ESTATE TAX
Differing QTIP Elections /
Deduction for State Death Taxes

April 8, 2004

	Yes	No
Separate Official Fiscal Note Requested		X
Fiscal Impact		
DOR Administrative Costs/Savings		X

Department of Revenue
Analysis of S.F. 3021 (Rest) / H.F. 3159 (Abrams)

	Revenue Gain or (Loss)			
	F.Y. 2004	F.Y. 2005	F.Y. 2006	F.Y. 2007
	(000's)			
General Fund	$0	($900)	($3,700)	($5,000)

Effective for decedents dying after June 30, 2004

EXPLANATION OF THE BILL

Current Law:
QTIP Elections: The Minnesota estate tax statutes are based on federal estate tax statutes as contained in the Internal Revenue Code. In 2001, Congress increased the exclusion amounts for years of death 2002 through 2009 applicable to federal estate tax. Minnesota did not increase the exclusion amounts applicable to Minnesota estate tax. Rather, the lower Minnesota exclusion amounts for those same years of death continue to be based on federal law prior to the 2001 federal changes. Also, current Minnesota law has no provision that, upon the death of the first spouse of a married couple, allows the executor of an estate to make a qualified terminable interest property (QTIP) election for Minnesota purposes that is different from the QTIP election made for federal purposes. The QTIP election made for federal purposes must be used for the Minnesota estate tax as well. This becomes an estate tax planning issue because it is a common practice for the executor of an estate to make a QTIP election equal to the amount of the taxable estate over the federal exclusion amount. This eliminates the federal estate tax but, because Minnesota's exclusion amounts are lower than the federal exclusion amounts, results in an estate tax being owed to Minnesota.

Deduction for State Death Taxes: The extensive changes to the federal estate tax in 2001 included the phaseout of the credit for state death taxes from 2002 through 2004. Starting with deaths in 2005, the credit is repealed and a deduction allowed for state death taxes actually paid. In 2002 Minnesota law was changed to provide that the state estate tax is based on pre-2001 federal law. In 2003 a reference in the estate tax statute to the Internal Revenue Code (IRC) was updated in order to pick up a change to expand the exclusion of land subject to the qualified conservation easement. There was no discussion in 2003 that updating the IRC reference meant that other federal changes were being adopted. In recent months a question has arisen as to how the statute should be interpreted with regard to the deductibility of state death taxes (which becomes effective for deaths in 2005).

EXPLANATION OF THE BILL (Continued)

The deduction of state death taxes also poses a calculation problem. In order to calculate the Minnesota estate tax, the taxable estate needs to be determined, but in order to calculate the taxable estate, the Minnesota estate tax needs to be determined.

Proposed Law:
QTIP Elections: The executor of the decedent's estate would be permitted to make a QTIP election for Minnesota estate tax purposes that is different from the QTIP election made for federal estate tax purposes. The property must meet the definition of qualified terminable interest property as defined in section 2056(b) (7) of the Internal Revenue Code. The Minnesota estate tax would be based on this alternative state QTIP election which would be made on the Minnesota estate tax return. Once made, the election would be irrevocable.

Deduction for State Death Taxes: The proposed law would provide that, in the calculation of Minnesota's taxable estate, state death taxes cannot be deducted from the gross estate.

REVENUE ANALYSIS DETAIL

QTIP Elections
- The Statistics of Income (SOI) Bulletin for Spring 2002 indicated that about 15.2% of federal estate tax returns filed for 1998 decedents were filed with a QTIP election. This was about 34.8% of the returns filed for decedents who were married at the time of their deaths. The percentage varied by amount of the gross estate – from about 23% for returns of married decedents showing a gross estate between $600,000 and $1,000,000, to about 71% for returns of married decedents showing a gross estate above $20,000,000.
- However, it is for the estate tax returns showing taxable estates equal to the federal exclusion ($1,500,000 for 2004) or less, regardless of whether or not a federal QTIP election might be used, where it is most likely that the executor of the estate would take advantage of a differing Minnesota QTIP election if one were made available.
- A sample of Minnesota estate tax returns for 2002 decedents was looked at where the tax amount owed to Minnesota was due to the decoupling of federal and state exclusion amounts. (For 2002, the first year of decoupling, the federal exclusion was $1,000,000 and the state exclusion was $700,000.)
- Sixty-two returns for 2002 decedents were on file showing a tax amount due of $33,200 plus or minus $10. This amount was the tax due to Minnesota for returns showing a taxable estate of $1,000,000. The amount was also applicable for 2003 decedents. A sample of returns for these two tax years was looked at and it was determined about 80% would likely have been filed using a differing Minnesota QTIP election if one had been available.
- It was estimated that the number of filings for 2002 decedents currently showing up on our estate tax return data base will increase by about 11%. It was also estimated that the number of differing Minnesota QTIP elections should be increased by an additional 10% to account for possible differing QTIP usage outside of the sampled group.

REVENUE ANALYSIS DETAIL - (Continued)

- The number of differing Minnesota QTIP elections was assumed to be 60 for each year during the forecast period.
- Under current law, if the QTIP election is for the amount of the estate over and above the federal exclusion, then the Minnesota estate tax is as follows:
    - $64,400 for deaths occurring in 2004 and 2005 based on a taxable estate = $1,500,000
    - $99,600 for deaths occurring in 2006 and 2007 based on a taxable estate = $2,000,000
- It is assumed that the returns will be filed nine months after the death of the deceased.
- Since some of the tax lost under the proposal could be recovered upon the death of the second spouse, probabilities of spousal death were estimated using the United States Life Tables, 2000. The ages of the spouses were assumed to be 76 years which is consistent with the ages of the decedents. Two-thirds of the spouses were assumed to be female.
- Approximate spousal death rates for each of the four years after the death of the first spouse are 4% per year for a female age 76 and 5% per year for a male age 76.
- Due to the uncertainty of how the estate of the second spouse will change over time, it was assumed that the amount of the Minnesota estate tax recovered upon the death of the second spouse was in proportion to the amount of the estate tax that would be lost under the proposal upon the death on the first spouse.

Deduction for State Death Taxes

- The purpose of 2002 Minnesota law changes was to base the Minnesota estate tax on pre-2001 federal law, so the changes were estimated to have no revenue impact. The intended scope of 2003 IRC update was narrow and estimated as having negligible revenue impact. The potential revenue loss from a deduction for state death taxes was not anticipated and was not included in the February 2004 forecast. Because the proposal is viewed as a clarification of prior law changes, its adoption would have no revenue impact.
- If this proposal is not adopted and if it is determined that current law allows the deduction of state death taxes, the resulting revenue loss will be included in future revenue forecasts. Since estate tax returns are due nine months after the death of the decedent, the revenue loss would start in October 2005.
- Because the marginal tax rates for Minnesota's estate tax vary from 0.8% to 16%, the potential revenue loss is estimated to be about 8%. Based on the February 2004 forecast, the possible loss to the forecasted revenue would be about $4,600,000 in fiscal year 2006 and $6,400,000 in fiscal year 2007.

Number of Taxpayers: About 60 taxpayers annually could be affected by the QTIP proposal. About 800 to 1,000 taxpayers annually could be affected by the proposal to prohibit the deduction of state death taxes.

Source: Minnesota Department of Revenue
Tax Research Division
http://www.taxes.state.mn.us/taxes/legal_policy