TESTIMONY OF SHARON WARD BEFORE THE HOUSE FINANCE COMMITTEE
OCTOBER 17, 2011

Thank you for the opportunity to testify today. My name is Sharon Ward. I am Director of the Pennsylvania Budget and Policy Center, a non-profit, non-partisan research project. PBPC provides budget and fiscal analysis and public education in support of policies that improve the economic and social well-being of low- and middle-income Pennsylvanians.

State inheritance and other wealth transfer taxes are unpopular, but they play a valuable role in state tax policy. They provide a significant source of income for state services and make the tax system more fair.

Prior to 1980, almost all states levied both an estate pick-up tax and a separate inheritance tax. Over the course of time, many states repealed inheritance taxes but retained federal estate pick-up taxes. Currently, 9 states (Indiana, Iowa, Kentucky, Maryland, Nebraska, New Jersey, Ohio (repealed effective 2013), Pennsylvania, and Tennessee) have inheritance taxes, and an additional 16 states and DC levy estate taxes (Connecticut, Delaware, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, North Carolina, Oregon, Rhode Island, Vermont, and Washington).

During the fiscal crisis, states have made numerous changes to their estate taxes. During the period 2009-2011, two states eliminated estate taxes (Oklahoma and Kansas) and two states reinstated the tax (Delaware and Hawaii). Estate taxes in North Carolina and Illinois sunsetted with the federal estate tax but were revived by state legislatures. Three states increased estate tax exemptions (Connecticut, Rhode Island and Vermont). Oregon modified its estate tax, with a rate change that will reduce tax for estates between $1 million and $2 million, but increase the tax on estates of more than $2 million.

At their current values, Pennsylvania’s top inheritance tax rates are comparable, or lower than, other state inheritance taxes. In Indiana, for example, the rate for descendents and ancestors ranges between 1% and 7%, for siblings between 7% and 15%, and for all others between 15% and 20%. In Iowa, the rate for siblings ranges from 5% to 10% and for all others between 10% and 15%, while in Kentucky the rate for nieces and nephews ranges from 4% to 16% and for all others between 6% and 16%. I have attached a document prepared by the Center on Budget and Policy Priorities which details state inheritance tax rates and policies in 2011 (Appendix A).

Most states with inheritance taxes include an exemption from the inheritance tax of some portion of the transfer, although it tends to be small, and have a graduated rate based on the value of the share, which makes the tax more equitable. Pennsylvania’s uniformity clause prohibits this approach.

The inheritance tax structure is another reason why Pennsylvania should consider eliminating the uniformity clause and establish a tax structure that is based on ability to pay.

Pennsylvania has is one of the terrible 10 most regressive state tax systems, according to the Institute on Tax Policy (ITEP). When all taxes are considered, the lowest 20% of Pennsylvania non-elderly taxpayers pays 11.3% of their income in state and local taxes, the middle 20% pay 9.6% and the top 1% pay an effective tax rate of 5.0%.

Pennsylvania should maintain its inheritance tax and should only make adjustments that address important policy objectives.

First, the inheritance tax is an important, consistent source of revenue for Pennsylvania, raising between $700 million and $800 million, roughly 3% of General Fund tax revenue. This amount is about what Pennsylvania spends on long-term care for the elderly through the General Fund each year.

Most estates subject to the inheritance tax are quite small. According to the Pennsylvania Department of Revenue, from 1990-2002, an average of 58,584 taxpayers per year of death filed inheritance tax returns. The average amount of taxable assets during that period was $137,582.

The amount of inheritance tax paid by most Pennsylvanians is small. The inheritance tax is not levied on bequests to husbands and wives. The tax is levied on the value of the inheritance *after* deducting mortgages, outstanding debts and other liabilities. In addition, donations to charities are exempt from the tax.

The tax is paid by the estate prior to the distribution of the share, so it is almost invisible to many beneficiaries.

Also, Pennsylvania does not have a gift tax, so a family member may make a gift anytime during their lifetime (except the last year) tax-free.

In 2002, there were roughly 56,000 estates under $2 million dollars. The average value of estates that year was $171,000 and the average inheritance tax payment was $8,782. For estates over $2 million, the average estate was worth around $6,322,000 with an average tax owed of $182,682.

While tax rates for the inheritance tax seem on the face to be high, one needs to consider the effective tax rate, which is the tax paid on total (gross) assets – assets before deductions such as debts, mortgages or charitable contributions. In 2002, the effective tax rate for estates under $2 million was 5.9% and for estates over $2 million was only 2.9%.

Only about half of estates file inheritance tax returns. In 2002, there were 129,855 deaths, leaving 72,881 estates that did not file, and presumably were not subject to the tax at all.

The inheritance tax, although a flat tax, has a mildly progressive effect. In 2002, estates valued at $2 million or more were 1.4% of all estates but paid 23% of the inheritance tax.

The tax rate for bequests to lineal heirs (children, parents and grandparents) is only 4.5 percent, which is down from a 6% rate in effect until 2000. About 50% of all filers fell into this category in 2004-05. This rate is only slightly higher than the income tax rate on ordinary income. So a lineal heir receiving a share at the $171,000 average would receive $165,750 if the income were taxed at the 3.07% rate and $163,305 after the estate pays the inheritance tax, a difference of $2,445.

So why have an inheritance tax at all?

Public services that are provided by state government aid in the accumulation of private wealth. Roads and transit, police and courts, public schools and colleges, immunizations and health initiatives each play a role in the lives of individuals and contribute to their economic success. The inheritance tax provides a form of reinvestment in the state and in our communities. It allows us all to give something back.

The inheritance tax does more than raise revenue. It also helps reduce concentrations of power and promote equality of economic opportunity, a value promoted in 1916 when Congress adopted the modern national estate tax, and a value we share today.

The inheritance tax captures the value of untaxed assets of the largest estates. A significant portion of the value of estates, and the majority of the value of the largest estates, has not been taxed as income because it is in the form of unrealized capital gains. Without an inheritance tax, asset appreciation included in an estate would never be taxed. The beneficiaries also benefit in that their taxable basis is stepped-up to current market value, meaning their capital gains will be lowered in the future.

As discussed above, Pennsylvania's inheritance tax could be improved. The uniformity clause is an impediment, but the commonwealth could establish a tax credit for taxes paid on the first $25,000 of an estate. This could function like a $25,000 exemption which would most benefit the smallest value estates.

The family exemption of $3,500 has not been increased since 1995. It can only be used by relatives who live in the same household as the decedent while the family member is settling the estate. The definition of family member could also be expanded to include more distant relatives who may be living with the decedent.

Other proposals need to be considered based on policy goals and costs. Lowering the tax to lower the tax is to my mind not a valid objective. Siblings, aunts, uncles and other friends and neighbors are unlikely to have contributed to the economic success of the individual and so what is the harm in assessing a reasonable tax on those transfers?

For the closest relatives, the inheritance tax rate now is slightly higher than the personal income tax rate, so the difference for the bulk of taxpayers will not be a large dollar amount.

Debts, costs and charitable contributions are exempt from the tax, so the decedent's liabilities will not be borne by other family members.

Estate and inheritance taxes promote work and discourage sloth**.** This sentiment was best expressed by Andrew Carnegie more than 100 years ago: "The parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and leads him to lead a less useful and less worthy life than he otherwise would."

As a state and a nation, we value equality of opportunity and individual enterprise. The inheritance tax helps to level the playing field to allow each of us to achieve success based on individual talents and the sweat of our brow.

Appendix A.

State Inheritance Taxes Provisions
(updated September 2011)

Indiana

Exemptions:

All transfers to a surviving spouse are exempt. Charitable contributions are exempt. Other exemptions vary based on the relationship to the decedent:

Class A - lineal descendent or ancestor
(child, grandchild, parent, grandparent) $100,000
Class B – siblings, their descendents, spouse or
widow of child $500
Class C – all others $100

Rates: vary by class and by size of bequest

Value of Share (after exemption is applied)		Class A	Class B	Class C
Over	But less than			
0	25,000	1%	7%	10%
25,000	50,000	2%	7%	10%
50,000	100,000	3%	7%	10%
100,000	200,000	3%	10%	15%
200,000	300,000	4%	10%	15%
300,000	500,000	5%	10%	15%
500,000	700,000	6%	12%	15%
700,000	1,000,000	7%	12%	15%
1,000,000	1,500,000	8%	15%	20%
1,500,000		10%	15%	20%

Collections:

Indiana Inheritance tax revenue	
Fiscal Year	Amount (millions)
FY00	$119.2
FY01	134.7
FY02	123.9
FY03	165.7
FY04	132.3
FY05	150.3
FY06	149.0

Source: Indiana Department of Revenue Annual Report, October 1, 2006

Iowa

Exemption levels:
All transfers to a surviving spouse, parents, children and lineal descendents are exempt. Contributions to in-state and some out-of-state charities are exempt. No tax is levied on estates with value of less than $25,000 after deducting debt.

Class A – spouse, parent, child, lineal descendent
Class B – sibling, spouse of child, step child
Class C – all other persons
Class D – some out-of-country charitable organizations
Class E – for-profit organizations

Rates: vary by class and by size of bequest

Value of Share (after exemption is applied)		Class A	Class B	Class C	Class D	Class E
Over	But less than					
0	5,000	0%	5%	10%	10%	15%
5,000	12,500	0%	5%	10%	10%	15%
12,500	25,000	0%	6%	10%	10%	15%
25,000	50,000	0%	7%	10%	10%	15%
50,000	75,000	0%	7%	12%	10%	15%
75,000	100,000	0%	8%	12%	10%	15%
100,000	150,000	0%	9%	15%	10%	15%
150,000			10%	15%	10%	15%

Collections:

Kentucky

Exemption levels:
All transfers to surviving spouse, parents, children, grandchildren and children adopted during infancy are exempt. Charitable contributions are exempt. Other exemptions vary based on the relationship to the decedent:

Class A - surviving spouse, parents, children, grandchildren,
and children adopted during infancy, siblings 100%

Class B – nieces, nephews, spouse of child, aunt, uncle: $1,000

Class C – all others $500

Rates: vary by class and by size of bequest

Value of Share (after exemption is applied)		Class A	Class B	Class C
Over	But less than			
0	10,000	0%	4%	6%
10,000	20,000	0%	5%	8%
20,000	30,000	0%	6%	10%
30,000	45,000	0%	8%	12%
45,000	60,000	0%	10%	14%
60,000	100,000	0%	12%	16%
100,000	200,000	0%	14%	16%
200,000	500,000	0%	16%	16%
500,000		0%	16%	16%

Collections:

Maryland

Maryland's inheritance tax equals to 10% of bequests made to persons other than a surviving spouse, child, stepchild, parent, grandparent, stepparent, lineal descendent, or sibling.

Exemptions: Individual transfers of less than $1,000 are exempt. Charitable contributions are exempt.

Nebraska

Nebraska's inheritance tax is administered by the counties.

Exemption levels:
All transfers to a surviving spouse are exempt. Charitable contributions are exempt. Other exemptions vary based on the relationship to the decedent:

Class A - lineal descendent or ancestor (child, grandchild, parent, grandparent), sibling, surviving spouse of these — $40,000

Class B – aunt, uncle, their descendents, spouses of descendents — $15,000

Class C – all others — $10,000

Rates: vary by class and by size of bequest

Value of Share (after exemption is applied)		Class A	Class B	Class C
Over	But less than			
0	10,000			
10,000	15,000			18%
15,000	40,000		13%	18%
40,000	And above	1%	13%	18%

Collections: Information on statewide collections is not available.

New Jersey

Exemption levels:
All transfers to a surviving spouse are exempt. Charitable contributions are exempt. Other exemptions vary based on the relationship to the decedent:

Class A – spouse, (grand) parent, child, adopted child, mutually acknowledged child, stepchild, grandchild — 100%

Class C – sibling, spouse or widow(er) of child — $25,000

Class D – all others — no exemption

No tax on individual transfers of less than $500.

Rates: vary by class and by size of bequest

Value of Share (after exemption is applied)		Class A	Class C	Class D
Over	But less than			
0	25,000	0%		15%
25,000	700,000	0%	11%	15%
700,000	1,100,000	0%	11%	16%
1,100,000	1,400,000	0%	13%	16%
1,400,000	1,700,000	0%	14%	16%
1,700,000		0%	16%	16%

Collections:

Ohio Estate tax not inheritance but was never tied to federal provisions. (**Repealed effective July 1, 2013**)

Exemption Level: Estates valued at $338,333 and below are exempt. (There is a credit equal to the lesser of $13,900 or the amount of taxes owed.)

Rates:

Taxable Estate Equal to or More than	Taxable Estate Less than	Tax on Amount in Column 1	Plus Rate of Tax on Excess Over Amount in Column 1
$338,833	$ 500,000	$ 13,900	6%
500,000		23,600	7%

Based on data from the Ohio Department of Taxation, I estimate that the average effective rate of Ohio's estate tax is 3.1 percent once deductions are taken into account.

The 7,515 estates that owed tax in 2005 represented about 7% of deaths.

Pennsylvania

Exemptions: All transfers to surviving spouse are exempt. Family exemption of $3,500. No dollar exemption for most other heirs

Rates: vary by relationship to decedent.

Class A – Spouse, to parents from children under 21.
Class B – Lineal heirs (children, stepchildren, parents, and grandparents)
Class C – Siblings.
Class D – all others

Class A	Class B	Class C	Class D
0%	4.5%	12%	15%

Special provisions:
Life insurance payments are exempt from inheritance tax.
Pensions, Individual Retirement Accounts, Keough accounts and the like are exempt from tax if the death occurs before an individual reaches the age of 59 ½.
Liabilities and Debts are deducted from the value of the estate, before any tax is calculated.
Many Federal pensions, including SSI death benefits, railroad pensions, military and national services pensions are exempt from the tax.
Small businesses transferred as part of an estate have five years to pay the inheritance tax, but must pay interest on the balance.
Farmland is valued as farmland, not other uses

Collections:

Pennsylvania Inheritance tax revenue	
Fiscal Year	Amount (millions)
FY00	$819.1
FY01	799.8
FY02	779.6
FY03	693.8
FY04	747.6
FY05	716.1
FY06	745.2
FY07est	765.5

Tennessee

Exemption level: $1,000,000

All transfers to a surviving spouse are exempt. Charitable contributions are exempt.

Rates: vary by size of bequest

Value of Share (after exemption is applied)		
Over	But less than	
0	40,000	5.5%
40,000	240,000	6.5%
240,000	440,000	7.5%
440,000		9.5%