House Legislative Analysis Section

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INHERITANCE TAX AMENDMENTS

House Bill 5914 (Substitute H-9)
First Analysis (9-11-90)

Sponsor: Rep. Roland G Niederstadt
Committee: Taxation

THE APPARENT PROBLEM:

One of the criticisms of the state's inheritance tax is that it sometimes prevents the passing on of family farms and other family businesses because heirs are forced to sell some or all of the assets in order to satisfy tax liabilities. While there is an exemption for property that passes from one spouse to another under the state law, other close relatives must pay on a sliding scale of from 2 to 10 percent on assets over $10,000 Other heirs are taxed on inheritances at rates between 12 and 17 percent, depending on the amount inherited. (It should be noted that inherited family farm property is currently 50 percent exempt if enrolled in the farmland preservation program, and tax payments can be deferred for ten years No such treatment is available, however, for other businesses) Proposals have been made to repeal the inheritance tax entirely on estates below $600,000 and then employ a special tax arrangement that allows a state tax to work in tandem with federal death taxes. Earlier this year, Governor Blanchard vetoed legislation that would have cut inheritance tax obligations for all heirs in half. (The legislature had approved the bill in combination with renewal of a utility tax for Detroit.) Although there is disagreement over the fairness of the inheritance tax and controversy over the many proposals to reform or repeal it, there appears widespread agreement that some additional protection should be afforded family farms and businesses from the effects of the tax.

THE CONTENT OF THE BILL:

The bill would amend the inheritance tax act in the following ways:

- As of January 31, 1991, the exemption for close relatives would be increased from $10,000 to $15,000 and stepchildren would specifically be added to the list of eligible relatives. (That list includes grandparents, parents, children, siblings, wives or widows of sons and husbands or widowers of daughters The bill would add the term "widower," which is not in the language of the act now.)
- The tax on the transfer of any property of a family-owned business to qualified heirs would be reduced by 33 percent for estates of decedents dying during 1991 (after January 31); by 67 percent for estates of those dying during 1992; and 100 percent for estates of those dying after December 31, 1992. The term "qualified heir" applies to the relatives referred to above and farm business partners. The term "family-owned" means that there is material participation by the decedent or qualified heir in the operation of the business and either· 1) the business is 100 percent owned by the decedent and qualified heirs or 2) the business is 50 percent or more owned by the decedent
- Farm real and personal property inherited by qualified heirs would be 33 percent exempt from the inheritance tax for the estates of decedents dying in 1991 after January 31; 67 percent exempt for the estates of those dying in 1992, and 100 percent exempt for the estates of those dying after December 31, 1992 (Currently, farm real property is 50 percent exempt if enrolled in the farmland preservation program, with the remaining taxes due over a ten-year period. This provision would remain effective for estates of those who die before January 1, 1993)
- A tax would be imposed upon a generation-skipping transfer of an estate or any part of an estate by someone dying after December 31, 1995, if the transfer was subject to the tax on generation-skipping transfers imposed by the federal Internal Revenue Code The tax would be equal to the maximum amount of credit allowed against the federal generation-skipping tax for taxes paid to a state in respect to any property included in the generation-skipping transfer
- The state treasurer would be required to report to the committees of the House and Senate with jurisdiction over taxation on the cost of the above-mentioned exemptions and reductions The report would also have to provide a summary and review of policy and procedures concerning the taxation of the exercise of or failure to exercise limited powers of appointment.

MCL 205 201 et al

FISCAL IMPLICATIONS:

The staff of the House Taxation Committee estimates the bill will cost about $5 million in the first year, $7 5 million the second year, and $10 million when fully phased in Of the $10 million, $6 million is attributable to the exemption for family businesses, $2 5 million for the increased exemption for close relatives, and $1 5 million for the exemption for family farms (7-10-90)

ARGUMENTS:

For:

The bill would provide much-needed relief from the inheritance tax for certain carefully targeted taxpayers those who inherit family farms and other family businesses and close relatives in all cases The phased-in exemption for family-owned farms and other family-owned businesses will prevent heirs from having to sell off assets or go out of business in order to pay inheritance taxes It recognizes in state tax policy the special benefits to the state from family-owned farms and businesses and the special burden imposed on those economically important concerns by the inheritance tax. The increased exemption for all close relatives benefits small and large estates in equal amounts, and thus makes the tax more progressive. Some people believe that this is a better approach than repeal of the tax, which would result in a large tax cut for the well-off and a significant loss of revenue for the state Some who support broader inheritance tax cuts believe that this bill will nevertheless be beneficial

OVER

Against:

This is a poor alternative to meaningful inheritance tax reform. Some 28 states rely only on the "pickup tax," which essentially exempts from state taxes estates up to $600,000, (and allows the state to collect, or pick up, from federal death taxes the maximum credit allowed for state death taxes paid). This is a better approach, particularly to eliminate the incentive for older people to choose other states, such as Florida, for their official residence or even to leave the state permanently so as to reduce the taxes on their heirs. The current inheritance tax is full of unfair treatment of heirs: tax rates vary based on the amount of the inheritance and, notably, on the relationship of the heir to the deceased. (And some have described the tax as a tax on the poorly advised, because those willing to engage in various legal arrangements can reduce or avoid the tax.) Tying the state tax to the federal law would promote tax simplification and fairness. An earlier proposal, passed by the legislature but vetoed by the governor, would have cut everybody's inheritance tax in half. While not as beneficial as adopting the pickup tax, that remains a far better proposal than the meager tax cut envisioned in this bill; it would have benefitted everyone, not just provided beneficial treatment for a few while continuing a burdensome tax on many others, including many small businesses that will not qualify under this bill. The approach in House Bill 5914 would mean that a family member who inherited a business would not have to pay taxes while a family member who inherited from the same estate an equivalent amount of cash would pay taxes. Is this fair? What is needed is a significant tax cut and equitable treatment for all.

Response: Defenders of the inheritance tax say it is relatively equitable and efficient. They say there is no evidence that it causes serious outmigration, that the state's death taxes are about average nationally, and that it already features special treatment for farm property, as well as unlimited exemptions for spouses and joint owners. (Some advocates of the inheritance tax and other death taxes do not favor such special treatment, it should be noted.) A family business can avoid the tax by being jointly owned by several generations. There are those who believe that taxes on inheritances, as windfalls, should be increased so that taxes on earned income can be reduced. This, they say, would increase the motivation to work and earn. Even if the state were in the position to give away large amounts from the treasury to finance tax reductions, this is hardly the tax that many expert tax policy planners would choose as the top priority.

Against:

Small business advocates say that a great many businesses that should be considered family owned would not benefit from this bill. This is because of the definition of "family-owned," which requires certain levels of participation in the business and levels of ownership by decedents and heirs, and the definition of "qualified heir," which rules out certain family members, such as nieces and nephews. A business that has a very minor non-family partner, for example, would not qualify. To say that this bill in general benefits family-owned business is misleading at best.

POSITIONS:

The Department of Treasury supports the bill. (9-7-90)

The Michigan Retailers Association supports the bill. (9-10-90)

The Michigan Farm Bureau has not yet taken an official position on the bill but favors the concept. (9-10-90)

The Small Business Association of Michigan is opposed to the bill. (9-10-90)

The National Federation of Independent Businesses-Michigan is opposed to the bill. (9-10-90)

The Michigan State Chamber of Commerce is opposed to the bill. (9-10-90)