



Wisconsin Briefs

from the Legislative Reference Bureau



Brief 06-8

May 2006

THE ESTATE TAX IN WISCONSIN

INTRODUCTION

Wisconsin estate tax law has changed substantially in recent years in response to changes in the federal estate tax. However, the issues surrounding the estate tax are far from settled, and the legislature will soon have to readdress Wisconsin's tax. In its current form, Wisconsin's estate tax law will sunset on January 1, 2008, and, due to changes in federal law, will revert to an earlier form, thereby effectively repealing the estate tax in Wisconsin.

Several bills were introduced in the 2005-2006 legislative session to address the issue. A major element in considering the future of this tax is finding a balance between the impact that the tax has on residents' decision to continue to live in Wisconsin as they begin their estate planning and the state's need for the revenue that the estate tax generates. This brief discusses the federal estate tax and its relationship to state estate taxes, focusing specifically on the history and future of the estate tax in Wisconsin.

THE FEDERAL ESTATE TAX

In 2001, Congress passed legislation that made major changes to the federal estate tax and will eventually repeal it entirely for one year. This legislation, the Economic Growth and Tax Relief Reconciliation Act of 2001, was signed into law by the President on June 7, 2001. Beginning in 2002, the law progressively reduces the federal estate tax rate and raises the portion of an estate that is excluded from the tax in one-year increments until the tax is ultimately repealed in 2010.

The repeal of the federal estate tax is only temporary at this point. After the complete repeal of the tax in 2010, the Economic Growth and Tax Relief Reconciliation Act of 2001 will sunset on January 1, 2011, and the tax will revert to its 2001 form. Congress may extend the Act or some of its provisions beyond 2010, and most observers think it is likely to do so. The question, then, is how the Economic Growth and Tax Relief Reconciliation Act of 2001 impacts the estate tax in Wisconsin now, and what the effect will be after its 2011 sunset date.

THE RELATIONSHIP BETWEEN FEDERAL AND STATE ESTATE TAXES

The debate over changes in estate laws has resulted in some confusion over what the estate tax is. The terms "estate tax" and "inheritance tax" are often incorrectly used interchangeably. In fact, an estate tax is levied against the nonexempt portion of an estate before any of that estate is transferred; an inheritance tax is assessed only on an individual heir's inherited portion of an estate.

Only 10 states currently collect an inheritance tax. Connecticut recently taxed inheritance, but phased it out as of 2006. Today, the federal government does not levy an inheritance tax either. Instead, most inheritance taxes in the U.S. have been replaced by state and federal estate taxes.

"Pick-up" Estate Taxes in the States. Most states that presently collect an estate tax started with an independent state tax on inheritance or estates. As these state inheritance and estate tax laws grew more and more

unwieldy and unpopular, a new approach was taken by many states. In the late 1980s and early 1990s, states began employing a “pick-up” or “gap” tax that is tied to the federal estate tax. The federal tax code allows a tax credit for the amount a taxpayer pays in state estate or inheritance taxes. States that use a pick-up tax will then claim, or pick up, the whole amount allowed as a federal tax credit. Most pick-up estate taxes also exclude estates worth less than the dollar amount excluded from federal estate tax under the federal tax code. Therefore, the pick-up tax leads to a dollar-for-dollar reduction in the federal tax on those estates that are not excluded from federal estate tax. This greatly simplifies state tax laws because states no longer have to set a tax rate for, or an exclusion from, the tax; they simply incorporate the federal tax code, using its exclusion and basing their tax rate on the maximum allowable federal tax credit. Not only does this simplify the state tax law, but it standardizes it between all states that employ a pick-up tax.

Federal Estate Tax Legislation. By 2001, 38 states were using a pick-up tax. This created a problem for states, however, because the Economic Growth and Tax Relief Reconciliation Act of 2001 does not provide a consistent credit for states to base their own tax on, nor does it provide a consistent amount for exclusion from the tax. The Act also rendered a state tax based on the federal tax completely incalculable after 2005, because it completely repealed the state estate tax credit starting that year.

The Modern State Estate Tax. For this reason, many states have created their own independent estate taxes that are not directly tied to the federal tax. Seventeen states and the District of Columbia have elected to keep their estate tax even after the changes caused by the federal law. Most of these states are using a “decoupled” state estate tax. Decoupling the estate tax means that the state tax will no lon-

ger be tied to the existing federal estate tax in any way. Instead, a number of states have tied their estate tax to the rate and exclusion provided by the federal tax code as it existed prior to the changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001. Only Nebraska and Washington have elected to create a new form of estate tax, rather than simply decouple from the federal tax and refer to an older federal credit and exclusion. But in some cases, these states are facing the same problem that led them to employ a pick-up tax in the first place: a complicated and unpopular tax.

THE HISTORY OF THE WISCONSIN ESTATE TAX

The first appearance of a true tax on property left after death in Wisconsin came in 1899 on the recommendation of the State Tax Commission. The Commission recommended the tax as a solution to the problem of taxing intangible, future property under the property tax, which is regarded as the most important local and state tax of that period. The legislature enacted Chapter 355, Laws of 1899, which was the first state tax on property transferred at death in Wisconsin. The law was challenged and ultimately evolved into a transfer tax that included an inheritance tax, gift tax, and estate tax. Due to an increasing number of exceptions that made this tax system fiscally irrelevant and technically cumbersome, it was ultimately phased out over five years by a provision of the 1987 biennial budget act.

CURRENT WISCONSIN ESTATE TAX

The estate tax in its present form was adopted in 1992, after a five-year phaseout of the earlier transfer tax. The phaseout resulted in a change to the title of Chapter 72, Wisconsin Statutes, from “Inheritance, Estate and Gift Tax” to “Estate Tax”, and did away with references to, and taxes on, individual gifts and inheritance after 1991.

The Modern Wisconsin Estate Tax. The 1992 changes to the estate tax modernized it and brought it in line with 36 other states and the District of Columbia by making the tax a pick-up tax. Employing a pick-up tax meant that the state claimed the full state estate or inheritance tax credit allowed for by the federal tax code. This meant that Wisconsin no longer needed its own complicated estate tax system, as it could simply piggy-back on the federal tax code. It also meant that Wisconsin had the same estate tax as all of the other states that used a pick-up tax, so there was no tax competition between the states. Wisconsin continued to employ a pick-up tax until the Economic Growth and Tax Relief Reconciliation Act of 2001 was adopted by Congress.

Wisconsin's Response to Federal Changes. Following the adoption of the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax rate and exclusion changed each year, making it difficult for state residents to know whether, and how much, the estate tax would impact them. In 2001, Congress also started to reduce the federal tax credit for state estate taxes, which made up the entire basis of the pick-up tax, by 25% each year until it was completely eliminated in 2005.

By 2005, Wisconsin would have had no basis on which to pick up any of the federal tax if changes were not made. In 2001, Wisconsin responded, as many states did, by amending its estate tax language to continue to use pick-up tax language that referenced the state estate tax credit and exclusion as contained in the 2000 federal tax code. The language of Section 72.01 of the Wisconsin Statutes specifically references the federal tax code as it existed on the last day of 2000, one day before the Economic Growth and Tax Relief Reconciliation Act took effect.

The Future of the Wisconsin Estate Tax. The Wisconsin estate tax will automatically

revert to a traditional pick-up tax tied to the existing federal tax code when the changes adopted in 2001 sunset on January 1, 2008. However, because of the 2001 federal law, there will be no state estate tax credit to pick up after 2005. The estate tax in Wisconsin, barring a change in federal tax code, will be unenforceable, although pick-up tax language will remain in the statutes if no changes are made.

ISSUES SURROUNDING THE WISCONSIN ESTATE TAX

Like most other states, Wisconsin will soon be forced to consider the future of its estate tax. Two clear positions have emerged in the debate. Opponents of the tax seek to repeal it or to limit how much the tax takes from an estate. Supporters of the tax want to see it stabilized after years of changes, and do not want the tax to be reduced or eliminated.

Estate Tax Legislation in Wisconsin. During the last several sessions, the legislature has considered several bills to address the repeal or reform of the estate tax in Wisconsin. In the 2005-2006 session, the legislature considered 2005 Senate Bills 9 and 16, which would have lowered the estate tax by 1/3 and 1/4, respectively, in each year until 2008, when the tax will effectively be repealed due to its reliance on the federal tax credit that no longer exists. 2005 Senate Bill 35, which sought to eliminate the Wisconsin estate tax entirely as of the first day of 2007, was also introduced. There was some discussion about ways to preserve or improve the estate tax by its supporters during the 2005-2006 session, but no legislation was introduced that addressed the pro-estate tax positions.

Arguments Against the Estate Tax. Opponents of the estate tax argue that it discourages earning and saving by Wisconsin residents and encourages wealthy residents to move from Wisconsin to a state without or with a lower estate tax as they get older and begin estate planning. They also argue that the

tax amounts to double taxation: once on the income when earned, and once when it is subject to taxation as an estate. Opponents of the estate tax also claim that the tax can result in the loss of small, well-established, family-owned businesses and agricultural operations, which may be forced to dissolve in order to pay the estate tax. Finally, opponents suggest that charitable giving decreases because of the estate tax; that is, assets normally given to charity prior to death are retained to pay the estate tax.

Arguments in Favor of the Estate Tax.

Supporters of the estate tax point out that the tax generates large sums of revenue that are important to both state and federal programs that benefit all citizens. Supporters argue that the estate tax is a progressive tax because its high exclusion means it generally only impacts the large estates of the very wealthy. According to estate tax proponents, an exclusion amount of over \$1 million means that small farm and business estates are rarely sub-

ject to the tax, nor are they forced to dissolve to pay it. Finally, supporters of the estate tax say that any increase in private charitable giving resulting from the repeal of the estate tax cannot possibly offset the revenue that the tax creates.

Compromise. Some have proposed a compromise that would avoid the worst fears of supporters and opponents. One suggested approach involves a relatively high exemption so that only the largest estates are taxed, and correspondingly high tax rates for these large estates. Other possibilities include very low exemption and tax rates, so that essentially all estates will be taxed a small amount. In either case, the amount of revenue taken in by the tax remains relatively steady, and the tax either impacts very few residents to a large degree or all residents to a very small degree.

In any event, the legislature will most likely reexamine the issue again in the 2007-2008 session.