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Death and No Taxes?

The federal tax-reform package recently approved by the President phases out the estate tax until it is entirely eliminated in 2010. This will have an effect on revenues in Michigan, as well as other states. The prior law provides a federal tax credit for state-levied estate taxes thereby permitting states to levy a tax up to the limit of the credit without increasing the estate's *total state and federal* tax liability. The credit will be eliminated over a four-year period ending December 31, 2004, producing a negative revenue effect on all states.

Estate Taxation: Pro and Con

The estate tax is the federal government's only tax on accumulated wealth. Estate taxes are used to tax the transfer of wealth between individuals at the time of death of the benefactor. The estate tax is similar to the income tax in that exemptions and credits are applied before a progressive rate schedule is used to compute the tax. Unlike the income tax, however, the estate tax is applied only once in a lifetime rather than year by year.

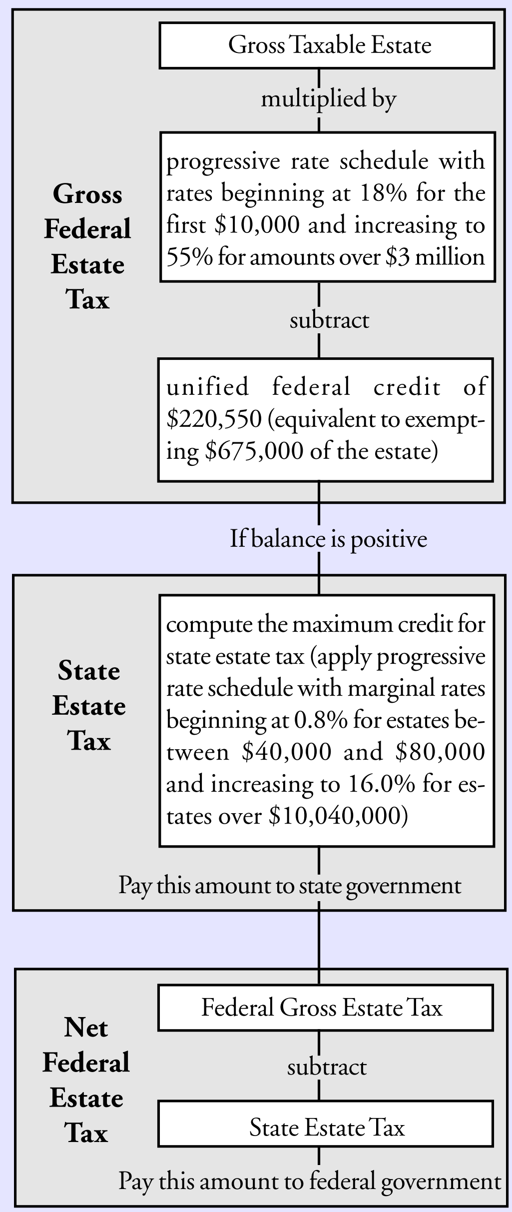
Proponents of the estate tax argue that it distributes wealth more evenly and promotes equality of economic opportunity. They also argue that the estate tax discourages heirs from unproductive lifetimes and that it has encouraged charitable giving by reducing the effective cost to potential heirs.

Opponents of the tax point out that the estate tax often prevents some family businesses from passing from generation to generation because the tax burden on the estate forces sale of the business or liquidation of some of its assets. Examples most commonly cited are family farms and non-farm family businesses. While the revenue yield from family-owned business estates is a very small percentage of the total federal estate tax revenues, the burden on some estates can be excessive.

Elimination of the Tax

Beginning in 2002, the first $1 million of each estate will be excluded from taxation. This compares with an exclusion of $675,000 in 2001. The exclusion is phased up to $3.5 million by 2009 and all estates are excluded from taxation in 2010. Considerable attention has been drawn to the fact that the new law sunsets in 2011 and tax exclusions and rates revert to the levels contained in the previous law. While the law presently expires in 2011, it seems unlikely the Congress would renege on such a major policy change without compelling financial pressures. It is more likely that extensions of the sunset date or repeal of it altogether would occur in some future session of the Congress. Nonetheless, some estate planners are advising their clients to proceed cautiously in developing their estate distributions. In addition, some

Determining Estate Tax Liabilities



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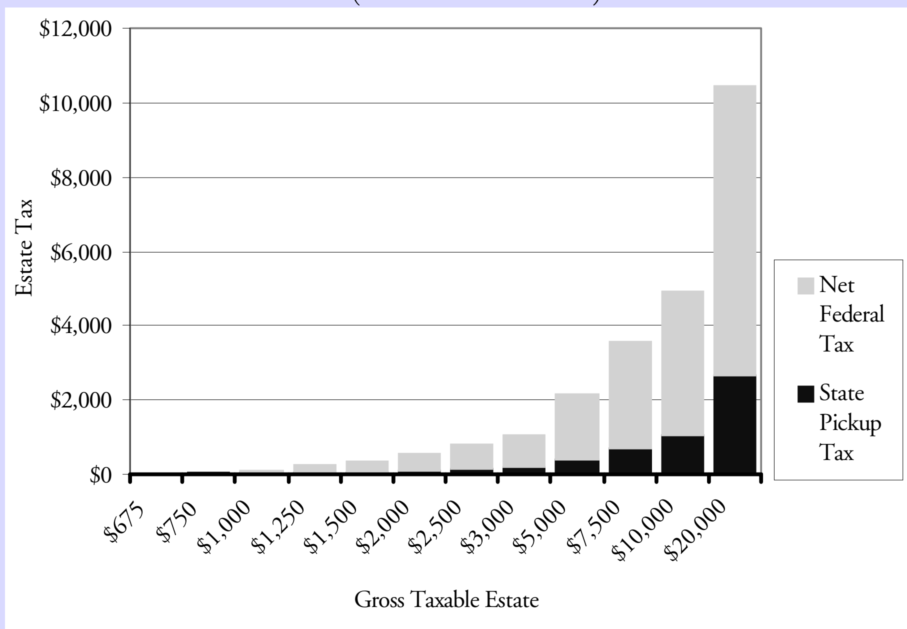
institutions are considering requiring releases from liability and other protections before handling trusts and estates in a fiduciary capacity.

State Revenue Impact

All states utilize the so-called federal "pickup tax" in computing state tax liabilities for estates. This approach sets the state liability equal to the credit allowed by the federal tax code for state taxes paid resulting in states collecting revenue with no increase in total federal-state tax liability for the estate. For example, an estate with a gross taxable amount of $1,000,000 would be taxed $125,250 by the federal government after applying the federal credit that effectively exempts $675,000 from taxation. The pickup tax has the effect of dividing the $125,250 into $33,200 for the State and $92,050 for the federal government. Chart 1 depicts the pickup tax and federal tax at various estate sizes for the law in effect for the remainder of 2001.

Chart 1
Federal and State "Pickup" Tax Revenues by Size of Gross Taxable Estate
(thousands of dollars)



The pickup tax provision in the tax code will decline in 25-percent increments over a four-year period. Michigan currently collects nearly $200 million annually. Consequently, beginning in 2002, revenues from the estate tax will decline by about $50 million annually until eliminated effective December 31, 2004. The estate tax represents only about two percent of the state's General Fund-General Purpose revenues and the reduction will occur at a rate of about one-half of one percent loss in revenue each year. Such a loss can probably be managed from normal revenue growth, so it is unlikely the State will pursue changes in state law that would prevent this loss in revenue from occurring. This unplanned reduction in state revenue, combined with other more modest state revenue reductions resulting from federal expansion of limits on income deferral programs, will nevertheless add to the difficulties in coping with the recent declines in revenues caused by the softening economy.