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BILL ANALYSIS

Senate Fiscal Agency

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Senate Bill 1024 (as passed by the Senate)

Sponsor: Senator Nick Smith

Senate Committee: Finance

Date Completed: 10-17-90

RATIONALE

For several years, there have been reports of "retiree flight", that is, retired persons changing residency to other states, particularly Florida. Among the primary reasons cited for changing residency are the advantages that other states' death taxes offer. There also have been continued complaints from small business owners and farmers who say that Michigan's inheritance tax places an unfair burden on their heirs: it has been claimed that the tax is so prohibitively high that those who inherit a small business or farm often must sell the inheritance to pay the tax.

Currently, the State's inheritance tax is computed by determining the amount of property each beneficiary receives and the relationship of the decedent to the beneficiary. (For further explanation, see **BACKGROUND**.) There are currently 28 states plus the District of Columbia that have adopted, many of them recently, what is called a "pick-up" tax. This method of taxation relies upon the application of provisions in the Internal Revenue Code to a state's treatment of death taxes. The Internal Revenue Code allows the taxpayer paying the death tax to apply a credit against the Federal estate tax liability equal to the lesser of actual state death taxes or a maximum allowable credit.

It has been argued that the adoption of this method would substantially lower Michigan residents' death taxes, and would put the State on an equal footing with most other states. Opponents of this proposal have argued, however, that adoption of the pick-up tax method would be too costly to the State. Still some people feel that since the State loses income, intangible, and sales tax revenue when

persons move their residency from Michigan, the inheritance tax laws should be amended so people would not find it advantageous to move solely for tax purposes.

CONTENT

The bill would amend Public Act 188 of 1899, which regulates the imposition and collection of State inheritance taxes, to eliminate several of the Act's current provisions and, for deaths occurring after December 31, 1990, base the State's level and method of assessing death taxes on Federal estate taxes.

Currently, the State's inheritance tax is computed by determining the amount of property each beneficiary receives and the relationship of the decedent to the beneficiary. The bill would maintain these provisions for persons who died before January 1, 1991; however, estates valued at under \$100,000 would be exempt from the State's inheritance tax. For deaths occurring after December 31, 1990, if the estate of a decedent were subject to the Federal estate tax imposed under the Internal Revenue Code, the tax due the State would be an amount equal to the maximum tax credit allowed for state death taxes against the Federal estate tax. The calculation of Federal estate tax allows persons to claim a credit against Federal tax based upon the size of the estate in question. No Federal estate tax is levied on estates of less than \$600,000. Under the bill, then, no State inheritance tax could be levied on an estate under \$600,000.

MCL 205.201 et al.

S.B. 1024 (10-17-90)

BACKGROUND

Under Michigan's inheritance tax, there is an unlimited exemption for property that passes from one spouse to another and qualifies for the marital deduction for Federal estate tax purposes. If the property does not qualify, the first \$65,000 and certain pensions and annuities are exempt from the tax. Close relatives are not taxed for the first \$10,000 transferred, but must pay 2% on the next \$40,000; the percentage increases as the amount increases, ending at 10% on amounts over \$750,000. Distant relatives, strangers, and certain corporations and organizations are taxed at a rate between 12% and 17%, while money transferred to religious, educational, or charitable organizations under certain conditions is exempt. (Note: The tax in Michigan is called the inheritance tax because it is a tax on the share that each beneficiary receives from a decedent. Other methods of taxation in other states rely on estate taxes, gift taxes, or pick-up taxes. As a rule, a tax on transfers of wealth from a decedent to another person or entity is known as a death tax. This analysis generally refers to taxes on such transfers of wealth as "death taxes".)

FISCAL IMPACT

Senate Bill 1024 would reduce State General Fund/General Purpose revenues by an estimated \$60 million to \$65 million in calendar year 1991 and each year thereafter. This direct revenue loss does not include the possible increase in other State revenues due to a lowering of State death taxes. The available evidence, however, does not support the proposition that a lowering of State death taxes would lead to a significant reduction in out-migration from Michigan to low death tax states. For further information, see the Senate Fiscal Agency memoranda of May 3, 1989, and November 14, 1988.

ARGUMENTS

Supporting Argument

Many older people who live part of the year in Michigan and elsewhere in the winter find themselves faced with the difficult decision of whether to change residency to avoid Michigan's inheritance taxes. Examination of the tax shows that it discriminates against relatives and persons other than immediate family members. Retiree flight to avoid high inheritance tax levels is occurring, and is in fact being encouraged by

estate planners. Aligning the State's death tax with the Federal estate tax credit, as is the trend recently in other states, would make the tax more progressive, and thus would encourage well-to-do Michigan residents to maintain residency in Michigan and continue to pay other State taxes such as income and intangibles tax. Although it is too late to change the lifestyle of those who already have taken the steps necessary to change residency, making Michigan's tax structure more like those of other low death tax states would make it less likely that other persons would leave the State for such tax havens as Florida and Arizona.

Supporting Argument

The inheritance tax laws as now administered simply contain too many inconsistencies, and the bill would correct these. The property a person receives from a decedent is taxed at rates that vary not only with the size of the inheritance, but also with the relationship of the person to the decedent. The inconsistencies in the tax lead to inequities. Why should a niece or nephew pay several times more than a son or daughter? Why should the estate of a decedent with no direct heirs be assessed at a greater rate than one with direct heirs? Further, jointly held property is exempt, but there are no restrictions on who can own property jointly and qualify for the exemption. Local probate courts are required to assess the clear market value of estates, but there is no way to check whether all estates are assessed uniformly. In standardizing the tax by tying it to the Federal credit, the bill would promote tax simplification and fairness in the application of the tax.

Supporting Argument

The current tax is particularly burdensome to small estates and small, family-owned businesses. First, because of the complexity of the tax, many persons have to hire legal counsel to perform the tasks required by the Act. Second, transferring the assets of a business from a decedent to another family member can be costly even without the application of the inheritance tax. Applying the current inheritance tax to some businesses, particularly if the value of the property has become inflated compared to what someone would actually pay for it without also buying the business, means that the heirs are faced with the option of paying a hefty tax bill or closing or selling the business.

These options are simply not acceptable to most heirs, and the situation created by the tax causes persons to become bitter toward the State and reluctant to expand or create other business opportunities. A dream of many small business owners and farmers is to pass the business or farm on to their future heirs--the nightmare is that many heirs are forced to sell what they've inherited to pay the inheritance tax.

Opposing Argument

The inheritance tax produces a substantial amount of revenue for the State, and the bill would reduce that revenue drastically. According to the Department of Treasury, inheritance tax returns in 1987 yielded \$107 million. While there are those who would argue that the inheritance tax contributed a very small proportion to total State revenue (1.3% of total General Fund/General Purpose revenues in 1987), it can also be argued that the ability of the State to absorb this revenue loss yearly is questionable. Although it is true that death taxes are becoming less important, nationwide, as a revenue source, the potential loss to the State could be placed in the category of "real money". Further, it must be asked, where would the lost revenue be going? The answer, it appears, is that a substantial portion of the State's loss would benefit those persons who were fortunate enough to have relatives who had accumulated wealth, businesses, or farms. When there are so many people in need, why should the State take steps to help those who least need the help?

Response: The contention that the bill would result in heavy revenue losses ignores the fact that the more persons are encouraged to stay in the State because of equitable death taxes, the more revenue is generated through other forms of taxation. In addition, when people take their dollars out of Michigan, money they have for investment is invested elsewhere. In the long run, the State would gain considerably if persons, especially those who have large estates and would face considerable inheritance taxes, didn't change their residency.

Further, the argument that this inheritance tax cut would mainly benefit the well-to-do is weak. The bill proposes an across-the-board cut; this would act as an incentive for people to work, save, and accumulate wealth so that it could be passed on to loved ones. As many states have recognized, high death taxes discourage saving. There are few people who want to work, pay

taxes, and save throughout a lifetime only to have the government become one of the major beneficiaries upon death.

Opposing Argument

To assume that persons change their residency solely on the basis of the inheritance taxes their heirs eventually will pay is not realistic. There are numerous reasons why people move from one state to another, ranging from business opportunities to the weather. While it cannot be estimated what, if any, tax revenue would be gained by keeping people from moving their primary residence to another state, it can be calculated with certainty the negative effect the bill would have on inheritance tax revenue.

Opposing Argument

A substantial portion of the tax cut embodied in the bill would go to a small number of wealthy estates, thus in essence providing tax relief to the well-to-do. The bill is an over-reaction to a problem that has been pointed out by farmers and small business owners. Because many farms and small businesses have substantial assets (in land, equipment, etc.) but little cashflow, the heirs to such operations may find it necessary to sell assets to pay the death taxes. This problem could be solved by crafting a solution that deferred payment of the taxes for a number of years, or lowered the taxes on farms and small businesses that were passed on to heirs. The bill goes far beyond what is necessary to help farms and small businesses and, in fact, offers benefits to the wealthy.

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