residents during 1986-90, when many more states had EIG taxes

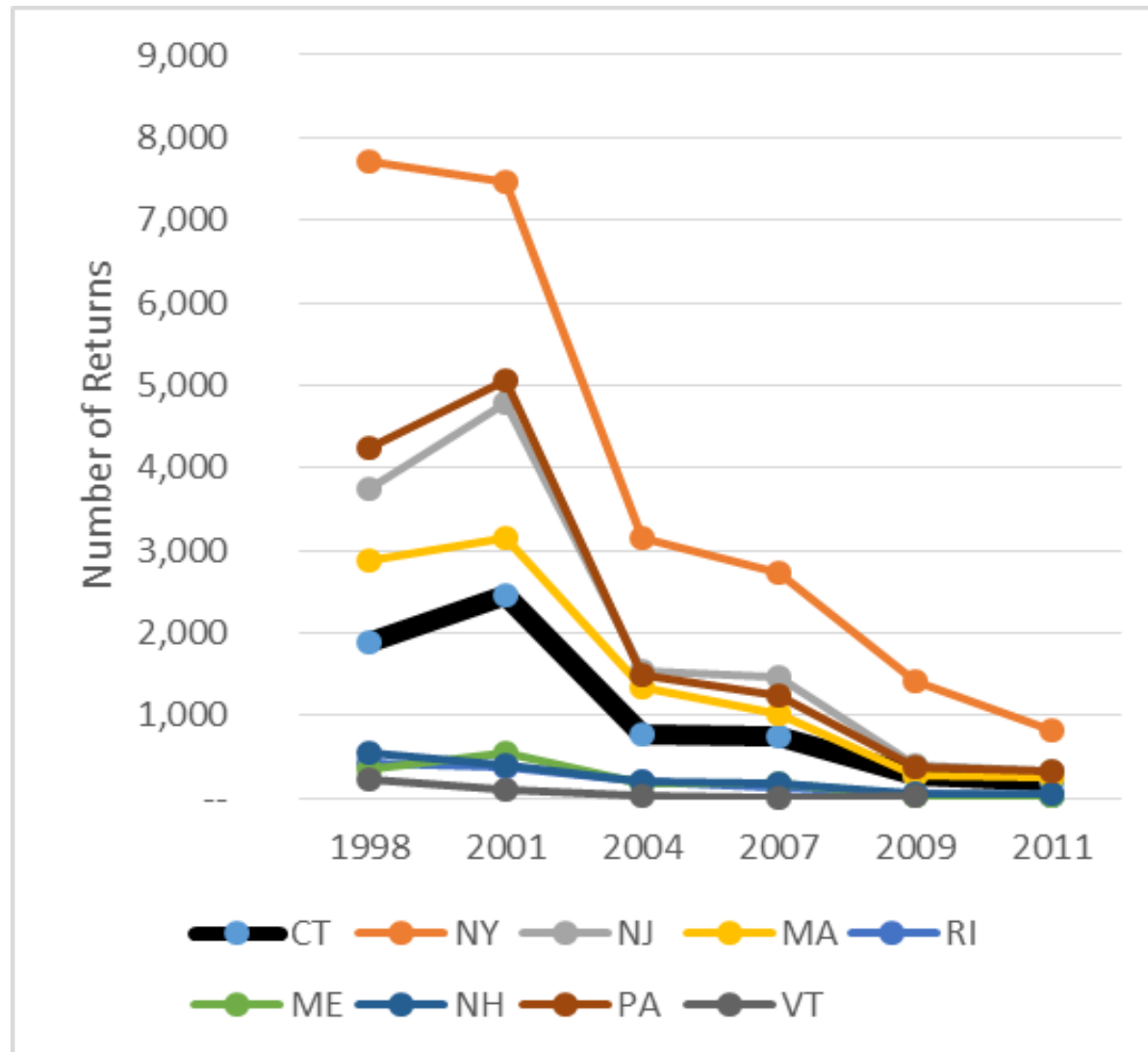Blanks occur when the number of observations become too small to report

3. Evidence for Migration Effects for Connecticut

B. Indirect Measures of Migration

    1. Federal estate tax returns (by year of death) filed in Connecticut (as in Bakija & Slemrod 2004). May be better at capturing the very rich, but has limitations:

- An indirect measure – must have moved to the state and died there to be counted
- The number of federal estate tax returns is changing over time because of changes in wealth but also during the 2000s because of the steep increase in the exemption
- We therefore compare the trend for CT to other states
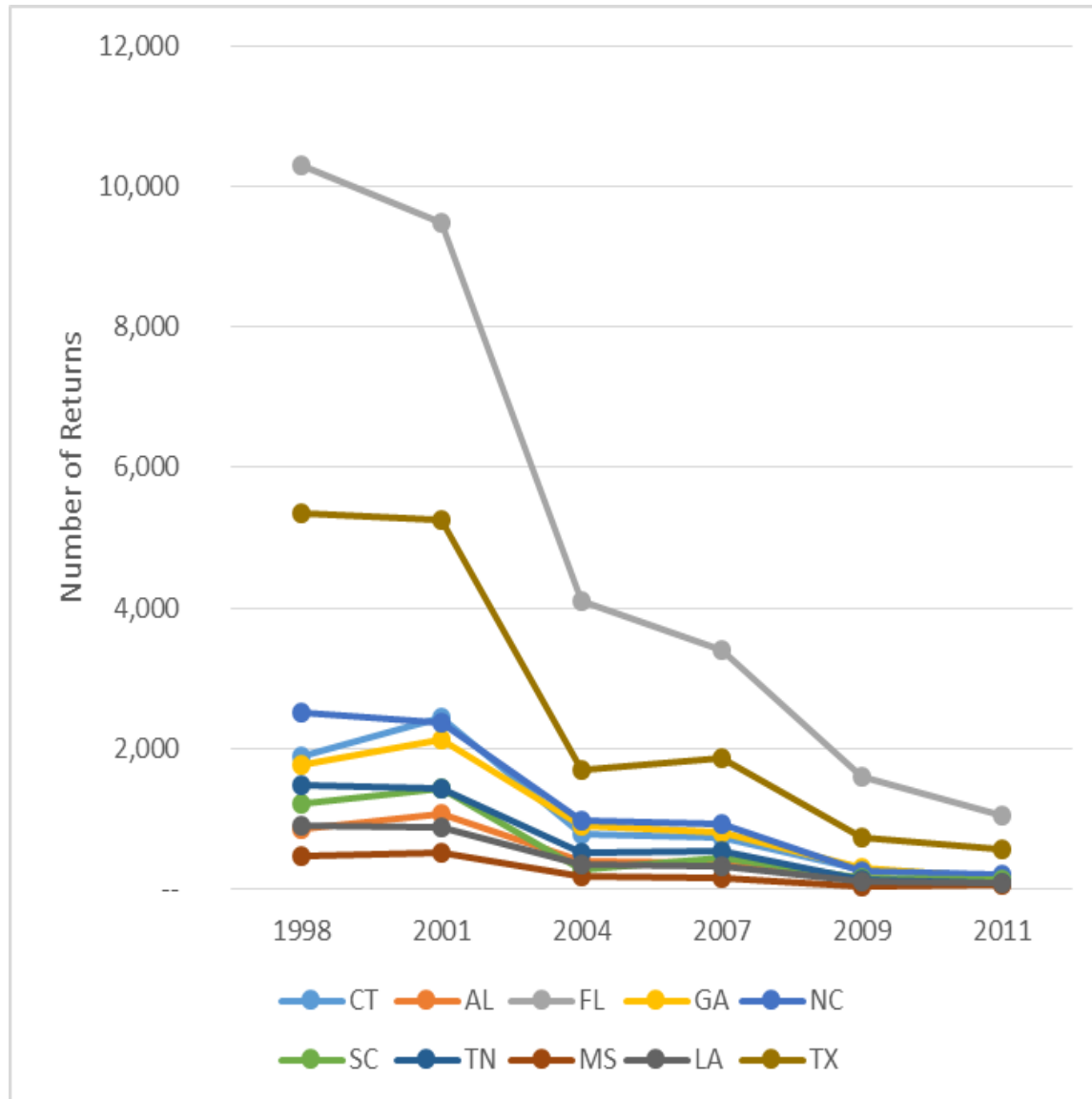- Reported in Figures 6-8

Total Number of Federal Estate Tax Returns, for each Northeast State

Decline in federal estate tax returns during 2000s is evident in all of the states – CT in the middle.

But most of these states have EIG taxes

Total Number of Federal Estate Tax Returns, for CT plus Southern States

The graph looks very similar and Connecticut is again right in the middle

We find CT is also similar if we plot % change in federal estate tax returns

3. Evidence for Migration Effects for Connecticut

B. Indirect Measures of Migration

2. CT income tax returns for high income filers who seem likely to be older (are claiming the social security adjustment). May also be better at capturing the very rich, but has limitations:

- Changes in the # of returns can be due to changes in income, aging into social security, or death -- and not necessary net-migration.
- There is no measure of 'age' and SS adjustment claim is an imperfect measure of being elderly
- It is only available since 2007 – only big change in CT EIG tax is the 2009 law, coincided with the recession.
- We compare across income groups and to those without SS adjustment
- Reported in Figures 9A & 9B

Total Number of CT Income Tax Filers Claiming SS Adjustment, by AGI
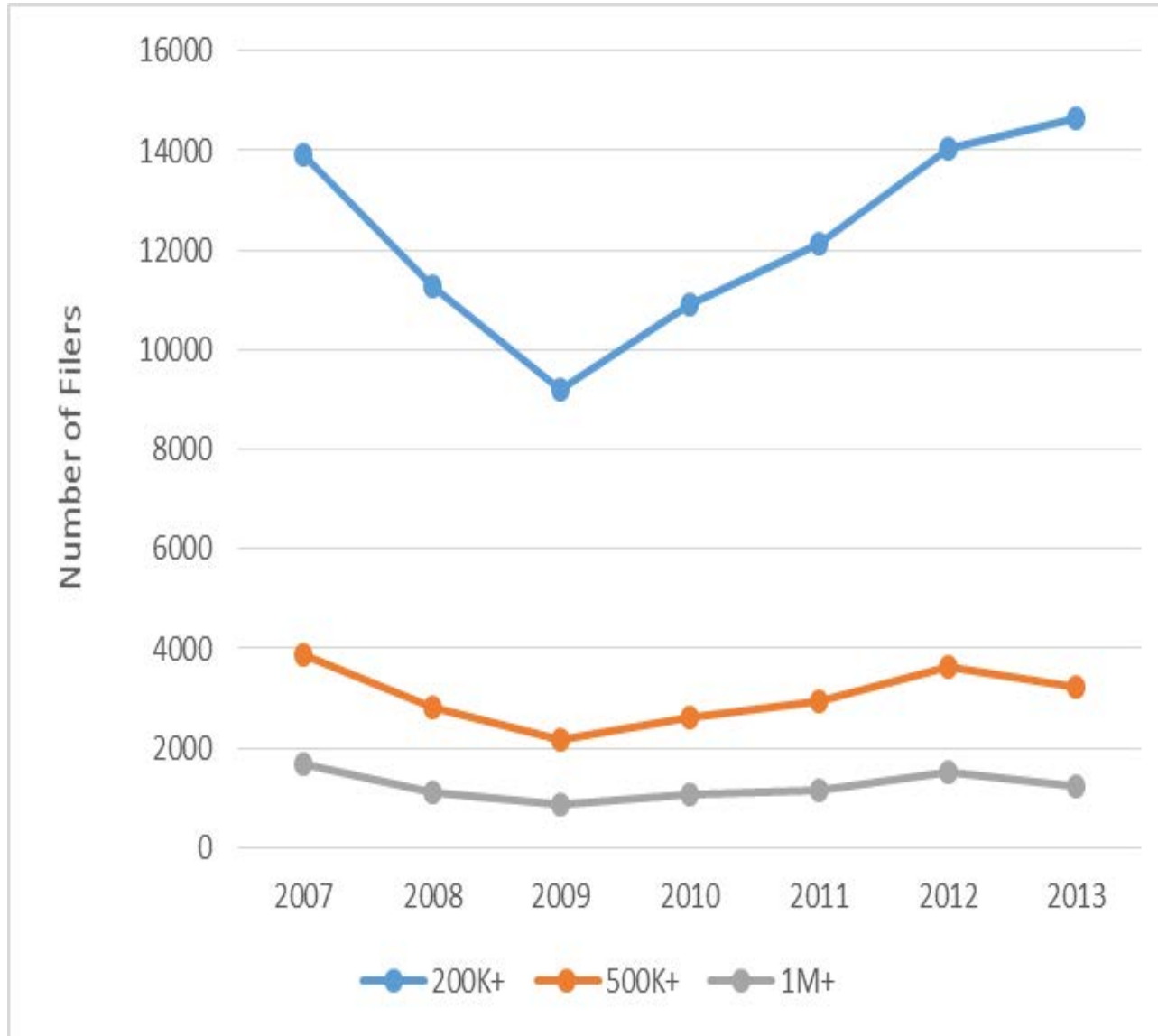
Can see the obvious effects of the 2009 recession and rebound.

Despite cut in EIG tax in 2009-10, returns of very rich are still lower than they were when tax was higher (2007)

Percent of All CT Income Tax Filers Claiming SS Adjustment, by AGI

This figure attempts to control for recession by calculating the percentage of all tax filers who are 'elderly'.

But elderly would be expected to get more $ from investments & effects of 2009 recession still obvious. Still haven't returned to 2007 levels.

3. Evidence for Economic Growth

- Little evidence that migration or other behaviors are affected, but they can be hard to measure and identify.

- Behavioral effects are primarily a concern because they may affect economic growth → Study the effects on economic growth directly.

- To our knowledge, there are no past studies other than preliminary work by Brewer et al (2015)
  - find no significant effect in standard tax growth models

3. Evidence for Economic Growth *for CT*

- Two Measures of Economic Growth (both annualized growth rates)
1. Gross State Product (or GDP by state) Per Capita
2. Per Capita Income Per Capita

➤Per capita better captures the well-being of the average CT resident.

➤Compare across different types of states

General Findings (reported in Figures 10-12)

1. The two growth measures yield similar trends
2. CT follows the same pattern as other states, those with and those without EIG taxes
3. CT appears to experience greater volatility in its growth, especially personal income, but has since 1978.

Annualized Growth in Per Capita Income, CT and Southern states
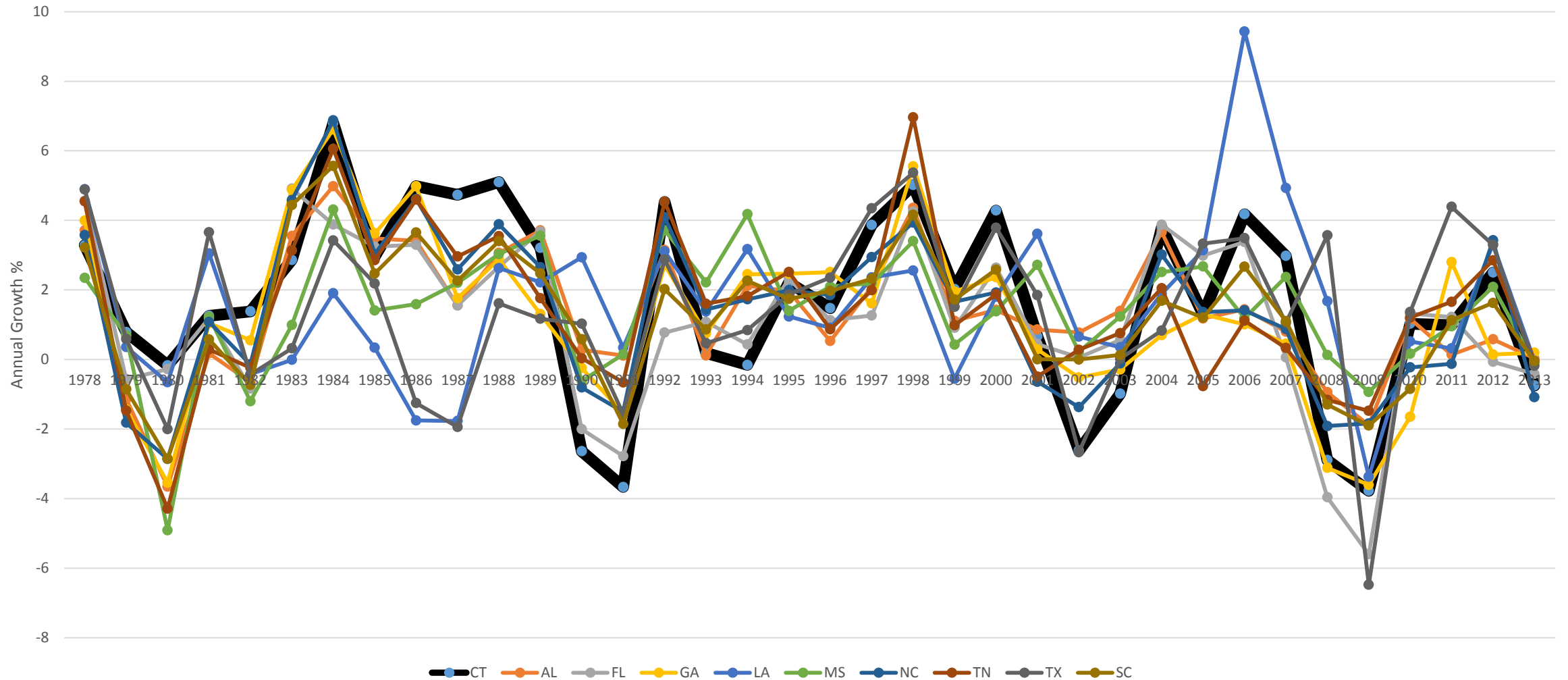
Annualized Growth in Per Capita Income, CT vs. Selected Regional Averages
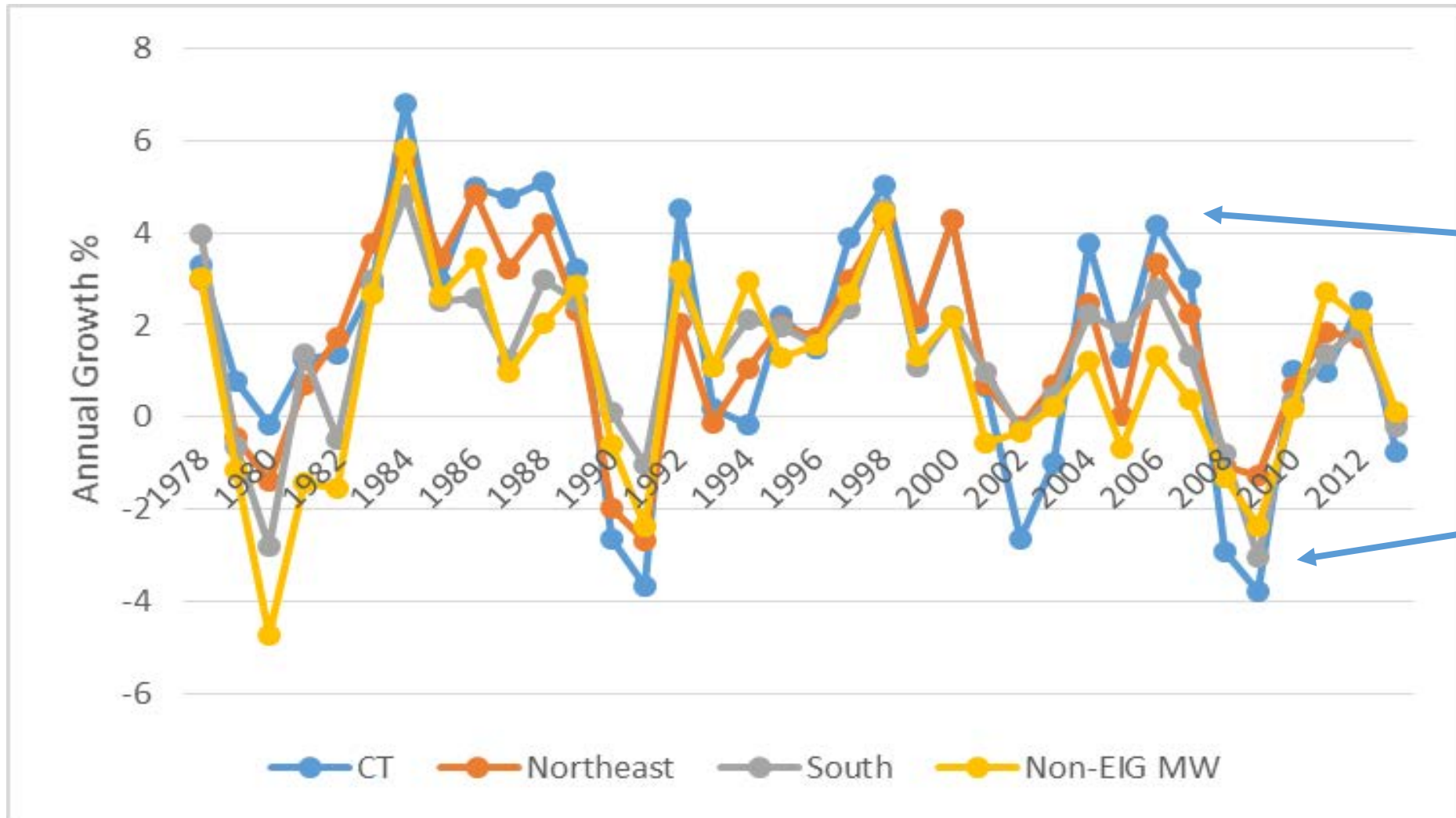
Economic growth looks higher, if anything, in the years after the new EIG tax was enacted, and lower after it was reduced.

Of course, recession too!

3. Other Issues to Consider – Administration and Compliance Costs

<u>3 Potential Issues:</u>

1) Lack of state-specific QTIP complicates estate planning, especially for blended families. (Policy reform option)

2) 6-month deadline for filing estimated tax appears shorter than most

3) Recent increase in Probate Fees increases compliance cost of filing an estate

➤ #2 is an administrative feature & #3 is linked to the funding of the CT judicial system = outside the purview of this study.

Option #1 – Retain the Current Tax

- Little available evidence that EIG taxes are affecting migration – at least not enough to offset loss in revenues
- Little evidence of effects on economic growth
- CT made important reforms in 2009 when it removed its cliff; lowered substantially the tax burden
- It is among the lowest EIG taxes in the region
- It is the most progressive tax in a state with high income inequality

But

- It is a relatively small, volatile source of revenues
- The migration of the very rich is hard to measure
- The landscape for state EIG taxes has potential to change rapidly -- # of states with EIG taxes is falling and several others have reduced their taxes.

Option #2 – Conform with Federal Estate Tax

Conforming with the federal law entails two possible features:

1. Match its exemption level ($5.43M in 2015 & indexed to inflation).
   - Using 2013-14 DRS estate revenue data provides illustrative calculations that suggest
      - At least 395 of the 520 returns would no longer pay any taxes
      - The remaining estates would have reduced tax liabilities of $267,900 each
      - Raising the exemption would reduce revenues by approximately 30%

2. Adopting portability – effectively doubles the exemption for married couples.
   - Calculations require many assumptions; one simple set suggests that it would reduce revenues by approximately 51%

➢CT already conforms with its unified gift tax

➢Has the advantage of simplifying estate tax planning

Option #3 – Allow for a Different QTIP Election

- Connecticut is one of 5 states that does not allow a separate QTIP election
- A different QTIP election will allow married couples to defer the payment of CT tax without forgoing the full federal exemption
- Would simplify estate tax planning
- Would result in a loss of revenue – but it seems minimal as QTIPs fall out of favor with the advent of federal portability

Option #4 – Increase the Marginal Tax Rate on those Paying Federal Estate Taxes

- This is the only option presented here that has the potential to increase EIG tax revenues.

- Once an estate exceeds the federal limit, state EIG taxes paid reduce the federal liability and in effect receive a subsidy (recall Figure 5.)
  - The top rate of 12% is actually only (1-.4)*12 = 7.2% net of federal taxes
  - Estates just above the federal exemption currently face a negative marginal tax rate net of federal taxes
  - States can capture a portion of federal revenues, as with the old pickup tax.

- CT's top rate is currently one of the lowest in the country

- Would increase the tax burden, but by less than the revenues raised

Option #5 – Eliminate the Gift Tax

- Connecticut is the only state with a stand-alone gift tax. But --
  - Many states have 'gift-in-contemplation-of-death' rules that make gifts made shortly before death (2-3 years) taxable.
  - In some states that base their EIG taxes on the old pickup tax (MA is one), lifetime taxable gifts may reduce the available exemption.

- CT would lose its gift tax revenues, which equaled $8.7M in 2013-14.

- Would also open the door to deathbed gift-planning strategies which could substantially reduce estate taxes.
  - State could consider enacting gifts-in-contemplation-of-death rules like other states with EIG taxes have done.

Option #6 – Eliminate the Estate & Gift Tax

- Renders the rest of these changes moot
- Connecticut would join the majority of other states without EIG taxes and be the only state in the region besides NH without one
- It would eliminate both gift & estate tax revenues, which in 2013-14 equaled $206M, a source of revenue that is typically less than 2% of revenues.
- There is little evidence to suggest that revenues would be made up for with behavioral responses such as migration or with increased economic growth.
- It would eliminate the most progressive tax in its system