It is widely known that the federal estate tax is on the way out. Legislation enacted in 2001 phases out the tax to a point where it will disappear in 2010. This will, of course, cost the US Treasury a substantial amount of money. Less well known, however, is the fact that repeal of the federal estate tax also will drain significant revenue from every state. That is because, in varying degrees, every state ties its own taxation of inherited wealth to the federal estate tax.

Indeed, the new federal law is written in such a way that states will see the portion of their estate and inheritance systems that are tied to the federal estate tax disappear even sooner than the federal tax fully phases out.

New Jersey is no exception. At a time when a recession and the aftermath of years of questionable governmental financial practices are forcing policy makers to scramble to replace lost revenue, what has become a reliable source of state income-paid only by the wealthiest residents-is scheduled for elimination.

But it need not be the case. There are steps New Jersey can take to prevent this revenue loss and keep in place a system that has proved its worth over the years. This report explains the situation New Jersey faces and what can be done.

ESTATE AND INHERITANCE TAX BACKGROUND

At the dawn of the 20th Century, many US leaders were concerned about a growing trend toward concentration of great amounts of wealth in the hands of very few people who made fortunes during the Gilded Age. President Theodore Roosevelt was among the first to call for income and inheritances taxes, making reference to fortunes "swollen beyond all healthy limits." Supreme Court Justice Louis Brandeis said "we can have democracy in this country, or great wealth concentrated in the hands of a few; but we can't have both."

Roosevelt and Brandeis were a little ahead of their time. A federal estate tax was not imposed until 1926, more than a decade after the income tax came into being. Prior to that, however, many states already had begun to tax inherited wealth. New Jersey, according to the state Division of Taxation, first imposed an inheritance tax in 1892, at a rate of 5 percent on any assets left to any beneficiary.

At first, states objected to establishment of a federal estate tax because they believed it infringed on one of their traditional ways to raise revenue. So a compromise was reached. In creating the federal estate tax Congress included a state credit. The way that works today,
taxpayers get a dollar-for-dollar credit against any federal estate tax liability for state estate or inheritance taxes they pay, up to a certain amount—with the maximum credit depending on the size of an estate. For example, an estate in New Jersey that owes $108,000 in federal estate taxes would actually pay $98,250 to the federal government and $9,750 to New Jersey.

At this point it is important to define two terms: estate tax and inheritance tax.

An estate tax is applied to the entire value of the holdings left by a person when he or she dies, regardless of how the estate is disbursed to beneficiaries.

An inheritance tax is not paid by the estate of the deceased, but rather by the individuals who actually receive property from an estate.

In 1909 New Jersey enacted legislation that formed the basis of the state's current transfer inheritance tax. Then in 1934 the state enacted its separate estate tax law, which takes advantage of the 1926 state-federal compromise.

Over the past decade, opposition has mounted to taxing assets left when people die. Opponents took to calling this a "death tax" and argued that it negatively affected many middle-class families—even though only the wealthiest people who died each year had their estates subject to any taxation. Supporters of the estate tax tried to keep the debate in perspective. In a recent Washington Post piece he wrote in support of keeping the federal estate tax, William H. Gates Sr. (father of Microsoft's Bill Gates), observed that: "In reality the estate tax is a tax on wealth, not death, and affects only the wealthiest two percent of Americans. Poverty, on the other hand, afflicts one out of six American children."4

For the past 25 years, assets left to spouses have not been subject to the federal estate tax. Changes to the federal tax code enacted during the Clinton administration raised to $1.3 million the amount at which an estate left to a non-spouse had to be valued before any taxes were owed at all. Then, in June 2001, President George W. Bush signed legislation that incrementally repeals the federal estate tax over the course of nine years. The exemption increases to $1.5 million in 2004; $2 million in 2006; and $3.5 million in 2009. In 2010, the tax is repealed for one year, but as the law currently directs there is in 2011 a return to the 2001 estate tax laws.

Elimination of the federal estate tax nullifies that 1926 compromise. And it does so under a faster timetable than the overall repeal. While the federal tax dies in 2010, the state credit phases out on a schedule that sees it fall by 25 percent this year, 50 percent in 2003 75 percent in 2004. In 2005 it is entirely eliminated. The 20 percent of federal estate taxes that went to states under the credit system will no longer exist as revenue.

**HOW INHERITANCE IS TAXED IN NEW JERSEY**

New Jersey is not among the states whose entire system for taxing the assets of wealthy decedents is linked to the federal estate tax. In New Jersey the state estate tax is linked to the federal estate tax, and the state transfer inheritance tax is not. So New Jersey would not lose all such revenue under the federal repeal. But the losses will be significant.
The amount a state takes in from inheritance taxation can vary greatly from year to year. The death of just one super-rich person can spike revenue way up. New Jersey ranks fifth in the nation in terms of money raised on a per capita basis from inheritance taxes.

**COLLECTIONS PER CAPITA**

<table>
<thead>
<tr>
<th>State</th>
<th>Per Capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>Connecticut</td>
<td>$69.37</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>51.21</td>
</tr>
<tr>
<td>New York</td>
<td>49.03</td>
</tr>
<tr>
<td>Delaware</td>
<td>43.38</td>
</tr>
<tr>
<td>New Jersey</td>
<td>38.92</td>
</tr>
</tbody>
</table>

Source: Office of Legislative Services

New Jersey divides recipients of inherited wealth into classes for the purposes of calculating whether they owe transfer inheritance tax and, if so, how much:

**Class A**
- spouses and other immediate family members

**Class B**
- churches, hospitals, religious and charitable organizations

**Class C**
- siblings; spouse or widow/er of a child of a decedent

**Class D**
- all other beneficiaries, such as distant relatives and non-relatives

In New Jersey, taxable assets include both real estate and personal property with a value of $500 or more. The amount of the tax depends on the value of the passed on assets and the beneficiary's relationship to the person who died. Since 1985, assets left to spouses have been totally exempt from New Jersey's transfer inheritance tax. Since 1988, assets left to children, grandchildren, parents or grandparents also have been exempt. Additionally, assets given to charitable entities such as schools, hospitals, and religious institutions are not taxed.

Under a formula that takes into account the value of inherited assets and the relationship of the beneficiary to the deceased, Class C and Class D beneficiaries are taxed. Assets left to siblings, sons-in-law and daughters-in-law worth more than $25,000 are taxed. For example, if a sister leaves you assets worth between $25,000 and $1.1 million you will face a tax of 11 percent. Additionally, assets over $500 left to any other beneficiary, such as a friend or distant relative, are taxed. If a friend leaves you assets valued between $500 and $700,000, your inheritance will be taxed at a rate of 15 percent.

As mentioned earlier, New Jersey state estate tax revenues are tied to the federal estate tax law in the form of a dollar-for-dollar credit. This is not a separate tax paid to New Jersey. Rather, a portion of what would have otherwise gone to Washington as federal estate tax is sent instead to the state. The maximum amount of the credit depends on the size of the estate. Under New Jersey law, if the amount of the state inheritance tax owed is less than the
maximum credit allowed against federal estate taxes, the state tax is increased to the amount of the maximum federal credit. This increase is the state estate tax. Thus, the federal credit is the source of New Jersey's estate tax revenues. The state estate tax is commonly called a "pickup tax" or "sponge tax" because it absorbs the value of any credit against the federal tax. In effect, the estate tax credit shifts revenue to New Jersey and away from the federal government without increasing the total tax burden on an estate.

THE VALUE OF INHERITANCE TAXES IN NEW JERSEY

From 1985 to 2001 New Jersey received approximately $5 billion from the combination of its state estate tax and transfer inheritance tax—with about $1.3 billion coming from the estate tax and $3.7 billion from the transfer inheritance tax. Between 1985 and 1990, the estate tax each year represented less than 5 percent of the combined total of estate tax and inheritance tax revenues. However, in 1991 the estate tax percentage jumped to 13 percent of combined inheritance and estate tax revenues, and has continued to increase.

<table>
<thead>
<tr>
<th>Year</th>
<th>Transfer Inheritance</th>
<th>Estate</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$311.1</td>
<td>$174.7</td>
<td>$485.9</td>
</tr>
<tr>
<td>2000</td>
<td>294.5</td>
<td>208.4</td>
<td>503.0</td>
</tr>
<tr>
<td>1999</td>
<td>261.6</td>
<td>170.7</td>
<td>432.4</td>
</tr>
<tr>
<td>1998</td>
<td>257.1</td>
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<td>355.0</td>
</tr>
<tr>
<td>1997</td>
<td>203.2</td>
<td>121.9</td>
<td>325.2</td>
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<tr>
<td>1996</td>
<td>226.7</td>
<td>92.1</td>
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<tr>
<td>1994</td>
<td>195.2</td>
<td>119.5</td>
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</tr>
<tr>
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<td>176.5</td>
<td>100.4</td>
<td>277.0</td>
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<tr>
<td>1992</td>
<td>181.3</td>
<td>41.1</td>
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<tr>
<td>1991</td>
<td>193.8</td>
<td>29.8</td>
<td>223.6</td>
</tr>
<tr>
<td>1990</td>
<td>198.2</td>
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<tr>
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<tr>
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</tr>
<tr>
<td>1985</td>
<td>198.0</td>
<td>2.0</td>
<td>200.1</td>
</tr>
</tbody>
</table>

In 1995, transfer inheritance tax revenues accounted for 71.5 percent of New Jersey's total inheritance and estate tax receipts; correspondingly, the estate tax made up 28.5 percent. By 2000, the composition of the inheritance and estate tax pool was vastly different. The transfer inheritance tax made up 57.5 percent of receipts and the estate tax represented 42.5 percent.

It was expected that in Fiscal Year 2001 inheritance taxation would be New Jersey's fourth largest source of state tax revenue, after the gross income tax, sales tax and corporate business tax. For Fiscal Year 2002 the Executive Branch projected inheritance revenues at $575 million. However the Office of Legislative Services (OLS) issued an estimate of $480 million.

The Office of Legislative Services has attributed the increasing importance of the estate tax to New Jersey to changes made to the federal tax code in 1986. "Currently, the estate tax is approaching parity with transfer inheritance tax revenues," OLS notes. This means that repeal of the federal estate tax will have an even more pronounced impact on New Jersey than it would have had if it were repealed at an earlier time.

If there had been no federal estate tax in effect from 1985 to 2001, New Jersey would have lost all of the $1.3 billion in state estate tax revenue it took in during that period from the
During the span from 2003 to 2007, the Washington-based Center on Budget and Policy Priorities projects that New Jersey stands to lose $699 million. The loss would increase rapidly:

OLS notes that during this period New Jersey would see a slight increase in transfer inheritance tax revenues because assets left to siblings, sons-in-law, daughters-in-law and friends would be taxed at a somewhat higher rate. But the overall effect on New Jersey would be a dramatic loss in the total revenue from taxes on wealth left when someone dies.

The estate tax is not the only part of New Jersey's inheritance taxation system that is in jeopardy. In the legislative session that began last month, six bills already have been introduced that call for elimination of the transfer inheritance tax component too. Some specify that the tax be phased-out in three years and others would eliminate it in two.

It is important to see the magnitude of this revenue loss in perspective. With the $51 million that the state is expected to lose in 2003 from just the phasing out of the estate tax credit, New Jersey public school districts could hire 1,002 new teachers. The $101 million that would be lost in 2004 would be enough to more than pay the cost of raising income eligibility levels for the state Earned Income Tax Credit to the level of the federal EITC, ending the cutoff of thousands of families making over $20,000 a year. The $209 million loss that would be felt in 2007 is more than double the $98 million the state now is diverting from sales tax revenues to purchase open space.

WHAT CAN NEW JERSEY DO?

Doing nothing will cost the state every penny it now takes in from the estate tax segment of the inheritance tax system. Repealing the transfer inheritance tax would only compound the situation. So two steps are needed.

**Step One: Un-link New Jersey's estate tax from repeal of the federal estate tax.**

What amounts to a relatively uncomplicated change in language can undo the damage to state revenues done by phase-out of the federal estate tax. Rhode Island, Minnesota and Wisconsin have taken such steps to shield themselves from revenue loss caused by federal repeal. New Jersey easily could follow in their footsteps.

There are two primary ways for this to be accomplished. The first option is for New Jersey to act legislatively to amend the wording of the state estate tax law to insert a provision saying the tax is based on the credit that would have been available under the federal estate
tax law as it stood in 2001. The second option is to tie the New Jersey law to the 2001 federal tax law, like in the first option, but still exempt from state tax any estate that in future years would be exempt from the federal estate tax.

Under the first option New Jersey would save itself from losing a single dollar of its estate tax revenue. The second option would protect about 85 percent of New Jersey estate tax revenue.

**Step Two: Do not repeal the transfer inheritance tax.**

The state-local tax structure in New Jersey already is heavily biased against lower- and middle-income people. Driven by the over-reliance on local property taxes to pay for many governmental services that in most other states are financed through broad-based statewide taxation, taxes are not based as much on ability to pay as they could be. Indeed, according to the most recent analysis conducted by Citizens for Tax Justice in Washington, the 20 percent of New Jerseyans who have the lowest incomes pay nearly 15 percent of that income every year in the form of major state and local taxes. The richest one percent, meanwhile, pays less than 9 percent of its income in those taxes.

Unlike the sales tax-and to a greater degree than the income tax-the transfer inheritance tax is one that is likely to fall almost exclusively on upper income households.

New Jersey and the rest of the states were warned of the situation they now face. Prior to Congressional approval of the estate tax repeal bill last June, Sen. Bob Graham of Florida, a member of the Senate Finance Committee, discussed the serious potential revenue loss for state governments stemming from rapid phase-out of the state credit. The *Seattle Times* reported that "Graham said many state legislatures have been caught off guard and may have to meet in emergency sessions…to find alternate revenue sources if the estate-tax provision takes effect." Faced with having to come up with replacement revenue if the state estate levy dies, policy makers would be ill-advised to gut the other half of New Jersey's inheritance tax revenues.

New Jersey has a responsibility to its residents—children, seniors, parents, workers—to offer state services in health care, education, transportation and many other areas. Losing the revenue that comes from taxing estates and inheritance of the wealthiest among us is a high price to pay to reduce tax liability for a relatively small portion of New Jerseyans. Indeed, a recent study by the US Treasury Department found that more than 90 percent of estate taxes are paid by the estates of persons whose income at the time of death was more than $190,000 and that less than one percent of estate tax comes from those whose income at the time of death was less than $100,000.

With New Jersey facing what appears to be its worst state budget crisis in recent memory, the emphasis should be on keeping the existing inheritance tax arrangements in place. Letting the estate tax die, killing the transfer inheritance tax—or doing both—is unsound policy.

This report was written by NJPP Policy Analyst Sarah Stecker, a Masters in Public
Administration candidate at the Robert F. Wagner Graduate School of Public Service, New York University

END NOTES


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