LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS

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FISCAL IMPACT STATEMENT

LS 6684 **DATE PREPARED:** Jan 31, 2001
BILL NUMBER: HB 1939 **BILL AMENDED:**

SUBJECT: Inheritance Tax Exemptions.

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FUNDS AFFECTED: X GENERAL **IMPACT:** State & Local
DEDICATED
FEDERAL

Summary of Legislation: The bill provides that each Class A transferee or Class B transferee inheriting a family farm or a family business is allowed an Indiana Inheritance Tax exemption equal to the amount of the estate's unified credit against the federal estate tax. The bill also provides that the amount of the exemption increases incrementally to $1 million for family farms and family businesses transferred by persons who die after June 30, 2006. The bill requires transferees who inherit a family farm or a family business to materially participate in the operation of the farm or business for at least ten years following the decedent's date of death. The bill also provides that the amount of Inheritance Tax exempted that exceeds the exemption available under current law is subject to recapture if the transferee disposes of the property or ceases to use the property for the family farm or family business. The bill provides that the finally determined federal Estate Tax value of a property interest is presumed to be the fair market value of the property interest for Indiana Inheritance Tax purposes in all circumstances. (Current law provides that the finally determined federal Estate Tax value does not apply to family farms and family businesses valued under Section 2032 of the Internal Revenue Code and requires the transferees to use the property's fair market value.)

Effective Date: July 1, 2001.

Explanation of State Expenditures: *County Replacement:* The bill could potentially result in a reduction in the amount of resident Inheritance Tax revenue retained by the counties. The minimum revenue loss to counties due to the exemption for transfers of qualified family-owned businesses or farms to Class A or B transferees is estimated to range from approximately $78,000 to $91,000 statewide beginning in FY 2003. The revenue loss to counties from allowing the finally determined federal Estate Tax value to be the fair market value of a property interest is indeterminable and believed to be minimal. As a result of the revenue loss, the bill could potentially increase expenditures from the state General Fund relating to the Inheritance Tax replacement for counties. The impact on the state General Fund may not equal the revenue loss to the counties since most are retaining more revenue than is guaranteed under the replacement procedure. Since the Inheritance Tax does not have to be paid until a maximum of 18 months after the decedent's death (within

12 months of the date of death to receive the 5% early payment discount), the impact that the bill may have on county replacement would be somewhat delayed. See Explanation of Local Revenues, below, for further explanation of the replacement procedure.

Department of State Revenue: The bill would impact the Department of State Revenue administratively by requiring the Department: (1) To ensure that exemptions are being claimed for qualified family farms and family businesses; (2) to ensure that transferees claiming the exemption maintain the required interest and qualified use of the farm or business for ten years; and (3) to recapture exempted Inheritance Tax if the transferee fails to so maintain the farm or business. Information-sharing between the Department and the U. S. Internal Revenue Service could potentially lower the administrative cost of these activities as they relate to estates utilizing the federal special use valuation provisions (relating to valuation of a family farm) or the federal qualified family-owned business interest deduction (QFOBI) for federal Estate Tax purposes. However, information obtained from the IRS would likely not include information on all transferees who inherit qualified family businesses or farms and utilize the Inheritance Tax exemption proposed in the bill. This is because the filing requirement for federal Estate Tax is currently $675,000 (increasing to $ 1.0 M in 2006) and the exemption proposed in the bill would be available to transferees inheriting the business or farm from estates that do not meet the federal filing requirement.

Explanation of State Revenues: The bill could potentially lead to a reduction in revenue from the Inheritance Tax. Such a reduction could potentially lead to an increase in revenue from the Estate Tax. However, the net effect of the bill is indeterminable. The revenue loss from allowing the finally determined federal Estate Tax value to be the fair market value of a property interest is indeterminable and believed to be minimal. The revenue loss due to the exemption for transfers of qualified family-owned businesses and farms to Class A or B transferees is not completely known. Depending upon the proportion of those inheriting a family business or farm who are Class A or B transferees, the minimum revenue loss could range from approximately $925,000 to $1.08 M per year beginning in FY 2003.

Finally Determined Federal Estate Tax Value: The bill allows the finally determined federal Estate Tax value to be the fair market value of property interest for Indiana Inheritance Tax purposes. As a result, it is possible that some property interests could be valued at a lower amount than under current law. This would serve to decrease revenue from the Inheritance Tax. The amount of the revenue loss is indeterminable and is believed to be minimal.

Exemption for Family Farms and Businesses: The bill provides an exemption from Inheritance Tax for the value of a qualified family-owned business or farm that is transferred by a decedent to a Class A or B transferee. Eligibility for the exemption requires that the transferee continue to materially participate in the use of the property as a business or farm for ten years following the decedent's date of death. The maximum value of the exemption increases annually for six years from $675,000 for transfers by decedents who die after June 30, 2001 but before July 1, 2002; to a maximum of $1.0 M for transfers by decedents who die after June 30, 2006. The minimum reduction in Inheritance Tax revenue annually could vary from a low range of approximately $924,000 to $938,000 to a high range of approximately $1.08 M to $1.1 M beginning in FY 2003. The upper bound in each range could not be reached until the third year of the phase-in of the exemption.

In addition to the exemption, the bill contains a recapture provision. The impact of the recapture provision cannot be estimated. Under the recapture provision, if the transferee disposes of an interest in a qualified business or farm, or ceases to use the property as a business or farm, within ten years of the decedent's date of death, the tax reduction due to the exemption is subject to recapture by the Department of State Revenue.

The amount subject to recapture is equal to the difference between the amount of Inheritance Tax exempted under this provision and (presumably) the amount exempted under the Class A or Class B exemption (equal to $100,000 for Class A transferees and $500 for Class B transferees), depending upon the classification of the transferee. This provision really only has important implications relating to Class A transferees. Given that the bill does not prohibit a Class A transferee from taking the $100,000 exemption against other property transfers, it would presumably allow such a transferee to retain $100,000 of the family-owned business or farm exemption. For instance, if a Class A transferee receives a qualified family-owned business worth $1,000,000 and $100,000 in stock from a decedent who dies between July 1, 2001 and June 30, 2002, total exemptions under the bill would equal $775,000 ($675,000 for the business plus the $100,000 Class A exemption). However, if the transferee sold the business one year later, the Department would only be able to recapture the Inheritance Tax on $575,000 of the family-owned business exemption.

Background: According to an Internal Revenue Service report, 34 federal Estate Tax returns filed by Indiana estates in 1999 utilized the federal Estate Tax deduction for a qualified family-owned business interest (QFOBI). In addition, three federal Estate Tax returns filed by Indiana estates in 1999 took advantage of the special use valuation provisions for family-owned farms. These federally-recognized transfers of family-owned businesses and farms would qualify for the exemption proposed in the bill. The QFOBI deductions totaled approximately $22.31 M, an average of $656,059 per return, and the special use value deductions totaled approximately $2.39 M, an average of approximately $795,333. The estimates are based on the average value of the QFOBI and special use value deductions claimed by Indiana estates in 1999, depending upon the maximum exemption allowed in any given year.

The low range estimate assumes that the properties for which these deductions were claimed were transferred to Class A transferees. However, it was found that only 50% of transferees receiving property from Indiana estates exceeding $675,000 were Class A transferees, while 25% were Class B transferees. Thus, the high range estimate assumes that only 17 of the qualified businesses and two of the qualified farms were transferred to Class A transferees. This estimate also assumes that nine qualified business and one qualified farm were transferred to Class B transferees. The effective Inheritance Tax rate utilized for Class A transferees is equal to 3.8% and the effective tax rate for Class B transferees is 9.2%. The distribution of transferees and the effective tax rate for Class A transferees was estimated using an Office of Fiscal and Management Analysis (OFMA) database consisting of Inheritance Tax returns relating to decedents who died between July 1, 1997, and June 30, 2000. The database consists of 112,951 transferee records. It is assumed that the sample is representative of the universe of persons paying the Inheritance Tax. Only transferees receiving property interest transfers from estates which would be filing federal Estate Tax returns in 2001 (gross estate value of $675,000) were utilized. This sub-sample contained 14,319 transferee records. Roughly 50% of the transferees in this sub-sample are Class A transferees and 25% are Class B transferees. The tax rate is the ratio of the total Inheritance Tax liability of the Class A transferees in the sub-sample to the total interest value for those transferees.

<u>It is important to note that the estimated revenue loss is a minimum and could potentially be higher because it does not account for transfers of family-owned businesses and farms from small estates (those that fell below the filing requirement for the federal Estate Tax in 1999)</u>. The filing thresh hold for the federal Estate Tax in 1998-99 was $625,000-$650,000.

<u>Explanation of Local Expenditures:</u> In order to utilize the exemption, the transferee must file with the appropriate probate court an agreement to materially participate in the continued operation of the family business or farm. The impact of this requirement is indeterminable.

Explanation of Local Revenues: Counties retain 8% of the Inheritance Tax collected on transfers made by Indiana residents. The minimum revenue loss to counties due to the exemption for transfers of qualified family-owned businesses or farms to Class A or B transferees is estimated to range from approximately $79,000 to $91,000 statewide beginning in FY 2003. The revenue loss to counties from allowing the finally determined federal Estate Tax value to be the fair market value of a property interest is indeterminable and believed to be minimal. It is important to note that a reduction in the amount of Inheritance Tax retained by counties due to the bill may be reimbursed by the state under the replacement provision established by P.L. 254-1997. The replacement provision was established when the Class A exemption was increased on July 1, 1997. The replacement provision guarantees that in each fiscal year each county receives an amount under the Inheritance Tax that is equal to the five-year annual average amount of Inheritance Tax revenue retained by that county from FY 1991 to FY 1997, excluding the highest and lowest year. Therefore, a reduction in tax retained by a county due to the bill would be reimbursed only to the extent that the changes made by the bill cause the amount of tax revenue retained by the county to fall below its guaranteed amount. Currently, most counties are retaining more Inheritance Tax revenue than is guaranteed under the replacement procedure. A copy of a spreadsheet showing the amount of Inheritance Tax replacement guaranteed to each county under P.L. 254-1997 is available from the Office of Fiscal and Management Analysis.

State Agencies Affected: Department of State Revenue.

Local Agencies Affected: Counties.

Information Sources: Bill Reynolds, Department of State Revenue, 232-2156.
Estate Tax Returns Filed in 1999 (Nation & Indiana): Selected Items by Taxable Status, Statistics of Income Program, U. S. Internal Revenue Service, January 2001.
Barry Johnson & Jacob Mikow, Statistics of Income Program, U. S. Internal Revenue Service, (202) 874-0316 & (202) 874-0313.
OFMA Inheritance and Estate Tax Databases.
2001 U. S. Master Tax Guide, CCH.