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POLICY BRIEF

Restoring Wisconsin's Estate Tax

The projected \$5.4 billion deficit in the next state budget is likely to lead to cuts in state spending for programs that are essential to the state's most vulnerable children and families. However, there are fair and progressive ways to hold down the magnitude of the cuts. Restoring the estate tax, which expired in 2008, would affect only a few of the state's wealthiest residents while generating about \$100 million annually.

Only 800 to 900 Wisconsin estates--fewer than 2 percent of the Wisconsin residents dying each year--would now be subject to a tax like that which was in effect until 2008.

Wisconsin's recently expired tax was imposed only when the estate's value exceeded \$675,000, and there was no tax on amounts left to a husband or wife. (Couples that engaged in tax planning could exempt as much as \$1,350,000.)

The tax would not take a significant portion of the estate. On average it would take about 5 percent, and far less for smaller estates because of graduated tax rates. The tax in effect until last year was only \$64,400 on an estate with a taxable value of \$1.5 million, and \$280,400 on a \$4 million estate. (The taxable estate equals gross estate less deductions for funeral and administrations expenses. The calculations assume that no part of the estate is left to a spouse.)

The estate tax expired in Wisconsin because of a 2001 change in federal law, which affected the vast majority of states whose state estate taxes were tied to the federal tax. Wisconsin and many other states responded by "decoupling" from the federal law, which

preserved the state-level estate taxes. The decoupling legislation in Wisconsin expired in at the end of 2007, which resulted in at least the temporary expiration of the Wisconsin estate tax last year. However, the federal change approved in 2001 sunsets in 2011, which means that Wisconsin's estate tax will resume then (with a \$1 million exemption), barring any changes in state or federal law.

Though imposed only on a few estates, the tax has been generating more than \$100 million per year. That amount rose to \$150 million in FY 2008. Because it often takes a year or so for estate taxes to be paid, the state is just starting to feel the fiscal effects of its expiration in January 2008, and there would also be a delay in collecting estate tax revenue if the tax were restored.

During an economic downturn, restoring the estate tax is a far more sensible option than many other alternatives. Because states have to balance their budgets, they are in a fiscal and strategic bind during a recession. Increases in broad-based taxes can take money out of the economy, especially if the tax falls more heavily on low-income state residents. Cutting state spending can have an even more immediate and larger negative effect on the economy because it quickly cuts into state or local employment or reduces state contracts with the private sector.

Tax increases have less effect on the state economy if they fall on people who live in other states or on higher income individuals, whose spending is less likely to be affected by a tax increase or a tax cut. For that reason, the

estate tax is an appropriate tax to restore during this difficult fiscal time, since many of the people who bear the burden of the tax are out-of-state relatives of the deceased person. In addition, even assuming they live in Wisconsin, the tax on inherited wealth will have far less near-term effect on the state economy than a broad-based tax.

A state estate tax may have some negative impacts, but they appear to be fairly limited. Most studies show that the estate tax may encourage some wealthy persons to move to another state. However, factors like proximity to family and climate are much more important. A National Bureau of Economic Research study indicated that even though the estate tax might contribute to some persons' decision to move, it generates far more revenue than it loses because of this migration. The \$150 million generated by the Wisconsin estate tax in FY 2008 attests to this point.

There is not a lot of evidence to support the argument that an estate tax dampens entrepreneurship. That should not be surprising, since the burden of the tax is relatively small, about 5 percent. This small burden also means that the tax seldom poses an obstacle on transferring farms or small businesses from one generation to the next, another concern raised by critics of the tax.

Raising the exemption could soften the impacts. The \$675,000 exemption under the tax in effect until this year was put in place in 2000, so it may be appropriate to raise it to a higher amount if the tax is restored. A \$1 million

exemption would eliminate the tax for about 40 percent of the estates otherwise taxable, but the estimated revenue reduction would only be about 7 percent. With a \$1.5 million exemption, about two-thirds of estates otherwise taxable would be exempt, while revenues would fall by only about 20 percent.

Because a higher exemption would eliminate the tax for a substantial number of estates and lower the assessment on those still subject to the tax, it would lessen the small incentive for wealthy persons to move from the state, reduce any disincentive for entrepreneurship, and largely eliminate any obstacles for passing farms and small businesses to the next generation.

Conclusion

Restoring the estate tax would generate revenue that would protect programs benefiting thousands of state residents from budget cuts. Falling on only the largest estates, the tax would affect fewer than 1,000 estates each year and amount to only 5 percent of those estates on average. Reinstating the tax is likely to have limited effects on entrepreneurship or decisions regarding where to live, and in all but a few instances would not hinder the passing of farms and small businesses to the next generation. Raising the threshold below which estates are exempt from the tax is a better way to address these concerns, while still generating substantial revenue to fund needed programs and avoid spending cuts that exacerbate the recession.