Minnesota
Estate Tax Study

MINNESOTA · REVENUE

Tax Research Division
March 5, 2014

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March 5, 2014

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St. Paul, MN 55155

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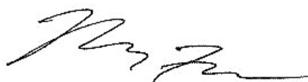
To the Members of the Legislature of the State of Minnesota:

It is my pleasure to submit to you the Estate Tax Study, as required by 2011 Laws of Minnesota, 1st Special Session, Chapter 7, Article 1, Section 10. The study identifies issues for policy makers to consider in deciding whether and how to revise, reform, replace, or repeal Minnesota's estate and gift taxes. It explains the challenge states encountered with repeal of the federal pick-up tax (phased out starting in 2002 and repealed in 2005) and explains how Minnesota and other states have responded to those challenges.

The study presents information about who pays Minnesota's estate tax, and it discusses potential changes. Estimates of the revenue impact of those changes are included where they are available. The Department of Revenue appreciates the input received from the probate section of the Minnesota State Bar Association and from Minnesota Association of Public Accountants.

Minnesota Statutes, Section 3.197, specifies that a study to the Legislature must include the cost of its preparation. The approximate cost of preparing this study was $20,000. The study is available on the Department of Revenue web site at
www.revenue.state.mn.us/research_stats/research_reports/2014/estate_tax_report_3_5_14.pdf.

Sincerely,



Myron Frans
Commissioner

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Executive Summary

Minnesota enacted an estate tax in 1979, replacing an inheritance tax that dated back to 1905. The estate tax is forecast to raise $173.4 million in FY 2014 growing to $218.9 million in FY 2017. The estate tax accounts for roughly 0.9% of Minnesota's total state tax revenue.

Background to Proposals to Repeal, Revise, or Reform the Structure of the Estate Tax

Major changes were made to the federal estate tax in 2001, with the phase-out and repeal (in 2005) of the "pick-up tax." Between 1985 and 2001, the federal estate tax provided a 100% tax credit for the Minnesota estate tax. Any estate tax paid to Minnesota reduced the federal estate tax by the same amount, so the tax imposed no burden (other than filing costs) on Minnesota taxpayers. The state simply "picked-up" a share of what would have been paid to the federal government. Most states (like Minnesota) limited structured their estate tax so the tax equaled the maximum allowable federal credit.

With the end of the pick-up tax, the 100% federal tax offset for state-level estate taxes ended. Although state-level estate and inheritance taxes are deductible in calculating federal estate tax, the deduction can offset no more than 40% of the state tax (because the federal tax rate is 40%). A state-level estate tax is no longer a nearly painless way to raise revenue.

One other federal change has also affected state policy. In 2001 the federal exclusion was $675,000 and was set to rise in steps to $1 million in 2006. Minnesota had conformed to that phased-in increase in the exclusion, so the first $1 million of an estate (after allowable deductions) has been exempt from tax in Minnesota since 2006. The federal exemption increased to $2 million in 2006 and is now $5.34 million and indexed each year for inflation. So the first $5.34 million of an estate's value (after deductions) is exempt from federal tax.

States have responded to the end of the pick-up tax in several ways:

- 31 states no longer have an estate or inheritance tax.
- 9 states (including Minnesota) and DC have retained their taxes by referring back to pre-2001 law. These states have maintained the structure of the pre-2001 tax. The exclusion levels vary from $675,000 to $5.34 million; Minnesota is one of 4 states and DC that are at $1 million.
- 5 states have enacted stand-alone tax structures, with their own tax rates and exclusions ranging from $1 million to $5.34 million.
- 5 states have no estate tax but have inheritance taxes.

States like Minnesota that have chosen to retain the structure of the pick-up tax by referring back to pre-2001 federal law have an odd tax rate structure that includes what is referred to as a "rate bubble." In Minnesota, the first $93,785 of estate in excess of the $1 million exclusion pays tax at a rate of 41%. The rate on each additional dollar of taxable estate then falls to 5.6% and rises in steps to 16% (over $10.1 million). States in this group with either lower or higher exclusions have similar rate bubbles.

Options for Structural Change

Chapter 5 of the study describes alternative policies for Minnesota, including the following:

- Repeal the estate tax.
- Keep the structure of the pick-up tax (and the bubble), but increase the exclusion by various amounts.
- Eliminate the bubble by enacting a stand-alone tax with the current exclusion ($1 million).
- Eliminate the bubble by enacting a stand-alone tax with a higher exclusion ($2 million).

The revenue impact is shown for each of the options, along with the percentage reduction in those who would pay tax and how the tax cut would vary by size of estate.

The results show that the least costly way to reduce the number who pay tax is to raise the exclusion while retaining the bubble, because all of the tax cut goes to those below or very near to the new exclusion level.

Other Possibilities

Chapter 5 also addresses some other potential changes:

- Gift tax:
  - The gift tax (enacted in 2013) could be reformed to create a unified estate and gift tax system. Only one other state has a gift tax (Connecticut), and it has a unified structure. The federal taxes are also unified. A unified structure is only possible if the bubble is eliminated.
  - Alternatively, the gift tax could be repealed.
- Other types of transfer taxes:
  - Switching to an inheritance tax would allow tax rates to depend on the relationship between the decedent and the recipient of the bequest. Transfers to spouses are exempt under all current estate and inheritance taxes, but existing inheritance taxes apply higher tax rates on bequests to more distant relatives and non-relatives.
  - Making bequests taxable under the income tax would allow the tax rate to vary with the income of the recipient of the bequest. This option would raise administrative issues if pursued by an individual state.
- Minnesota could make some other changes that would simplify estate tax planning, such as a stand-alone qualified terminable interest property (QTIP) trust or adoption of “portability”.

Who Pays the Minnesota Estate Tax?

Chapter 3 uses recent return data to answer this question, reaching the following conclusions:

- Only a small proportion of decedents (less than 3%) pay Minnesota estate tax.
- Forty percent of those who file a Minnesota estate tax return pay no tax.
- Nonresidents pay only a small share of the tax (2.6%).
- The tax is highly concentrated among a small number of residents with large estates. Half of the tax was paid by those with gross estates (before deductions) over $5 million.
- The estate tax is Minnesota's most progressive tax.
- Due to the much higher federal exclusion, only 3.2% of Minnesota residents who paid Minnesota estate tax pay federal estate tax.
- Minnesota's deduction for farm and small business property reduces tax liability for 8.5% of returns and eliminates tax for 79% of those who claimed the deduction. Less than 2% of estates claiming the deduction had enough qualifying property to claim the maximum amount ($4 million).

The Estate Tax and Tax Policy Principles

Chapter 4 discusses whether the estate tax is a desirable part of a state tax system.

The tax system should be understandable, fair, competitive, reliable, and efficient. The estate tax scores well by some of these criteria. The largest negatives are related to understandability and tax planning. The Minnesota estate tax, with an exclusion much lower than the federal exclusion, increases the number of people who do estate tax planning. The tax also falls unevenly on similarly-situated taxpayers as a result of tax planning.

A longer discussion is provided on each of the following issues:

- Issues raised by proponents of the tax include:
    - The estate tax can function as a backstop to the income tax. Because the basis of appreciated assets is "stepped up at death," much of the earnings from those assets is never taxed.
    - The estate tax is a way to reduce the concentration of wealth by limiting intergenerational transfers.
    - The estate tax is the state's most progressive tax.
- Issues raised by opponents to the tax include:
    - The tax creates a hardship for small and family-owned businesses, who lack liquidity.
    - The estate tax causes people to leave the state.

The chapter includes an extensive review of recent literature on the effects of the estate tax on interstate mobility. Most peer-reviewed statistical studies using Census data have identified little if any statistically significant effects. However, one study that used IRS data to focus on the largest estates found that a state-level estate tax raised 6% to 13% less revenue than would have raised in the absence of any behavioral responses.

Introduction

In 2011, the Minnesota Legislature required the Commissioner of Revenue to prepare a study on the Minnesota estate tax. The study was required to consider the implications of federal estate tax changes and identify issues that policy makers should consider in deciding whether to revise, reform, replace, or repeal Minnesota's estate tax.

Federal law changes enacted in 2001 eliminated the pick-up tax, which had fully offset the burden of state-level estate taxes by providing a 100% tax credit. With the pick-up tax, each dollar paid in Minnesota estate tax reduced the federal estate tax by one dollar. In this way, the federal government shared part of federal estate tax revenue with the states. When the credit was eliminated (effective in 2005), many states ended their estate taxes. Others (including Minnesota) kept their taxes but tied them to the structure of the pick-up tax as it existed in pre-2001 federal law.

The federal exclusion from the estate tax has also increased. In 2014, the first $5.34 million of federal tax is exempt from tax. Of the 14 states and DC that have an estate tax, only two have matched the federal exclusion.

During the decade after 2001, there was great uncertainty about the future of the federal estate tax. The tax disappeared in 2011, only to reappear in 2011. Much of that uncertainty has now ended. The federal tax is no longer subject to any sunset, and the federal exclusion is likely to remain at its current level (adjusted for inflation). As a result, this is a good time to evaluate the role of Minnesota's estate tax (and new gift tax) and to consider whether to revise, replace, reform, or repeal those taxes.

Structure of this Study

Chapter 1 of this study provides a brief history of Minnesota's estate, inheritance, and gift taxes and the revenue they have raised and are forecast to raise in the next few years.

Chapter 2 summarizes Minnesota's current estate tax, describing the tax base, the tax rates, and changes enacted in 2011 and 2013.

Chapter 3 describes who pays the tax based on return data from recent years.

Chapter 4 briefly evaluates the estate and gift taxes using standard tax policy principles. It then discusses some issues and arguments raised by proponents and opponents of the taxes.

Chapter 5 addresses the policy choices facing Minnesota policymakers. It first summarizes how other states have responded to federal law changes in 2001 and later years. It then considers alternative policy choices including repeal, increases in the exclusion level, and switching to a stand-alone tax (no longer tied to pre-2001 federal law). The estimated revenue impact of potential changes is provided if it is available. Finally, the estate tax is contrasted with alternative transfer taxes (inheritance taxes or with making bequests subject to the income tax).

The Appendix includes tables describing estate, inheritance, and gift taxes in other states, along with other supplemental tables. It also includes language in 2011 Minnesota Laws that required this study.

Chapter 1
History of Minnesota's Estate, Inheritance, and Gift Taxes

Statutory Changes

Minnesota's history with estate, inheritance, and gift taxes began with the adoption of an inheritance tax in 1905.[1] An inheritance tax levies the tax on the beneficiary, and different tax rates applied depending on the relationship between the decedent and the beneficiary. Rates initially varied from 1.5 percent to 5 percent, but the rates were soon increased. Exclusions were added that depended on the relationship of the heir (higher exclusion levels for surviving spouses and children than for more distant or unrelated heirs).

A complementary gift tax was enacted in 1937 to prevent avoidance of the inheritance tax by making transfers prior to death.

In 1979 the inheritance tax was replaced by an estate tax and the gift tax was repealed. The changes were prompted partly by a desire to reduce the level of tax and partly to simplify the administration of the tax. Revenue from the new estate tax was considerably less than from the prior inheritance tax.

Between 1979 and 1985, Minnesota had its own rate schedule, with rates ranging from 7% to 12%. During this period, Minnesota's tax sometimes exceeded the federal credit for state inheritance and estate taxes, but it could not be less than that credit. Beginning in 1985, Minnesota's estate tax was set equal to the federal credit.

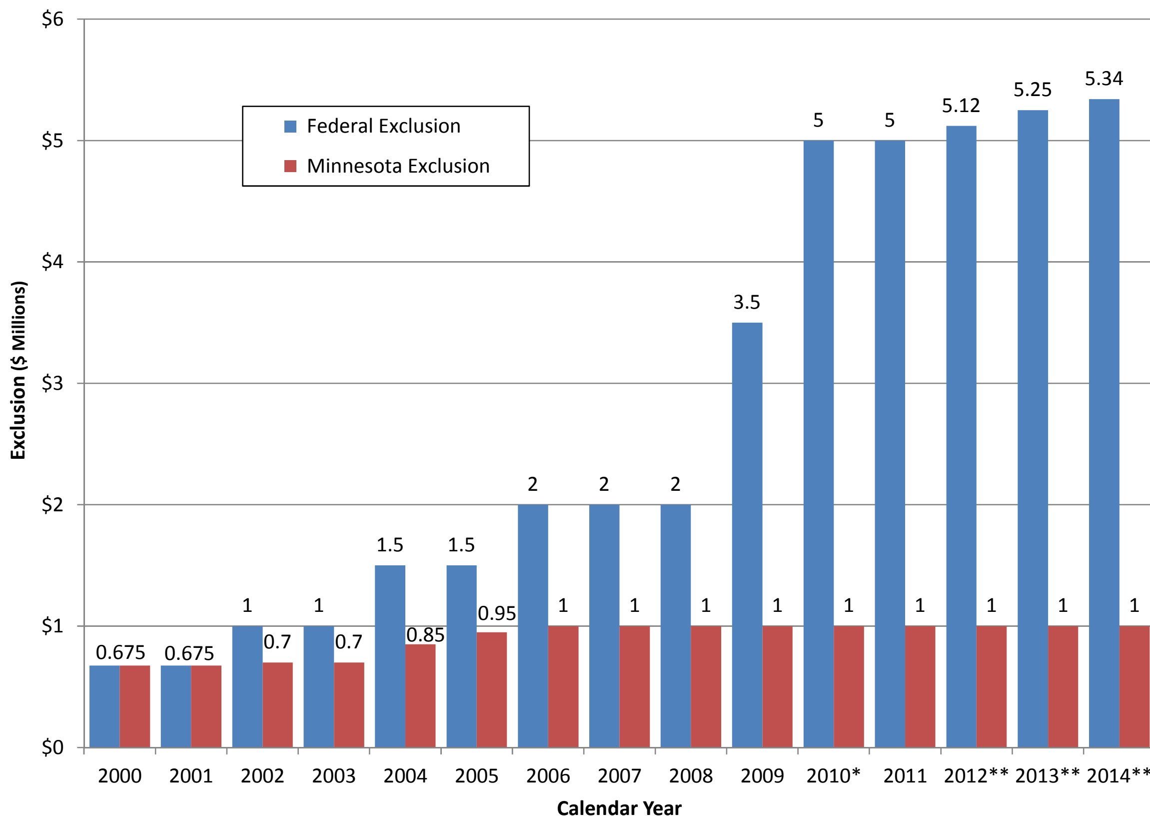
Minnesota adopted federal law changes made between 1979 and 2000. This included (1) an unlimited exclusion for assets left to a spouse (adopted in 1981) and (2) increased exclusion levels (enacted in 1998) that raised the general exclusion in steps from $600,000 in 1997 to $1 million in 2006 and later years.

When federal law changes were adopted in 2001 – further increasing exclusion levels and phasing out the federal credit for state inheritance and estate taxes – Minnesota decoupled from federal law. The Minnesota tax was instead tied to federal law *as it existed in 2000*. The exclusion level continued to increase to $1 million in 2006 under the law as it existed in 2000, but Minnesota did not match the higher exclusion levels enacted federally in 2001. As shown in Figure 1, Minnesota's exclusion has been below the federal exclusion since 2002 and the difference has increased over time.

[1] Earlier efforts to enact an inheritance tax were blocked by the courts. A fee based on the size of a probate estate was enacted in 1878 but ruled unconstitutional by the Minnesota Supreme Court because its progressive rate structure violated the constitutional requirement for uniformity. The Minnesota Constitution was amended to allow a progressive inheritance tax in 1894, but each of the three attempts to enact an inheritance tax under that authority (in 1897, 1901, and 1903) were ruled unconstitutional. The fifth try, enacted 27 years after the first, was upheld by the Minnesota Supreme Court in 1905. More details can be found in Michael (2002), p. 7.

Minnesota made four changes since decoupling from federal law. First, Minnesota allowed a deduction of up to $4 million for certain farm and small business property. Enacted in 2011, this deduction effectively exempts $5 million for estates consisting mostly of farm and small business property, matching the federal exclusion level at that time. Second, Minnesota required gifts given in the three years immediately prior to death to be included in the taxable estate. Third, Minnesota enacted a 10% tax on lifetime taxable gifts in excess of one million dollars. Fourth, Minnesota required nonresidents to include real and tangible personal property located in Minnesota in the Minnesota tax base even if the property is held in a pass-through entity. The last three changes were all enacted in 2013.[2]

Figure 1. Federal and Minnesota Estate Tax Exclusions



*In 2010, estates could either pay no federal estate tax or they could pay the federal estate tax in order to qualify for a step-up in basis for appreciated assets. Without the step-up in basis at time of death, heirs who received the property would pay higher income tax when they sold the assets. For some estates, the benefits from a step-up in basis for income tax purposes outweighed the cost of paying the estate tax.

**The federal exclusion level is indexed for inflation (starting in 2012).

A more complete list of law changes is shown on the following page.

[2] The 2011 and 2013 law changes are described in more detail in the latter sections of Chapter 2.

History of Minnesota's Estate, Gift, and Inheritance Taxes

1905 – Minnesota inheritance tax first adopted. Individual successions to property taxed at rates from 1.5% on inheritances less than $50,000 to 5% on inheritances over $100,000.

1911 – Exclusions of $10,000 for spouse to $100 for non-relatives provided. Rates from 1% on inheritances less than $15,000 to 20% on amounts over $100,000 adopted, depending on the relationship

1937 – Gift tax enacted to prevent evasion of inheritance tax. Inheritance taxes increased from a maximum of 20% to 60%, not greater than 35% of value of property.

1959 – Rates changed and exclusions increased.

1976 – Homestead exclusion increased $45,000. Optional marital exclusion of 50% of the gross estate to $250,000 adopted. Marital exclusion increased to $60,000 and equalized between spouses. Exclusion for minor child increased to $30,000.

1979 – Inheritance and gift tax repealed; replaced by estate tax with rates graduated from 7% to 12%.

1981 – Eliminated 10% distribution to counties. Conformed to federal changes increasing minimum filing requirements and providing unlimited marital deduction.

1985 – Eliminated the provisions of the Minnesota rate schedule so that the tax is equal to the Minnesota portion of the federal estate tax credit for state taxes, known as the "pick-up" tax.

1998 – Adopted the 1997 federal changes including the phased-in increase in exclusion from $600,000 to $1 million in 2006.

2002 – Tax decoupled from federal law and is determined under pre-2001 federal law.

2005 – Federal estate tax credit for state taxes replaced with deduction for state taxes.

2011 –Enacted deduction for up to $4 million of qualified farm and small business property. A single-year QTIP election for 2010 was enacted for estates that did not need/choose to file a federal estate tax return in that year.

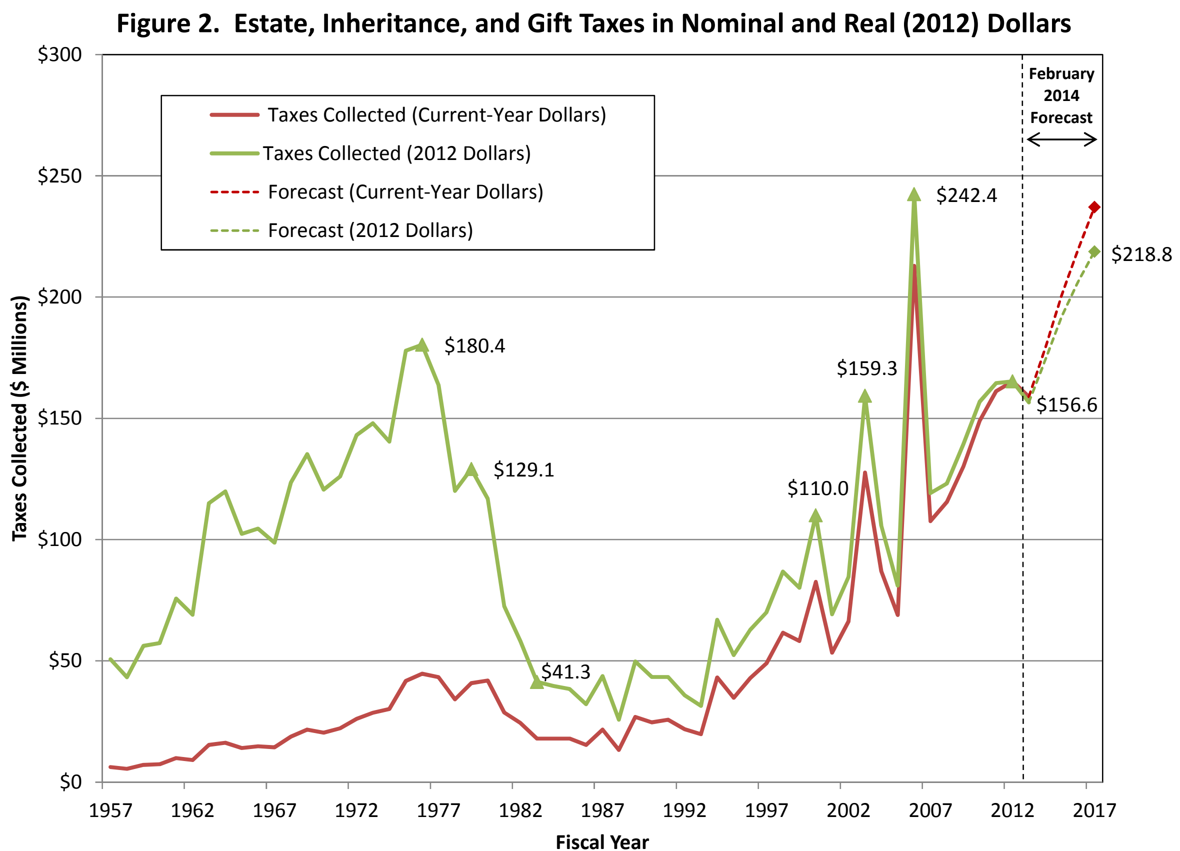
2013 – Gifts given in three years preceding death included in estate. Gift tax exacted with rate of 10%. For nonresidents, included property owned by a flow-through entity in the tax base.

Tax Collections History

Figure 2 shows tax collections for the inheritance and estate taxes from 1957 through 2012, both in nominal dollars and adjusted for inflation. Inheritance tax collections rose fairly steadily from 1957 through 1976, reaching $180 million in inflation-adjusted (2012) dollars in 1976. When it was replaced by an estate tax, revenues plummeted from $129 million to $41 million in 1983 (again in 2012 dollars). Collections remained below $50 million through 1993, before starting an unsteady increase to $157 million in 2013.

Revenue spikes in 2000, 2003, and 2006 were the result of one or more very large estate tax payments. The estate tax is an unstable revenue source, but its revenue has grown rapidly. Between 1993 and 2013 revenue grew at an average annual rate of 11% in nominal dollars and 8% in inflation-adjusted dollars.[3] Continued rapid growth is forecast for future years as well, as shown by the dashed lines in Figure 18.

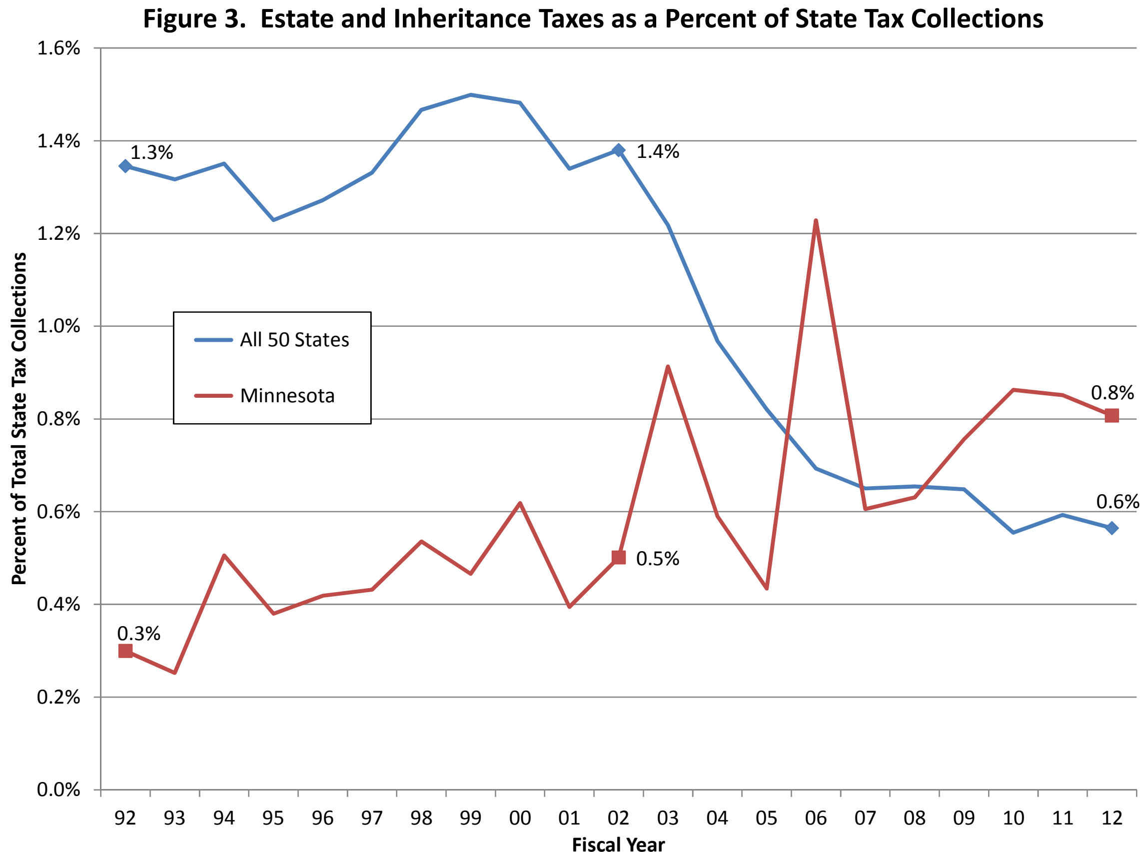
Figure 2. Estate, Inheritance, and Gift Taxes in Nominal and Real (2012) Dollars



The rapid growth in estate tax revenue has more than doubled its share of Minnesota's total state tax revenue, which rose from 0.3% in the early 1990s to 0.88% in 2012. Its share is forecast to grow to 0.93% in FY 2015.

[3] If the starting point is 1990 rather than 1993, the average growth rate is still high, at 8% in nominal and 6% in real dollars.

As shown in Figure 3, the estate tax's share of state tax revenue in Minnesota was well below that of other states in the 1990s through 2002. These were years when every state had an estate or inheritance tax (or both). With the phase-out of the federal death credit starting in 2002 and its repeal in 2005, many state-level estate taxes were either repealed or became dormant. As a result, the share of Minnesota state taxes coming from the estate tax (at 0.8% in 2012)[4] now exceeds the share for all 50 states combined (at 0.6%).



Source: U.S Department of Commerce, State and Local Government Finances, 2013

[4] Figure 18 shares are calculated from U.S. Commerce data, which defines "total taxes" more broadly than the definition used by Minnesota Management and Budget. This explains the lower Minnesota share in Figure 19 (0.8% of state tax revenue in 2012) compared to the share cited in the previous paragraph (0.88%). The all-states share is based on the sum of taxes in all 50 states, including those with no estate or inheritance tax.

Chapter 2
Minnesota's Estate and Gift Taxes in 2014

After first explaining the basic structure of the current Minnesota estate tax, this chapter describes changes enacted in 2011 and 2013, including the Minnesota gift tax.

The Structure of the Minnesota Estate Tax

Tax Base

The Minnesota estate tax calculation begins with federal gross estate, which equals the market value of wealth held at the time of death (or six months from that date, if lower[5]). Federal gross estate includes all property in which the decedent had an interest at the time of death.

Federal law provides preferential valuation rules for some farm and small business property. In 2014, federal gross estate can exclude up to $1.09 million in real property used in a farm or business, based on the difference between the market value of the property and the capitalized income from its use in the business. The amount eligible for this "special use valuation" is indexed for inflation.

The Minnesota estate tax is then generated using the lesser of the two calculations modeled in Figure 4. Both of these calculations begin with federal gross estate and subtract all federal deductions except the deduction for state taxes.

- The allowable federal deductions are:[6]
  - Marital deduction for all transfers to a spouse.
  - All charitable bequests to charitable organizations.
  - All debts, including mortgages and outstanding medical expenses.
  - Other expenses, including funeral expenses, estate administration, and attorney costs of settling the estate.
- Minnesota also allows a deduction of up to $4 million in certain farm or small business assets.
- Minnesota requires an addition for all taxable gifts made within three years of death (if gifts were made after June 30, 2013).

[5] The option to use the alternative valuation date is only available for those who file a federal estate tax return.

[6] The impact of several of these deductions on Minnesota estate tax revenue is estimated in the *2014 Minnesota Tax Expenditure Budget.* The estimated revenue reductions in FY 2014 are: $146.9 million for the marital deduction, $36.7 million for the charitable deduction, $20.8 million for exclusion of certain life insurance proceeds, $17.6 million for the farm and small business deduction, and $0.4 million for the special use valuation rules for farms and small businesses. For comparison, total estate tax revenue (net of refunds) is forecast to be $176.4 million in FY 2014.

Calculating the Tax

At shown in Figure 4, the taxpayer must calculate two tentative tax amounts, one using Tax Table A and one using Tax Table B.[7] The smaller of the two results is the Minnesota tax before adjustment for non-Minnesota assets.

> *Calculation A*: The first of the two required calculations is essentially the way federal tax was calculated as it existed in 2000. Because it follows the federal calculations, it includes *all* adjusted taxable gifts (not just those made in the last three years before death). The 2000 Internal Revenue Code (IRC 2000) federal estate tax rates are applied, reduced by the unified credit that existed at that time, which creates an effective $1 million exclusion (no tax on the first $1 million).
>
> *Calculation B*: The second calculation is based on calculations for the old (2000 statutes) federal credit for state taxes, which has since been repealed. It differs from the first calculation in several ways. First, rather than adding all federal adjusted taxable gifts, it only includes Minnesota gifts made in the last three years and made after June 30, 2013. Second, it applies rates based on the IRC 2000 calculation for the maximum credit for state taxes, but the rates are applied after subtracting $60,000, yielding an effective exclusion (zero tax rate) on the first $100,000.[8]

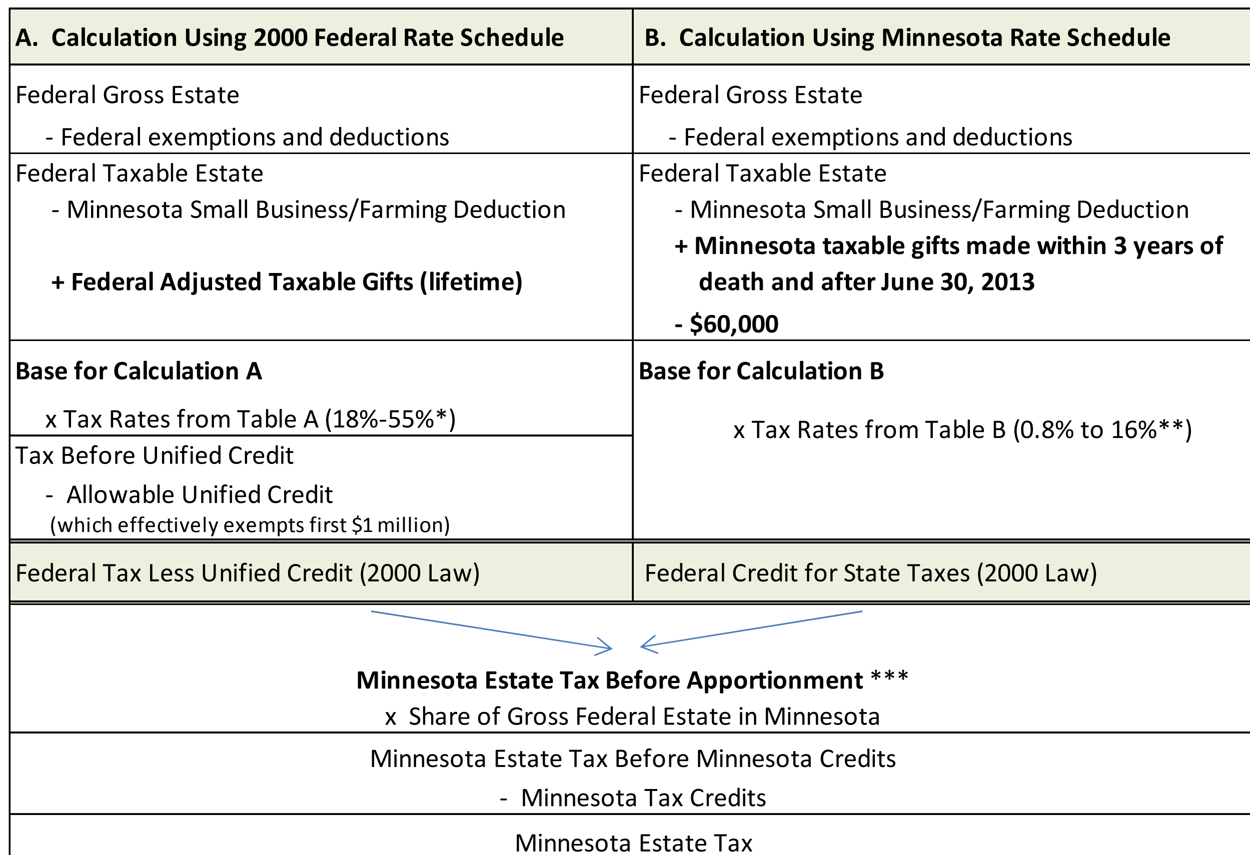
The Minnesota estate tax is calculated as the minimum of these two calculations – the lesser of "Calculation A" (applying 2000 federal tax rates) and "Calculation B" (equal to the 2000 federal credit for state taxes)."

The calculated tax amount is then apportioned to remove any share of gross estate that is not subject to Minnesota tax. For residents, the tax is reduced in proportion to the share of the gross federal estate that consists of real or tangible property located in another state. For non-residents, the tax is based on the share of the gross estate that consists of real or tangible property located in Minnesota.

[7] Tax Tables A and B are included in the instruction booklet for the Minnesota Estate Tax (Form M706). They are also included in Appendix E of this study.

[8] Tax Table B has a zero bracket of $40,000. When added to the $60,000 deduction, the total is $100,000.

Figure 4. Process for Calculating the Minnesota Estate Tax



A. Calculation Using 2000 Federal Rate Schedule	B. Calculation Using Minnesota Rate Schedule
Federal Gross Estate - Federal exemptions and deductions	Federal Gross Estate - Federal exemptions and deductions
Federal Taxable Estate - Minnesota Small Business/Farming Deduction **+ Federal Adjusted Taxable Gifts (lifetime)**	Federal Taxable Estate - Minnesota Small Business/Farming Deduction **+ Minnesota taxable gifts made within 3 years of death and after June 30, 2013** **- $60,000**
Base for Calculation A x Tax Rates from Table A (18%-55%*)	**Base for Calculation B** x Tax Rates from Table B (0.8% to 16%**)
Tax Before Unified Credit - Allowable Unified Credit (which effectively exempts first $1 million)	
Federal Tax Less Unified Credit (2000 Law)	Federal Credit for State Taxes (2000 Law)

Minnesota Estate Tax Before Apportionment ***
x Share of Gross Federal Estate in Minnesota

Minnesota Estate Tax Before Minnesota Credits
- Minnesota Tax Credits

Minnesota Estate Tax

* An additional 5% rate applies between $10,000,000 and $17,184,000. As noted below, only the 41% rate applies for a relevant range for Minnesota tax purposes.

**Because the first $1 million is exempted from tax, applicable tax rates on Schedule B start at 5.6%.

***This is the starting point for Minnesota Estate Tax Form M706.

Figure 5 shows how the two calculations are combined to generate the Minnesota estate tax. The intersection of the two calculations occurs at a taxable estate of $1,093,785 and, consequently, estates with between $1 million and $1,093,785 in taxable estate are subject to the higher marginal tax rates from Calculation A (41 percent). This is a fairly small range, but in 2012 it included 7.3% of Minnesota estate tax filers and about 12.1% of all the estates that owed tax.[9]

[9] Estates valued over $1,093,785 also pay the 41% rate on the first $93,785, but only those in the bubble range pay the 41% rate on the last dollar of their estate. In 2012, 2,043 estates filed Minnesota estate tax returns and 1,232 estates owed tax. Of these, 149 had taxable estates solely within the bubble range between $1 million and $1,093,685.

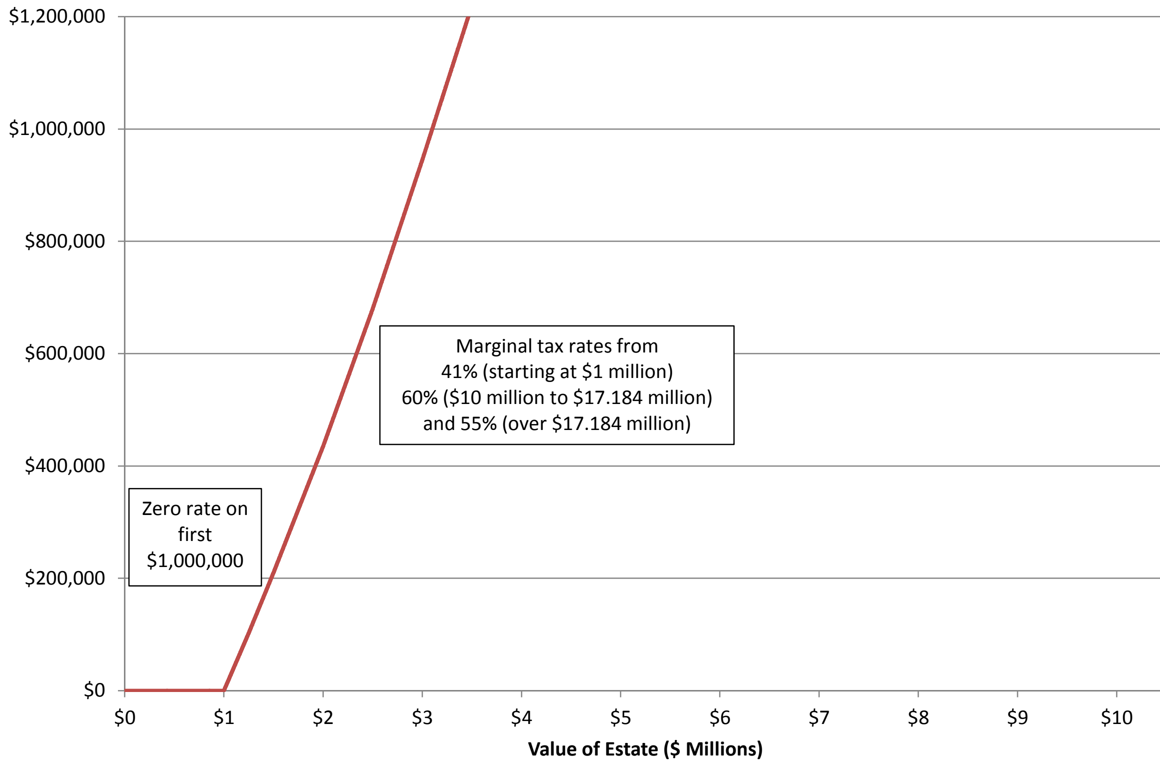


Figure 5a. "Calculation A"
(Federal Estate Tax in 2000)
$1,200,000
$1,000,000
$800,000
$600,000
$400,000
$200,000
$0
Marginal tax rates from
41% (starting at $1 million)
60% ($10 million to $17.184 million)
and 55% (over $17.184 million)
Zero rate on
first
$1,000,000
$0
$1
$2
$3
$4
$5
$6
$7
$8
$9
$10
Value of Estate ($ Millions)

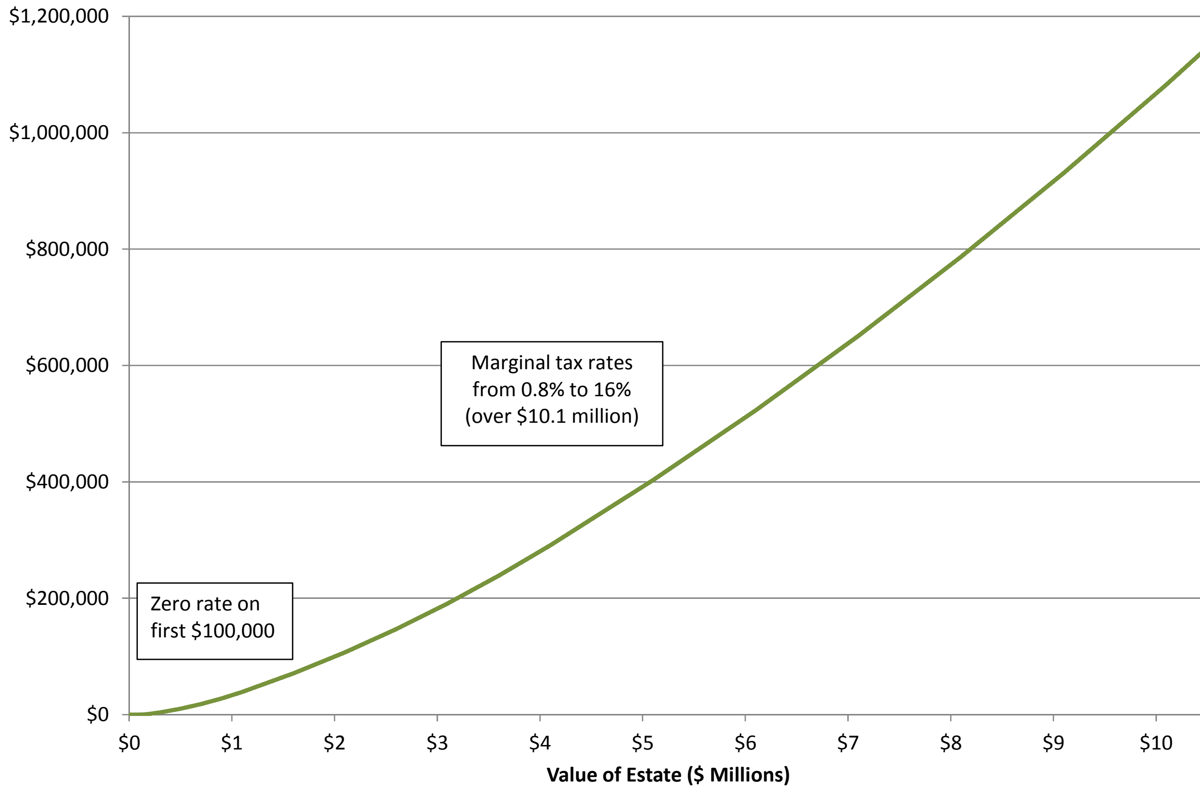
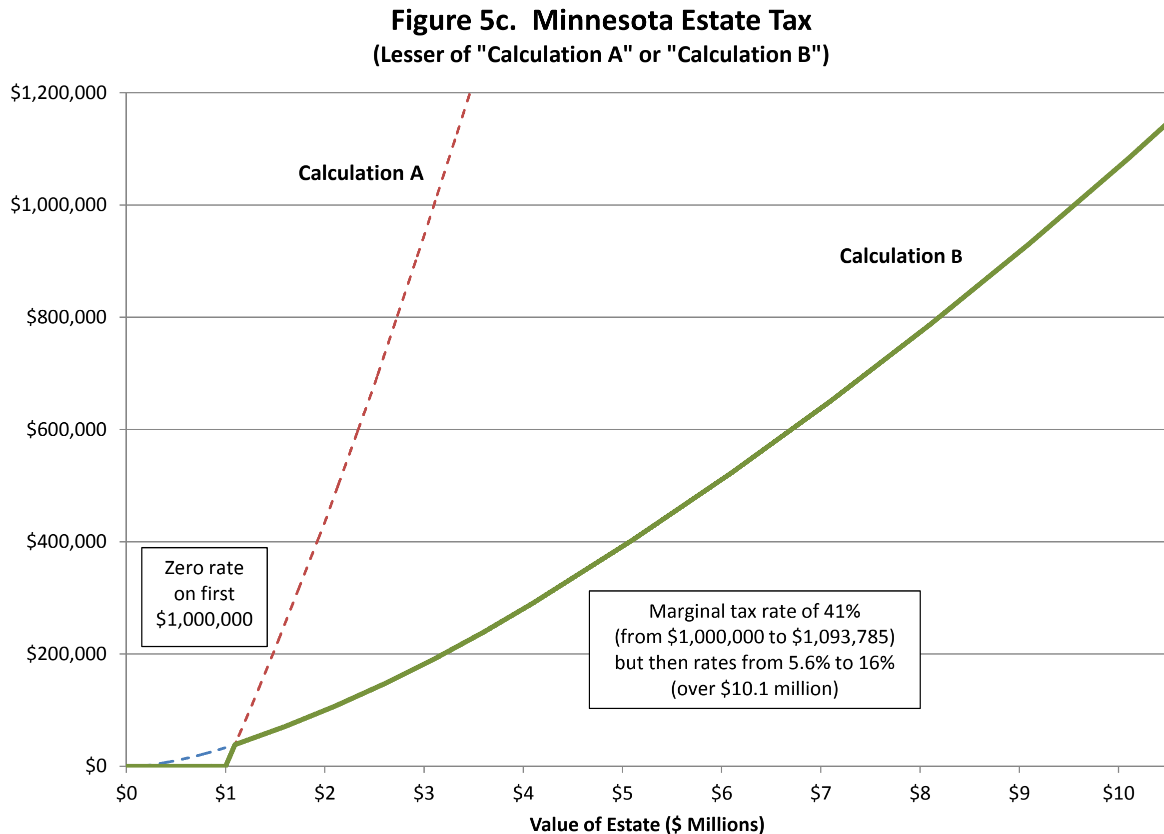


Figure 5b. "Calculation B"
(Federal Credit for State Taxes in 2000)
$1,200,000
$1,000,000
$800,000
$600,000
$400,000
$200,000
$0
Marginal tax rates
from 0.8% to 16%
(over $10.1 million)
Zero rate on
first $100,000
$0
$1
$2
$3
$4
$5
$6
$7
$8
$9
$10
Value of Estate ($ Millions)



Calculation A is smaller for those with taxable estates under $1,093,785; Calculation B is smaller for taxable estates of higher value.[10] Because the applicable tax rates for the federal estate tax in 2000 were much higher than those for the state death credit in 2000, estates valued between $1,000,000 and $1,093,785 face a substantially higher marginal rate (at 41%) than larger estates (with marginal rates ranging from 5.6% to 16%). This 41% rate is referred to as the "rate bubble."

Although the "marginal" tax rate – the tax on the last dollar of estate subject to tax – is higher for these smaller estates, Figure 5c makes it clear that the total estate tax always rises with the value of the estate. Tax *per dollar of the estate's value* (the "average" tax rate) is always higher for larger taxable estates (see Figure 6), rising from zero at $1 million to 3.49% at $1.1 million, 11.56% at $12 million, and 15.47% at $100 million. The "rate bubble" refers to the marginal tax rate, not to the average tax rate or to the total tax.

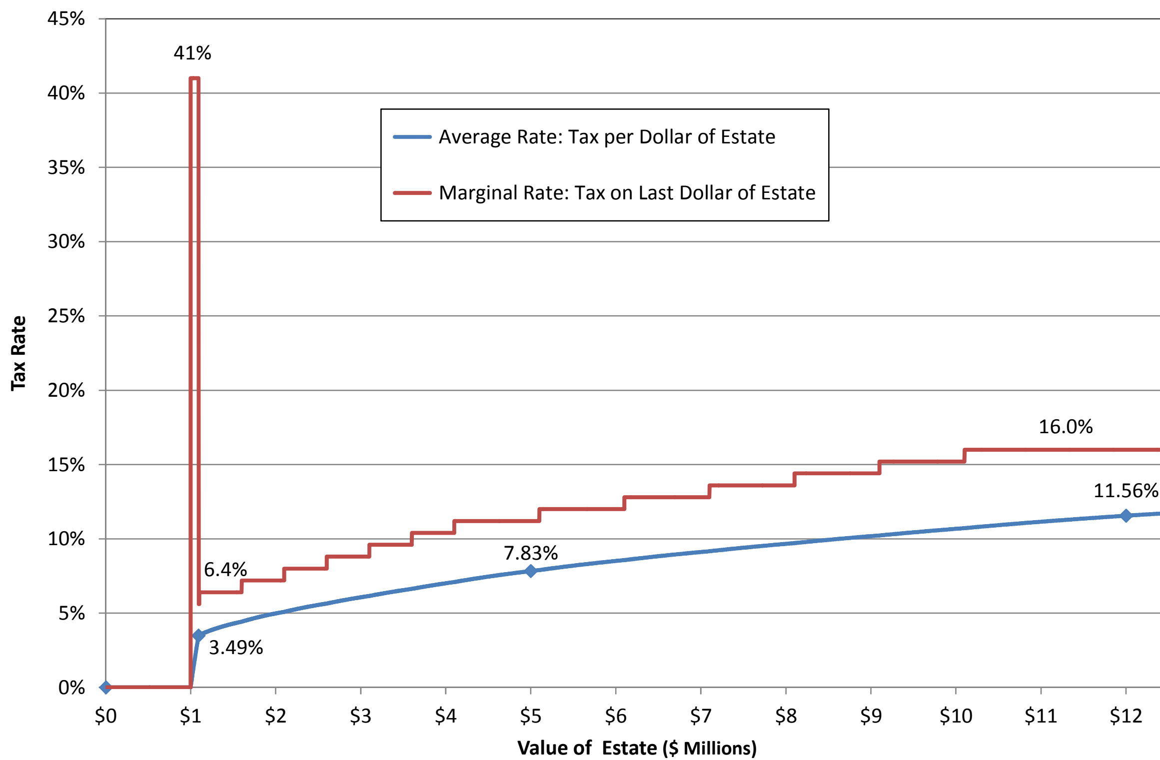
[10] There are exceptions. The statement is always true if there are no adjusted taxable gifts other than those given in the last 3 years (and after June 30, 2013). For an estate with other adjusted taxable gifts, the break point will be lower because those gifts will increase the tax paid under Option A and have no effect on the tax paid under Option B. For simplicity, this complication is ignored in the remaining discussion and in the related charts.

For simplicity, the charts also assume that the taxpayer qualifies for no tax credits and that all of the taxpayer's assets are located in Minnesota.

Value of Estate: In this study, "value of estate" refers to the tax base used for Calculations A or B. It is the value before any unified credit (or "exclusion") in Calculation A and before subtracting the $60,000 "minimum amount" in Calculation B. It should be considered shorthand for "value of the estate after all deductions and additions but before credits or Minnesota apportionment." It differs from "gross federal estate" because it is net of deductions and may include adjusted taxable gifts.

The tax base for Calculations A and B differs for estates with adjusted taxable gifts other than those made in the three years before death. As a simplification, the charts in this study generally disregard this difference in the definition of the tax base. They implicitly assume any taxable gifts included in the estate were given in the three years prior to death.

Figure 6. Marginal and Average Tax Rates for the Minnesota Estate Tax



The rate structure that includes such a rate bubble is unique to state-level estate taxes. No other tax type has such a rate bubble on the first dollars subject to tax. One way to interpret the bubble is that the 41% rate phases out all the benefits of the $1 million exclusion between estate values of $1 million and $1,093,785. Larger estates get no benefit from the exclusion.[11] It is unlikely such a rapid phase-out of the benefit of the exclusion would have been adopted as a stand-alone tax. Rather, the bubble is best viewed as a historical accident. It was designed as part of the federal "pick-up tax" that existed prior to 2002. The federal government gave a 100% tax credit for amounts paid in state estate or inheritance tax so long as the state tax did not exceed the minimum of Calculation A and Calculation B. As a result, the "pick-up tax" did not increase the tax burden on an estate. Each dollar paid to Minnesota in 2001 reduced the federal estate tax by a full dollar. The bubble was not a problem because it had no impact on the net tax paid by an estate. The pick-up tax was just a calculation that determined how much federal estate tax revenue the federal government would share with Minnesota.

With the phase-out of the pick-up tax (2002 to 2005), the bubble now matters. All states with an estate tax that is tied to the old pick-up tax have a rate bubble, even those that have increased their exclusion levels well above $1 million.

Although many criticize the estate tax for its "bubble," some question whether it poses a serious problem.[12] Some claim that what matters is the average tax rate, and (as shown in Figure 6) the average tax rate consistently rises with no bubble. High tax rates (such as the 41% bubble rate) matter when they change taxpayer behavior, but the high rate exists over a fairly short range of estate values and few taxpayers can know ahead of time whether they will end up in that range.

Of the 13 other states with an estate tax, seven have similar rate bubbles. As shown below, raising the exclusion level does not eliminate the bubble, yet many states have concentrated on raising their exclusion levels rather than eliminating their rate bubble. None of the bills introduced in past sessions to raise Minnesota's exclusion would have eliminated the rate bubble. Perhaps this reflects a misperception, with some mistakenly believing that raising the exclusion would eliminate the bubble. The rate bubble is certainly an easy target for those who dislike the estate tax, and most who hear about the bubble think it is unfair. It is certainly not a feature that would be chosen for its own sake.

Federal Deductibility, Tax Burdens, and Effective Tax Rates

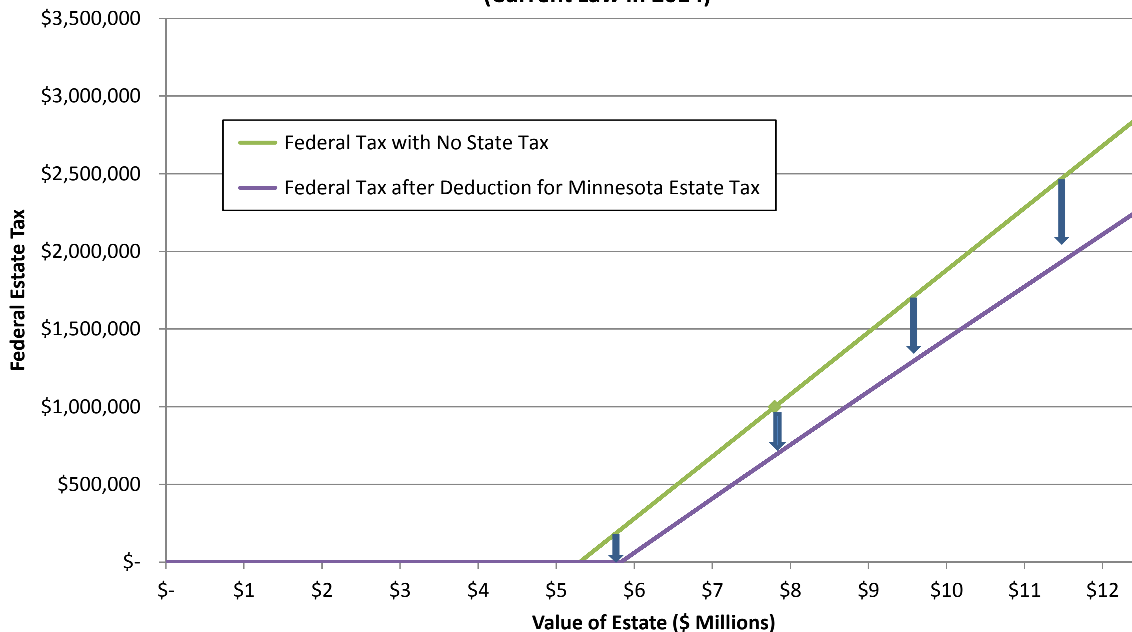
Although the 100% federal tax credit for the pick-up tax has been repealed, state estate and inheritance taxes are still deductible in calculating the federal estate tax. The resulting drop in federal tax can offset some of the cost of the Minnesota tax.

[11] As shown later in Chapter 5, higher-valued estates would get no benefit from an increase in the exclusion given the current structure of the tax. Consider Figure 5c, a higher exclusion moves the "Calculation A" line to the right, but it does not move the "Calculation B" line. The Minnesota estate tax is the minimum of Calculation A and Calculation B. It still includes a steep segment from Calculation B, and that steep segment is longer than before. The bubble is wider because when the exclusion is increased more dollars need to be phased out by the high bubble rate.

[12] See Michael (2013a), pp. 8-9.

Figure 7 shows the drop in federal tax for an estate subject to the Minnesota estate tax. Estates valued less than $5.34 million pay no federal tax in 2014, so there is no "federal tax offset" for those estates. For estates valued between $5.34 million and $5.83 million the deduction for state tax cuts the federal tax to zero. For higher valued estates (over $5.83 million), the deduction reduces federal tax by 40 percent of what is paid in state tax. For those estates, forty percent of their Minnesota tax burden is "exported" to the federal government, which loses $40 in federal tax for every $100 Minnesota collects.

Figure 7. Federal Estate Tax on Minnesota Estate With and Without Minnesota Estate Tax
(Current Law in 2014)



For those who pay the Minnesota estate tax, its true burden is the net tax after adjusting for the reduced federal tax. This is illustrated in Figure 8. If the Minnesota tax is $1 million, this reduces the taxable federal estate by $1 million and, given the federal estate tax rate of 40%, the federal estate tax falls by $400,000. The burden of the Minnesota tax on the estate is $600,000 rather than the full $1 million. *This burden after federal tax offset is the amount the taxpayer would save if the Minnesota tax were repealed – or if the taxpayer moved to a state with no estate tax.*

Lower-valued estates – those with estates under $5.34 million – bear the full burden of Minnesota's tax. There is no reduction in federal tax to offset any of their tax burden. As illustrated in Figure 8, the Minnesota estate tax burden net of federal tax change is actually higher for a $5.34 million estate (at $431,600) than for a $7 million estate (at $382,800). The Minnesota estate tax burden net of federal tax change is almost 50 percent higher for a $5.34 million estate than for a $5.83 million one (at $294,400).[13]

[13] The $7 million estate pays $638,000 in Minnesota tax but when it is deducted federally, it reduces federal tax by $255,200, for a net burden of $382,800. The $5.83 million estate pays $490,400 in Minnesota tax but the federal deduction saves it $196,000 in federal estate tax, for a net burden of $294,400.

Note that the sum of the state and federal tax is always higher for a higher-valued estate. The calculations show the added burden of having to pay the Minnesota tax.

Figure 8. Net Minnesota Estate Tax Burden After Federal Deduction for Minnesota Estate Tax (Current Law in 2014)

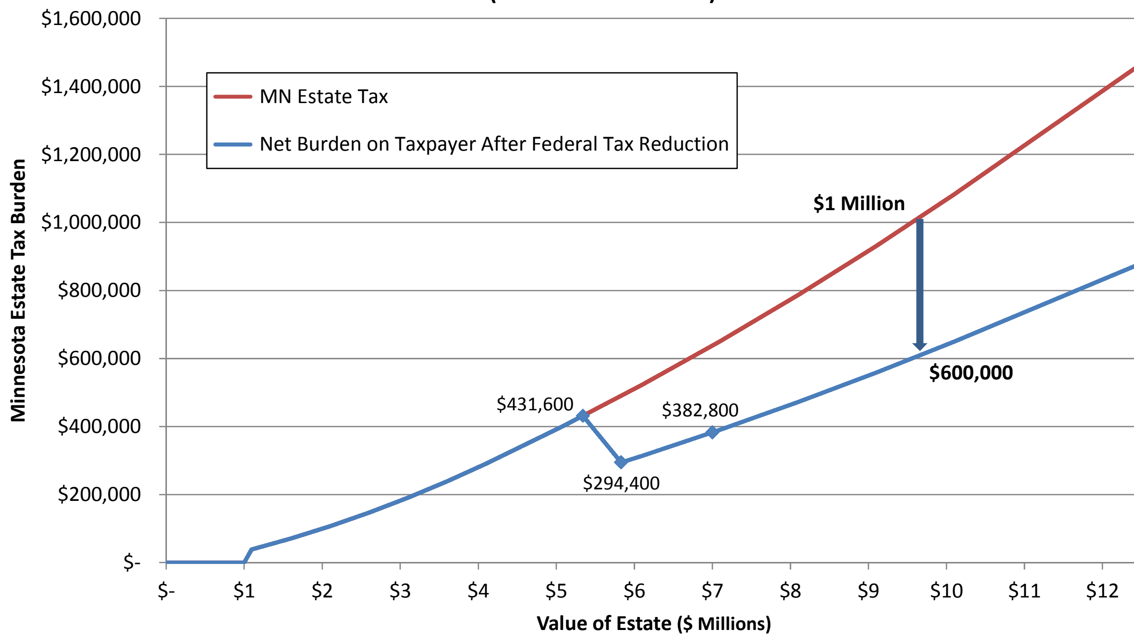
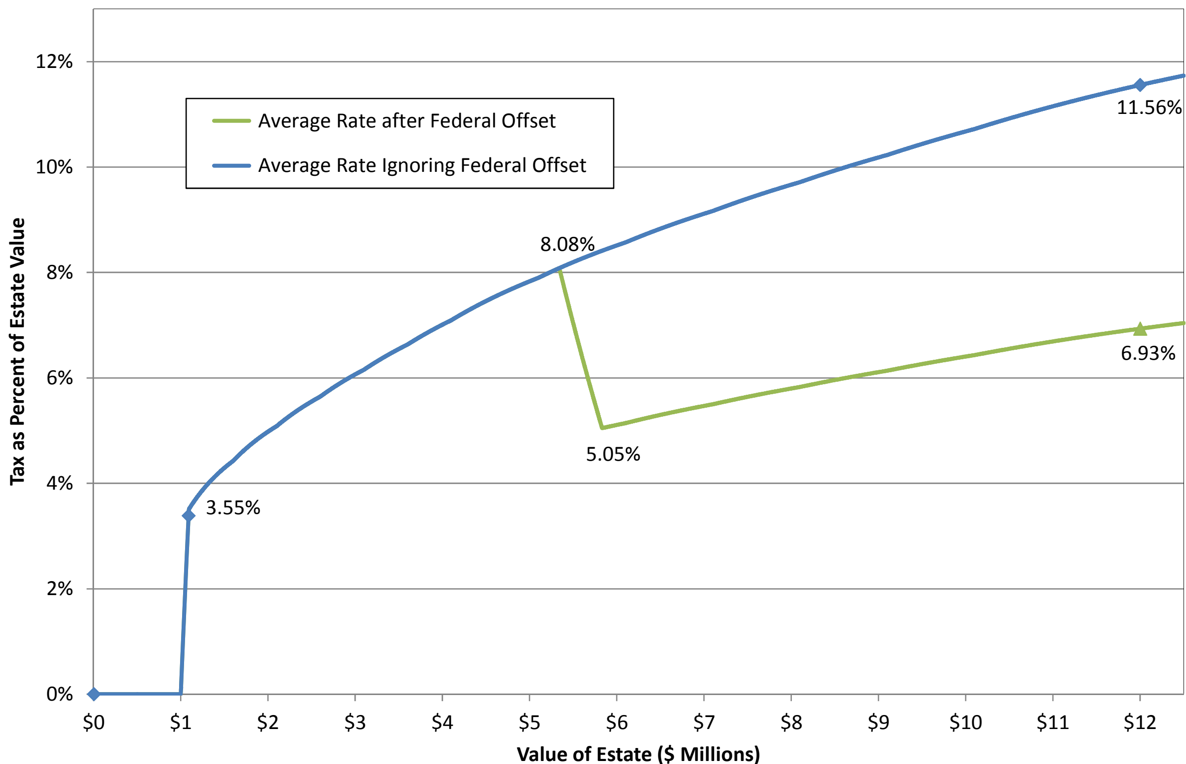


Figure 9 shows how the average tax rate (tax as a percent of the value of the estate) changes when the federal tax offset is included. The net burden is a smaller share of an estate's value for a $12 million estate (at 6.93%) than for a $5.34 million estate (at 8.08%).

The federal tax offset reduces the marginal tax rate on the highest valued estates (those valued more than $10 million) from 16% to 9.6%. This means that estates valued between $3.6 million and $5.34 million face higher marginal tax rates – at 10.4% to 12.0% – than are faced (net of federal tax offset) by the largest estates. The marginal tax rate (net of reduction in federal tax) exceeds 10% on mid-size estates but not the largest estates.

Between 1985 and 2002, the 100% federal credit for state estate and inheritance taxes reduced the Minnesota estate tax burden to zero. Every added dollar paid in state tax was offset by a full dollar reduction in federal tax. Although its replacement – a federal deduction – does far less, its impact in lowering the burden of the Minnesota tax should not be ignored. For estates over $5.83 million, it offsets a full 40% of the state tax burden. For the largest estates, the marginal tax rate is effectively 9.6% rather than the full 16%.

Figure 9. Average Tax Per Dollar of Minnesota Estate in 2014



Adjustment for Out-of-State Property on Resident and Nonresident Returns

If the taxpayer's estate includes property located outside of Minnesota, the total tax calculated above is multiplied by the proportion of the federal estate that is located – for tax purposes – in Minnesota. This adjustment occurs after the tax is calculated, so a nonresident with a large estate can owe estate tax in Minnesota even if the Minnesota portion of the estate is less than $1 million. Similarly, a Minnesota resident whose Minnesota portion of the estate is less than $1 million can still owe tax in Minnesota if the total estate exceeds $1 million.

Tax Credits

Tax credits are provided for (a) gift taxes paid to Minnesota on gifts given in the three years prior to death and (b) any estate or inheritance tax nonresidents pay to another state on assets included in the Minnesota tax base. Both credits are designed to eliminate double taxation and were enacted in 2013.[14]

Filing Requirement, Deadlines, and Penalties

If the federal gross estate plus gifts made in the three years before death exceeds $1 million, taxpayers are required to file a Minnesota estate tax return.[15] As is true with other taxes (such as the income tax), many who meet the filing requirement will owe no tax. For example, if an estate value exceeds $1 million but the entire estate is transferred to a surviving spouse, there would be no tax liability.

[14] The estate tax credit for taxes paid to another state differs from the income tax credit for taxes paid to another state. The income tax credit is provided by the taxpayer's home state. Minnesota's estate tax credit is paid by Minnesota rather than the home state.

[15] The three-year look-back in the filing requirement is not limited to gifts given after June 30, 2013.

Because the federal filing requirement is much higher (at $5.34 million), many more taxpayers are required to file a Minnesota return than are required to file a federal return. Although 1,921 Minnesota residents filed a Minnesota return in 2012, federal statistics show only 109 Minnesota residents filed a federal return in 2012.[16]

The Minnesota estate tax filing deadline is nine months after death, but an automatic six-month extension is provided on request. The late filing penalty is 5% of any unpaid tax.

Payment is also due nine months after the date of death, and an additional six-month payment extension may be requested with good cause. The late payment penalty is 6% of any tax not paid by the payment due date. To avoid a payment penalty, at least 90% of the tax must be paid by the regular due date and the remaining tax paid no later than 15 months after the decedent's death. Interest is due on any payment made after the original due date. The interest rate is currently 3 percent but is set annually based on prime rate charged by banks.

Five-Year Deferral and Installment Payments for Closely-Held Business Assets

If assets in a closely-held business account for at least 35% of a taxpayer's federal adjusted gross estate, the estate can elect to defer a portion of the federal estate tax for five years and pay in up to ten equal annual installments. The portion eligible for deferral and installment payments equals the share of the estate's value represented by the closely-held business assets.[17] If Minnesota estate tax liability exceeds $5,000 and the IRS allows the federal tax to be paid in installments, the state tax may also be paid in installments (on the same dates as the federal tax). Interest must be paid annually, even during the deferral years.

Tax Changes Enacted in 2011 and 2013

Deduction for Farm and Small Business Property

This deduction was enacted in 2011. It removes up to $4 million of certain farm and small business assets from the tax base. This can effectively exempt the first $5 million of an estate for those with farm and small business property, compared to $1 million for anyone else.

To qualify as farm property, the deceased must have had a farm homestead and must have owned the property for the three-year period ending on the date of death. However, the deceased need not have been actively farming in the years immediately preceding death. The land may have been rented and farmed by others.

To qualify as small business property, the decedent must have owned the property for the three-year period just prior to death. The deceased or spouse of the deceased must have materially participated in the business in the year prior to death. The business must have had total sales of $10 million or less in the last taxable year before the year of death, and the business cannot have been traded on a public exchange within three years of death.

[16] Federal statistics are from www.irs.gov/uac/SOI-Tax-Stats-Estate-Tax-Statistics-Filing-Year-Table-2. Some of these filers may have filed only to claim a qualified terminable Interest property (QTIP) trust on their Minnesota return.

[17] Federal requirements are found in Section 6166 of the Internal Revenue Code. Deferral rights end if at least half of the value of closely-held assets is distributed, sold, exchanged, disposed of, or withdrawn from the trade or business.

Two additional requirements apply to both farm and small business property. First, for the farm property deduction, a family member must maintain the agricultural land classification for three years after death. For the small business property deduction, a family member must materially participate for three years after death. Second, the heirs must agree to pay a recapture tax if they fail to meet these conditions for three years following the death of the decedent. The recapture tax is levied at the maximum estate tax rate (16 percent), so it may exceed the tax savings from claiming the deduction, but no interest is charged to compensate for the delay in paying the tax.

The statutory language for the farm and small business deductions was enacted in 2011 during the state government shutdown. Modifications to make the language match the intent at the time of enactment were included in the 2012 Tax Omnibus Bill that was vetoed for other reasons. This clean-up language was enacted, though, in the 2013 legislative session.

A summary of deductions claimed for farm and small business assets in the first 17 months after it took effect is included in Chapter 3 below.

Revenue Impact of Deduction for Farm and Small Business Assets

(Dollars in $1,000s)

	FY 2014	FY 2015	FY 2016	FY 2017
Estate Tax	($17,600)	($18,600)	($20,200)	($21,600)

Source: *Tax Expenditure Budget* (2014)

Inclusion of Nonresident Property Held in a Pass-Through Entity

Prior to law change enacted in 2013, Minnesota real or tangible personal property owned by a nonresident was excluded from the tax base if the assets were held by an S-corporation or similar pass-through business. Such interest was defined as intangible personal property, which is only taxable by the taxpayer’s home state. The law change eliminated a nonresident’s ability to avoid tax by placing ownership of real or tangible Minnesota assets in an S-corporation or other pass-through entity. Note that this change had no impact on those who are Minnesota residents at the time of death, because intangible property was already taxable by their home state.

Revenue Impact of Inclusion of Nonresident Property Held in a Pass-Through Entity

(Dollars in $1,000s)

	FY 2014	FY 2015	FY 2016	FY 2017
Estate Tax	$5,400	$7,400	$7,600	$7,700

Source: Estimate at time of enactment, with effective date 1/1/13.

Inclusion of Gifts Made Within 3 Years of Death

A three-year look-back for taxable gifts was enacted in 2013. Taxable gifts are defined in federal law. Taxable gifts exclude gifts to a spouse, gifts to charities, gifts to a political organization, and the payment of tuition or medical expenses for someone else. They also exclude the first $14,000 in gifts during a year to any individual, which equals the federal exclusion. This annual exclusion applies separately to each donor, so the annual exclusion is $28,000 per year for a married couple. A separate exclusion amount applies to each recipient, and there is no annual maximum for total excluded gifts per donor.

The three-year look-back was enacted to eliminate the strong incentive for Minnesotans to avoid the Minnesota estate tax by making gifts shortly before death. Such “deathbed gifts” might be taxable federally under the integrated estate and gift taxes, but they would avoid the state-level estate tax. The increase of the federal exclusion for life-time taxable gifts from $1 million to $5.34 million had increased the potential tax benefits from deathbed gifts. This raised issues of fairness. It also sometimes required difficult financial decisions by people who were very ill or had limited competency shortly before death.

The effective date of the law change was July 1, 2013. No gifts made prior to that date will be subject to the estate tax, so the look-back will apply to a full three years only for deaths after July 1, 2016.[18]

In recent years, about 220 Minnesota estate tax returns (out of 1,500) have reported adjusted taxable gifts. An unknown portion of those 220 decedents made taxable gifts in the three years before death and would have been affected by the law change. At the time it was enacted, the three-year look-back was estimated to raise an additional $6 million per year when fully in effect.

Because a separate gift tax was also enacted in 2013 (as described below), a credit is given on the estate tax for any tax paid on gifts made within 3 years of death.

Revenue Impact of Inclusion of Gifts Within Three Years of Death
(Dollars in $1,000s)

	FY 2014	FY 2015	FY 2016	FY 2017
Estate Tax	$4,500	$5,900	$5,900	$6,000

Source: Estimate at time of enactment, with effective date 1/1/13.

Gift Tax

A gift tax was also enacted in 2013, with the same July 1, 2013 effective date. The tax rate is 10%, and a lifetime tax credit of $100,000 exempts the first $1 million in taxable gifts a person makes after the effective date.

A gift tax is considered a backstop for the estate tax. It prevents large intergenerational transfers from avoiding the estate tax if they are made as life-time gifts rather than transferred at the time of death. The federal gift tax was created for this reason, and it was the rationale for Minnesota’s own gift tax from 1937 through 1979.

The effective $1 million exclusion applies to “taxable gifts.” Many sizable gifts are not defined as taxable gifts. This is particularly true if gifts are spread out over many years. As explained above, a married couple can give gifts of up to $28,000 per beneficiary to an unlimited number of beneficiaries every year without generating any “taxable gifts.” This means that a couple with two married children and four grandchildren could give those 8 beneficiaries a total of $224,000 in gifts per year – $28,000 to each of the 8 people – without owing any gift tax. If those gifts were made annually for 10 years prior to the death of the first spouse, they would total $2,240,000 in nontaxable gifts. With an additional $1 million gift tax exclusion, this means a total of $3,240,000 could be given to those 8 beneficiaries over 10 years – and an unlimited amount to charities – without owing any Minnesota gift tax.[19] In the absence of the gift tax there would be no limit at all, of course, for gifts given at least 3 years prior to death.

[18] The filing requirement was also changed to include adjusted taxable gifts made within three years of death, so gifts made as far back as 2010 might count toward the $1 million exclusion.

[19] For appreciated assets received as gifts, the basis is carried over at the time of death. Appreciated assets received by an heir at the time of death benefit from a step-up in basis. As a result, there is a strong tax incentive to transfer appreciated assets as part of the estate rather than as gifts.

Although the federal estate and gift taxes are fully integrated (or "unified"), Minnesota's taxes are not. The federal exclusion for "taxable gifts" is the same as the federal exclusion for an estate, and taxable gifts and estates are both taxed at the same progressive rates. The federal gift tax can be considered an early payment of the federal estate tax. When the federal estate tax return is filed, "adjusted taxable gifts" are included in the tax calculations and a credit is provided for any taxes paid on those gifts.

Although Minnesota's effective exclusion for "taxable gifts" is the same as its estate tax exclusion (at $1 million), the gift tax rate (at a flat 10%) differs from the estate tax rates. In addition, only taxable gifts made in the 3 years prior to death are generally included in the taxable estate. Gifts made in earlier years are not included in the taxable estate.[20]

Taxable gifts made after June 30, 2013 will be subject to the 10% gift tax. If included in the value of the estate, a credit for any gift tax paid is provided on the estate tax return. Taxpayers in the top tax bracket (16%) would pay an additional tax of 6% on such gifts (their 16% estate tax rate less the credit for the 10% gift tax) when they file their estate tax. For a taxpayer in the 8% estate tax bracket, the estate tax credit for the 10% gift tax would generally give back the 2% difference.

The failure to enact a unified estate and gift tax for Minnesota means that the tax rate that applies to an estate may be either higher or lower than the tax rate that applies to taxable gifts.

Based on federal gift tax information, it is estimated that about 2,000 Minnesota gift tax returns will be filed annually. Initially only a small number of individuals will pay the Minnesota gift tax, but as the lifetime credit get used, the number will increase.[21]

Connecticut is the only other state with a gift tax, and Connecticut's estate and gift taxes are unified, with an exclusion of $2 million and rates between 7.2% and 12%.

Summary: A Complex Tax

The estate tax in its current form is complicated. It uses two parallel calculations with two different tax rate tables from federal law as it existed 14 years ago (in 2000). It includes in its calculation a "unified credit" at its 2000 level ($345,800). It includes calculations for the phase out of the benefits of a progressive rate structure (between $10 million and $17.184 million) on the form rather than in the rate table. It places the highest marginal tax rate (41%) on the smallest estates that pay tax (the rate bubble). And the new gift tax is not part of a unified estate and gift tax system.

[20] This is generally true for larger estates, but not for all estates. As explained above, the estate tax is the smaller of the tax calculated using Calculation A or Calculation B. Calculation A includes all taxable gifts, but it only applies (is smaller than Calculation B) for smaller estates (between $1 million and $1.094 million). These smaller estates will receive a credit for any Minnesota gift tax they have paid on those earlier gifts.

[21] In 2012 less than one percent of federal gift tax returns owed tax, but 2.5 percent owed tax in 2003, when the federal estate tax exclusion was the same as Minnesota's is today ($1 million).

Chapter 3
Who Pays the Estate Tax?

This chapter uses recent return data to make several observations about those who pay the estate tax.

Only a Small Proportion of Decedents Pays Minnesota Estate Tax

As shown in Figure 10, an estate tax return was filed for fewer than 2,000 of the 40,000 Minnesota residents who died in Minnesota in 2011 (less than 5%). Fewer than 1,200 (less than 3%) paid any estate tax.

The percentages filing tax and paying tax have increased over time (though the increases are not steady).

Figure 10. Minnesota Deaths and Resident Estate Tax Returns by Year Filed

Year	Deaths in Previous Year*	Estate Tax Returns Filed	Paid Estate Tax	Returns as Percent of Deaths	Returns Paying Tax as Percent of Deaths	Percent of Returns that Paid Tax
2012	39,799	1,921	1,141	4.8%	2.9%	59.4%
2011	38,857	1,535	925	4.0%	2.4%	60.3%
2010	37,801	1,384	878	3.7%	2.3%	63.4%
2009	38,431	1,280	834	3.3%	2.2%	65.2%
2008	37,086	1,536	965	4.1%	2.6%	62.8%
2007	36,963	1,357	877	3.7%	2.4%	64.6%

*Deaths in previous year because return not due until 9 months after death.

Many File Estate Tax Returns but Owe No Tax

Figure 11 summarizes estate tax returns filed in 2012, by nonresidents as well as residents. Of 2,043 returns, only 1,232 (60%) paid Minnesota estate tax. So 40% of all estate tax returns owed no tax.[22] These estates were required to file a tax return because their gross federal estate exceeded $1 million, but allowable deductions were large enough to eliminate any tax liability. In most cases this reflected the (unlimited) spousal deduction, which was claimed on 834 filers (41%). A deduction for charitable contributions was claimed on 17% of all returns, equal to 4.4% of total federal gross estate. About 5% of all returns claimed a deduction for qualified farm or small business assets. Total deductions reduced federal gross estate by 42% (40% for resident returns).

[22] Among all federal estate taxes filed in 2012 (in all states), 39.7% owed no federal tax. So the fact that 40.8% of all Minnesota filers owed no tax should not be surprising.
Source for federal counts: www.irs.gov/uac/SOI-Tax-Stats-Estate-Tax-Statistics-Filing-Year-Table-1

Figure 11. Estate Tax Deductions and Minnesota Estate Tax by Resident Status, Returns Filed in 2012

	Minnesota Residents		Non-Minnesota Residents		Total	
	Returns	Dollars	Returns	Dollars	Returns	Dollars
Federal gross estate	1,921	$ 5,313	122	$ 2,573	2,043	$ 7,886
− Debts and mortgages	1,153	189	84	31	1,237	220
− Other expenses	1,717	62	102	11	1,819	73
− Transfers to spouse	772	1,571	62	966	834	2,537
− Charitable contributions	334	318	20	32	354	350
Estate after federal deductions	1,761	3,171	114	1,535	1,875	4,706
− Qualified small business property	12	10	0	0	12	10
− Qualified farm property	96	121	0	0	96	121
Minnesota taxable estate	1,756	$ 3,040	114	$ 1,535	1,870	$ 4,575
Tentative Minnesota estate tax	1,141	$ 172	91	$ 215	1,232	$ 387
× Share of gross estate in Minnesota		96.8%		2.6%		44.5%
Minnesota estate tax	1,141	$ 167	91	$ 6	1,232	$ 172

Numbers may not add up due to rounding.

Nonresidents Pay Only a Small Share of the Tax

In 2012, non-residents accounted for 6% of taxable returns but paid only 3.3% of Minnesota tax. Of their federal gross estate, only 2.6% was located in Minnesota. For Minnesota residents, 96.8% of the federal estate was apportioned to Minnesota.

The Tax is Concentrated among a Small Number of Residents with Large Estates

Figure 12 provides a breakdown of returns filed by residents by size of federal gross estate in 2012. Only returns with tax liability are included. Over half of their total tax was paid by the 10% of returns with gross estate over $5 million, over 60% by the 18% of returns with gross estate over $3.5 million, and almost 80% by the 42% with gross estate over $2 million.[23]

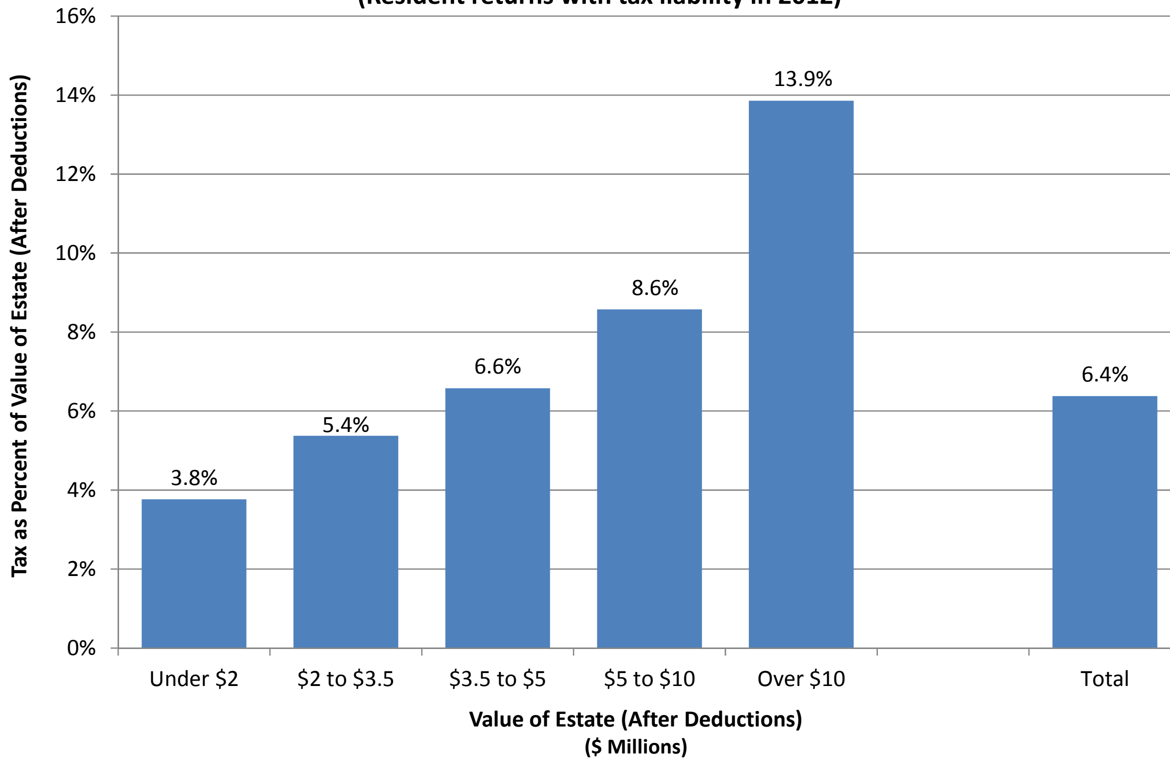
Figure 12. Estate Taxes Paid by Size of Gross Estate, Returns Filed in 2012

Gross Estate ($ Millions)	Number Paying Tax	Percent of All Returns with Tax Liability	Taxes Paid ($ Thousands)	Average Tax Paid ($ Thousands)	Percent of Total Tax Paid
Under $2	692	60.6%	$ 34,351	$ 50	20.6%
$2 to $3.5	266	23.3%	30,395	114	18.2%
$3.5 to $5	82	7.2%	18,569	226	11.1%
$5 to $10	65	5.7%	26,046	401	15.6%
Over $10	36	3.2%	57,284	1,591	34.4%
Total	1,141	100.0%	$ 166,645	$ 146	100.0%

Excludes nonresident returns. Numbers may not add up due to rounding.

[23] If those with tax liability are instead distributed by taxable estate *after deductions*, 45% is paid by the 6% with taxable estate over $5 million, almost 60% by the 14% with taxable estate over $3.5 million, and over three-quarters by the one-third of returns with taxable estate over $2 million.

As shown in Figure 13, tax liability rose from 3.8% of the value of taxable estate for estates valued between $1 million and $2 million to 13.9% for estates valued over $10 million. This reflects the progressive tax rate schedule. Overall, the tax averages 6.4% for resident returns with tax liability.[24]



While Figure 13 shows tax as a percent of an estate's value *after* deductions, Figure 14 shows how tax as a percent of federal gross estate (*before* deductions) varies by size of federal gross estate. As noted above, deductions reduce federal gross estate by 40%, so tax as a percent of federal gross estate would be expected to be much lower than tax as a percent of taxable estate.

The average tax rate as a percent of federal gross estate (after deductions) *falls* for the largest estates. This is because deductions are a larger proportion of the highest valued gross estates. This explains the drop in the average tax rate for the largest estates. Deductions reduce gross estate by 24% for estates valued between $1 million and $2 million. That rises to 34% between $2 million and $5 million, 40% between $5 million and $10 million, and 67% for gross estates over $10 million. As shown in Appendix D, both the marital deduction and the charitable deduction rise sharply for gross estates valued more than $10 million.[25]

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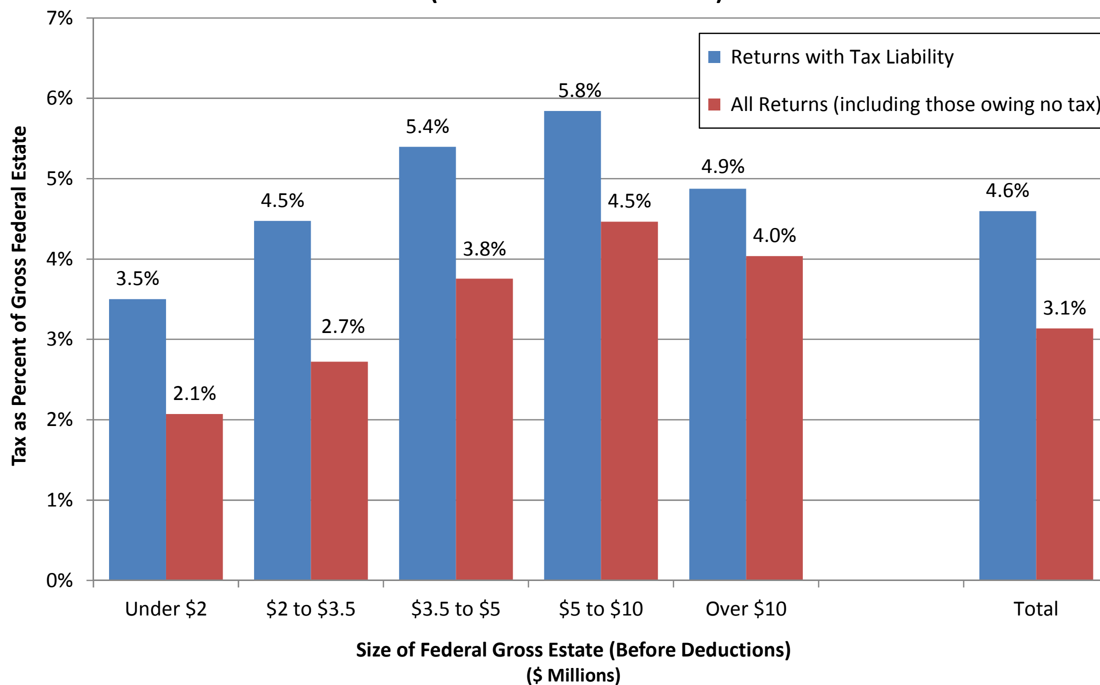
[24] The average tax rate for non-residents is much lower because a much lower proportion of their estates are subject to Minnesota tax.

[25] For residents, the Minnesota share of assets looks fairly constant across the gross estate categories, so differences in the share of assets apportioned to Minnesota do not explain the decline in average tax rates for higher valued estates.



The Estate Tax is Minnesota's Most Progressive Tax

The estate tax is a tax on wealth, not income. Nevertheless, wealth and income are quite highly correlated, so the estate tax burden will generally fall on those who have had high lifetime incomes. To distribute the Minnesota estate tax burden by income class in its biennial *Tax Incidence Study*, the Department of Revenue matches estate tax liability with income reported on income tax returns in the years prior to the year of death. The data includes estate tax returns over a 10-year period (2002-2011). As expected, income is highest for those with the largest estates and highest tax. One-quarter of the tax was paid by the one percent with annual incomes over $1 million; one-half was paid by the 12% with annual incomes over $350,000. On the other hand, 20% was paid by the 45 percent who had annual incomes under $100,000.

Figure 15 summarizes the same data from a different perspective. It reports the average income for those with estate tax liability within selected ranges.

The limitations of this analysis of the relationship between income and wealth must be acknowledged. Tax law provides a strong disincentive for realizing capital gains in the years just prior to the year of death. Unrealized capital gains will escape income tax entirely at death due to the step-up in basis at death. Because capital gains are only reported on tax returns at the time an appreciated asset is sold, the disincentive to sell appreciated assets can distort incomes in the years prior to death. This is particularly true if the decedent is quite old or death is anticipated in the years immediately preceding death. Appreciated investments may be earning a return (as they appreciate in value) but that income does not show up as income on the income tax return.

Figure 15. Average Annual Income in the Three Years Prior to Death Those with Estate Tax Liability (2002 to 2011)

Gross Estate ($ Millions)	Number of Matched Records	Average Annual Income	Median Annual Income
Under $2	6,135	$ 192,454	$ 90,150
$2 to $3.5	1,420	309,378	150,509
$3.5 to $5	329	366,404	214,962
$5 to $10	237	713,724	346,771
Over $10	111	4,669,717	930,362
Total	8,232	$ 294,954	$ 105,924

Includes all records with positive estate tax that could be matched to income tax records for the three years prior to death. Dollars are adjusted for inflation. The *Minnesota Tax Incidence Study* reports median household income of $41,100 overall and between $80,000 and $87,000 for nonsenior married couples.

Despite these limitations, the information shows that the estate tax is by far the most progressive of Minnesota's state or local taxes. The 2013 *Tax Incidence Study* estimated that Minnesota households with incomes in the top 10 percent (over $129,000) had 42% of household income in 2010. The study estimated those households paid 96% of the estate tax, 56% of the income tax, and 28% of all other taxes. They paid 38% of all state and local taxes combined borne by Minnesota residents. The top 1% paid 92% of the estate tax. No other tax has a burden that is so concentrated at the top of the income distribution.[26]

Most Minnesota Residents Who Pay Minnesota Estate Tax Pay No Federal Estate Tax

For taxes filed in 2012, there were 1,141 Minnesota residents who paid Minnesota estate tax. Federal statistics report only 36 Minnesota residents paid federal tax on returns filed in 2012, so only 3.2 percent of residents with Minnesota estate tax liability paid federal tax. This is because the federal exclusion was about five times as high as Minnesota's exclusion. As shown in Figure 12 above, only 101 of the 1,141 who paid Minnesota tax (9%) had a gross estate (before deductions) above $5 million.

[26] A tax is progressive if the effective tax rate (tax as a percent of income) rises with income. A tax is regressive if the effective tax rate falls with income. The *Tax Incidence Study* uses the Suits Index to measure the degree to which a tax is progressive (positive Suits Index) or regressive (negative Suits Index). The Suits Index for the estate tax (at +0.832) far exceeds that for the income tax (at +0.230). Almost all other taxes are regressive with negative Suits indexes. See pages numbered 25-26 of the *Tax Incidence Study* at www.revenue.state.mn.us/research_stats/Pages/Tax_Incidence_Studies.aspx.

The 2013 *Tax Incidence Study* estimated that the Suits Index for all state and local taxes in 2010 was -0.060. Without the estate tax, the Suits Index would have become more negative (regressive), falling to -0.067.

Minnesota's Deduction for Farm and Small Business Property Reduces Tax Liability

In the 17 months following April 1, 2012, returns were filed by 3,039 estates. Of these estates, 258 (8.5%) claimed the farm and small business deduction. Overall, the deduction reduced tax collections by $24.3 million (8.8%).

Figure 16 shows how much farm and small business property was deducted over this period. Farm property accounted for 95% of the total amount deducted, with an average farm property deduction of $1.4 million. Deductions of small business property were much less common, with just 24 estates deducting an average of $766,000. The farm and small business deduction is capped at $4 million, but only 5 of the 258 estates who claimed the deduction (2%) claimed the maximum amount.

Figure 16. Farm and Small Business Deductions

Returns filed from April 2012 to August 2013

	Returns	Dollars ($ Millions)
Small Business Property	24	$ 18
Farm Property	240	336
Farm & Small Business Property	258	$ 355

*Six estates deducted both farm and small business property.
Numbers may not add up due to rounding.

Figure 17 shows the number of returns claiming the farm and small business deduction by size of the estate. It also shows how much the deductions reduced tax liability. The farm and small business deduction eliminated tax liability for 79% of those who claimed it and reduced the group's total estate tax liability by 82%.

Figure 17. Estates Deducting Farm and Small Business Property

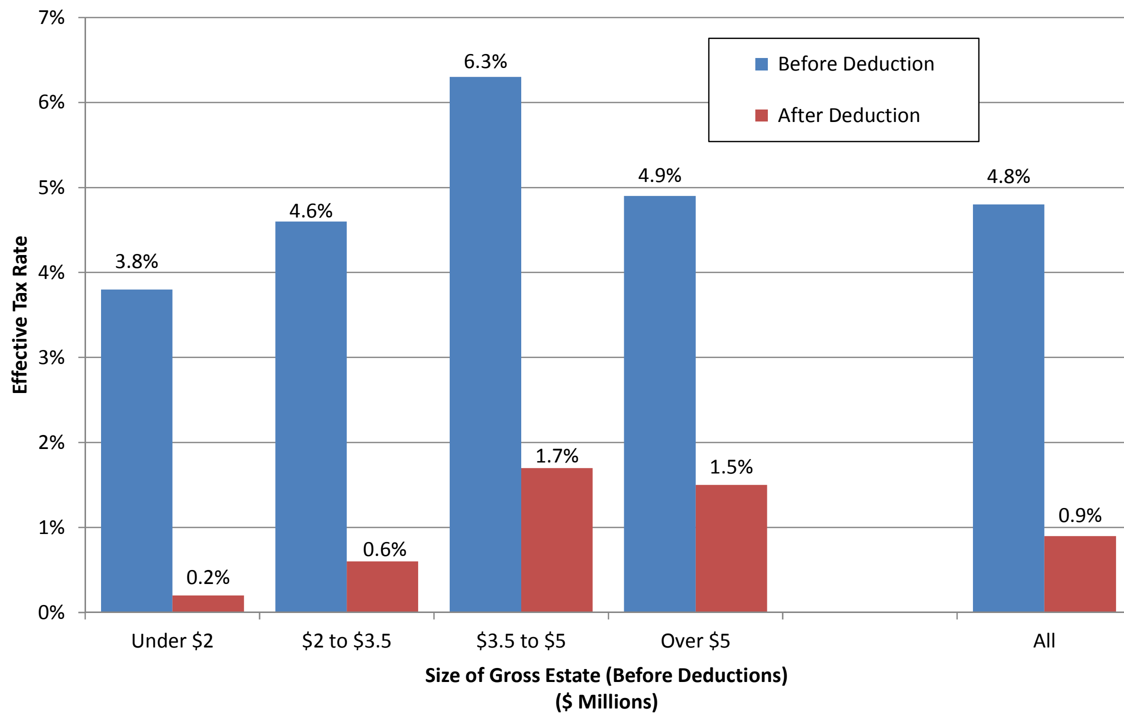
Returns filed from April 2012 to August 2013

		Number Paying Tax			Average Estate Tax ($ Thousands)		
Gross Estate ($ Millions)	Number Claiming Deduction	Before Deduction	After Deduction	Difference	Before Deduction	After Deduction	Difference
Under $2	131	128	12	(116)	$ 56	$ 4	$ (52)
$2 to $3.5	84	79	17	(62)	118	15	(103)
$3.5 to $5	33	33	17	(16)	262	72	(189)
Over $5	10	10	7	(3)	366	116	(250)
All Estates	258	250	53	(197)	$ 115	$ 21	$ (94)

Numbers may not add up due to rounding.

For those with the deduction, Figure 18 shows how much the deduction reduced average tax rates (tax as percent of the gross estate). For the group overall, the deduction cut the effective tax rate from 4.8% to 0.9% of the value of the gross estate.

Figure 18. Impact of the Farm and Small Business Deduction on Minnesota Tax as a Percent of Gross Estate
Returns Filed April 2012 to August 2013 that Claimed the Deduction



Chapter 4
Evaluating the Estate and Gift Taxes

Opinions about the estate tax vary widely, particularly regarding questions of tax fairness and the impact such taxes have on economic growth. This section first briefly evaluates the estate tax based on some standard tax policy principles. This is followed by a more in-depth analysis of issues raised by proponents and opponents of the tax.

The Estate Tax and Tax System Goals

The five basic goals of a tax system are defined in *The Model Revenue System for Minnesota*, a 1992 report by the Department of Revenue. A tax system should be (1) understandable, (2) fair, (3) competitive, (4) reliable, and (5) efficient.

***Understandable*:** As the description of the tax in Chapter 2 illustrates, the structure of the current tax is complex. It is difficult for taxpayers, public officials, and revenue administrators to understand. There is no single tax table, calculations are complicated, and the law is tied to federal statutory language that was repealed 13 years ago. The bubble is difficult to explain, and it also makes it impossible to fully integrate the gift tax with the estate tax. Tax planning uses complicated terminology and financial structures, which are also difficult to understand. The current estate tax scores low on this criteria, but progress could be made if a stand-alone tax were enacted.

***Fair*:** Two dimensions of fairness are important.

First, equals should be treated equally ("horizontal equity"). Because a portion of the estate tax can be avoided through careful tax planning, the tax will fall disproportionally on those who die unexpectedly or those who are less sophisticated about financial matters. Those who pass on equal amounts of wealth to the next generation can pay very different amounts of tax. The addition of the three-year look-back for gifts (to reduce deathbed gifts) and the gift tax are moves toward more equal treatment of equals. On the other hand, the deduction of up to $4 million of small business and farm property, by favoring owners of small businesses and farms, undercuts the horizontal equity of the tax; owners of these assets pay substantially lower effective tax rates than others with estates of equal value.[27]

The argument presented below that the estate tax is a backstop for the income tax, taxing assets that escape income tax due to step-up in basis at death, also addresses the goal of horizontal equity.

Second, the distribution of the tax burden by income class (or wealth class) is evaluated by standards of "vertical equity." People differ on how they evaluate vertical equity, with some favoring more progressivity and others opposing it. As shown in Chapter 2 and discussed further below, the estate tax is the most progressive Minnesota tax and reduces the regressivity of the overall state and local tax system.

[27] Compare Figure 16 (those claiming the farm and small business deduction) with Figure 12 (all taxpayers).

***Competitive*:** To the extent that high-wealth people leave the state to avoid the estate tax, the tax will score poorly on this criteria. This evidence regarding interstate mobility is described in detail below.

***Reliable*:** The revenue should be stable, sufficient, and certain. The estate tax is one of the least predictable sources of revenue, with revenue spikes resulting in some years from a very large payment from a single taxpayer. These spikes are all positive revenue surprises, and if these few outliers are removed, the variability from year to year is greatly reduced. Because the unusually large payments are excluded when estate tax revenues are forecast, all the risk is up-side risk. So volatility is not a problem for budgeting. Moreover, the estate tax revenue variation is uncorrelated with the variation of other taxes that make up the state's tax portfolio.

Sufficiency refers to growth in tax revenue (as contrasted with the stability of that growth). As shown in Chapter 1, estate tax revenue has grown more rapidly than total state revenue or the revenue from most other taxes. Average annual revenue growth from 1990 to 2013 was 8% in nominal dollars and 6% in inflation-adjusted dollars. So although the estate tax makes a relatively small contribution to state revenue, it scores well on reliability.

***Efficient*:** Compliance cost should be kept low both for taxpayers and for tax administration, compliance should be high, and the tax should not discriminate between different forms of economic activity.

The estate tax is paid by a small number of taxpayers, so the Department of Revenue's administrative cost per dollar received is quite low. As shown in Figure 9, the average tax is almost $150,000 per return. In addition, most estates have an abundance of liquid assets to pay the tax readily when due, avoiding extensive collection actions witnessed by many other Minnesota taxes.

On the other hand, the costs of tax planning that are added by the existence of the state tax (costs beyond those already existing with the federal tax) are substantial, particularly when the exclusion rates differ so greatly. Many estates valued well below the current federal exclusion level ($5.34 million) may only need to do tax planning for the state tax. Of returns that paid tax in 2012, less than 10 percent has gross estates (before deductions) over $5 million; only 16 percent had gross estates over $3.5 million.

The gift tax will add noticeably to the number who file tax, and very few of those filers will owe tax (because the first $1 million of taxable gifts is excluded from tax). This is a new tax, so little is known about compliance or the administrative costs for the Department of Revenue.

Issues Raised by Proponents

The Estate Tax as a Backstop to the Income Tax

Proponents of the tax argue that the estate tax should be considered a "backstop" for the income tax because much of the value of assets transferred at death has never been subject to the income tax. Income tax treatment of assets transferred at death allows appreciated assets to avoid tax by granting those appreciated assets a "step-up in basis" at the time of death. For example, if stock purchased for $100,000 is currently valued at $1 million, the $900,000 capital gain from its sale would generally be subject to income tax if it were sold prior to death. Step-up in basis allows the person who inherits the stock to sell it and report as income only the gains above $1 million. The $900,000 capital gain has not been subject to income tax and never will be.[28]

[28] Some retirement assets (such as IRAs) do not receive a step-up in basis at death, but any estate tax paid on these assets is deductible on the recipient's income tax return.

The importance of a step-up in basis at death is illustrated by choices made in 2010. In that year, there was no federal estate tax for any estate that was willing to forgo the step-up of basis. Those who chose to pay the federal tax that year valued the step-up in basis enough to pay the estate tax.[29]

Poterba and Weisbenner (2001) found that 37% of all estate value among estates above $500,000 is due to unrealized capital gains. For estates over $5 million, 56% was in the form of unrealized capital gains. This gives credibility to the argument that the estate tax is a backstop for the income tax. The *2014 Minnesota Tax Expenditure Budget* estimates that step-up in basis at death will reduce Minnesota income tax revenue by $241 million in FY 2015, which is about 15% above what is forecast to be raised by the Minnesota estate tax ($191 million).[30]

At the federal level, the option of repealing the estate tax in exchange for repeal of the step-up in basis has been considered. One benefit of this would be to reduce the "lock-in effect" created by the step-up in basis at death. Those with assets that would qualify for a step-up in basis are strongly discouraged from selling those assets. This distorts asset markets and locks money in less desirable investments, reducing the economy's overall productivity. Unfortunately, the option to repeal step-up in basis at death has little appeal at the state level because it would mean two different basis calculations for tax purposes – one for state tax and one for federal – for each asset over many years.

Proponents use the backstop argument to counter estate tax opponents' arguments that the estate tax is double taxation. However, the opponents' argument is generally that any tax on investment income is double taxation – essentially the argument that we should have a consumption tax rather than an income tax. For those who believe that capital gains (and other forms of capital income) should never be taxed, the backstop argument is obviously not convincing.

The Estate Tax and the Concentration of Wealth

Proponents of an estate tax argue that the estate tax is beneficial because it constrains the concentration of wealth. Passing wealth from generation to generation without tax at the time of transfer allows the children of those with high wealth to become members of that group themselves without earning that status.

The current estate taxes are not well designed if the goal is to curtail the concentration of wealth. The tax depends only on the size of the estate. A tax designed to prevent the formation of a persistent elite class would provide an incentive to disperse the estate widely rather than to just a single or few heirs. Currently, however, (given similar estate planning) the estate tax would be the same for an individual who leaves $100,000 to each of 100 people as for the individual who leaves the entire $10 million to a single heir.

Tax planning can certainly limit the ability of the estate tax to affect the distribution of wealth. Opponents sometimes refer to the estate tax as a "voluntary tax," because estate planning can sharply reduce the need to pay any tax. The tax can be avoided by the financially astute, though it may surprise some who die young and unexpectedly and others who are less financially sophisticated. Opponents question the ability of a voluntary tax to effectively reduce the concentration of wealth.

[29] The IRS Statistics of Income for the 2010 estate tax has not yet been released, so the number choosing to pay the estate tax in order to preserve step-up in basis is not known.

[30] See www.revenue.state.mn.us/research_stats/research_reports/2014/2014_tax_expenditure_links.pdf (p. 43). Forecast estate tax collections are from the February 2014 forecast.

The tax may be harder to avoid than is generally appreciated, though. Richard Schmalbeck's extensive analysis of tax avoidance at the federal level (written in 2001, when the federal exclusion was $625,000) concluded that although avoidance of a tax is possible, the avoidance methods are often perceived as having unacceptable costs.

> The transfer system depicted in this chapter has two faces. On the one hand, a number of devices are available that significantly reduce the base of the transfer tax. At the threshold of the taxable range – those estates that might be potentially in the $1-3 million range – a reasonably attentive approach to the marital deduction, the annual gift tax exclusion, and the lifetime transfer tax exclusion can eliminate much or all of the tax liability. In the higher ranges – above $20 million, those deductions and exclusions become relatively insignificant, but other devices such as family partnerships and grantor-retained trusts, are available to reduce the size of the estate by at least one-third of its potential size…
>
> On the other hand, the devices have limits; the stories of complete avoidance of transfer taxes by the very wealthy are mostly hyperbolic. Massive transfers to charity or a surviving spouse can transfer wealth without wealth transfer taxes, but most other large wealth transfers will be subject to significant effective rates of tax. Further, the hypothetical strategies that could minimize the transfer tax liabilities of an individual will frequently be eschewed because of nontax considerations. … [A]s one estate tax planner put it: people simply do not like to give away their property while they are alive. And … most of the more effective strategies require a considerable willingness to make truly irrevocable transfers during a donor's life. (Schmalbeck, 2001, pp. 155-56)

More recent sources point to substantial tax avoidance at the federal level. One well-known tax avoidance method is the Grantor Retained Annuity Trust, or GRAT. Federal law changes enacted in 1990 aimed at shutting down another tax avoidance method unintentionally made GRATs possible. News reports based on filings with the U.S. Securities and Exchange Commission show that many of the wealthiest Americans have used GRATs and suggest that GRATs have cut federal estate and gift tax revenue by as much as one-third.[31]

Schmalbeck (2001) noted that the best proof that avoidance techniques at the federal level are more limited than some claim is the revenue raised by the tax. His analysis was limited to the federal tax, so he did not address avoidance of a state tax by migrating out of state, but Minnesota's tax has been raising over $150 million each year, half from those with taxable estates in excess of $5 million (and more than one-third from taxable estates over $10 million). Those collection totals suggest that the costs to those high-value estates of avoiding the tax must be having an effect.

[31] Richard Covey is credited with the design of GRATs. They are described as follows:

"Covey recognized that a client could use the 1990 legislation to avoid gift taxes if he did something that would otherwise make no sense: put money in a trust with instructions to return the entire amount to himself within two years. Because he doesn't have to pay tax on a gift to himself, the trust incurs no gift tax, Covey calls the trust 'zeroed out.' Because the client isn't paying any tax upfront, the transaction amounts to a can't-lose bet with the IRS. If the trust's investments make large enough gains, the excess goes to heirs tax-free. If not, the only costs are lawyer's fees, typically $5,000 to $10,000." (Mider, 2013)

The Estate Tax as a Progressive Tax

The estate tax is favored by some simply because it is a progressive tax. Those with substantial wealth generally have high incomes as well – though that income may not show up on a tax return if it is in the form of unrealized capital gains. As explained in Chapter 3, no other state or local tax has a burden so concentrated at the top of the income distribution. Raising a similar amount of tax from equally high-income taxpayers could be done through the income tax (by adding a higher-rate bracket at the top) or to a lesser extent with the property tax (a higher class rate, perhaps, on the most expensive homes). If the goal is progressivity, then the estate tax has some advantages over other taxes. Because the estate tax is levied on individuals after death, it may have fewer adverse effects on work incentives than an equal-yield income tax that targeted high-income taxpayers. In other words, income taxes reduce the return from effort while income is still being earned, while estate and inheritance taxes are paid after a lifetime of work and therefore have less weight in work, saving and investment decisions. (Pechman, 1987).

In contrast, detractors suggest that the estate tax hurts economic growth by reducing saving and work (Pechman, 1987). The impact on savings depends on the goals of the saver, though, and economic theory suggests that even those whose goal is to pass wealth along to an heir might save either more or less in response to an estate tax.

Proponents of the tax sometimes stress its impact on work incentives *for the heirs*. They suggest that estate and inheritance taxes may *increase* work effort among those who might otherwise choose to depend on their inheritance rather than working diligently to earn their own wealth. The most commonly cited defense of this position is Andrew Carnegie's *Gospel of Wealth* in which he wrote that "the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would" (quoted in Pechman 1987: 235).

Issues Raised by Opponents

The Estate Tax Creates a Hardship for Small and Family-Owned Businesses, Who Lack Liquidity

The estate tax is sometimes described as a special hardship for decedents whose assets are in the form of a farm or small business. The ratio of wealth to income may be high, and business assets may not be liquid. Payment of estate tax may require borrowing against the assets or selling off part of the farm or business.

There is some dispute about the degree of hardship the estate tax would create in the absence of this subtraction. At both the federal and state levels, those with closely-held business assets can delay the tax for five years and pay the tax in installments, spreading the cost over as many as 15 years. Some argue that this is a sufficient response to liquidity problems.

A 2005 Congressional Budget Office study concluded:

> In 2000, about 8 percent of the estates of farmers who left enough assets to owe estate taxes faced a tax payment that exceeded their liquid assets, compared with about 5 percent of all estates that owed taxes. For estates claiming the qualified family-owned business-interest deduction, the corresponding figure was about 34 percent. (p. viii)

In response to the concerns about farms and small businesses, the 2011 Minnesota legislature enacted a deduction of up to $4 million for small business and farm property. This effectively increased the exclusion for those with small business or farm assets from $1 million to $5 million. Clarifications and modifications enacted in 2013 addressed taxpayer confusion and administrative difficulties caused by the original language.[32]

The requirement that those who inherit the businesses continue to operate the businesses for at least three years attempts to limit the preference to those who would not choose to sell the assets immediately anyway. Although the original farm and small business deduction would have allowed others to game the system by creating a "small business" and stashing unrelated assets into that business, the 2013 law changes limited any such planning opportunities. Targeting a $5 million exclusion in this way to a small group of taxpayers is much less costly (at roughly $20 million per year) than raising the exclusion to $5 million for everyone (which would cost seven times as much).

Other states have enacted somewhat similar provisions. For a summary of those recently enacted in Maryland, Pennsylvania, Oregon, and Washington, see Michael, 2013a, pages 16-17.

The Estate Tax and Interstate Mobility

At the federal level there is limited concern about migration because a taxpayer would need to leave the country (or not settle here initially) to avoid the federal tax. In contrast, a state tax can be avoided in many cases simply by moving to another state with no such tax. Changing state residence for tax purposes is much less costly than moving to another country. This may be particularly true for those who already own homes in multiple states.

It is often claimed that individuals are leaving Minnesota to avoid the Minnesota estate tax. Attempts to prove the hypothesis using accepted statistical techniques have found it difficult to identify such tax-motivated mobility.

[32] Each of the 2013 changes reflected a desire to achieve tax fairness and horizontal equity while providing an incentive to maintain a small business or farm through a cross-generation transition. The goal was to treat equivalent individuals the same and to avoid unintended tax avoidance opportunities. A few of the 2013 changes:

(1) Allowed transfers from a decedent's revocable trust to qualify for the deduction.
(2) Treated businesses equally regardless of how they are registered, treating sole proprietors the same as LLCs.
(3) Clarified that the material participation test (a) applies to the taxable year that ended prior to the decedent's death and (b) extends to the three years following the decedent's death.
(4) Replaced the material participation requirement for farms with a requirement that the property must be classified as class 2a agricultural property for property tax purposes. This allows heirs of decedents who had rented out their farms to qualify if they farmed the land themselves, rather than being required to continue renting out the land.
(5) Addressed the "stuffing capacity" of small businesses by excluding publicly traded securities and assets not used in the operation of the trade or business. For example, if an individual's small business is valued at $2 million, an individual is no longer permitted to "stuff" $2 million of personal assets (not directly related to that business) into the LLC, thereby increasing the value of the LLC to $4 million and maximizing the small business deduction.

The Department of Revenue worked with legislative staff, members of the Minnesota Bar Association and representatives of the Minnesota Farm Bureau, Minnesota Farmers Union, and National Federation of Small Businesses to clarify legislative intent and make the exclusion more understandable for taxpayers and administrable for the Department.

Several recent studies of the impact of estate, inheritance, and gift taxes are vast improvements over earlier studies. The new studies use panel data, larger datasets, more discriminating measures of tax differences, and better controls for other variables that may affect migration. Prior studies had generally used data from a single Census year's long form, focusing on those who reported living in a different state five years earlier. Although these earlier studies found statistical evidence that taxes mattered, they invariably suffered from the "same-sign problem." If they found that higher taxes discouraged people from moving into a state, they found that those same higher taxes also discouraged people from moving out of the state.[33] Given the illogical implications of this same-sign problem, the results of these were of little or no value in addressing policy.

Two recent studies by Rork and Conway focus on interstate migration of seniors, using data from multiple Census years. In one study they were able to focus separately on younger seniors. A study by Bakija and Slemrod used a large sample of federal estate tax returns over many years to test whether changes in estate and inheritance tax rates affect the number of estate tax returns filed in each state. Their data allowed them to make separate estimates by wealth class.

Before summarizing the findings of these recent studies, it is worth explaining why it is so difficult to estimate the migration impact of state-level estate taxes.

1. People migrate for many reasons. To isolate the impact of taxes, it is necessary to control for the many other factors that affect migration, such as climate, crime rates, cultural amenities, and the quality of health care. Unless they are included in the statistical analysis, the results will be biased. The three recent studies use advanced statistical techniques (including state and year fixed effects) to more fully control for these other factors.
2. Sample sizes are often too small, because few people move to a different state in any single year. This is particularly true for seniors. Census data for 2007-11 shows that Minnesota had a net annual loss of 0.24% of those aged 55-64 and 0.46% of those aged 65-75, with a net gain of 0.05% of those aged 75 and over. The patterns of state-to-state interstate migration have been stable through time as well, so larger samples are needed to identify statistically significant impacts. Identifying the impact of estate taxes on migration is also difficult because states with high in-migration were among the first to reduce their estate taxes, but they had high in-migration rates both before and after the change.
3. Earlier studies limited their analysis to simple tax variables (simply the presence or absence of the estate tax, or just the maximum income tax rate). The three studies summarized below all used more refined tax measures (effective tax rates on estates with rates that vary by size of estate, and the tax value of income tax preferences targeted specifically at seniors).
4. Because estate taxes affect a much smaller proportion of seniors than are affected by other taxes (or by income tax preferences for seniors), estate taxes may affect the migration of high-income seniors but not seniors as a whole. Two of the recent studies have in some cases been able to estimate the impact on high-income seniors separately.
5. There is some evidence that migration flows for younger seniors are later reversed as older seniors migrate back to their original home state to be nearer family and perhaps better medical care. At least one recent study has tried to separate the analysis by age.

[33] The same-sign problem is not limited to taxes. Higher crime rates generally reduced both in-migration and out-migration as well, and the same problem existed for most other variables included in earlier migration studies.

6. There is also the so-called "chicken or egg" issue. Does migration change tax rates, or do changed tax rates cause migration? Political models suggest that causation may run in both directions. States where seniors are a high percentage of voters are more likely to enact tax laws favoring seniors. The potential for such "reverse causality" was not addressed in earlier studies but has been tested in several of the recent studies.

Statistical Significance vs. Economic Significance

An impact is "statistically significant" if the analysis concludes that there is at least a 95% probability that it differs from zero. An impact can be tiny but still be statistically significant. Statistical significance clearly differs from economic significance, which *also* requires that the estimated magnitude of the impact be large enough to matter.

Conway and Rork (2006)

This study compared the migration of seniors (aged 65 and over) to migration of a younger control group (aged 25 to 44). They included numerous tax variables, including effective tax rates for each state's estate, inheritance, and gift (EIG) taxes. The study was rigorously reviewed and published in a top economics journal. The authors concluded:

> It is notable that none of the tax coefficients is statistically significant. In general, elderly migration appears mostly affected by amenities. Tax policy, including EIG taxes, appears unimportant. The reasonableness of our results and the appearance that many of the problems that have plagued elderly (and other) migration research, such as the "same-sign" problem and the "desirable" effect of crime, are solved with this methodology leads us to conclude that it is a worthwhile approach. That the resulting estimates from this approach suggest that EIG taxes have no differential or absolute effect on elderly migration is a serious blow, in our view, to the belief that widespread elderly migration is affected by state EIG taxes. (p. 116)

They did extensive additional analysis to see how sensitive their results were to their assumptions, including limiting their population to the younger elderly (aged 65 to 74).

On the chicken-or-egg question, they concluded:

> Our research casts doubt on the view that the elderly react to state EIG tax policies in making their migration decisions. In fact, using two different analyses, we find some evidence that the causality may instead run in the other direction – states that experience high elderly in-migration may be more likely to subsequently eliminate or reduce their incremental EIG taxes. (p. 123)

Because the study included all seniors, not just those with the highest incomes, the conclusion is weaker than it may seem. If only a small portion of seniors expect to pay the estate tax during the years covered in the study, then it is perhaps less surprising that no statistically significant impact was found.

Conway and Rork (2012)

This paper, by the same authors and published in the same journal, focuses equally on (1) state income tax preferences for seniors and (2) state EIG taxes. It concludes:

> The results from all analyses overwhelmingly find no credible effect of state income tax breaks on elderly migration. Our conclusion is consistent with historical trends in elderly migration and tax policy. Past research has shown (and we confirm) that elderly state income tax breaks and EIG taxes have both varied a great deal across states and over time, while elderly migration patterns have remained largely the same. Our analyses here further demonstrate very strong correlations of elderly migration patterns over time and across different income groups. Put simply, state tax policies towards the elderly have changed substantially while elderly migration patterns have not. (pp. 351-352)

Even when the population is limited to those who are most likely to respond to tax differences – the quarter of seniors with highest income, those under age 74 with no disability and not returning to their state of birth – the results show no statistically significant impact (or a significant impact in the wrong direction). As the authors note, "moving to elderly samples that are most likely to be affected by the policy thus also fails to yield evidence of statistically significant effects." (p. 351)

The lack of any statistically significant impact of income tax breaks targeted specifically at seniors (such as income tax exemptions for Social Security and pension income) is striking. The lack of any statistically significant impact of differences in state EIG taxes even for the richest 25% is also surprising, though that group still includes many who would not be subject to an estate tax.

Bakija and Slemrod (2004)

This study concludes that EIG taxes have a statistically significant impact on interstate migration. They conclude that the impact is also economically significant. The study predates the other two studies, but it is based on a completely different set of data. Bakija and Slemrod use a sample of federal estate tax returns from 18 tax years between 1965 and 1998. By using federal estate tax returns, they limit their population to high-wealth taxpayers who would generally be more aware and concerned about state-level effective EIG tax rates. They separate the returns into five wealth classes and calculate average EIG tax rates in each of the five classes in each state. They also provide separate estimates for each of those separate wealth classes, with the estimated migration impact rising with wealth.

State-level EIG tax rates varied considerably during this time period (1965-1998). Their estimated average effective EIG tax rates by state and by wealth class are adjusted for the fact that a state "pick-up" tax has an effective tax rate of zero during this time. In 1965, 43 of the 50 states had EIG taxes exceeded the maximum federal credit for state EIG taxes for a $1 million estate. By 2000, this was true in only 3 states. (Minnesota's effective tax rate on such an estate – the amount of tax in excess of the maximum federal credit – was 2.8% of the estate's value in 1965, 1.0% in 1980, and zero after 1985.[34]) The variation in rates over time within individual states is helpful to the statistical analysis.

[34] In the calculations, the estate is assumed to be divided equally among two adult children.

The analysis estimates the impact of taxes on the number of estate tax returns filed in each state, not actual interstate migration. This makes it important to control for the impact of employment variables and the concentration of high-income jobs in certain states (such as New York, New Jersey, and Connecticut). In addition to including four tax variables for each state and wealth class category (average EIG tax rate and average income tax rate for each state and wealth category; average state and local sales tax rate in each state; and property taxes as a percent of personal income for each state), they include a number of other state-specific variables. Their use of dummy variables for each state-wealth class combination effectively controls for any *time-invariant* characteristics of a state that make it particularly attractive to elderly people in each wealth class, and they use time trend variables as a further control.

They conclude that "taken together, our estimates provide robust evidence of some sort of behavioral response to state taxes by the rich." They show several alternative sets of results.

- Conditional logit equations: Each one percentage point increase in the average effective estate tax rate reduces the number of estate tax returns by 1.4 percent, which is statistically significant (less than zero) at the 99% level.
- Linear regression equations: Each one percentage point increase in the average effective estate tax rate reduces the number of estate tax returns by 2.2 percent, which is again statistically significant at the 99% level.
- Linear regression with separate estimate for top wealth class: Each one percentage point increase in the average effective estate tax rate reduces the number of estate tax returns by 4.0 percent for the top wealth class (over $5 million) and 1.8 percent for smaller estates.

The also show statistically significant negative impacts for higher sales tax rates and, in some cases, higher average effective income tax rates[35].

Although the estimated effects are statistically significant – showing some impact – are they large enough to be economically significant? Bakija and Slemrod use their statistical results to estimate the impact of a state maintaining the old pick-up tax after the federal credit for state EIG taxes is replaced by a federal deduction. They estimate that this would result in an average effective estate tax rate (net of federal deductibility) of 4.5 percent (varying only little by wealth class). The estimated behavioral impact would reduce estate tax revenue below what would be raised in the absence of any behavioral effects by between 6.2% (using their first estimate) and 13.5% (using their wealth-class-specific estimate).

Given Minnesota estate tax collections of about $200 million per year, this suggests that the behavioral impact has reduced collections from between $13 and $30 million per year. With no behavioral effects, estate tax revenue would be $213 to $230 million rather than $200 million.[36]

[35] Bakija and Slemrod still have some questionable results. They show higher crime rates increasing the number of estate tax returns (p. 27), and the impact of differences in state death rates gives "a result for which we do not have a good explanation", (p. 27). Two separate tests for reverse causality failed to find it, and they conclude that "any bias to our estimates from either political economy considerations or slow adjustment to changes in tax rates … is likely to be a bias towards zero", (p. 31).

[36] The calculations are based on the estimates of a 6.2% or 13.5% decline in collections. Collections of $213 reduced by 6.2% would yield revenues of $200 million (a drop of $13 million). Collections of $231 million reduced by 13.5% would yield revenue of $200 million (a drop of $30 million).

Bakija and Slemrod also provide an estimate of the potential loss in sales, income, and property tax revenue due to migration, which increases the revenue loss as percent of the estate tax collected with no behavioral effects. Even after accounting for losses in other taxes, they estimate that the state would retain between 67 and 89 percent of what would be collected in the absence of any migration effect.

Their conclusion: "Although we are confident that the behavioral response to such a tax change would be non-zero, our best guess is that the welfare cost and revenue loss from any tax-induced migration would be small relative to the revenue that would be collected. … Although behavioral responses can be expected to reduce the net revenue due to decoupling, it is unlikely that states would put themselves anywhere near the wrong side of the Laffer curve by doing so." (pp. 34-35)

Summary of Evidence on Tax-Induced Mobility

Most rigorous and peer-reviewed studies of migration fail to find any statistically significant effects of tax variables. This is true even when studies are limited to seniors, and it is true for both estate taxes and income taxes. Estate taxes affect such a small proportion of seniors, though, which may explain the failure to find a statistically significant impact when studies include all seniors (or even the richest quarter of seniors). This explains the ability of Bakija and Slemrod to identify statistically significant – but fairly modest – effects.

These peer-reviewed and rigorous analyses certainly show less of an impact than would be expected based on either the anecdotal evidence or fairly simplistic analysis often cited by opponents of the tax.[37] The finding that increased sales taxes and income taxes also significantly affect the number of estate tax returns filed in a state should also be kept in mind. If a choice is to be made among progressive taxes – choosing between the estate tax or a new top income tax rate, for example – it is not clear which would have the larger impact on interstate mobility.

Unfortunately, it is unlikely that the results of these studies will be updated to include data from the 21st century anytime soon. The switch from a decennial census to the annual American Community Survey (ACS) has reduced the amount of useful data that would otherwise have been included in the 2010 Census, and federal estate tax data is of much less value given the much higher exclusion levels (generally far higher than in states that have retained an estate or inheritance tax).

Discussions of mobility often refer to the 16 percent estate tax rate, and it is important to note that the effective tax rate on large estates is only 9.6%. When $16 more is paid in state tax, that $16 is deducted at the federal level. With a 40% federal rate, the $16 in state tax reduces federal tax by $6.40.

[37] For example, IRS migration data shows annual aggregate migration of tax returns and federal adjusted gross income by state. A recent article in *State Tax Notes* (Furchtgott-Roth 2013) used this data to compare out-migration from states with and without state EIG taxes. Use of the IRS migration data in this way is misleading for two reasons: (1) The data includes all migrants, with no information on their age or income and (2) the calculations ignore any other causes of migration.

Chapter 5
Policy Alternatives: Revise, Reform, Replace, or Repeal

Experience of Other States

Following the repeal of the pick-up tax and increase in the federal exclusion, other states have faced the same choices that Minnesota faces. In a majority of states, state-level estate taxes disappeared when the pick-up tax was repealed. This happened automatically in the many states where the estate tax was defined to be equal to the federal credit, because that credit was now zero. Twenty-eight states allowed their estate tax to end in 2005, though a few of them retained an independent inheritance tax. An additional 7 states have ended their estate taxes in the years since 2005 (though 2 of them retained an inheritance tax). Five states in which the estate tax ended have since reinstated estate taxes. As of 2014, 14 states and DC have an estate tax. Two of these 14 and 5 others have separate inheritance taxes, so a total of 19 states and DC now have either estate or inheritance taxes.[38, 39]

Of the 14 states and DC with estate taxes, two now have exclusions below $1 million. Five plus DC – including Minnesota – have exclusions of $1 million. Three more are at $2 million, one is at $2.75 million, one at $4 million, and two (Delaware and Hawaii) match the federal exclusion ($5.34 million in 2014 and indexed for inflation). Two other states have also indexed their exclusion levels for inflation (Washington and Rhode Island).

Minnesota tax collections are about average among the states (and DC) that have estate or inheritance taxes. In fiscal year 2011, eight states and DC collected more tax per capita than Minnesota, while ten states collected less.[40]

Appendix A shows the states that currently have an estate tax, along with characteristics of each state's tax.

Appendix B shows the states that currently have an inheritance tax, along with characteristics of each state's tax.

Appendix C shows how states responded to the end of the pick-up tax in 2005 and after.

[38] For more information on estate and gift taxes in other states, see tables A, B, and C in the Appendix.

[39] As discussed in more detail below, an inheritance tax is levied not on the estate itself but on those who receive money from an estate. Tax rates generally vary with the nature of the relationship between the decedent and the recipient. An estate tax is levied on the estate itself, at rates that do not depend on that relationship (except for a full exclusion for transfers to a spouse or qualifying charity). Tennessee's inheritance tax is repealed in 2016 but is included in the total, as is Nebraska's county-level (rather than state) inheritance tax.

[40] Several changes have been enacted in Minnesota since the date of this comparison – adding a deduction for farms and small businesses, including gifts given within three years of death, and a gift tax. The comparison only included states that still have an estate or inheritance tax in 2014.

Reform States

Of the 14 states and DC with estate taxes, all but five states remain tied to the pick-up tax structure. Stand-alone estate taxes have been enacted in five states (Washington in 2005, Hawaii in 2010, and Connecticut, Maine, and Oregon in 2011). With the exception of Hawaii, these states have chosen to address the rate bubble and the other complications created by linking to a defunct federal law rather than concentrating on moving the greatest number of taxpayers off the estate tax. Hawaii is the exception, having both eliminated the bubble and conformed to the federal exclusion. The tax structures in the five reform states are summarized in Figure 19.

Figure 19. Tax Characteristics in Reform States

State	Effective Year	Exclusion Level	Number of Rates	Tax Rates	Top Rate Starts At:
Connecticut	2011	$2 million	9	7.2% - 12.0%	$10.1 million
Hawaii	2010	$5.34 million	6	10.0% - 15.7%	$10.34 million
Maine	2013	$2 million	3	8.0% - 12.0%	$ 8.0 million
Oregon	2012	$1 million	10	10.0% - 16.0%	$ 9.5 million
Washington	2005*	$2 million	8	10.0% - 20.0%	$11.0 million

*Exemption raised from $1.6 to $2 million effective 2006 and top rate increased from 19% to 20% in 2013.

Starting tax rate: The marginal rates prior to reform were 5.6% at $1 million (ignoring the bubble) and 7.2% at $2 million. Connecticut chose to retain the starting rate at $2 million, but the other three states raised the starting rate. Despite those higher rates, tax liability fell because the 41% bubble rate was eliminated.

Top tax rate: The pre-reform top marginal rate (at 16%) started at $10.1 million. Two of the four states reduced the maximum rate to 12%. Oregon kept it at 16% but reduced the threshold. Washington raised the rate above 16% for estates valued over $6 million. Hawaii dropped the top rate slightly to 15.7%.

The Alternatives

States have generally chosen one of four paths. Most (36 in all) have chosen to have no estate or inheritance tax. A second group (9 states plus DC) has chosen to retain the link to the federal law as it existed in 2000. Three of these nine states have increased their exclusions above $1 million. A third group (the 5 reform states) has adopted stand-alone taxes with their own rate schedules and no bubble. A fourth group (5 states, soon dropping to 4) has inheritance taxes rather than estate taxes.

Two states currently have gift taxes (one with a unified estate and gift tax). Ten states have adopted a state-specific QTIP but only one (Hawaii) has adopted portability.

The rest of this chapter looks at similar choices for Minnesota. Minnesota could choose to (1) repeal the estate tax, (2) raise the exclusion without addressing the rate bubble, (3) eliminate the rate bubble with no change in the exclusion, or (4) eliminate the rate bubble and also raise the exclusion. Or Minnesota could replace the estate tax with an inheritance tax or an income tax on bequests.

Minnesota could also decide to either repeal the gift tax or follow Connecticut in enacting a unified estate and gift tax. Minnesota might also choose to adopt a state-specific QTIP or portability.

Option 1: Repeal the Estate and Gift Taxes

Minnesota could join the 31 states that have no estate or inheritance tax. Repeal would reduce estate tax revenues to zero starting roughly 9 months after the effective date, because estate tax returns are filed nine months after the date of death. If repeal were effective for deaths on or after January 1, 2014, the first returns affected would be those that would have been filed in September 2014. Figure 20 shows the revenue lost from repeal. The gift tax is assumed to be repealed retroactive to its original effective date, so refunds would need to be paid to anyone who has paid gift tax.

Figure 20. Repeal Effective for Deaths after December 31, 2013 and Gifts Made After June 30, 2013

	FY 2014	FY 2015	FY 2016	FY 2017
Estate Tax	($0)	($141,600)	($205,100)	($218,900)
Gift Tax	($5,600)	($ 12,100)	($14,500)	($18,200)
Total	($5,600)	($153,700)	($219,600)	($237,100)

Based on February 2014 forecast.

Option 2: Raise Exclusion Level, but Keep Current Rates and Tax Structure

Raising the exclusion level while leaving the tax structure tied to pre-2001 federal law will reduce the number required to file and the number who pay tax. However, raising the exclusion level does not eliminate the "tax bubble." It just moves the bubble to higher-valued estates, increases the tax bubble rate, and widens the range across which the bubble applies. Raising the exclusion level leaves tax liability unchanged for the largest estates.

The revenue impacts for alternative increases in the exclusion level are shown in Figure 21. The estimates assume that the maximum deduction for farm and small business property is reduced by the same amount the overall exclusion level raises, keeping the effective exclusion level unchanged at $5 million. Any changes to the gift tax are ignored,[41] but the three-year look-back for gifts is assumed to apply. Estimates are based on returns filed July 2012 through June 2013.

Figure 21. Revenue Impact
Increase Exclusion Level for Deaths after December 31, 2013
(Dollars in $1,000s)

	FY 2014	FY 2015	FY 2016	FY 2017
$2.0 million exclusion	($0)	($37,100)	($ 53,700)	($ 57,300)
$3.5 million exclusion	($0)	($64,900)	($ 94,100)	($100,400)
$5.0 million exclusion	($0)	($81,400)	($118,000)	($125,900)
$5.34 million exclusion*	($0)	($84,300)	($122,100)	($130,300)

*Not indexed for inflation. Impact of a higher exclusion level on the gift tax is ignored.

[41] Presumably the gift tax exclusion would also be increased to equal the new estate tax exclusion. The numbers ignore any such interaction to keep the analysis simple. Given the uncertainty about gift tax revenue, it is difficult to estimate those interactions.

Figure 22 provides perspective by showing the revenue impact as a percent of total estate tax collections under current law.

Figure 22. Revenue Impact as Percent of Estate Tax Collections

Increase Exclusion to:	Impact as Percent of Collections
$2.0 million	-26%
$3.5 million	-46%
$5.0 million	-58%
$5.34 million*	-60%

*Not indexed for inflation.

Given the current tax structure, raising the exclusion level will reduce the number of estates that would be required to file an estate tax return or pay any tax. Figure 23 shows how the proportion of those paying tax under current law falls as the exclusion rises. For example, with a $2 million exclusion only 33% of those who currently owe tax would continue to owe tax. With a $5 million exclusion, the percentage drops to 6%.

Figure 23. Impact of Raising Exclusion Level on Number Who Owe Tax

Exclusion Level	Current Payers Who Continue to Owe Tax
1.0 million	100%
1.6 million	49%
2.0 million	33%
3.1 million	17%
3.5 million	13%
4.1 million	10%
5.0 million	6%
5.34 million	5%

Although raising the exclusion reduces the number who owe tax, it has no impact on the tax liability of higher valued estates. As a result, a higher exclusion by itself does not eliminate the rate bubble, with its current-law 41% rate over a $93,785 range. Instead, the higher exclusion level by itself would *increase* both the bubble's tax rate and its range. Although it would reduce the number of estates within the affected range, it would greatly increase the *percentage* of taxable returns "in the bubble." Figure 24 shows how increased exclusion levels change the width and height of the bubble and the percentage of returns with taxable estates within the bubble's range. Conforming to the federal exclusion level (at $5.34 million in 2014 and indexed for inflation) would raise the bubble rate to 55% and leave one-third of all who still owe tax in the bubble range.

Figure 24. Impact of Higher Exclusion on the Rate Bubble

Exclusion ($ Millions)	Bubble Rate	Bubble Range ($ Millions)	Width of Range	Returns in Range
$1	41%	$1 to $1.094	93,785	139 of 1,268 (11%)
$2	49%	$2 to $2.241	240,975	70 of 418 (17%)
$3.5	55%	$3.5 to $4.012	512,107	41 of 173 (24%)
$5	55%*	$5 to $5.908	908,837	27 of 77 (35%)
$5.34	55%**	$5.34 to $6.348	1,008,341	19 of 64 (30%)

*With federal offset, ranges at 55%, 15% and 33%. ** With federal offset, 33%.

Proposals to reduce the estate tax in past years have proposed a higher exclusion level. That is also the approach taken by many other states. Simply raising the exclusion reduces the number of estates subject to the tax at the lowest possible cost because it concentrates the benefits entirely on those below or just slightly above the new exclusion level. Almost no resources are spent to reduce the tax on estates above the new exclusion level.

Option 3: Eliminate the Rate Bubble, but Keep the Exclusion at $1 Million

There are several alternative ways to do this, and three possibilities are described below.

The first keeps the rate structure unchanged except that the 41% rate drops to 5.6%. The second raises rates to keep costs down. All still benefit, but the tax reductions are phased down for higher valued estates. Estates valued over $4 million get negligible benefit. The third option is a revenue neutral alternative. It increases taxes on estates over $2.2 million to finance tax cuts for lower-valued estates.

The revenue estimates in this section assume no change in the gift tax and no other changes in the estate tax.

The tax rates assumed in each example are included in Appendix F.

***Option 3A**.* Replace 41% rate with 5.6% rate**.**

Those in the current bubble will see rates fall from 41% to 5.6%, so they will see their taxes fall by 86%. All estates above the bubble will pay $33,200 less in tax.

Revenue Impact of Option 3A

(Dollars in $1,000s)

	FY 2014	FY 2015	FY 2016	FY 2017
Estate Tax	($0)	($28,900)	($41,800)	($44,600)

There would be no change in the number paying tax. Estate tax revenue would fall by 20%.

***Option 3B**.* Modify Option 3A by raising rates so estates over $4 million receive minimal benefits. Rates would start at 8% (rather than 5.6%). Top rate is maintained at 16% with the same threshold ($10.1 million).

Those in the bubble would see rates fall from 41% to 8%, so they will see their taxes fall by 80 percent. All will see a cut in tax, but the maximum gain of $30,950 (the gain for those at the top of the current bubble) will fall to $1,000 for any estate over $4 million.

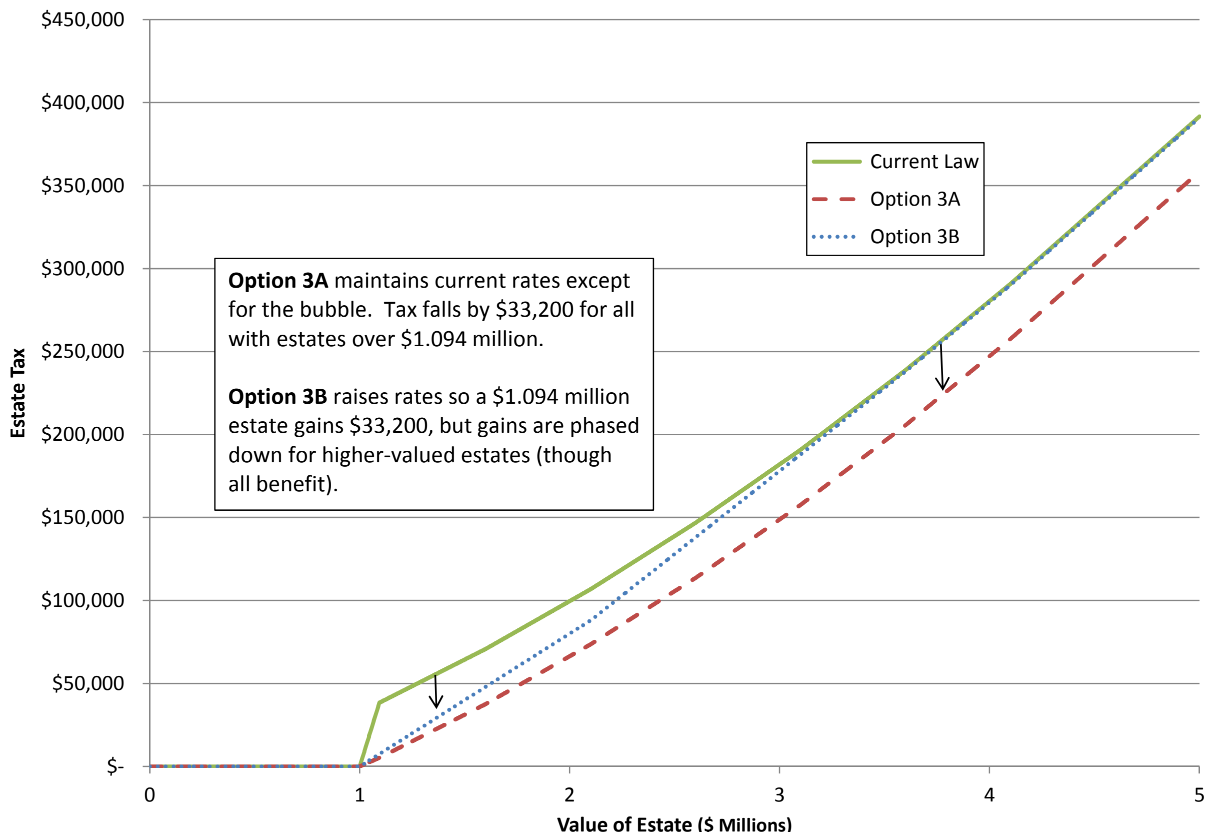
Revenue Impact of Option 3B

(Dollars in $1,000s)

	FY 2014	FY 2015	FY 2016	FY 2017
Estate Tax	($0)	($17,400)	($25,100)	($26,800)

There would be no change in the number paying tax. Estate tax revenue would fall by 12%. This is the cheapest way to eliminate the bubble without raising anyone's taxes or having a strange rate structure with rates falling over the middle of the range before rising to 16%.

Figure 25 shows estate tax liability under each of the first two options. Option 3A is a parallel downward shift, with liability falling by $33,200. Option 3B focuses tax cuts on those with smaller estates.



Option 3C. Modify Option 3B so it is revenue neutral, with tax cuts for those with estates of $2 million or less and tax increases for those with estates over $2 million.

Rates start at 10%, and top rate rises from 16% to 17%.

Those in the bubble would see rates fall from 41% to 10%, so they will see their taxes fall by 76%. The maximum tax cut ($29,073 at the top of the current bubble) will fall to $400 for a $2 million estate. Tax would rise by $50,000 (13%) for a $5 million estate and $100,000 (9%) for a $10 million estate.

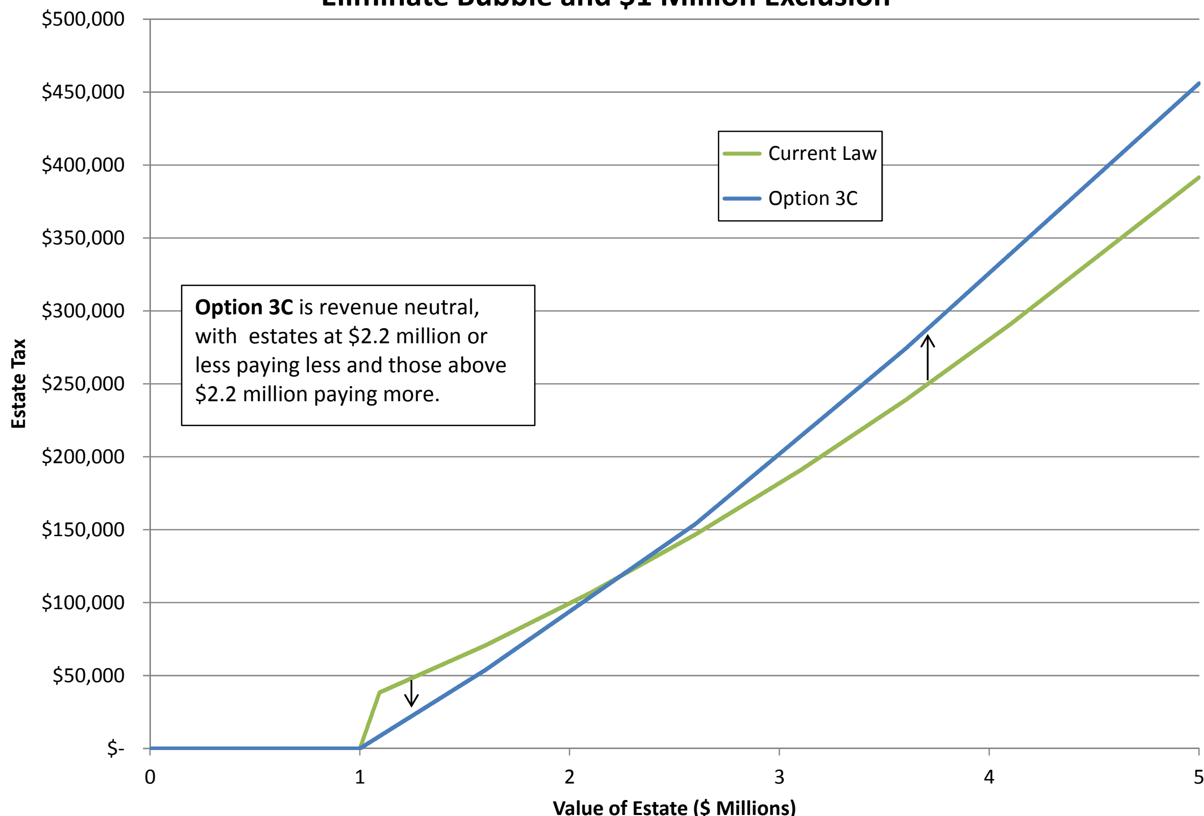
Revenue Impact of Option 3C

(Dollars in $1,000s)

	FY 2014	FY 2015	FY 2016	FY 2017
Estate Tax	($0)	($0)	($0)	($0)

Figure 26 shows estate tax liability under revenue-neutral Option 3, with lower liability for those at $2 million or below offset by higher tax liability for larger estates.

Figure 26. Revenue Neutral Eliminate Bubble and $1 Million Exclusion



Option 4. Eliminate the Rate Bubble, and Raise the Exclusion to $2 Million

As with Option 3, three possibilities are described below.

The first keeps the rate structure unchanged, so the rate at $2 million is 7.2% (rising to 16%). The second raises rates so that all benefit, but to keep costs down, the tax reductions are phased out so that there are negligible benefits for estates valued over $10 million. The third is a revenue neutral alternative, which increases taxes on estates over $2.2 million to finance tax cuts for lower-valued estates.

The revenue estimates in this section assume that the maximum deduction for farm and small business property is reduced by $1 million, keeping the effective exclusion level unchanged at $5 million. Any changes to the gift tax are ignored,[42] but the three-year look-back for gifts is assumed to apply.

Tax rates for each of the first two options are shown in Appendix F.

Option 4A. Eliminate bubble, raise exclusion to $2 million, and keep current rate schedule so rates start at 7.2%.

All estates of $2 million or less will no longer pay tax. All estates valued over $2 million will see taxes fall by $99,600.

Revenue Impact of Option 4A
(Dollars in $1,000s)

	FY 2014	FY 2015	FY 2016	FY 2017
Estate Tax	($0)	($62,900)	($91,200)	($97,300)

The number owing tax would fall by two-thirds. Estate tax revenue would fall by 44%.

Note that raising the exclusion to $2 million and eliminating the bubble costs 75% more than simply raising the exclusion to $2 million without eliminating the bubble.[43] The difference is the cost of eliminating the bubble.

Option 4B. Modify Option 4A by raising rates so estates over $10 million receive minimal benefits.

Rates would start at 10% (rather than 7.2%), and the top rate is maintained at 16% with the current-law threshold ($10.1 million).

All estates of $2 million or less will no longer pay tax. All estates valued over $2 million will see a cut in tax, but the maximum gain of $99,600 (at the level of the new $2 million exclusion) will fall to $3,000 for estates over $10.1 million.

[42] Presumably the gift tax exclusion would also be increased to equal the new estate tax exclusion. The numbers ignore any such interaction to keep the analysis simple. Given the uncertainty about gift tax revenue, it is difficult to estimate those interactions.

[43] See estimate in Figure 23.

Revenue Impact of Option 4B
(Dollars in $1,000s)

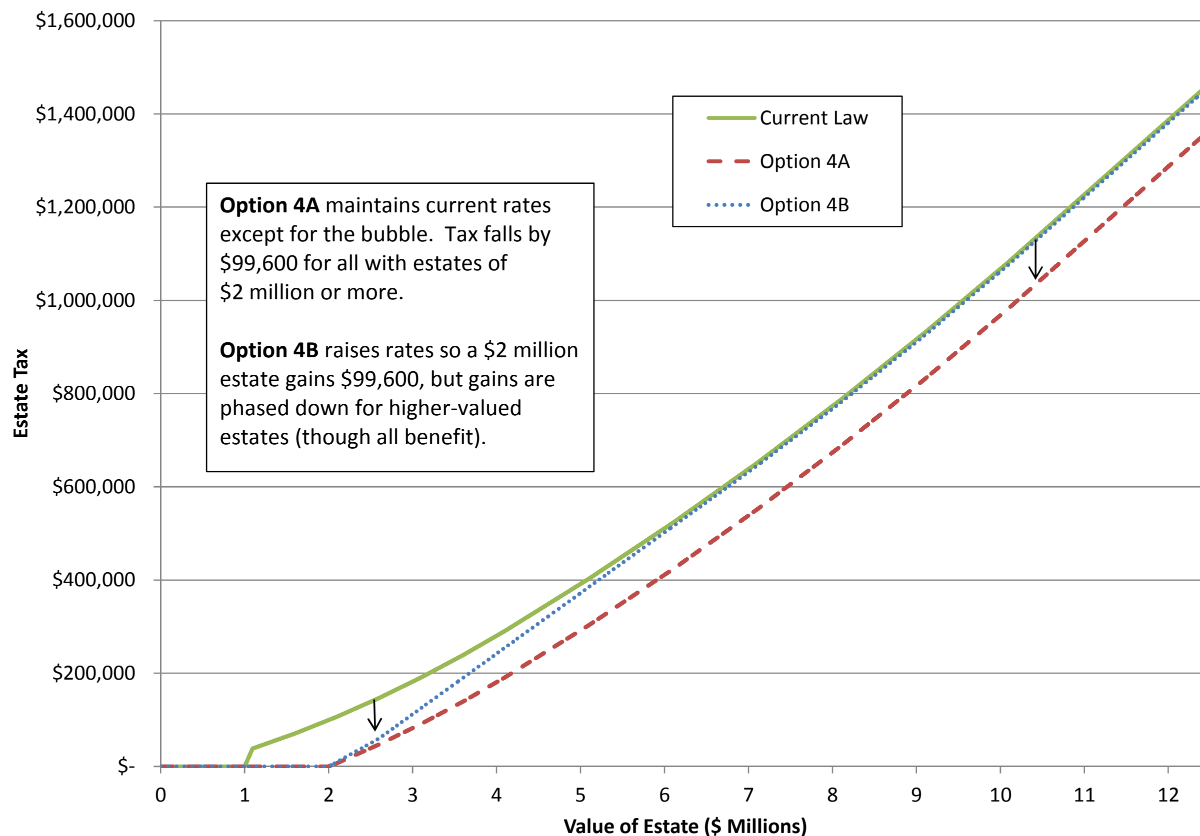
	FY 2014	FY 2015	FY 2016	FY 2017
Estate Tax	($0)	($52,400)	($76,000)	($81,100)

The number owing tax would fall by two-thirds. Estate tax revenue would fall by 33%.

Raising the exclusion to $2 million and eliminating the bubble in this way costs 45% more than simply raising the exclusion to $2 million without eliminating the bubble.

Figure 27 illustrates the impact on liability for Options 4A and 4B.

Figure 27. Eliminate Bubble with No Losers and $2 Million Exclusion



Option 4C. A revenue neutral option would require rates rising from 18% to 24% or a flat rate of 21.25%.

Summary on Stand-Alone Tax Options

A stand-alone tax addresses the rate bubble and the administrative complexities of tying the tax to defunct federal law. The tax would be much less complicated and more easily understood with tax liability calculated using a simple rate table. The stand-alone tax would also allow a fully-integrated state gift tax, which is not feasible when the initial (bubble) tax rate is 41% or more.

Eliminating the bubble is costly, though. Even if tax rates are adjusted to limit gains for the largest estates, ending the bubble by itself reduces estate tax revenue by 12% (Option 3B). The cost of raising the exclusion to $2 million rises from 26% of current revenues (retaining a 49 percent tax rate bubble) to 37% of current revenue if the bubble is eliminated (Option 4B).

Ending the bubble and raising the exclusion could be achieved at lower budgetary cost, of course, if some of the costs of reform were borne by higher-valued estates in the form of tax increases on their estates.

The options considered above do not address the impact of federal deductibility and the drop in effective tax burdens (net of the change in federal tax) starting just above the federal exclusion. A case could be made for a rate structure that makes a substantial rate jump at or near the federal exclusion level. This would mitigate the drop in effective tax rates. For example, rates of 8% to 9% below the federal exclusion could jump to 16% for estates with a value equal to the federal exclusion. This would guarantee that lower valued estates had effective tax rates (after adjusting for the drop in federal estate tax) that were below those for the largest estates. If Minnesota were designing an estate tax from scratch, such an option would be more feasible. It is unlikely that any such change could avoid tax increases for some estates compared to what they pay under current law.

Other Types of Taxes

An Inheritance Tax

Minnesota repealed its inheritance tax, switching to an estate tax, in 1979. Seven states maintain inheritance taxes, though one will be phased out by 2016 (Tennessee) and two others are in states that also have an estate tax (Maryland and New Jersey).[44]

Current estate taxes exempt transfers to a spouse, but the same rate schedule is applied to transfers to any other people, whether related or not. An inheritance tax varies the tax rate based on a recipient's relationship to the decedent. Generally, the closer the relationship the lower is the rate. All existing inheritance taxes exempt transfers to a spouse. All except Pennsylvania and Nebraska also exempt all transfers to lineal heirs (parents, children, or grandchildren), and the Nebraska tax rate on lineal heirs is only 1%. Two states exempt transfers to siblings. Transfers to unrelated or distantly related recipients are taxed at the highest rates.

[44] In those states, inheritance taxes can be claimed as a credit against the estate tax, eliminating double taxation.

As can be seen in Figure 28, the maximum inheritance tax rates in the states with no estate taxes are similar to the top rates on state-level estate taxes (15% to 18%).

Pennsylvania is an outlier, taxing transfers over $3,500 to lineal heirs at a 4.5% rate and transfers to others at 15% with no exclusion. Pennsylvania tax collections per capita are higher than in most of the states with an estate tax ($61 per capita in 2011, which is twice what Minnesota collected per capita from the estate tax). Inheritance taxes in other states raise relatively little revenue due to the full exclusion for lineal heirs (or the low 1% rate for lineal heirs in Nebraska).

The inheritance taxes generally have look-back rules that apply the tax to gifts given in the years immediately prior to death. Several also have state-specific qualified terminable interest property (QTIP) trusts.

Because only Pennsylvania levies a substantial tax on transfers to lineal heirs, the goal of the inheritance taxes in the other states does not appear to be reducing the concentration of wealth. If anything, inheritance taxes that fully exempt transfers to lineal heirs and tax transfers to others provide an incentive to transfer assets to lineal heirs rather than to others.

The full exclusion for lineal heirs raises the relative taxation of childless couples and individuals who have no lineal heirs.

Figure 28. States With an Inheritance Tax in 2014

	Lineal Heirs		Collateral Heirs		State-Specific	Look-Back for Gifts Prior to
State	**Exclusion**	**Top Rate**	**Exclusion**	**Top Rate**	**QTIP**	**Death**
IA	All		0	15%		3 years
KY	All		500	16%	yes	3 years
MD	All		1,000	10%	yes	2 years
NE	40,000	1%	10,000	18%		3 years
NJ	All		500	16%		3 years
PA	3,500	4.50%	0	15%	yes	1 year (>$3000)
TN*	1,250,000	9.50%	1,250,000	9.5%	yes	

*Phased out in 2016.

Source: Michael (2013a)

The advantage of an inheritance tax is that the tax rate can vary with the characteristics of the recipient. If policymakers want to reward or punish transfers to particular types of people, an inheritance tax would make it possible.

Despite different rates depending on relationships, the tax calculation is done for the estate and administrative costs may not be higher than for an estate tax. The tax can affect more decedents, though, including some with small estates who make bequests to non-lineal heirs.

Income Tax on Bequests

Neither the estate tax nor inheritance taxes make the tax rate depend on the income of the recipient of a transfer. If bequests were defined as income that is taxable under the income tax, then the tax rate would be higher if the recipient had high income and lower if the recipient had low income. In Minnesota, income tax rates vary from 5.35% to 9.85%.

The challenge would be in compliance. Taxing bequests would be less difficult if done at the federal level. Estates could be required to report transfers to the IRS, just like other income is reported on 1099s. At the state level compliance would be more of a challenge, because states depend on federally mandated information to identify those with unearned income. Reporting might be limited to those with estates above a reporting threshold, though. For example, all estates now required to file an estate tax return could instead be required to file an informational return identifying the beneficiaries and dollar amounts. Compliance would be more likely when both the decedent and the beneficiary were Minnesota residents.

Gift Tax Options

Repeal the Gift Tax

The estimate shown here assumes that the three-year look-back for gifts for the estate tax is maintained when the gift tax is repealed. Gift tax repeal is assumed to be retroactive to its original effective date, so refunds would need to be paid to anyone who has paid gift tax.

Revenue Estimate
Repeal for Gifts Made After June 30, 2013
(Dollars in $1,000s)

	FY 2014	FY 2015	FY 2016	FY 2017
Gift Tax	($5,600)	($12,100)	($14,500)	($18,200)

Based on the February 2014 forecast.

A Unified Estate and Gift Tax

The gift tax could be fully integrated with a stand-alone tax such as those in Options 3 and 4, in the same way that the federal gift and estate taxes have a unified tax structure. Any gift tax would be paid in full by April 15 of the year following the year the taxable gift was made, with a credit from the estate tax at death. The tax rate schedules would be unified in addition to the exclusion level. This would address a complaint about the structure of the current Minnesota gift tax.

The only reform state to have a gift tax is Connecticut, and the Connecticut estate and gift taxes are such a unified system. The federal estate and gift taxes are also unified.

The purpose of a gift tax is to eliminate unequal tax treatment of asset transfers that occur before death rather than after death. The three-year look-back under current Minnesota law includes all gifts given in the three years immediately prior to death. This prevents “death bed gifts” from avoiding Minnesota tax. In the absence of a gift tax, Minnesota tax could be avoided by gifting at least three years prior to death rather than transferring the same assets at death.

With a unified estate and gift tax, there would be no need for the three-year look-back.

If the estate tax includes the deduction for farm and small business property, a unified estate and gift tax would likely include a similar deduction from the gift tax.

State-Specific QTIPs and Portability

Overview of the Issue

Any discussion of qualified terminable interest property (QTIP) trusts is complicated. The basic conclusions of the discussion below are as follows:

- QTIP trusts are most useful for those in blended families or those who expect a surviving spouse to remarry.
- States that allow a different QTIP election for state tax than for federal tax reduce the tax planning complexity caused by different state and federal exclusion levels.
- Minnesota does not allow state-specific QTIP election.[45]
- Federal law now allows a surviving spouse to make use of any portion of the federal exclusion not used at the time the first spouse died (so-called "portability"). This has simplified estate planning and has largely reduced the need for state-specific QTIP elections.
- This is true even if Minnesota does not adopt portability for estate tax purposes.
- The case for allowing portability at the state level is fairly weak.

What is a QTIP Trust?

The estate tax is generally levied on the transfer of estates. The marital deduction is an exception to this rule. An unlimited amount of assets can be passed tax-free to a surviving spouse.

Generally, this property must be passed outright to the surviving spouse to be eligible for the marital deduction, so the spouse has full control over the use of the transferred dollars. However, the transfer of qualified terminable interest property (QTIP) qualifies for the marital deduction even though it gives the surviving spouse no discretion over the ultimate beneficiaries. The surviving spouse has a right to all of the income earned on assets in a QTIP, payable at least annually, for the remainder of the spouse's life. However, the decedent (first spouse to die) has determined the identity of the ultimate beneficiaries of the assets. Upon the death of the surviving spouse, the value of the assets elected as QTIP must be reported as a part of the second spouse's gross estate.

[45] An exception was made for decedents dying in 2010. Minnesota law provided an irrevocable QTIP election for those who opted out of the federal estate tax. The election could not reduce the taxable estate below $3.5 million, which was the federal exclusion amount in the previous year (2009).

QTIPs provide the tax benefits of the marital deduction while allowing the decedent to dictate which heirs receive the assets in the trust. This is particularly beneficial to decedents who were part of a blended family, as the following examples illustrate.

> Ex. 1) Mr. Jones has two children from a previous marriage and is currently married to Ms. Smith who also has two children from a previous marriage. Mr. Jones has promised his own children that his assets will eventually be passed to them, but he also wants to ensure the stability and comfort of Ms. Smith should he die first. Mr. Jones could establish a QTIP-eligible trust. If the executor makes a QTIP election for this trust, the income generated from the trust would provide for Ms. Smith during her life and the assets would pass to Mr. Jones' children at her death and would be subject to the estate tax at that time.
>
> Ex. 2) Mr. and Mrs. Jones had been married for 40 years, have accumulated a substantial estate together and have two children at the time of Mr. Jones' death. The assets from this estate were held in a QTIP-eligible trust and a QTIP election was made at Mr. Jones' death. Mrs. Jones eventually married Mr. Smith, and she died before Mr. Smith. The income from the QTIP-eligible trust established by Mr. and Mrs. Jones provided for the surviving spouse (Mrs. Jones) for the remainder of her life, but it also ensured that the assets would eventually pass to their children rather than to Mr. Smith.

QTIPs also allow a married couple to defer the payment of estate tax until the death of the surviving spouse, which could provide potential tax benefit.

The Context: Estate Tax Planning

A common tax-planning approach for married filers at the death of the first spouse has been to put assets into a "credit-shelter trust" in an amount equal to the estate tax exclusion.[46] The rest of the estate is transferred to the surviving spouse tax-free, using the marital deduction. Use of a credit shelter trust in this way allows distribution of the assets to be delayed but allows the full exclusion amount to avoid the estate tax at the death of the second spouse as well. In this manner, a couple can maximize their tax-free transfer to their heirs ($5.34 million for each spouse in 2014, for a total of $10.68 million free of any federal tax). The dollars deposited in the credit shelter trust would become part of the surviving spouse's estate only to the extent they are not distributed to others. In contrast, dollars transferred to the spouse using the marital deduction – if not spent by the spouse prior to death – would become part of the surviving spouse's estate. This is true of QTIP assets as well, which are included in the value of the surviving spouse's estate and are potentially subject to estate tax at his or her death.

Tax planning using credit-shelter trusts became more difficult in Minnesota and many other states starting in 2002, when the federal estate tax exclusion rose above Minnesota's exclusion. Creating a credit-shelter trust equal to the larger federal exclusion (and transferring the remainder of the estate to the surviving spouse) now created a state tax burden. Creating a credit-shelter trust equal to the lower state exclusion meant potentially paying more federal tax when the surviving spouse died.

[46] Giving assets to heirs other than the spouse at the time the first spouse dies would also allow full use of the estate tax exclusion. The examples below assume any such distribution is delayed, using the credit-shelter trust, but some mix of immediate distribution and deposits in the credit-shelter trust would work the same way.

Ex. 3) A married couple has a combined estate of $10 million ($5 million owned by each spouse), and their estate plan includes a QTIP-eligible trust. The first spouse dies in 2009, when the state exclusion is $1 million and the federal exclusion is $3.5 million. The QTIP election must be identical for federal and Minnesota purposes, so the executor must decide whether to (1) elect a marital deduction[47] of only $1.5 million ($5 million - $3.5 million) so the full $3.5 million federal exclusion can be placed in a credit-shelter trust, but pay Minnesota estate tax on $2.5 million ($3.5 million - $1 million), or (2) elect a marital deduction of $4 million, putting only $1 million in the credit-shelter trust and "wasting" $2.5 million of the federal exclusion.

This conundrum was avoided in states that permit estates to take a different marital deduction for state purposes than for federal purposes. Of the 12 states whose state exclusions differ from the federal exclusion, 7 allow the state QTIP to differ from the federal QTIP. (See Michael 2012.) This makes it possible to set up a credit-shelter trust equal to the federal exclusion without paying additional state tax at the time the first spouse dies.

Ex. 4) A married couple has a combined estate of $10 million ($5 million owned by each spouse), and their estate plan includes a QTIP-eligible trust. The first spouse dies in 2009, when the state exclusion is $1 million and the federal exclusion is $3.5 million. The QTIP election does not need to be identical for federal and state purposes, so the executor can (1) elect a federal marital deduction of $1.5 million ($5 million - $3.5 million) so the full $3.5 million can be placed in a credit-shelter trust and (2) elect a state marital deduction of $4 million ($5 million - $1 million), so no state tax is due until the second spouse dies.

Portability

The newly portable federal exclusion reduces the need for stand-alone state QTIP elections. The 2010 federal tax changes permit the transfer of any unused unified credit from the first spouse to die to the surviving spouse. Consequently, a married couple may transfer up to twice the federal exclusion free of federal gift and estate taxes. A QTIP election can be made for the estate in excess of the state exclusion ($1 million in Minnesota) without forgoing the benefits of the higher federal exclusion. The following example demonstrates the effects of this portable exclusion:

Ex. 5) A married couple has a combined estate of $10 million ($5 million owned by each spouse), and their estate plan includes a QTIP trust. The first spouse dies in 2011, when the state exclusion is $1 million and the federal exclusion is $5 million. The QTIP election must be identical for federal and state purposes, but the portable exclusion renders this point less important since excess federal exclusion can travel between spouses. The executor can, therefore, elect a federal/state QTIP deduction of $4 million ($5 million - $1 million), maximizing the state exclusion and allowing the estate to defer paying all estate tax until the second spouse dies. Since only $1 million of a possible $5 million federal exclusion was used, the remaining $4 million exclusion is transferred to the second spouse. At the death of the second spouse with a total estate of $9 million (the original $5 million + the $4 million QTIP trust – ignoring appreciation of assets) the estate can use the second spouse's full $5 million exclusion plus the remaining $4 million exclusion that was transferred after the death of the first spouse, effectively exempting the entire estate from federal estate tax.

[47] Assets may be in a QTIP-eligible trust without becoming subject to QTIP rules. The executor must make a QTIP election for some or all of the QTIP-eligible property; this property then becomes eligible for the marital deduction. These examples assume that all QTIP-eligible property is part of the QTIP election.

Even with federal portability, the state taxable amount remains the same ($8 million) at the death of the second spouse ($9 million minus the $1 million personal exclusion for the second spouse). However, none of the federal exclusion is "wasted" in the process of deferring estate tax until the death of the second spouse.[48]

While federal portability effectively eases the problem of differing state and federal exclusion limits, remarriage may eliminate some or all of its benefits. Only the unused exclusion of the most-recent spouse can be used when a taxpayer dies. Otherwise there would be an incentive to keep remarrying to pass along the portable exclusion.

Federal law also requires that portability be elected at the time the first spouse dies, even if the taxpayer is not required to file a federal estate tax at that time. If the election is not made, the surviving spouse cannot receive its benefit at the time of death.

If Minnesota chooses to move to a stand-alone estate tax, two considerations would be whether to include a state specific QTIP election and/or allow portability of the individual exclusion within married couples. The arguments for recognizing QTIPs at the state level remain the same as before.

State level portability would reduce tax in some cases. It would also allow married couples to avoid setting up two separate credit-shelter trusts (though many tax planners would suggest the two-trust format for other reasons).

In comparison to federal portability, the case for portability at the state level is much weaker, given the issues that will arise when people move from state to state. The first spouse may die while the couple is resident in another state. If no Minnesota estate tax return was filed, how would the taxpayer elect portability? Portability at the state level would seem to face great administrative challenges, and it will be difficult to treat taxpayers equally. There is a good reason why only one state has chosen to recognize portability (Hawaii, which also conforms to the federal exclusion level).

Adopting portability would reduce estate tax revenue to the extent the unused exclusion of the first decedent would be used by the second. Given the gap between the years of death, the revenue or portability would be low at first.

In addition to its revenue impact, state-level portability would also increase administrative costs for the Department of Revenue. State-level portability could greatly increase the number of returns filed to Minnesota at the death of the first spouse if portability could only be elected at the death of the first spouse (as is true under federal law). Estate planners would presumably recommend filing a Minnesota estate tax return in many cases simply to elect portability, even for estates well below the filing requirement. The additional returns would need to be processed and reviewed.

[48] Due to the progressive rate structure, deferring tax in this way may raise the effective tax on the combined estate. The taxable value will be concentrated in one estate at the time the second spouse dies. This risk will be considered in estate tax planning.

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Appendix

A. States with an Estate Tax in 2014

State	Exclusion Level	Top Rate	Stand-Alone Tax	Indexed Exclusion	State-Specific QTIP	Look-Back for Gifts Prior to Death	Gift Tax Maximum Rate	Also Have Inheritance Tax
CT	2,000,000	12%	Yes		if no federal QTIP	All years	12%	
DC	1,000,000	16%						
DE	5,340,000	16%		Yes				
HI	5,340,000	15.7%	Yes	Yes	yes			
IL	4,000,000	16%			yes			
MA	1,000,000	16%			yes			
MD	1,000,000	16%			yes	2 years		yes
ME	2,000,000	12%	Yes		if no federal QTIP			
MN	1,000,000	16%				3 years	10%	
NJ	675,000	16%				3 years		yes
NY	1,000,000	16%			if no federal tax			
OR	1,000,000	12%	Yes		yes			
RI	910,725	16%		Yes	yes			
VT	2,750,000	16%						
WA	2,000,000	20%	Yes	Yes	yes			

Source: Michael (2013a)

B. States with an Inheritance Tax in 2014

	Lineal Heirs		Collateral Heirs			
State	Exclusion	Top Rate	Exclusion	Top Rate	State-Specific QTIP	Look-Back for Gifts Prior to Death
IA	All		0	15%		3 years
KY	All		500	16%	yes	3 years
MD	All		1,000	10%	yes	2 years
NE	40,000	1%	10,000	18%		3 years
NJ	All		500	16%		3 years
PA	3,500	4.50%	0	15%	yes	1 year (>$3000)
TN*	1,250,000	9.50%	1,250,000	9.50%	yes	

*Phased out in 2016.

Source: Michael (2013a)

C. Chronology of Estate Taxes Following Repeal of Pick-Up Tax in 2005

	State	Year Eliminated	Year Reinstated	Notes
No Tax Since 2005	AK	2005		
	AL	2005		
	CA	2005		
	CO	2005		
	GA	2005		
	ID	2005		
	LA	2005		
	MI	2005		
	MO	2005		
	MS	2005		
	MT	2005		
	ND	2005		
	NH	2005		
	NM	2005		
	NV	2005		
	SC	2005		
	SD	2005		
	TX	2005		
	UT	2005		
	WV	2005		
	WY	2005		
Repealed More Recently	VA	2007		
	WI	2008		
	OK	2010		
	OH	2013		
	NC	2013		
	IN	2005		Inheritance tax through 2012
Kept Inheritance Tax	TN	2005		Inheritance tax through 2015
	PA	2005		Inheritance tax
	NE	2007		Inheritance tax
	IA	2008		Inheritance tax
Repealed and Reinstated	DE	2005	2009 temporary, 2013 permanent	
	HI	2005	2010	Stand-alone tax
	IL	2010	2013	
	CT	2005	2011	Stand-alone tax
	OR	2005	2013	Stand-alone tax replaced inheritance tax 2005 to 2012
Never Repealed	DC	not eliminated		
	MA	not eliminated		
	MD	not eliminated		
	ME	not eliminated		Stand-alone tax eff. 2012
	MN	not eliminated		
	NJ	not eliminated		
	NY	not eliminated		
	RI	not eliminated		
	VT	not eliminated		
	WA	not eliminated		

D. Deductions as a Percent of Federal Gross Estate Minnesota Resident Returns Filed in 2012

Gross Estate ($ Millions)	Spousal	Charitable	Debt	Mortgage	Funeral	Expenses	Total
$1 to $2	17.4%	3.0%	0.9%	1.2%	1.4%	0.1%	24.0%
$2 to $3.5	26.0%	3.3%	1.5%	2.1%	1.0%	0.1%	34.0%
$3.5 to $5	25.4%	4.3%	0.9%	2.3%	0.8%	0.1%	33.8%
$5 to $10	28.9%	5.6%	1.9%	1.9%	1.1%	0.1%	39.5%
Over $10	48.2%	12.6%	3.5%	1.9%	0.7%	0.3%	67.2%
Total	29.6%	6.0%	1.8%	1.7%	1.0%	0.1%	40.2%

E. Tax Rate Tables A & B from Form M706 Instructions

Table A —Use to determine step 8 of your line 1 worksheet

If step 7 of your line 1 worksheet is:

over	but not over	subtract from step 7	multiply result by	and add
$ 0	$ 10,000	$ 0	18%	$ 0
10,000	20,000	10,000	20%	1,800
20,000	40,000	20,000	22%	3,800
40,000	60,000	40,000	24%	8,200
60,000	80,000	60,000	26%	13,000
80,000	100,000	80,000	28%	18,200
100,000	150,000	100,000	30%	23,800
150,000	250,000	150,000	32%	38,800
250,000	500,000	250,000	34%	70,800
500,000	750,000	500,000	37%	155,800
750,000	1,000,000	750,000	39%	248,300
1,000,000	1,250,000	1,000,000	41%	345,800
1,250,000	1,500,000	1,250,000	43%	448,300
1,500,000	2,000,000	1,500,000	45%	555,800
2,000,000	2,500,000	2,000,000	49%	780,800
2,500,000	3,000,000	2,500,000	53%	1,025,800
3,000,000	————	3,000,000	55%	1,290,800

Enter the result on step 8 of your line 1 worksheet.

Table B—Use to determine step 24 of the line 1 worksheet

If step 23 of the line 1 worksheet is:

at least	but less than	subtract from step 23	multiply result by	and add
$ 0	$ 40,000	$ 0		$ 0
40,000	90,000	40,000	0.8%	0
90,000	140,000	90,000	1.6%	400
140,000	240,000	140,000	2.4%	1,200
240,000	440,000	240,000	3.2%	3,600
440,000	640,000	440,000	4.0%	10,000
640,000	840,000	640,000	4.8%	18,000
840,000	1,040,000	840,000	5.6%	27,600
1,040,000	1,540,000	1,040,000	6.4%	38,800
1,540,000	2,040,000	1,540,000	7.2%	70,800
2,040,000	2,540,000	2,040,000	8.0%	106,800
2,540,000	3,040,000	2,540,000	8.8%	146,800
3,040,000	3,540,000	3,040,000	9.6%	190,800
3,540,000	4,040,000	3,540,000	10.4%	238,800
4,040,000	5,040,000	4,040,000	11.2%	290,800
5,040,000	6,040,000	5,040,000	12.0%	402,800
6,040,000	7,040,000	6,040,000	12.8%	522,800
7,040,000	8,040,000	7,040,000	13.6%	650,800
8,040,000	9,040,000	8,040,000	14.4%	786,800
9,040,000	10,040,000	9,040,000	15.2%	930,800
10,040,000	————	10,040,000	16.0%	1,082,800

Enter the result on step 24 of the line 1 worksheet.

F. Tax Rates: Current Law and Selected Options

Current Law												
Value of Estate						Amount of Tax						
Not over	$	1,000,000				None						
Over	$	1,000,000	but not over	$	1,093,785				41%	of excess over	$	1,000,000
Over	$	1,093,785	but not over	$	1,100,000	$	38,452	plus	5.6%	of excess over	$	1,093,785
Over	$	1,100,000	but not over	$	1,600,000	$	38,800	plus	6.4%	of excess over	$	1,100,000
Over	$	1,600,000	but not over	$	2,100,000	$	70,800	plus	7.2%	of excess over	$	1,600,000
Over	$	2,100,000	but not over	$	2,600,000	$	106,800	plus	8.0%	of excess over	$	2,100,000
Over	$	2,600,000	but not over	$	3,100,000	$	146,800	plus	8.8%	of excess over	$	2,600,000
Over	$	3,100,000	but not over	$	3,600,000	$	190,800	plus	9.6%	of excess over	$	3,100,000
Over	$	3,600,000	but not over	$	4,100,000	$	238,800	plus	10.4%	of excess over	$	3,600,000
Over	$	4,100,000	but not over	$	5,100,000	$	290,800	plus	11.2%	of excess over	$	4,100,000
Over	$	5,100,000	but not over	$	6,100,000	$	402,800	plus	12.0%	of excess over	$	5,100,000
Over	$	6,100,000	but not over	$	7,100,000	$	522,800	plus	12.8%	of excess over	$	6,100,000
Over	$	7,100,000	but not over	$	8,100,000	$	650,800	plus	13.6%	of excess over	$	7,100,000
Over	$	8,100,000	but not over	$	9,100,000	$	786,800	plus	14.4%	of excess over	$	8,100,000
Over	$	9,100,000	but not over	$	10,100,000	$	930,800	plus	15.2%	of excess over	$	9,100,000
Over	$	10,100,000	and over			$	1,082,800	plus	16.0%	of excess over	$	10,100,000

Note: "Table B" uses estate values after deducting $60,000. These tables use estate values before thatdeduction.

Option 3A												
Value of Estate						Amount of Tax						
Not over	$	1,000,000				None						
Over	$	1,000,000	but not over	$	1,100,000				5.6%	of excess over	$	1,000,000
Over	$	1,100,000	but not over	$	1,600,000	$	5,600	plus	6.4%	of excess over	$	1,100,000
Over	$	1,600,000	but not over	$	2,100,000	$	37,600	plus	7.2%	of excess over	$	1,600,000
Over	$	2,100,000	but not over	$	2,600,000	$	73,600	plus	8.0%	of excess over	$	2,100,000
Over	$	2,600,000	but not over	$	3,100,000	$	113,600	plus	8.8%	of excess over	$	2,600,000
Over	$	3,100,000	but not over	$	3,600,000	$	157,600	plus	9.6%	of excess over	$	3,100,000
Over	$	3,600,000	but not over	$	4,100,000	$	205,600	plus	10.4%	of excess over	$	3,600,000
Over	$	4,100,000	but not over	$	5,100,000	$	257,600	plus	11.2%	of excess over	$	4,100,000
Over	$	5,100,000	but not over	$	6,100,000	$	369,600	plus	12.0%	of excess over	$	5,100,000
Over	$	6,100,000	but not over	$	7,100,000	$	489,600	plus	12.8%	of excess over	$	6,100,000
Over	$	7,100,000	but not over	$	8,100,000	$	617,600	plus	13.6%	of excess over	$	7,100,000
Over	$	8,100,000	but not over	$	9,100,000	$	753,600	plus	14.4%	of excess over	$	8,100,000
Over	$	9,100,000	but not over	$	10,100,000	$	897,600	plus	15.2%	of excess over	$	9,100,000
Over	$	10,100,000	and over			$	1,049,600	plus	16.0%	of excess over	$	10,100,000

Option 3B												
Value of Estate						Amount of Tax						
Not over	$	1,000,000				None						
Over	$	1,000,000	but not over	$	2,100,000				8.0%	of excess over	$	1,000,000
Over	$	2,100,000	but not over	$	3,600,000	$	88,000	plus	10.0%	of excess over	$	2,100,000
Over	$	3,600,000	but not over	$	4,100,000	$	238,000	plus	10.4%	of excess over	$	3,600,000
Over	$	4,100,000	but not over	$	5,100,000	$	290,000	plus	11.2%	of excess over	$	4,100,000
Over	$	5,100,000	but not over	$	6,100,000	$	402,000	plus	12.0%	of excess over	$	5,100,000
Over	$	6,100,000	but not over	$	7,100,000	$	522,000	plus	12.8%	of excess over	$	6,100,000
Over	$	7,100,000	but not over	$	8,100,000	$	650,000	plus	13.6%	of excess over	$	7,100,000
Over	$	8,100,000	but not over	$	9,100,000	$	786,000	plus	14.4%	of excess over	$	8,100,000
Over	$	9,100,000	but not over	$	10,100,000	$	930,000	plus	15.2%	of excess over	$	9,100,000
Over	$	10,100,000	and over			$	1,082,000	plus	16.0%	of excess over	$	10,100,000

F. Tax Rates: Current Law and Selected Options (Cont.)

Option 3C								
	Value of Estate			Amount of Tax				
Not over	$ 1,000,000			None				
Over	$ 1,000,000	but not over	$ 2,100,000		plus	10.0%	of excess over	$ 1,000,000
Over	$ 2,100,000	but not over	$ 2,600,000	$ 110,000	plus	10.4%	of excess over	$ 2,100,000
Over	$ 2,600,000	but not over	$ 4,100,000	$ 162,000	plus	11.4%	of excess over	$ 2,600,000
Over	$ 4,100,000	but not over	$ 5,100,000	$ 333,000	plus	12.2%	of excess over	$ 4,100,000
Over	$ 5,100,000	but not over	$ 6,100,000	$ 455,000	plus	13.0%	of excess over	$ 5,100,000
Over	$ 6,100,000	but not over	$ 7,100,000	$ 585,000	plus	13.8%	of excess over	$ 6,100,000
Over	$ 7,100,000	and over	$ 8,100,000	$ 723,000	plus	14.6%	of excess over	$ 7,100,000
Over	$ 8,100,000	and over	$ 9,100,000	$ 869,000	plus	15.4%	of excess over	$ 8,100,000
Over	$ 9,100,000	and over	$ 10,100,000	$ 1,023,000	plus	16.2%	of excess over	$ 9,100,000
Over	$ 10,100,000	and over	and over	$ 1,185,000	plus	17.0%	of excess over	$ 10,100,000

Option 4A								
	Value of Estate			Amount of Tax				
Not over	$ 2,000,000			None				
Over	$ 2,000,000	but not over	$ 2,100,000			7.2%	of excess over	$ 2,000,000
Over	$ 2,100,000	but not over	$ 2,600,000	$ 7,200	plus	8.0%	of excess over	$ 2,100,000
Over	$ 2,600,000	but not over	$ 3,100,000	$ 47,200	plus	8.8%	of excess over	$ 2,600,000
Over	$ 3,100,000	but not over	$ 3,600,000	$ 91,200	plus	9.6%	of excess over	$ 3,100,000
Over	$ 3,600,000	but not over	$ 4,100,000	$ 139,200	plus	10.4%	of excess over	$ 3,600,000
Over	$ 4,100,000	but not over	$ 5,100,000	$ 191,200	plus	11.2%	of excess over	$ 4,100,000
Over	$ 5,100,000	but not over	$ 6,100,000	$ 303,200	plus	12.0%	of excess over	$ 5,100,000
Over	$ 6,100,000	but not over	$ 7,100,000	$ 423,200	plus	12.8%	of excess over	$ 6,100,000
Over	$ 7,100,000	but not over	$ 8,100,000	$ 551,200	plus	13.6%	of excess over	$ 7,100,000
Over	$ 8,100,000	but not over	$ 9,100,000	$ 687,200	plus	14.4%	of excess over	$ 8,100,000
Over	$ 9,100,000	but not over	$ 10,100,000	$ 831,200	plus	15.2%	of excess over	$ 9,100,000
Over	$ 10,100,000	and over		$ 983,200	plus	16.0%	of excess over	$ 10,100,000

Option 4B								
	Value of Estate			Amount of Tax				
Not over	$ 2,000,000			None				
Over	$ 2,000,000	but not over	$ 2,600,000			10%	of excess over	$ 2,000,000
Over	$ 2,600,000	but not over	$ 7,100,000	$ 60,000	plus	13.0%	of excess over	$ 2,600,000
Over	$ 7,100,000	but not over	$ 8,100,000	$ 645,000	plus	13.6%	of excess over	$ 7,100,000
Over	$ 8,100,000	but not over	$ 9,100,000	$ 781,000	plus	14.4%	of excess over	$ 8,100,000
Over	$ 9,100,000	but not over	$ 10,100,000	$ 925,000	plus	15.2%	of excess over	$ 9,100,000
Over	$ 10,100,000	and over		$ 1,077,000	plus	16.0%	of excess over	$ 10,100,000

G. Minnesota Law Requiring the Estate Tax Study

2011 Laws of Minnesota, 1st Special Session, Chapter 7, Article 1

Sec. 10. **ESTATE TAX; STUDY.**

(a) The commissioner of revenue shall conduct a study of the Minnesota estate tax. The study must include at least the following elements:

(1) evaluation of the estate tax using standard tax policy principles and methods of analysis;

(2) consideration of the implications of recent federal estate tax changes, including the repeal of the federal credit for state death taxes, the increase in the federal exclusion amount, and the portability of the federal exclusion, for state estate and inheritance taxes;

(3) consideration of the advantages and disadvantages of revenue neutral alternatives to the estate tax, such as an inheritance tax, a complementary gift tax, or imposition of the income tax on bequests; and

(4) analysis of the available empirical evidence on the effects of the present and alternative tax structures of a Minnesota tax on estates or inheritances on domicile and migration decisions of residents and the implications for state revenues.

(b) In preparing the study, the commissioner shall consult with and seek advice from the probate and estate section of the Minnesota State Bar Association.

(c) By February 1, 2013, the commissioner shall submit a report to the chairs and ranking minority members of the house of representatives and senate committees with jurisdiction over taxation, in compliance with Minnesota Statutes, sections 3.195 and 3.197, of the findings of the study and identification of issues for policy makers to consider in deciding whether to revise, reform, replace, or repeal the estate tax.

EFFECTIVE DATE. This section is effective the day following final enactment.