Approved: January 19, 2006
Date

MINUTES OF THE SENATE ASSESSMENT AND TAXATION COMMITTEE

The meeting was called to order by Chairman Barbara Allen at 10:30 A.M. on January 18, 2006 in Room 519-S of the Capitol.

All members were present.

Committee staff present:
Chris Courtwright, Kansas Legislative Research
Martha Dorsey, Kansas Legislative Research
Gordon Self, Revisor of Statutes Office
Judy Swanson, Secretary

Conferees appearing before the committee:
State Senator John Vratil
Martin Dickinson, Kansas University Professor
Bill Waugh, Attorney
Jim Weisgerber, Kansas Department of Revenue
Brad Harrelson
Allie Devine
Marlee carpenter
Leslie Kaufman, Kansas Cooperative Council (Written Only)

Others attending:
See attached list.

Senator Donovan requested the introduction of two bills. The first concerning a tax exemption for the Kansas Food Bank Warehouse in Wichita; and the second to change property tax on automobiles in Kansas. Senator Bruce moved the introduction of both requested bills. Senator Pine seconded the motion, and the motion passed.

Hearing on: SB 356–concerning estate tax taxation
SB365–enacting the Kansas estate tax law

Senator John Vratil testified the Kansas estate tax is clearly dysfunctional. (Attachment 1) He shared examples of some of the more bizarre aspects of the current estate tax. The state will incur a loss of approximately $50 million in annual revenue if the estate tax is repealed.

Martin Dickinson, Kansas University Law Professor specializing in tax law, said the existing estate tax has significant problems, and should be fixed, but indicated no preference between adopting a stand-alone estate tax for Kansas and repealing the Kansas estate tax. (Attachment 2) He distributed copies of his published article, The Kansas Estate Tax Problem. (Attachment 3)

Bill Waugh, attorney, testified he has experienced numerous problems with his clients regarding the existing Kansas estate tax law, especially in the Kansas City area where Kansans move across the state line to Missouri to avoid the estate tax. (Attachment 4)

Jim Weisgerber, Kansas Department of Revenue, reviewed provisions in **SB 365.** (Attachment 5) The current estate tax will become almost impossible to administer. The State only has two employees who work on the problems with the estate tax and its collection.

Brad Harrelson, Kansas Farm Bureau, thanked the Committee for **SB 356**, and said KFB opposes any type of death tax. (Attachment 6)

Senator Donovan requested Legislative Research to provide information about what other states are doing in regard to estate taxes.

Allie Devine, Kansas Livestock Association, testified in favor of **SB 356** and in opposition to **SB 365**.

MINUTES OF THE Senate Assessment and Taxation Committee at 10:30 A.M. on January 18, 2006 in Room 519-S of the Capitol.

(Attachment 7) She said the estate tax should be repealed because it disrupts businesses, reduces incentives to save and invest, is difficult to administer, and has a negative impact on environmental conservation. She included "The Economics of the Estate Tax: An Update from the Joint Economic Committee of the United states Congress" with her testimony. She will provide the Committee with suggested amendments to **SB 365.**

Marlee Carpenter, The Kansas Chamber, testified in favor of **SB 356** (Attachment 8) and in opposition to **SB 365** (Attachment 9) She provided a proposed KDOR regulation revising the definition of residency with her testimony.

Written testimony was received from Leslie Kaufman, Kansas Cooperative Council in support of **SB 356.** (Attachment 10)

A memo entitled, Estate Tax Receipts Under Current Law, **SB 365** and **SB 356,** was presented by Legislative Research. (Attachment 11)

Hearing on **SB 356** and **SB 365** was closed.

Senator Donovan moved to approve the January 11 Committee meeting minutes. Senator Bruce seconded the motion, and the motion passed.

Richard Cram, on behalf of Governor Sebelius, requested a military check off bill for a military family relief fund. Senator Schmidt moved to introduce the requested bill. Motion was seconded by Senator Donovan and was passed.

Being no further business, the meeting adjourned at 11:35 a.m.

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

SENATE
ASSESSMENT & TAXATION COMMITTEE

GUEST LIST

DATE: 01-18-06

NAME	REPRESENTING
Jim Weisgerber	KDOR
Hal Hudson	NFIB/KS
Bill Brady	C.S.
Julie Hein	Hein Law Firm
Mary Jane Stankiewicz	KGFA/KARA
Brad Harrelson	KFB
Kathy Olsen	Ks Bankers Assn.
Mike Beam	Ks LVSTK. ASSN.
Terry Holdren	Kansas Farm Bureau
Jim Clark	Ks Bar Assoc.
Ann Durkes	DOB
David R. Corbin	KDOR
Richard Cram	KDOR
Leslie Kaufman	Ks Coop Council
Dana Hoffman	Ks Assoc of Wheat Growers
Ronald Richey	ME
Terry Forsyth	KNEA
Elaine Martin	KDOR

SENATE
ASSESSMENT & TAXATION COMMITTEE

GUEST LIST

DATE: 1/18/06

NAME	REPRESENTING
Brenda Sweezey	KDOR
Claudia Weaver	Bob Vancrum
Tom Palace	PMCA of Kansas
Pam Scott	KS Funeral Directors Assn
Marlee Carpenter	KS Chamber
Debbie Meador	KLA
Aileen Devine	KLA

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TESTIMONY IN SUPPORT OF S.B. 356 and S.B 365
Before the Senate Committee on Assessment and Taxation
January 18, 2006

You have before you today two bill concerning the Kansas estate tax. One of those bills, Senate Bill 356, repeals the existing Kansas estate tax. The other bill, Senate Bill 365, enacts a free-standing Kansas estate tax which is decoupled from the federal estate tax. At least three choices are presented to this Committee: (1) You can do nothing and allow a dysfunctional tax to remain in effect, (2) you can recommend repeal of the existing estate tax, or (3) you can recommend adoption of a free-standing estate tax. You may ask why something needs to be done on the issue of our existing Kansas estate tax!

The Kansas estate tax is clearly dysfunctional. Currently, the estate tax makes planning and compliance extremely difficult for both taxpayers and tax practitioners, while creating problems of interpretation and administration for the Kansas Department of Revenue. Beginning in 2007, the Kansas estate tax will produce truly bizarre results. There is serious doubt whether the post-2006 estate tax provisions accurately reflect legislative intent. This Legislature should either fix the estate tax or repeal it.

Let me briefly share with you some of the more bizarre aspects of the current Kansas estate tax. The estate tax incorporates provisions of the United States Internal Revenue Code as they existed on December 31, 1997. This requires any lawyer or accountant handling estate taxes to be a historian, having to determine what the Internal Revenue Code said more than eight years ago. Some forms that are required to file an estate tax return are no longer available.

Current Kansas law provides that beginning in 2007, the filing threshold for the Kansas estate tax will be determined by the Internal Revenue Code as it existed on December 31, 2001. This will dramatically change the minimum amount required for taxability in Kansas. In 2005, the threshold was $950,000. In 2006, it will be $1 million. In 2007 and 2008, that threshold will jump to $2 million and will increase to $3, 500,000 in 2009. It now appears that the Kansas

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estate tax will then be effectively repealed in 2010. The result of increasing the minimum amount required for taxability is a dramatic reduction in revenue from the Kansas estate tax over the next three years and repeal of that tax in 2010. It is my recollection that these provisions of the Kansas estate tax were added to the bill in the final hectic hours of the 2003 Legislative Session. I question how many legislators were aware of these dramatic results.

The most bizarre result from the current estate tax provisions results from a disconnect between the exemption amount and the filing threshold beginning in 2007. For example, in 2007 and 2008, a Kansas taxable estate of $2 million will have no tax liability whatever. But a Kansas taxable estate of $2,000,001 will have a tax liability of $99,600. As another example, in 2009, a Kansas taxable estate of $3,500,000 will have no tax liability whatsoever. But a Kansas taxable estate of $3,500,001 will have a tax liability of $229,200. These results are irrational and have no basis in common sense.

I encourage you to read, or at least review, an article written by Prof. Martin Dickinson for the November/December, 2005, issue of "The Journal of the Kansas Bar Association." That article is entitled "The Kansas Estate Tax Problem." I have distributed copies of that article to each committee member.

The current Kansas estate tax has significant defects and the problems it creates become more serious beginning in 2007. For that reason, it is important that the Legislature fix this problem in 2006. Perhaps this Committee will recommend repeal of the estate tax and loss of approximately $50 million in annual revenue it produces. However, if the Committee decides to recommend retaining the estate tax, it is important that the tax problems be fixed. Those problems arise from continued linkage with federal law. Adoption of a free-standing estate tax will permit the Legislature to make its own decisions as to how much revenue an estate tax should raise, what the filing threshold should be, what rate structure should be imposed, and how the tax should be interpreted and administered. Citizens of Kansas should not be left at the mercy of a dysfunctional Kansas estate tax.

SENATE COMMITTEE ON ASSESSMENT AND TAXATION

TESTIMONY OF MARTIN DICKINSON* REGARDING SENATE BILLS 356 AND 365

JANUARY 18, 2006

1. The existing Kansas Estate Tax has significant problems, and the defects will become severe in 2007.

2. The Kansas Estate Tax should be repealed (Senate Bill 356) or replaced by a new law that is free of the current defects (Senate Bill 365).

3. Defects in the current law

   A. The current law imposes a tax equal to a credit that was formerly allowed under the United States Estate Tax. The current law requires application of the Internal Revenue Code as it existed on December 31, 1997–more than 8 years ago.

   B. Beginning in 2007, there will be dramatic "tax cliffs," i.e., situations in which a tiny additional amount in the estate triggers a very large tax.

      (1) If the decedent dies in 2007 and the gross estate and taxable estate totals $2,000,000 or less, no tax will be due. If, however, the decedent's gross estate and taxable estate total $2,000,100, a tax of $99,607 will be due. In other words, $100 of additional estate triggers a tax liability of $99,607.

      (2) The "tax cliff" problem will become more dramatic in 2009. If a decedent dies in 2009 and the gross estate and taxable estate totals $3,500,000 or less, no tax will be due. If, however, the decedent's gross estate and taxable estate total $3,500,100, a tax of $229,210 will be due. In other words, $100 of additional estate triggers a tax liability of $229,210.

   C. Beginning in 2007 there will be circumstances in which a smaller taxable estate pays more tax than a larger taxable estate.

   D. Currently the exemption is $1,000,000. The exemption will rise to $2,000,000 in 2007 and to $3,500,000 in 2009. In 2010 the Kansas estate tax will be permanently repealed. These dramatic changes are produced by the following sentence, which was added to the law in the final days of the 2003 session:

      > "For estates of decedents dying on or after January 1, 2007, the determination of whether the estate is required by federal law to file a return for federal estate taxes shall be made by referring to the provisions of the United States internal revenue code of 1986, as such code exists on December 31, 2001."

      One must wonder how many legislators (or others) understood the effects of this obscure language.

   E. Executors of decedents' estates must apply current federal law in determining

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federal tax liability but must apply federal law as of December 31, 1997, in determining Kansas tax liability. This discrepancy has created serious interpretation problems for the Department of Revenue, especially where a will includes formula provisions tied to federal law.

F. The defects are more fully explained in an article titled "The Kansas Estate Tax Problem," which appeared in the November-December 2005 Journal of the Kansas Bar Association. I have copies available for those who wish them.

4. Senate Bill 356 would repeal the Kansas Estate Tax, effective upon publication in the statute book.

5. Senate Bill 365 would replace the current law with an entirely new estate tax.

A. SB 365 is a "free-standing" tax in the sense of being free of connection to federal law, except for reliance on federal law for certain definitions. This would eliminate all of the problems described above.

B. SB 365 incorporates longstanding and well established principles regarding both the assets to be taxed and the deductions available.

C. According to the Department of Revenue, the rate structure provided in Section 3(b) is revenue neutral in the sense that it would raise the same $52 million annually that is produced by the current law.

D. Section 6 provides that land valued as agricultural property for property tax purposes will be assigned the same value for estate tax purposes.

E. Section 9(a) provides that any gifts made by the decedent within one year prior to death are added back to the decedent's estate and subjected to tax. This is necessary because Kansas does not have a gift tax, and "deathbed" transfers could otherwise be used to avoid the Kansas estate tax.

F. Sections 25 through 50 are procedural and largely replicate procedural provisions already embodied in KSA 79-15,129 through 79-15,144.

G. Section 51 provides that the new law would apply to decedents dying after December 31, 2005.

H. SB 365 was drafted by a group of experienced estate planning lawyers, chaired by Nancy Schmidt Roush of Overland Park, with the assistance of James Weisgerber of the Department of Revenue.

---

* Although I am a member of the faculty of the School of Law of the University of Kansas, the views expressed are strictly my own and do not represent those of the School of Law or the University

The Kansas Estate Tax Problem

By Martin Dickenson[1]

The Kansas Estate Tax (KET) is a problem. Current law makes planning and compliance difficult for both taxpayers and practitioners, while creating interpretation and administration problems for the Kansas Department of Revenue (KDOR). Beginning in 2007 the KET law will produce truly bizarre results. Finally, there may be serious doubt whether the post-2006 provisions accurately reflect legislative intent. The 2006 Legislature should fix the estate tax — or repeal it.

The principal problems are summarized below.

The Lawyer as Historian

Kansas currently imposes an estate tax[2] in the amount of a credit for state death taxes that was formerly allowed by the Internal Revenue Code (IRC).[3] Federal estate tax liability was reduced in the amount of the credit. The credit was phased out and ultimately repealed as to decedents dying after 2004.[4]

The amount of the Kansas tax is determined by the provisions of the IRC as it existed on Dec. 31, 1997 — more than seven years ago.[5] It may not be difficult for a tax specialist to determine what the IRC said in 1997, but the task can be daunting for a nonspecialist. One must have access to a version of the IRC that provides the full amendment history dating back at least to 1997, and then the amendment history must be carefully studied.[6]

The KDOR requires that the executor complete the April 1997 version of the United States Estate Tax Return (Form 706).[7] The KDOR provides an e-mail address[8] on its Web site[9] from which copies of the April 1997 version of Form 706 and the accompanying instructions can be obtained. Unfortunately, use of the 1997 form can cause further confusion. The KET is *not* based on the IRC applicable to deaths that occurred during 1997, but is instead based on the IRC as it existed on Dec. 31, 1997, *as applied to the actual year of death.* For example, § 2010 of the IRC, as in effect on Dec. 31, 1997, provided an "applicable exclusion amount" of only $600,000 in the case of deaths during 1997, but provided for larger exclusion amounts in each year thereafter, culminating in an exclusion amount of $1 million

FOOTNOTES

1. The author appreciates the contributions of Jillian Hekmati, Stephen Mazza, Robert Mead, Philip Ridenour, Nancy Schmidt Roush, Willard B. Thompson, William K. Waugh, and James Weisgerber, who reviewed drafts or provided other assistance, as well as Tamara Davis, who edited the article. The views expressed in the article, however, are solely those of the author and do not necessarily represent the views of the reviewers. Any errors are entirely the author's responsibility. The author does not speak for either the University of Kansas or its School of Law, and the views expressed are strictly his own.
2. K.S.A. 79-15,102.
3. I.R.C. § 2011.
4. I.R.C. §§ 2011(b)(2) and (f).
5. K.S.A. 79-15,101(a).
6. Among the more important changes made in the federal estate tax since 1997 are these: dramatic increases in the applicable exclusion amounts; phase-out and ultimate repeal of the state death tax credit; provision of a deduction for state death taxes; repeal of I.R.C. § 2057, which provided a special deduction for family-owned businesses; and total repeal of the estate tax in 2010.
7. Kansas Department of Revenue, KANSAS ESTATE TAX BOOKLET FOR DEATHS OCCURRING ON OR AFTER MAY 22, 2003, pp. 4 and 8.
8. forms@kdor.state.ks.us
9. http://www.ksrevenue.org/formsih.htm

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for [illegible]ns in 2006 and later years. The exclusion amount is crucial in determining whether a state death credit is available, and therefore whether a Kansas tax is imposed.[10] A taxpayer who uses the 1997 version of Form 706 and Instructions for a death in 2006 might well mistakenly apply the $600,000 exclusion amount applicable in 1997, producing a substantial but entirely erroneous Kansas tax liability.[11]

Phantom Returns

Because the KET requires taxpayers to apply the IRC as of December 1997, taxpayers must file with Kansas a "phantom" federal return in order to determine the Kansas tax. For example, if a decedent dies in 2005, and the gross estate exceeds the federal filing threshold, the executor must file with the United States the 2005 version of Form 706, applying current federal law. To determine the amount of the Kansas tax, however, the executor must file with Kansas the version of Form 706 that would have applied to a death in 2005 if Congress had made no changes in the IRC estate tax provisions after 1997. No such version of Form 706 exists. The version of Form 706 required for Kansas purposes is truly a "phantom."[12]

Tax Cliffs

The 2003 Legislature added to the KET law a provision stating that, in the case of deaths occurring after 2006, the IRC as of Dec. 31, 2001 (rather than Dec. 31, 1997) is to be used to determine whether a Kansas return must be filed.[13] Therefore, beginning in 2007 a Kansas return will be required only if a federal return would be required under the IRC as of Dec. 31, 2001.[14]

This change had the effect of "decoupling" the Kansas filing threshold from the Kansas exclusion amount. In 2007, for example, both the Kansas and federal filing thresholds will be $2,000,001,[15] but the Kansas exclusion amount remains "anchored" to 1997 law at $1 million. The result is the creation of dramatic "tax cliffs" — circumstances in which a tiny additional amount in the estate can trigger a massive tax liability.

For example, assume that Alice, a widow, dies in 2007 with a gross estate and taxable estate of $2 million. Because Alice would not be required to file a United States return under the IRC as of Dec. 31, 2001, no Kansas return is required, and no Kansas tax is due.

By contrast, assume that Betty, likewise a widow, dies in 2007 with a gross estate and taxable estate of $2,000,100 — just $100 more than Alice. Be[illegible] gross estate exceeds the $2 million exclusion amount for 2007, and Betty's executor is therefore required to file a federal estate tax return.[16] Betty's executor is also required to file a KET return. For Kansas purposes, however, the exclusion amount is determined by the IRC as of Dec. 31, 1997, which dictates an exclusion amount of only $1 million for 2007. Therefore, the "phantom" federal return prepared for Kansas purposes, based on the IRC as of Dec. 31, 1997, will indicate a hypothetical state death tax credit of $99,607,[17] and Betty's executor must pay $99,607 to the state of Kansas.[18]

In other words, Betty's estate is only $100 more than Alice's estate, but Betty's estate has a Kansas tax liability of $99,607, while Alice's estate has none.

An even more dramatic "cliff" will apply to estates of decedents dying in 2009, when the United States filing threshold will rise to $3,500,001.[19] If a Kansan dies in 2009 with a gross estate and taxable estate of $3.5 million, no United States or Kansas return will

(continued on next page)

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10. Under the 1997 I.R.C., the state death tax credit was limited to the amount by which the federal tax exceeded the unified credit. I.R.C. § 2011(e). The unified credit is determined by the applicable exclusion amount. I.R.C. § 2010(c).

11. The Kansas Department of Revenue instructions do explain that the 1997 form and instructions must be modified to reflect the increased applicable exclusion amounts. Kansas Department of Revenue, *supra* note 7, at 4.

12. Because I.R.C. § 2058 became effective in 2005, a three-step process is now required in determining the federal and KET liability: (1) The hypothetical federal estate tax liability under 1997 law is computed. (2) The KET liability is computed. (3) The actual federal liability under current law is computed; this includes the § 2058 deduction for Kansas and other state death taxes.

13. L. 2003, ch. 147, §§ 45 and 46.

14. K.S.A. 79-15,101 and 79-15,102.

15. A federal return is required if the gross estate exceeds the applicable exclusion amount under I.R.C. § 2010(c). I.R.C. § 6018(a)(1). Under § 2010(c) as it existed on Dec. 31, 2001, the § 2010(c) applicable exclusion amount for 2007 is $2 million.

16. At first glance it would appear that Betty's estate has a federal estate tax liability of $45, applying the 45 percent rate applicable in 2007. I.R.C. § 2001(c)(2)(B). The KET liability, however, will produce a deduction that entirely offsets this liability. I.R.C. § 2058(a). Therefore Betty's estate has no federal estate tax liability.

17. Under I.R.C. § 2011(b)(1), the maximum state death tax credit on a taxable estate of $2,000,100 is $99,607. §§ 2011(b)(2) and (f) are ignored because they were added after 1997. Under 1997 law, the federal tax before credits is $780,845, and the unified credit is only $345,800. The difference is $435,045, which far exceeds the maximum state death tax credit. Therefore the § 2011(e) limitation has no effect, and the final state death tax credit amount is $99,607.

18. The exclusion amount is crucial to determination of the state death tax credit (and therefore the Kansas tax) because of I.R.C. § 2011(e), which limits the state death tax credit to the amount of the tax imposed by § 2001, less the § 2010 unified credit (which is determined by the exclusion amount). If the actual 2007 exclusion amount of $2 million were applied, the federal tax before credits would be $780,845, and the unified credit would be $780,800, producing a difference of only $45. Under § 2011(e), this would be the maximum state death tax credit, and therefore the Kansas tax would be limited to this amount.

19. I.R.C. §§ 6018(a)(1) and 2010(c).

have to be filed, and there will be no United States or Kansas tax liability. If, however, the gross estate and taxable estate total $3,500,100, both United States and Kansas returns must be filed. There will be no federal tax liability, but the Kansas tax liability will be $229,210. In other words, $100 in additional assets triggers a Kansas tax liability of $229,210.

It is hard to conceive of circumstances creating a stronger incentive for tax evasion. Imagine that you represent the executor of the estate of a widow who dies in 2009. The executor (the decedent's son) marshals the assets and concludes that the total value of the gross estate is $3,490,100. You are pleased to inform the executor that there will be no estate tax liability to either the United States or Kansas. A week later, however, the executor calls to tell you a final search among his mother's documents revealed one additional asset — a bank certificate of deposit (CD) worth $10,000. This will raise the gross estate value to $3,500,100. You will have to inform the executor that, because of his commendable diligence, federal and KET returns must be filed. There will be no liability to the United States,[20] but the Kansas tax liability will be $229,210. At best, you have a bewildered and very unhappy client on your hands. The executor may ask that you "overlook" the CD. You must of course decline, and the executor is put to a painful choice. He can do his duty, pay the tax, and diminish the family's resources by $229,210, or he can switch to other counsel, who will not be informed of the CD.

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Less Pays More

The disconnect between the filing threshold and the exemption amount creates circumstances in which a smaller taxable estate may pay *more* tax than a larger taxable estate.

For example, assume that Bill, a widower, dies in 2007 with a gross estate of $2 million. There are no deductions, and Bill's taxable estate is likewise $2 million. Bill's estate is below the filing threshold and therefore has no federal or Kansas tax liability.

By contrast, assume that Tom, likewise a widower, dies in 2007 with a gross estate of $2.1 million. Tom bequeaths $600,000 of his estate to a charity, and the charitable deduction lowers the taxable estate to $1.5 million. However, because Tom's gross estate exceeds the filing threshold, a return must be filed, and Tom's estate must pay KET of $64,400.

In other words, Bill's taxable estate of $2 million has no tax liability, while Tom's $1.5 million taxable estate must pay $64,400 in Kansas tax.

Stealth Exemptions

K.S.A. 79-15,102 provides that a Kansas return must be filed if a federal return must be filed. In the final days of the 2003 session, the following sentence was added to K.S.A. 15,102:

> "For estates of decedents dying on or after Jan. 1, 2007, the determination of whether the estate is required by federal law to file a return for federal estate taxes shall be made by referring to the provisions of the United States [I]nternal [R]evenue [C]ode of 1986, as such code exists on Dec. 31, 2001."[21]

As explained above, this sentence has the effect of raising the Kansas filing threshold from $1,000,001 to $2,000,001 in 2007 and 2008 and to $3,500,001 in 2009. These are big numbers for Kansas. Surely they will dramatically reduce both the number of estates subject to tax and the amount of tax collected.

To most readers, the added sentence appears to be nothing more than an innocuous updating of the law. One must wonder how many legislators knew that it would have the effect of dramatically reducing estate tax revenues.[22]

Stealth Repeal

As explained above, the sentence added to K.S.A. 79-15,102 in 2003 provides that, in the case of decedents dying in 2007 and later years, no Kansas return is required unless a U.S. return is required, under the IRC as of Dec. 31, 2001.

Section 2210(a) of the IRC, as of Dec. 31, 2001, provides that all federal estate tax provisions are repealed as to

20. *See* the explanation in footnote 16.

21. L. 2003, ch. 147, § 46 [Now K.S.A. 2004 Supp. 79-15,102] An essentially identical sentence was added to K.S.A. 79-15,101 as well. L. 2003, ch. 147, § 45.

22. The 2003 estate tax changes were ultimately included in HB 2005, the omnibus tax legislation enacted as Chapter 147 of the 2003 Session Laws. Chapter 147, which was adopted in the final hours of the 2003 session, has 71 sections, spans 88 pages in the Session Laws, and affects 37 sections of K.S.A., relating primarily to the sales tax. The changes in K.S.A. 79-15,101 and 79-15,102 discussed in this article appear to have been added by the conference committee at the very end of the legislative session. Neither the conference committee report nor the explanations of votes in the House and Senate make any mention of the K.S.A. 79-15,101 and 79-15,102 changes. Journal of Kan. Senate 946-965; Journal of Kan. House, 845-864, 2003. Early in the 2003 session, two bills were introduced that would have conformed the KET to federal law as of Dec. 31, 2001, rather than Dec. 31, 1997; HB 2097 and SB 182. Each was referred to a committee, but no further action was taken on either bill. Journal of Kan. Senate 1046, 2003; Journal of Kan. House 943, 2003.

3-2

decec. , dying after 2009. In other words, no U.S. estate tax return is required if the decedent dies after 2009. Therefore, under the sentence added to K.S.A. 79-15,102 in 2003, no KET return will be required with respect to any decedent who dies after 2009. The sentence added in 2003 has the effect of permanently repealing the KET as to deaths after 2009.

Again, one must wonder how many legislators understood this. And one must question why the repeal of an important tax was effected with language so obscure. The KET currently raises approximately $52 million each year.[23] Did legislators actually intend to forgo this important revenue source?

Some legislators may have been aware of the "sunset" provision included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 Act),[24] which (if not modified) will have the effect of restoring the federal estate tax (and, therefore, a federal filing requirement) in 2011. They may have assumed that the KET would be restored along with the federal tax.

That, however, is not the case. The "sunset" provision is embodied only in Section 901(a) of the 2001 Act and was not added to the IRC The sentence added to K.S.A. 79-15,102 in 2003 refers only to the IRC itself, and IRC § 2210 permanently repeals the estate tax. K.S.A. 79-15,101 and 79-15,102 make no reference to provisions that were included in the 2001 Act but not incorporated in the IRC As a result, the sentence added to K.S.A. 79-15,102 in 2003 will have the effect of permanently repealing the Kansas tax in 2010, regardless of any action taken by Congress in the future to reinstate the federal estate tax.

Differential Elections

The 2001 act raised the federal exclusion amounts and thereby created a "gap" between the current federal exclusion amounts and the Kansas exclusion amounts, which are "anchored" to 1997 federal law. As a result planners have sought to apply different strategies to the federal tax and Kansas tax, respectively. A primary technique involves the use of differential elections to achieve "the best of both worlds."

The most common strategy is use of different marital deduction elections for federal and Kansas purposes, respectively. The first spouse to die bequeaths a portion of his or her assets to a trust that provides annual income for the surviving spouse, thereby, qualifying the trust for the marital deduction to the extent Qualified Terminable Interest Property (QTIP) treatment is elected by the executor.[25]

For example, assume that the first spouse dies in 2005. The executor makes a QTIP election for federal purposes in an amount sufficient to lower the taxable estate to $1.5 million, an amount that is entirely sheltered by the federal unified credit. For Kansas purposes, however, the executor wishes to make a larger QTIP election, lowering the taxable estate for Kansas purposes to $950,000, thus eliminating any Kansas tax.

The question then is whether the executor can make different QTIP elections for federal and Kansas purposes. The KDOR's answer is "yes." Differential elections are expressly allowed.[26] For deaths during 2005, the estate's saving in KET from differential elections can be as much as $64,400.[27] The potential saving will be even greater in later years.

The KET statutes make no mention of differential elections. The KDOR's interpretation may well be an

"It appears that the KDOR's allowance of differential elections for federal and Kansas purposes, respectively, may have been enlarged to permit filing of Kansas returns on the basis of hypothetical — rather than actual — property dispositions."

23. Kansas Division of the Budget and Kansas Legislative Department, "Update to SGF memo for FY 2005 (Revised) and FY 2006 (Revised)," June 14, 2005, Table 1.

24. Pub. L. No. 107-16, 115 Stat. 38.

25. I.R.C. § 2056(b)(7).

26. Kansas Department of Revenue, *supra* note 7, at 4.

27. If the taxable estate is only $950,000, the tax before credits is $326,300. I.R.C. § 2001(c). The unified credit for 2005 deaths under 1997 law is likewise $326,300. I.R.C. § 2010(c) as in effect prior to Pub. L. No. 107-16. Because the state death tax credit is limited to the difference between the tax before credits and the unified credit, no state death tax credit is allowed, and therefore no Kansas tax is imposed. I.R.C. § 2011(e); K.S.A. 79-15,102. By contrast, if the taxable estate is $1.5 million, the tax before credits is $555,800, which far exceeds the 2005 unified credit (under 1997 law) of $326,300. The hypothetical state death tax credit computed under I.R.C. § 2011 is $64,400, and this is the KET due. K.S.A. 79-15,102.

appropriate exercise of the Secretary of Revenue's discretion, but it remains only an interpretation, and one that could be reversed at any time by the KDOR. Many estate planners and their clients are relying on this interpretation and preparing wills and trusts accordingly. The availability of differential elections is a central issue that should be resolved by statute, not left to administrative discretion.

Phantom Dispositions

It appears that the KDOR's allowance of differential elections for federal and Kansas purposes, respectively, may have been enlarged to permit filing of Kansas returns on the basis of hypothetical — rather than actual — property dispositions. The importance of this principle is illustrated by the following example.

Assume that a wife, the first spouse to die, has a gross estate of $2.5 million. Her will includes a formula providing that the children are to receive the maximum amount that will reduce the federal and Kansas estate taxes to zero. The surviving husband is to receive the remainder of the estate. If the wife dies in 2005, this formula, as applied under current federal estate tax law, will dictate an allocation of $1 million to the surviving spouse and $1.5 million to the children. The $1.5 million going to the children is fully sheltered from federal tax by the current $1.5 million exclusion amount. Therefore the executor will distribute the funds in this fashion and file the federal estate tax return accordingly.

For Kansas purposes, however, the 1997 IRC applies, and this provides for an exclusion amount of only $950,000 in 2005. For Kansas purposes, therefore, the executor would prefer to treat the allocation to the children as being only $950,000, with the remaining $1,550,000 going to the surviving husband. Lowering the children's share to $950,000 would eliminate any Kansas tax.

The question then becomes whether the executor can report for Kansas purposes a "phantom" disposition — an allocation of property different from what actually occurred. In this case, the executor would prefer to report, for Kansas purposes, that application of the formula bequest under 1997 federal law produces an allocation of $950,000 to the children and $1,550,000 to the husband. The executor would prefer to file a "phantom" return based on this allocation, presumably with an explanation that the actual disposition was otherwise. The result would be savings in KET of $64,400.

This approach was first proposed by Timothy O'Sullivan and Stewart Weaver in the *Journal of the Kansas Bar Association* articles published in 2002 and 2003.[28] In the 2003 article O'Sullivan and Weaver report they "have confirmed with a KDOR official that the KDOR will interpret marital deduction formula clauses under prior federal law, *irrespective of the amount of assets actually funding the bypass share.*"[29] (Emphasis added.) It appears that at least some returns have been filed and accepted on this basis. However, as of the writing of this article, to the best of this author's knowledge there has been no formal announcement of the KDOR's position on this matter.[30]

As with differential elections, acceptance of returns reporting "phantom" dispositions does not appear to be a foregone conclusion based on the language of the statute. This position may well be an appropriate exercise of the Secretary of Revenue's discretion, but it is an administrative policy that could be changed at any time. Many estate planners and clients are preparing wills and trusts in reliance on this policy. It is an important issue that should be addressed in the statute itself.

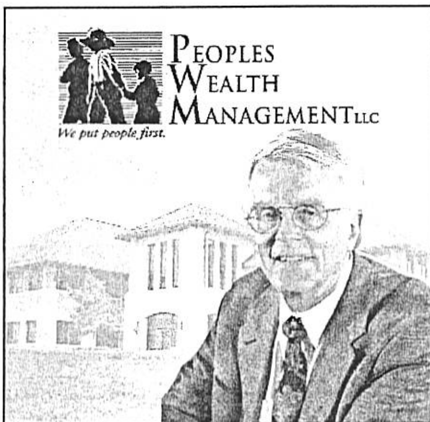
Dad vs. the Kids

The distorted linkage between federal and Kansas law, combined with the KDOR's acceptance of returns based on dispositions that did not in fact occur, could well prove a fertile source of litigation.

For example, assume the circumstances described under "Phantom Dispositions" above. The will includes a typical formula clause calling for a division of assets that reduces both federal and state taxes to zero. As described above, the executor actually allocates only $1 million to the surviving husband and reports this as the marital deduction on the federal return. On the Kansas return, however, the executor reports an allocation of $1,550,000 to the husband, lowering the Kansas taxable estate to zero and the Kansas tax to zero.

If the executor reports to Kansas an allocation of $1,550,000 to the surviving husband, does this create an entitlement of the surviving husband to actually receive that amount? Do the children have an offsetting right to limit the surviving husband's allocation to $1 million because that is the amount reported on the federal return? If the children and the surviving husband are all of one mind, there may be no problem. But if there is conflict or disagreement, how can the executor satisfy both dad and the children?

This potential for litigation suggests that the current distorted linkage between federal and Kansas law is a trap for the unwary — both taxpayers and their counsel.



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28. Timothy O'Sullivan and Stewart Weaver, *2002 Kansas Death Tax Legislation: An Emperor in Need of Clothes*, 71 J. Kan. Bar Assn. 10, 23 (2002); Timothy O'Sullivan and Stewart Weaver, *Planning for Kansas Death Taxes in 2003: A 'Notice-Able' Difference*, 72 J. Kan. Bar Assn. 10, 32-33 (2003).

29. Timothy O'Sullivan and Stewart Weaver, *Planning for Kansas Death Taxes in 2003: A 'Notice-Able' Difference*, 72 J. Kan. Bar Assn. 10, 33 (2003).

30. In their 2003 article O'Sullivan and Weaver state that "It is anticipated that future notices or pronouncements of the KDOR will formally confirm this position." *Id.*

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Con[...]ion

The current KET law has significant defects, and the problems it creates will become more serious beginning in 2007. For that reason it is important that the Legislature address this problem in 2006. Perhaps the Legislature will decide to repeal the estate tax and forgo the $52 million of annual revenue it produces. If, however, the Legislature decides to retain an estate tax, it is important that the tax be fixed.

The KET problems all arise from the continued linkage with federal law. The solution, therefore, is obvious: Kansas needs to terminate the relationship with federal law and go its own way. There should be a new, free-standing KET, devoid of reliance on or links to federal exemptions and credits. Adoption of such a free-standing tax[31] would permit the Legislature to make its own decisions as to how much revenue an estate tax should raise, what the filing threshold should be, what rate structure should be imposed, and how the tax should be interpreted and administered. ■

About the Author

***Martin Dickinson** is the Robert Schroeder Professor of Law at the University of Kansas. He is the author or co-author of many publications, including* "Taxation of Estates, Gifts and Trusts," *now in its 22nd edition, and has received the ABA's Harrison Tweed Award for his numerous continuing legal education presentations. He has also received the KBA's Outstanding Service Award and Phil Lewis Medal of Distinction. He was formerly of counsel with the Lawrence firm of Barber Emerson.*

Dickinson received his bachelor's degree from the University of Kansas and his law degree from the University of Michigan. He served as dean of the University of Kansas School of Law from 1971 to 1980.

31. Legislation of this kind was introduced as SB 148 in the 2003 session of the Kansas Legislature. SB 148 was considered by the Committee on Assessment and Taxation but was not referred to the full Senate. SB 148 was drafted by an informal working group chaired by Nancy Schmidt Roush, Overland Park. The author of this article was a member of that group.

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TESTIMONY OF WILLIAM K. WAUGH III

JANUARY 18, 2006 – S.B. 356

My name is William K. Waugh III, 8507 High Drive, Leawood, Kansas, 66205. I graduated from Kansas University Law School in 1968 and have practiced law with Lathrop & Gage, L.C. and its predecessors since 1968. My practice is primarily in the estate and trust area. Over the years, I have prepared and filed many Kansas inheritance and estate tax returns. I estimate that I have prepared over 800 estate plans.

Because my practice is located in Johnson County, I am very familiar with both Kansas and Missouri law and am admitted to practice in both states.

There are numerous problems with the existing Kansas Estate Tax law and these are well documented in the Kansas Bar Journal, November/December, 2005 article, "The Kansas Estate Tax Problem" written by Martin Dickinson. Professor Dickinson asked that I review this article prior to publication, which I did. It states the issues clearly.

An additional issue which I have observed affects the State of Kansas tax revenue. Because under the current Kansas law will result in nearly $100,000 tax on a $2,000,001 estate in 2007, while Missouri has no estate tax, I have observed clients moving from Kansas during their late years. This means that the state not only loses the estate tax, but also loses the income, property and sales taxes during the remaining lifetime. Often, these moves are to retirement homes or condos within one mile of the state line.

As an attorney who works in this area, it is my obligation to inform my clients of this difference in tax treatment.

While I understand the need for revenue, many of my clients seem more concerned with death tax than any other tax. They complain that they have already paid tax on their assets.

If you do not eliminate the death tax, I recommend that it be fixed to avoid the problems set forth by Professor Dickinson.

Assessment & Taxation
Date 1-18-06
Attachment # 4

WILLIAM K. WAUGH III

Admitted to Bar in Missouri 1968
Admitted to Bar in Kansas 1984

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EDUCATION

University of Kansas, J.D., *with highest distinction*, 1968
University of Kansas, B.S., *with distinction*, 1965

PRACTICE

Wealth strategies and charitable organizations.

EXPERIENCE

Mr. Waugh has concentrated his practice in Trust and Estates and charitable organizations including tax issues for over thirty years. He works with tax exempt organizations in a number of areas which are unique to such entities. He has experience in tax issues, planned giving issues and general not-for-profit legal issues. He works with individuals in creating estate plans and the administration of estates and trusts.

HONORS

- Selected by peers, "Best of the Bar", *The Kansas City Business Journal*, 2003-2004
- Best Lawyers in America®, 2003-2004 and 2006
- Order of the Coif
- Beta Gamma Sigma

ACTIVITIES AND MEMBERSHIPS

- Fellow, American College of Trust & Estate Counsel; Kansas State Chair, 1996-2001
- American Bar Association, Real Property, Probate & Trust Law Section; Economics Section
- Kansas Bar Association; Real Property, Probate and Trust Law Section, past Board of Directors
- Federal Estate Tax Symposium Committee, 1992-2000; Chairman 1997
- Chairman, American College of Trust & Estate Counsel Quad-State Meetings, June 1994 and May 1998
- Secretary to Board of Trustees of Children's Mercy Hospital, 1990-2003
- Children's Center for the Visually Impaired, Board member, 1989-95; President, 1994-95; Treasurer, 1992-93; Vice President, 1993-94
- Heart of America Tax Institute, Committee member, 1981-88; Board of Directors, 1986-88; Chair, 1986
- Secretary to The Children's Mercy Hospital Foundation
- President – Estate Planning Society of Kansas City, 2002-2003
- Wayside Waifs – Board Member, 2004

SENATE BILL No. 365

BY COMMITTEE ON ASSESSMENT AND TAXATION

Brief of Bill

By Kansas Department of Revenue

Title of Act

Section 1 is the citation of the act. The act shall be known and may be cited as the Kansas estate tax act.

Definitions

Section 2 defines terms used in the act. Among other definitions, this section provides that any reference to the Internal Revenue Code means the provisions of the Internal Revenue Code of 1986, as such code exists on December 31, 2005.

Imposition of Tax

Section 3 provides for the imposition of tax and establishes the rates of tax. No estate tax is imposed unless the taxable estate exceeds $1,000,000. Rates start at 6.5% for estates of more than $1,000,000 and less than $2,000,000. The top rate of 15% applies to estates in excess of $10,000,000.

Section 4 provides for the proration of tax. The tax is to be multiplied by a percentage determined by dividing the value of property in Kansas by the value of all the property in the estate.

Valuation of Property Comprising Gross Estate

Section 5 defines the gross estate. It provides that property included in the gross estate shall be valued at its fair market value, with the exception found in Section 6.

Section 6 provides that if the decedent was a resident of Kansas, real property located in Kansas and treated as "land devoted to agricultural use" for property tax purposes shall be valued for estate tax purposes as it is for property tax purposes in accordance with K.S.A. 79-1476.

Property Included in Gross Estate

Section 7 provides the gross estate shall include the value of all property to the extent provided in sections 8 through 17.

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Section 8 provides that all property in which a decedent had an interest is to be included in the gross estate.

Section 9 provides that property transferred by the decedent within one year of the date of death is to be included in the gross estate.

Section 10 provides that property transferred by the decedent in which the decedent retained a life estate is to be included in the gross estate.

Section 11 provides that property transferred by the decedent in which the decedent retained the right to revoke the transfer is to be included in the gross estate.

Section 12 provides that annuities or other payments that are receivable by a beneficiary be reason of the death of the decedent are to be included in the gross estate.

Section 13 provides that property held in joint tenancy with the decedent, or as tenants in entirety between the decedent and spouse, is to be included in the gross estate.

Section 14 provides that property in respect to which the decedent had a general power of appointment is to be included in the gross estate.

Section 15 provides that life insurance proceeds are to be included in the gross estate.

Section 16 provides that transfers made by the decedent for insufficient consideration are to be included in the gross estate.

Section 17 provides that property for which a marital deduction was previously allowed is to be included in the gross estate.

Taxable Estate

Section 18 defines the taxable estate. It provides that the taxable estate shall be determined by deducting from the gross estate the deductions provided for in sections 19 through 23.

Section 19 provides deductions for funeral expenses, administration expenses, and claims against the estate.

Section 20 provides a deduction for casualty losses.

Section 21 provides a deduction for property that is specifically exempt by state or federal law.

Section 22 provides a deduction for transfers for public, charitable, and religious uses.

Section 23 provides a deduction for transfers to a surviving spouse.

Assessment & Taxation

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Section 24 provides that certain deductions made in computing the taxable estate are not allowed as deductions for Kansas income tax purposes.

Reports and Returns

Section 25 defines who has responsibility for filing the estate tax return.

Section 26 provides that the time for filing the return shall be within 9 months of the decedent's death.

Section 27 provides for extensions of time to file the return when good cause exists, and that tax remains due and payable by the due date.

Section 28 provides all returns shall be filed with the Director of Taxation.

Section 39 provides for signatures on the return, and that the return is filed under penalty of perjury.

Section 30 provides for filing of the return by disclosure of information.

Section 31 provides rules for the treatment of fractional dollar amounts shown on the return.

Section 32 provides for the preservation and confidentiality of the return, and that performance of certain activities by administrative personnel are unlawful and subject to penalty.

Payment of Tax

Section 33 provides that the estate tax shall be paid by the personal representative.

Section 34 provides that the tax shall be paid within 9 months of the date of death of the decedent.

Section 35 provides for the imposition of penalty and interest if the tax is not paid in a timely fashion.

Examination of Returns by Director

Section 36 provides the duties of the Director of Taxation include the examination of returns, the refund of excess tax paid, the assessment of additional tax, and the conducting of informal conferences.

Section 37 provides for the issuance of jeopardy assessments by the Director of Taxation, and for review of those assessments.

Section 38 provides for the personal representative's request for a determination of tax and discharge from liability.

Collection of Tax

Section 39 provides for a tax lien to aid in the enforcement and collection of tax.

Section 40 provides the filing of notice of the tax lien.

Section 41 provides for the issuance of tax warrants.

Section 42 provides for actions for collection by the Director of Taxation.

Section 43 provides for the release of the lien imposed by Section 40.

Section 44 provides for the issuance of proof and notice of release of the lien.

Issuance of Closing Letter

Section 45 provides for the issuance of a closing letter.

Disposition of Revenue / Tax Refunds; Interest

Section 46 provides for the disposition of revenue to the state general fund.

Section 47 creates the estate tax abatement fund and provides for the payment of abatements and refunds of interest.

Fees for Copies

Section 48 provides for the imposition of fees for services, and for the disposition of proceeds to the state general fund.

Statute of Limitations

Section 49 creates a statute of limitations, and requires the personal representative notify the Director of Taxation of adjustments by the internal revenue service.

Rules and Regulations

Section 50 provides the Secretary of Revenue shall adopt rules and regulations necessary to carry out the purposes of the act.

Application of Act

Section 51 provides the act shall apply to the estates of all decedents dying after December 31, 2005, and that prior acts shall apply to deaths occurring prior to that date.

Severability

Section 52 provides a severability clause.

Section 53 repeals the existing estate and succession tax statutes.

Section 54 provides that the act shall be effective and in force upon publication in the statute book (July 1).

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PUBLIC POLICY STATEMENT

SENATE COMMITTEE ON ASSESSMENT and TAXATION

RE: SB No. 356 – an act concerning estate taxation; repealing the Kansas Estate Tax

January 18, 2006
Topeka, Kansas

Testimony provided by:
Brad Harrelson
State Policy Director
KFB Governmental Relations

Chairperson Allen, and members of the Senate Committee on Assessment and Taxation, thank you for the opportunity to appear before you today. I am Brad Harrelson, State Policy Director—Governmental Relations for Kansas Farm Bureau. KFB is the state's largest general farm organization representing more than 40,000 farm and ranch families through our 105 county Farm Bureau Associations.

Farm Bureau policy, on both the state and national levels, has long opposed any form of "death tax" and permanent repeal is a top priority. Aside from the issue of fundamental fairness, there are a host of economic and tax policy reasons why the Legislature should act now to permanently repeal the Kansas estate tax.

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Across Kansas, small businesses and family farms face the threat of a punitive death tax that could undo a lifetime of hard work and thrift. By necessity, these farms and ranches are increasing in size, providing opportunities for the next generation of Kansas agriculture. These new, larger farms are more than ever, very capital-intensive businesses which face increasing pressure when it comes to passing the family business to the next generation. The death tax is a significant impediment to the successful transfer of family farms. It can severely damage, and even destroy the economic viability of the business. In a time when fewer and fewer of our young people are choosing to return to the farm, it's important that we provide every incentive to encourage that decision.

The Kansas estate tax also causes persons who have a choice of residence to consider relocating to one of the many states that has no death tax. The inadvertent costs of the death tax are high—the loss of valuable citizens, and the loss of income and sales tax revenue they would otherwise contribute to the health of our economy. Further, the death tax discourages savings and investment. Not only is this a perverse dis-incentive, it punishes a lifetime of success. But perhaps the most important reason to permanently repeal the death tax is the common-sense presumption that death should not be a taxable event.

Effective January 1, 2006, the Kansas estate tax is no longer a credit against the Federal estate tax, but now is only a deduction. The State Death Tax Credit has been phased out over the last four years. The policy of a dollar for dollar credit which was once helpful to Kansas residents has now been replaced with a mere deduction against the Federal gross estate.

Nationally, farm and ranch estates face heavier, potentially more disruptive estate tax burdens than other estates. Roughly twice the number of farm estates paid federal estate taxes in the late 1990's compared to other estates. We assume comparable impacts were seen in Kansas during the same time frame. Additionally, the average

farm estate tax is larger than the tax paid by most other estates. Again, more reasons to seriously consider repeal.

While arguably an improvement over current law, a stand-alone estate tax, as provided in Senate Bill 365, is not a reasonable alternative to the current Kansas estate tax. The Kansas estate tax is currently tied to the 1997 federal estate tax, subject to increasing exemptions over the next few years. This makes estate planning very difficult, because the planner does not know what the exemption will be beyond 2011. This unknown exemption level results in an inability to effectively plan for the future. Additionally, administration is difficult because a full Federal estate tax return, based on the 1997 law, is required even if the estate is not subject to Federal tax. This results in excessive legal and accounting fees, dollars that could be better invested elsewhere. We acknowledge a stand-alone tax may simplify the process, but does nothing to justify the already harsh and unmerited tax. Only repeal can truly erase the burden and uncertainties of estate tax planning, or the inexcusable levy associated with it.

Kansas Farm Bureau recognizes the budgetary challenges currently faced by the legislature. You will likely ask the question of how the state can withstand lost revenues by repeal of the estate tax. We believe that is a fair and responsible question. However, we believe elimination of the estate tax may have a potentially beneficial fiscal impact. In time, we firmly anticipate more accumulated wealth will remain in the state and that other revenue sources will continue their upward trend. Furthermore, elimination of this deterrent to growing wealth will encourage new economic growth, and increased opportunities for younger Kansans, especially in rural areas of the state, where the need is great.

In conclusion, Kansas Farm Bureau respectfully urges your recommendation to pass favorably SB 356. Thank you, once again, for the opportunity to appear before you and share the policy of our members. KFB stands ready to assist you as you consider this important measure. Thank you.

Since 1894

To: Senate Committee on Assessment and Taxation
Senator Barbara Allen, Chair

From: Allie Devine, Vice President and General Counsel

Date: January 18, 2006

Re: Estate Taxes: Support SB 356; Oppose SB 365

The Kansas Livestock Association (KLA), formed in 1894, is a trade association representing over 6,000 members on legislative and regulatory issues. KLA members are involved in many aspects of the livestock industry, including seed stock, cow-calf and stocker production, cattle feeding, grazing land management and diversified farming operations.

The Kansas Livestock Association has repeatedly supported the repeal of estate and inheritance taxes in Kansas. This issue has been before the legislature several times over the past few years and we ask your support for SB 356, the total repeal of the estate tax.

KLA and our national organization the National Cattlemen's Beef Association (NCBA) have worked aggressively to pass a permanent repeal of the federal estate tax. There are several economic and political reasons that the estate tax should be repealed.

The tax disrupts businesses. The estate tax is assessed at the time of death which is not an income producing event. A key aspect of any "good" tax is that it is assessed at a time when income is available to pay the tax. Since death is not an income producing event, there is no revenue to pay the tax. Small businesses and agricultural operations are often broken apart to pay the tax. Typically small business owners have their family's net worth invested in the business. Estate taxes often put a large cash demand onto businesses which typically do not have liquid assets.

Survey data included in "*The Economics of the Estate Tax; An Update*," (hereafter *Economics*) a study by the Joint Economic Committee of the United States Congress (June 2003) found that 98 percent of heirs cited "needed to raise funds to pay estate taxes" as a reason why family businesses failed beyond the first generation.

The estate tax reduces incentives to save and invest. The estate tax results in the direct loss of capital because it forces privately-held assets to be liquidated to pay the government. Wealth that would be available for production is transferred to consumption-intensive government uses. (*Economics* p. 6)

Assessment & Taxation
Date 1-18-06
Attachment # 2

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The estate tax is complicated, and difficult to administer. Estate holders spend thousands of dollars on tax planning. Tax liability often depends upon the skill of the estate planner, rather than the capacity to pay. This does not always result in what most people would consider "fair and equitable" treatment. (*Economics* p. 9)

The estate tax has a negative impact on environmental conservation. When heirs are forced to divide or develop land to pay estate taxes, it has an adverse impact on the environment. This may seem unlikely in Kansas, but today ranchers in parts of the Flint hills are considering conservation easements as sources of both environmental and economic benefits- a means to reduce their estates by transferring the development rights and preserving the agricultural nature of the property. (*Economics* p. 9)

These are some of the highlights of *Economics*. The report outlines a number of reasons for the repeal of the estate tax at the federal level and while not entirely applicable to the state estate tax, we encourage you to consider some of the issues addressed.

SB 365

KLA policy strongly opposes the imposition of any estate tax. The creation of a free-standing estate tax is contrary to what our members have advocated for years. KLA members will be attending our annual legislative meeting on February 16, 2006. We anticipate considerable discussion of these proposals at that time. Today, I'd like to offer some observations of SB 365.

We have reviewed SB 365 and are pleased that some of the concerns we raised with SB 148 (2003) have been addressed in this bill. Some of you may recall that in 2003, we asked for an outline of the substantial differences between the proposed Kansas estate tax and the federal estate tax. (See Response to the Senate Committee on Taxation, prepared by Nancy Roush, Martin Dickinson, Jim Weisgerber, Tim O'Sullivan, and Terry Fry, 2-19-2003)

Our comparison of SB 365 and current federal law indicates that some portions have been included while others have been excluded. We are pleased with Section 6 of SB 365, as it provides for valuation of agricultural real estate for estate purposes according to current Kansas property tax valuation procedures.

If this bill proceeds, we would encourage the legislature to consider adding provisions for a simplified method of making installment payments of the estate tax for the estates of decedents whose estates consist in significant part of property dedicated to agricultural uses, exclusions for conservation easements (like Section 2031(c)) of the federal Code, and an exclusion from a decedent's "gross estate" of tangible property used in agriculture at the date of death. This last item is in keeping with the policy of SB 365 section 6 and current Kansas personal property tax policy with respect to agricultural property. The ability of a decedent's family to retain tangible property used in agriculture is critical to ensuring continued farm operations. Some of the more costly items of tangible property

used in agriculture do not lend themselves to convenient or quick sale other than on a "distressed" basis, and given this degree of illiquidity coupled with the crucial role of this property in agricultural operations, we strongly believe such property should not be subjected to a Kansas estate tax under any set of circumstances.

We also want to note that the bill appears to hold the $1,000,000 exemption amount into place with no upward adjustments tied to inflation or other cost-of-living indices. In addition to becoming increasingly regressive over time, this is considerably different from federal law, which contemplates an increasing applicable exemption amount leading up to total repeal and is different even from 1997 federal law which provided for incremental increases in the applicable exemption amount. We also note that the bill has several penalty provisions that our members are likely to oppose. Finally, the bill does nothing to simplify a complex tax area, and in fact may complicate the process for Kansas taxpayers in addition to being susceptible to the perception that it is in fact a revenue increasing regime.

We appreciate the opportunity to address these bills, and will work with the Committee to resolve these issues. Thank you.

THE ECONOMICS OF THE ESTATE TAX: AN UPDATE

A JOINT ECONOMIC COMMITTEE STUDY

Vice Chairman Jim Saxton (R-NJ)

Joint Economic Committee
United States Congress

June 2003

Executive Summary

This analysis examines the arguments for and against the federal estate tax and concludes that the estate tax generates costs to taxpayers, the economy, and the environment that far exceed any potential benefits that it might arguably produce.

- The existence of the estate tax has reduced the stock of capital in the economy by approximately $497 billion, or 3.2 percent.
- The estate tax is a leading cause of dissolution for thousands of family-run businesses, diverting resources available for investment and employment.
- The estate tax is a "virtue tax" in the sense that it penalizes work, saving and thrift in favor of large-scale consumption.
- Empirical and theoretical research indicates that the estate tax is ineffective at reducing inequality and may actually increase inequality of consumption.
- The estate tax raises very little, if any, net revenue. The distortionary effects of the estate tax result in income tax losses that are roughly the same size as estate tax revenue.
- Estate taxes force the development of environmentally sensitive land. Through 2001, 2.6 million acres of forest land were harvested and 1.3 million acres were sold each year to raise funds to pay for estate taxes.

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THE ECONOMICS OF THE ESTATE TAX: AN UPDATE

This analysis summarizes the arguments for and against the federal estate tax and concludes that the estate tax generates costs to taxpayers, the economy and the environment that far exceed any potential benefits that it might arguably produce. Most of the arguments summarized here were originally published in the 1998 Joint Economic Committee study *The Economics of the Estate Tax*. Where feasible and appropriate, the current report updates the previous study to reflect newer data and supplements that study to reflect more recent research.

This paper documents the extensive costs associated with the federal estate tax. Specifically, the report finds:

- The existence of the estate tax has reduced the stock of capital in the economy by approximately $497 billion, or 3.2 percent, based on the 1998 analysis.
- The distortionary incentives in the estate tax result in the inefficient allocation of resources, discouraging savings and investment and lowering the after-tax return on investments.
- The estate tax is extremely punitive, with marginal tax rates in 2003 reaching 49 percent.
- The estate tax is a leading cause of dissolution for thousands of family-run businesses. Estate tax planning further diverts resources available for investment and employment.
- The estate tax obstructs environmental conservation, as the need to pay large estate tax bills often forces families to divide or develop environmentally sensitive land. Through 2001, 2.6 million acres of forest land were harvested and 1.3 million acres were sold each year to raise funds to pay for estate taxes
- The estate tax violates the basic principles of a good tax system: it is complicated, unfair and inefficient.

In addition, a review of the arguments in favor of the estate tax suggests that the tax produces no benefits that would justify the large social and economic costs.

- The estate tax is a "virtue tax" in the sense that it penalizes work, savings and thrift in favor of large-scale consumption.
- Empirical and theoretical research indicates that the estate tax is ineffective at reducing inequality and may actually increase inequality of consumption.
- The enormous compliance costs associated with the estate tax are of the same general magnitude as the tax's revenue yield, or about $22 billion in 2003.
- The deduction for charitable bequests stimulates little or no additional giving.
- The estate tax raises very little, if any, net revenue for the federal government. The distortionary effects of the estate tax result in losses under the income tax that are roughly the same size as estate tax revenue.

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THE ECONOMICS OF THE ESTATE TAX: AN UPDATE

I. INTRODUCTION

Benjamin Franklin noted over 200 years ago that "in this world nothing can be said to be certain, except death and taxes."[1] Unfortunately, the convergence of these two inescapable events, in the form of the federal estate tax, results in a number of destructive outcomes in terms of slower economic growth, reduced social mobility and wasted productive activity. Moreover, the costs imposed by the estate tax far outweigh any benefits that the tax might produce.

Some observers might believe that the estate tax is free from serious controversy. For example, it is often claimed that the tax only falls on the "rich" and thus serves to reduce income inequality. Other supporters of the estate tax point to the $22 billion in tax revenues for 2003, or to the incentive for charitable bequests. Nonetheless, there are many reasons to question the value of taxing the accumulated savings of productive citizens. Not the least of these reasons is the widely-held belief that families who work hard and accumulate savings should not be punished for sound budgeting. Additionally, it is unclear whether the estate tax raises any revenue at all, since most if not all of its receipts are offset by losses under the income tax.

To preview the results of the present analysis, consider the conclusion drawn by Henry Aaron and Alicia Munnell, two prominent liberal economists, in their study of the estate tax:

> In short, the estate and gift taxes in the United States have failed to achieve their intended purposes. They raise little revenue. They impose large excess burdens. They are unfair.[2]

This paper summarizes the 1998 Joint Economic Committee study *The Economics of the Estate Tax*.[3] Where feasible and appropriate, the current report updates the previous study to reflect more recent data and legislation. Readers wishing additional information on the various arguments for and against estate taxation, or more detailed documentation, should consult the 1998 study.

II. THE CURRENT ESTATE TAX

The estate tax, also known as a death tax, is simply a tax imposed on wealth transfers made at the holder's death. Three times in this nation's history a federal death tax has been imposed only to be repealed shortly thereafter. In each instance, the tax was implemented to provide revenue on a short-term basis to finance military action (1797-1802, 1862-1870, and 1898-1902). With the advent of World War I, the estate tax was reintroduced in 1916 and has existed ever since.

The 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA), among other things, implemented a gradual reduction in federal estate taxes, culminating in full repeal in 2010 (Table 1).[4] Gift taxes were cut, effective in 2010, to equal the top applicable income tax rate. The rules of the U.S. Senate make it difficult to implement permanent changes (lasting longer

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Table 1. Effective Estate Tax Rates & Exemptions

Fiscal Year	Effective Tax Rates		Exemption Amount
	Starting	Ending	
2001	41%	60%	$1 million
2002	41%	50%	$1 million
2003	41%	49%	$1 million
2004	45%	48%	$1.5 million
2005	45%	47%	$1.5 million
2006	46%	46%	$2 million
2007	46%	45%	$2 million
2008	45%	45%	$2 million
2009	45%	45%	$3.5 million
2010	*Repealed*	*Repealed*	*Repealed*
2011 & After	41%	60%*	$1 million

* The top statutory rate is 55 percent, plus there is a 5 percent surtax for taxable estates of $10 million to $17.184 million.
Source: Congressional Research Service.

than ten years) in reconciliation legislation. Thus, the estate tax repeal was made temporary, followed by full estate tax restoration in 2011 to 2001 levels.

III. ARGUMENTS FOR ESTATE TAXATION

Supporters of the estate tax generally rely on three different arguments. First, supporters claim the estate tax reduces inequality. Second, estate tax advocates contend that the deduction for charitable bequests induces giving to nonprofit organizations. Finally, supporters argue that the $22 billion it is expected to raise in fiscal year 2003 warrants the estate tax's existence.

A. Inequality and the Distribution of Wealth

One of the most common arguments made in favor of the estate tax is that it reduces income and wealth inequality. Supporters of the estate tax contend that since the high tax rates apply only to the "rich," the effect should unambiguously reduce inequality. This assertion actually relies on two assumptions: that high estate tax rates are "good" according to a liberal, progressive philosophy; and that high estate tax rates do in fact reduce inequality.

Both of these assumptions are flawed. First, the estate tax fails on liberal, progressive grounds because it discourages work and savings in favor of large-scale consumption. The liberal philosophical argument against the estate tax is articulated by legal scholar Edward McCaffery, who identifies himself as an "an unrequited liberal … whose views on social and distributive justice might best be described as progressive."[5] McCaffery argues that in its basest form, the estate tax actually undermines the very concept of fairness and equality that the liberal progressive movement ought to support:

> The estate tax discourages behavior that a liberal, democratic society ought to like – work, savings, bequests – and encourages behavior that such a society ought to suspect – the large-scale consumption, leisure, and inter vivos giving of the very rich. … The estate tax is an anti-sin, or a virtue, tax. It is a tax on work and savings without consumption, on thrift, on long-term savings. There is no reason even a liberal populace need support it.[6]

On the second assumption, there simply is no empirical evidence that the estate tax actually reduces inequality. A large body of empirical and theoretical research has emerged showing that inheritance either is not a major source of inequality, or that government policies

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aimed at inheritance are likely to be ineffective. There are three reasons for such conclusions. First, there is only a weak correlation between wealth and income. Thus, the reduction of wealth transfers can have only a limited impact on the distribution of earnings. Second, efforts to curtail wealth transfers will induce wealth holders to increase their consumption, thereby increasing the inequality of consumption. Finally, the high degree of wealth and income mobility in society means that government efforts to redistribute wealth will necessarily meet with limited success.

Much of the research which suggests that the estate tax is a poor tool to address inequality has been done by economists who themselves are generally sympathetic to issues of income inequality. Alan Blinder, a former member of the Federal Reserve Board appointed by President Bill Clinton, found that only about 2 percent of inequality was attributable to the unequal distribution of inherited wealth, leading him to conclude that "a radical reform of inheritance policies can accomplish comparatively little income redistribution."[7]

Another critical analysis comes from Joseph Stiglitz, who served as Chairman of President Clinton's Council of Economic Advisers. Taking into account the long-term impact on capital accumulation, Stiglitz found that the estate tax may ultimately *increase* income inequality.[8] Even if the government acts to offset these capital accumulation effects, Stiglitz argued that the "desirability of the estate tax may still be questioned, not only because of the distortions which it introduces but also because it may actually increase inequality in the distribution of consumption."

Stiglitz further argued that inheritances actually decrease inequality: because inheritances redistribute income within families, they may decrease inequality in lifetime consumption.[9] In yet another analysis, Stiglitz concluded that "it would seem clear that inheritances are unambiguously equality increasing" in terms of consumption, and an argument can be made that inheritances reduce inequality of income and wealth as well.[10] The conclusions reached by Blinder and Stiglitz have been replicated by numerous other researchers.[11]

Survey data also confirm these conclusions. A study of wealthy investors by Prince & Associates found that just 7 percent of respondents identified inheritance as the source of their wealth.[12] In *The Millionaire Next Door*, authors Thomas Stanley and William Danko report that 81 percent of millionaires are first-generation rich, and just 14 percent cite inheritance as the source of their wealth.[13]

The fact that just four out of five millionaires are first-generation rich raises the question: if inheritance is not the source of their wealth, how did these did these individuals become millionaires? Stanley and Danko's survey indicates that the primary mechanism of achieving wealth is for families to manage their money effectively and lead a frugal lifestyle. Contrary to conventional wisdom, most millionaires do not lead high-priced lifestyles. For example, the typical millionaire has never spent more than $400 on a suit and paid just $24,800 for his current automobile.

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B. Charitable Contributions

One objection to a reduction in the estate tax is that it would reduce contributions to charitable organizations. Because the estate tax allows individuals to deduct gifts to charitable organizations, there is a significant tax incentive to donate money at one's death. Reducing the tax on estates, the argument goes, could cause people to donate less money to charity. Recent research on this subject, however, indicates that the charitable tax deduction exerts only a modest, if any, stimulative effect. Although the charitable deduction may affect the timing of donations, it may not significantly alter the overall level of giving.

Despite the substantial tax benefits, a casual review of the data provides little evidence that tax incentives greatly affect charitable bequests. According to IRS data, only 20 percent of taxable estate tax returns actually made a charitable bequest on returns filed in 2001. Four out five tax estate tax returns did *not* take advantage of the price benefit of a charitable bequest.[14] Remarkably, a similar percentage – 22 percent – of households nationwide (most of whom do not receive tax benefits from charitable bequests) have either already included a charitable bequest in their will (8 percent) or are considering doing so (14 percent).[15]

To a certain degree, even these numbers overstate the scope of charitable giving, as a very small number of estates account for the vast majority of bequests to charity. The most recent tax return data indicate that the wealthiest 0.18 percent of decedents accounted for 79 percent of all charitable bequests made in 2000. In fact, a mere 0.011 percent of decedents (260 estate tax returns out of 2.4 million deaths) accounted for more than 38 percent of all charitable bequests that year.[16]

One of the most revealing studies on this subject found that individuals who gave generously during their life gave little at death, while those who gave little during life tended to give much more at death.[17] In brief, this research suggests that tax incentives may play a relatively limited role in determining total lifetime giving. Tax incentives may induce some donors to give their contributions earlier in life, but on balance, it appears that tax incentives (both income and estate) do not greatly alter the total amount of charitable giving made over an individual's lifetime.

The estate tax may actually be one of the greatest obstacles to charitable giving, as estate taxes crowd out charitable bequests. A survey of wealthy households (net worth of at least $5 million) found that respondents *expected* to distribute 16 percent of their estates to charity and 37 percent to taxes. However, respondents also indicated how they would *prefer* to distribute their wealth, with 26 percent going to charity and just 9 percent to taxes. In other words, for a $10 million estate, the wealth holder expected to leave $1.6 million to charity. In the absence of excessive estate taxation, the amount going to charity would increase 62.5 percent to $2.6 million.[18] In fact, some research suggests that repeal of the estate tax could actually result in an increase in charitable bequests.[19]

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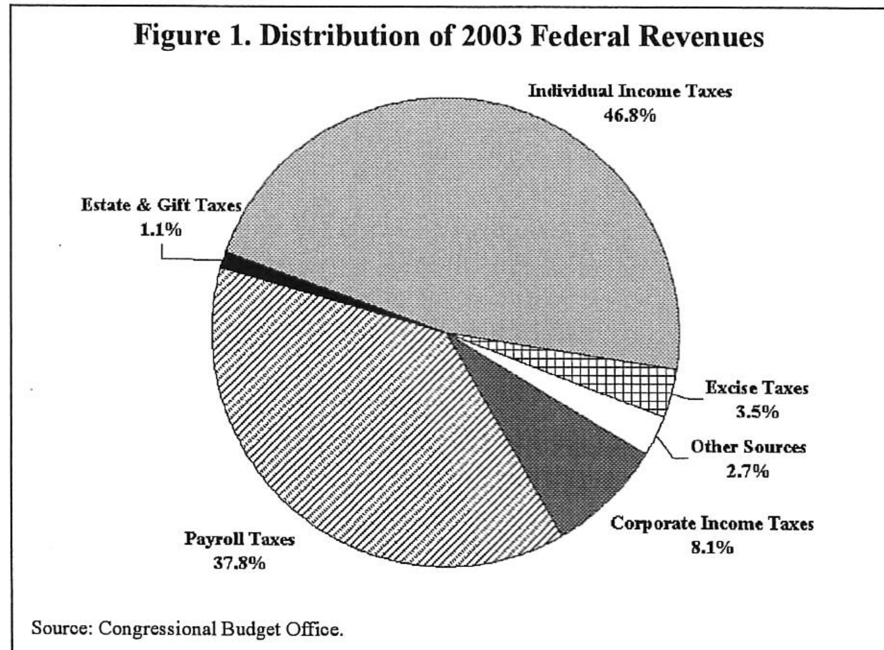
C. Federal Revenue

A third objection to cutting estate taxes is the alleged loss of revenue to the federal government. The estate tax accounts for a relatively small portion of federal revenue. Although the $22 billion that the estate tax will raise in 2003 is hardly insignificant, it amounts to only about 1.1 percent of the $1.9 trillion in total receipts (Figure 1).[20]

Figure 1. Distribution of 2003 Federal Revenues



Source: Congressional Budget Office.

The available data indicate that the estate tax may actually result in a net revenue loss for the federal government. The primary payers of the estate tax, the wealthy, tend to be well-educated about and willing to engage in extensive tax avoidance strategies. Moreover, it is difficult for any tax to assess accumulated savings and capital because such holdings can be manipulated through tax-free transfers and favorable asset valuation. These features led Joseph Stiglitz, chairman of President Clinton's Council of Economic Advisers, to conclude that,

> Of course, prohibitively high inheritance tax rates generate no revenue; they simply force the individual to consume his income during his lifetime.[21]

A more in-depth examination of the net revenue effect of the estate tax comes from Stanford University economist Douglas Bernheim. As has been well documented, the estate tax affords many opportunities to avoid paying any tax at all. However, such avoidance strategies principally occur by shifting resources from parents to their heirs. In general, revenue is lost whenever assets are transferred from parents in high income tax brackets to children (who typically face lower tax rates) or to tax-exempt organizations through charitable bequests.[22] Through an analysis of estate tax returns under different assumptions and tax regimes, Bernheim found that the income tax revenue loss associated with these factors is very large relative to the revenue raised by the estate tax. In sum, Bernheim concluded:

> Although it is very difficult to estimate these effects precisely, **in recent years true estate tax revenues may well have been negative**.[23] (emphasis added)

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IV. ARGUMENTS AGAINST ESTATE TAXATION

This section of the paper reviews the theoretical and empirical arguments against estate taxation. The four arguments considered here are that estate taxes: inhibit capital accumulation and economic growth; threaten the survival of family businesses and depress entrepreneurial activity; violate the principles of good tax policy; and adversely impact the conservation of environmentally sensitive land.

A. Economic Growth

Of all taxes imposed by the federal government, the estate tax is one of the most harmful to economic growth when measured on a per-dollar-of-revenue-raised basis. Although relatively small in terms of revenue raised, the estate tax is exerts a disproportionately negative impact on the economy. At its basest level, the estate tax adds yet another layer to the already heavy taxation of savings and investment.

The negative economic effect manifests in multiple ways. First, the estate tax has excessively high compliance costs. Although it is possible to avoid most, if not all tax liability on estates, doing so requires a substantial amount of planning and undesired allocation of resources. Alicia Munnell, a member of President Clinton's Council of Economic Advisers, estimated that the costs of complying with estate tax laws are roughly the same magnitude as the revenue raised.[24] Based on this ratio, compliance costs would amount to about $22 billion in 2003. Thus, for every dollar of tax revenue raised by the estate tax, another dollar is squandered in the economy simply to comply with or avoid the tax.

Secondly, the estate tax is a tax on capital, and as such it reduces the incentive to save and invest. The estate tax directly results in the loss of capital because it forces privately-held assets to be liquidated and transferred to governmental control. Wealth that would otherwise serve productive uses in the economy as capital assets, are transferred to consumption-intensive government uses. According to James Poterba, an economist at the Massachusetts Institute of Technology, the federal estate tax increases the effective tax burden on capital income by 1.3 to 1.9 percentage points.[25]

By reducing the after-tax return on investment, the estate tax encourages consumption and discourages savings, which in turn cause the capital stock to grow at a slower rate. To illustrate this effect, consider a situation where parents must choose between leaving an asset to their children or consuming it themselves. When faced with a 49 percent marginal tax rate, the "price" of bequeathing $1 is nearly $2 ($1.96). Alternatively, the parents could consume significantly more of that $1.96 for their own benefit. In the presence of high marginal estate tax rates, the decision between consumption and saving is significantly biased in favor of consumption. In his public finance textbook, Stiglitz, while admitting to some ambiguity, argues that on balance estate taxes "probably" reduce savings.[26]

A comprehensive estimate of all the negative impacts of the estate tax on economic growth is beyond the scope of this paper. However, an econometric framework is available for analyzing the effect of the estate tax on the existing capital stock. According to published

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research, every $1 reduction in the annual flow of intergenerational transfers is associated with a corresponding loss of roughly $39 in the long-run amount of capital in the economy. The 1998 Joint Economic Study estimated that the estate tax has reduced the stock of capital in the economy by approximately $497 billion, or 3.2 percent.[27]

B. Family Businesses and Entrepreneurial Activity

In addition to the aggregate effect on capital accumulation and economic efficiency, the estate tax exerts a strongly negative influence on entrepreneurial activity. Entrepreneurship infuses the economy with risk-takers willing to exploit new technologies and enables families to achieve upward income mobility. By hindering entry into self-employment and by breaking up family-run businesses, the estate tax inhibits economic efficiency and stifles innovation.

The existing tax code already offers family businesses limited estate tax relief. The chief provision has been a deduction for qualified family-owned businesses that allows such firms to shelter up to $1.3 million from estate taxation. However, the EGTRRA of 2001 repeals this provision effective in 2004, when the unified credit allows all estates to shield $1.5 million in assets, thus superceding the older provision. Other provisions preserved in EGTRRA for family-run businesses include the ability to apply to the IRS to pay estate tax bills in installments over 14 years. This is particularly useful for family farms, which may be asset-rich and cash-poor. Family businesses may also attempt to apply special valuation rules to their enterprise, which allow them to be valued at their current actual usage (subject to caps on the reduction in value), rather than at a potentially more valuable usage. In addition, the EGTRRA of 2001 made it easier for family businesses to qualify for these benefits.

Although these tax provisions do provide some relief, they are often inadequate to prevent the estate tax from breaking up many family businesses. Survey data indicate that the estate tax continues to be a primary reason why small businesses fail to survive beyond one generation. In fact, the estate tax is more likely to be the cause of failure during business succession than is the health or success of the business itself. A survey of family business owners by Prince & Associates found that 98 percent of heirs cited "needed to raise funds to pay estate taxes" when asked why family businesses fail.[28]

To the degree that the estate tax disrupts the transmission of a family business to succeeding generations, the estate tax impedes upward income mobility. Entrepreneurship is a key means by which lower-income households move to a higher-income class. For instance, one study found that low-wealth workers who become self-employed are more than twice as likely to move to a higher wealth class than are individuals who continue traditional work.[29]

Estate tax planning is crucial for the succession of family businesses to the next generation. The presence of the estate tax already makes such succession planning unnecessarily complicated and painful. Yet the current situation in which the level of estate taxation is uncertain precludes any sound planning. As the law now stands, the estate tax will slowly be phased out over the next several years until complete repeal in 2010. However, effective January 1, 2011, the repeal itself is revoked, and the estate tax returns to the level that existed in 2001. Thus, a difference in death of just a single day could mean the difference between no estate tax at

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all or extremely punitive taxation. This contradiction represents a major hurdle to any successful passing of family-run businesses to the next generation.

Concerns about the obstacles involved in passing a family business on to the next generation are especially significant for minority groups. Research indicates that blacks are more likely to become self-employed if their parents are self-employed than are other ethnic groups.[30] By making it more difficult for blacks to continue a family business, the harmful effects of estate taxes are magnified for black-owned enterprises.

Key black business leaders have advocated for estate tax repeal, arguing that it is only since the Civil Rights Act of 1964 that blacks have been able to accumulate wealth. Robert L. Johnson, the founder of Black Entertainment Television and contributor to Democrat political causes, has even argued that "Elimination of the estate tax will help close the wealth gap in this nation between African-American families and white families."[31] In fact, wealth accumulation was the lead essay in the National Urban League's *The State of Black America 1998*, concluding that "new and bold policy initiatives are needed to help African Americans accumulate assets to undergird their own social mobility and that of their children."[32]

For many low-income minority or ethnic groups, the estate tax represents a major obstacle to a successful family business. The importance of passing a family business to the next generation was the subject of a 1995 article in the magazine *Black Enterprise*, which reported:

> Leaving a legacy for future generations is a key motivation for pursuing entrepreneurship, particularly for African Americans. But achieving that legacy isn't easy. Only one in three family firms survives two generations; only one in six survives three generations. "The challenge is not starting a family business, but being able to pass it on from generation to generation," says John Sibley Butler, professor of management and chairman of sociology at the University of Texas at Austin.[33]

A similar sentiment is reflected in the advice of the financial planning book *The Black Woman's Guide to Financial Independence*:

> Estate taxes are the most expensive taxes you will ever have to pay. The federal estate tax has graduated rates ranging from 40-55%. The more you have, the higher the tax rate. This is money you have earned and should be passed on to your heirs instead of to the federal government.[34]

The principal reason that estate taxes cause such disruption to family businesses is that they impose large cash demands on firms that generally have limited access to liquid assets. For example, the typical small business owner has 60 percent of the family net worth invested in the business.[35] Smaller firms, typically lacking access to capital from financial markets, may be unable to obtain the optimal amount of capital to finance their investments. Intergenerational transfers function, in essence, as a sort of internal financing mechanism. To the degree that estate taxes reduce or limit intergenerational transfers, they also reduce the amount of financing available for investment in small or family-run enterprises.

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Inheritances play an important role in alleviating the liquidity constraints that impede the formation and success of small businesses. A 1994 study found that individuals who receive an inheritance are more likely to become self-employed, and those who are already self-employed are more likely to remain so.[36] Overall, the authors estimate that receiving a $150,000 inheritance (in 1985 dollars) results in a 1.3 percentage point increase in survival probability and a 20 percent increase in gross receipts.

C. Fairness, Simplicity and Efficiency

The estate tax violates the three principles of good tax policy: equity, simplicity and efficiency. The large number of tax avoidance options permitted under the estate tax (dubbed the "voluntary tax") means that the tax will result in a tax burden distributed unfairly among payers of the tax, will be unnecessarily complicated, and will significantly distort taxpayer behavior.

In terms of equity and simplicity, the existence of so many loopholes virtually guarantees that the estate tax will violate the principles of horizontal and vertical equity, as well as that of simplicity. An individual worth $5 million can not only pay less in estate taxes than other individuals worth $5 million, but can pay less than those worth $1 million. According to IRS data for 2001 returns, the average estate tax rate for the largest estates (gross estates over $20 million) is actually lower than the average rate for estates in the $2.5 to $5 million range. This aspect of estate taxation was summarized by Munnell, who wrote:

> Horizontal and vertical equity considerations have disappeared in the estate and gift area; **tax liabilities depend on the skill of the estate planner, rather than on capacity to pay**.[37] (emphasis added)

The efficiency of a tax system refers to the costs of complying with the tax. An efficient tax should not impede economic growth or change the way people behave. As previously noted, Aaron and Munnell estimate that the compliance costs of the estate tax are roughly the same size as the amount of revenue raised:

> In the United States, resources spent on avoiding wealth transfer taxes are of the same general magnitude as the [revenue] yield, suggesting that the ratio of excess burden to revenue of wealth transfer taxes is among the highest of all taxes.[38]

In 2002, the estate and gift taxes raised $27 billion. However, based on Aaron and Munnell's analysis, the true cost to the economy of these taxes was closer to $54 billion. In other words, for every $1 removed from the economy to pay estate taxes, another $1 is wasted in order to comply with or legally avoid the tax. Measured in these terms, the estate tax is highly inefficient.

D. Environmental Conservation

An often-overlooked aspect of the estate tax is its harmful effect on the environment. The impact manifests when heirs are forced to divide up or develop environmentally sensitive

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land in order to pay estate taxes. The problem of estate taxation faced by private landowners was addressed by *The Keystone Report*:

> Federal estate tax requirements are a major obstacle for private landowners whose land stewardship has been sensitive to its environmental value and who would like to be able to pass on their land to their heirs without destroying that value. The imposition of federal estate taxes often forces large parcels of environmentally valuable land to be broken up into smaller, less environmentally valuable parcels. Some of the best remaining habitat for endangered species is put at risk in this manner.[39]

When the time comes to pay estate taxes, real estate assets often produce a substantial tax liability that can only be paid by developing the land. The impact is most apparent for natural habitats that are destroyed. Endangered species are affected as well, since about one-half of all listed species are found only on privately-owned land. These effects of estate taxation led Michael Bean of The Nature Conservancy to label the estate tax as "highly regressive in the sense that it encourages the destruction of ecologically important land in private ownership."[40]

A 2001 analysis of estates and rural land holdings found that estate taxes have significant impacts on land use.[41] According to this study, conducted prior to EGTRRA of 2001, approximately 2.6 million acres of forest land must be harvested each year to pay for the estate tax. Another 1.3 million acres must be sold to raise funds to pay estate taxes, of which close to one-third (29 percent) is either developed or converted to other uses. Moreover, 36 percent of forest estates incur an estate tax liability, far higher than the overall rate in the U.S. population.

In recognition of the adverse environmental impact of taxing estates, the current federal tax code grants limited estate tax relief for qualifying "conservation easements," land that is set aside for environmental conservation. Land owners are exempt from paying estate taxes on the value of land that is lost due to the conservation easement (subject to certain requirements). The Taxpayer Relief Act of 1997 granted estates that donate such easements an additional tax deduction worth 40 percent (up to a maximum of $500,000) of the remaining value of the land. The EGTRRA of 2001 further assisted conservation efforts by making more land eligible to qualify as a conservation easement.

The conservation easement provisions, however, fall considerably short of remedying the tax's adverse environmental impact. Even with the limited conservation easement now in place, many estates will not, for a variety of reasons, take advantage of the option. Although many environmentalists would prefer expanding conservation easement options rather than complete repeal of the estate tax, it is nonetheless clear that the federal estate tax represents a continuing threat to endangered and threatened species and habitats.

V. CONCLUSION

This paper has documented the extensive costs associated with the federal estate tax. The detrimental effects of the estate tax are grossly disproportionate to the modest amount federal revenue it raises (if it raises any net revenue at all). Estate taxes result in a large amount of wasted economic activity. Over its lifetime, the presence of the estate tax has cost the economy

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roughly one-half a trillion dollars in capital stock. Moreover, the estate tax destabilizes family businesses at one of their most vulnerable points, the succession from one generation to the next. The enormous liquidity demands of the estate tax have contributed to the break up of thousands of small businesses as well as the destruction of environmentally sensitive land. In generating these outcomes, the estate tax has violated the basic principles of a good tax system – simplicity, fairness and efficiency.

If the estate tax generated sufficiently large benefits, then an argument could be made to justify its existence. However, all the evidence indicates that the estate tax has no redeeming qualities. There is no theoretical or empirical basis to suggest that the estate tax promotes fairness or reduces inequality. In addition, research indicates that the deduction for charitable bequests stimulates little or no additional giving. Even the $23 billion in revenue it raises is illusory, since estate tax avoidance activities likely generate equally large revenue losses under the income tax.

The estate tax is an unfortunate feature of the current federal tax system. The estate tax's punitive tax rates are not only the highest of all federal taxes (reaching nearly 80 percent), but are imposed at the most inappropriate of times – the death of a loved one. As if mourning such a loss were not enough, the federal government worsens the pain by seeking to confiscate upwards of one-half of all the decedent's accomplishments and successes. This final injurious grievance simply strengthens the conclusion that the estate tax generates costs to taxpayers, the economy and the environment that far exceed any potential benefits that it might arguably produce.

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ENDNOTES:

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Legislative Testimony

SB 356

January 18, 2006

Testimony before the Kansas Senate Assessment and Taxation Committee
By Marlee Carpenter, Vice President of Government Affairs

THE KANSAS CHAMBER

The Force for Business

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The Kansas Chamber and it's over 10,000 members support SB 356. Ninety-five percent of our members are small businesses and have less than 50 employees. Health insurance and tax relief is at the top of our agenda, and for our small and family owned business members estate taxes are an especially high priority.

Kansas is at a competitive disadvantage because of the current Kansas estate tax. The federal government has made significant strides in alleviating the burden of this tax, however, Kansas' laws does not comply with the federal law. The majority of states have either eliminated or phased out their state estate taxes. Kansas is only one of 19 states that continue to burden its residents with this punitive tax.

Small businesses believe that the Kansas estate tax is an obstacle in leaving their business to family members upon their death. Data from the US Chamber of Commerce show that a family-owned business stands to lose 55% of all its assets when it passes from one generation to the next. Because of this tax, 70% of families choose to cash out or abandon their business after one generation and only 13% of businesses survive into a third generation.

Family owned businesses invest their capital back into their companies though equipment or property purchases. Narrow profit margins and global competition make it difficult for most business owners to have the cash on hand to pay the tax.

Estate tax is an issue that affects a states competitive position. Today's society is a mobile society. Business owners that can locate in other states to avoid this tax will do so, taking with it their income tax and sales tax revenue. In Kansas, this has become such a large issue the Kansas Department of Revenue has published a new regulation that defines the residency of an individual. The proposed KAR 92-12-4a state that among other criteria, that where an individual has their bank account or buys a car has a bearing on whether they pay Kansas income taxes. In addition, these residency regulations can have a bearing on whether a person is a Kansas resident for estate tax purposes as well.

As the disparity grows between states, Kansas becomes a less competitive place to locate, stay and pass down a business. To encourage business growth in the state, barriers to passing down businesses from generation to generation becomes more and more important. We encourage the committee to favorably pass SB 356. Thank you for your time and I will be happy to answer any questions.

The Kansas Chamber, with headquarters in Topeka, is the statewide business advocacy group moving Kansas towards becoming the best state in America to do business. The Kansas Chamber and its affiliate organization, The Kansas Chamber Federation, have more than 10,000 member businesses, including local and regional chambers of commerce and trade organizations. The Chamber represents small, medium and large employers all across Kansas.

Assessment & Taxation
Date 1-18-06
Attachment # 8

Legislative Testimony

SB 365

January 18, 2006

Testimony before the Kansas Senate Assessment and Taxation Committee
By Marlee Carpenter, Vice President of Government Affairs

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The Kansas Chamber and its over 10,000 members have reservations about SB 365 its affects. The approach our member support is encompassed in SB 356, full repeal of the Kansas estate tax.

Philosophically, the Kansas Chamber opposes a stand alone estate tax because it places a financial burden on all types of businesses including farms and ranches. These operations are critical to the financial success of the state.

Family owned businesses must plan on an ongoing basis to pay legal and accounting fees, insurance premiums and appraisal fees related to estate tax planning. These considerations affect business decisions about company improvements, expansions and jobs. Many do not have the cash to fully avoid the tax, as one small business can easily be valued at $10 million and can trigger the top Kansas estate tax rate.

The Kansas Chamber and its members support a full repeal of the Kansas estate tax and have reservations about SB 365.

Thank you for your time and I will be happy to answer any questions.

The Kansas Chamber, with headquarters in Topeka, is the statewide business advocacy group moving Kansas towards becoming the best state in America to do business. The Kansas Chamber and its affiliate organization, The Kansas Chamber Federation, have more than 10,000 member businesses, including local and regional chambers of commerce and trade organizations. The Chamber represents small, medium and large employers all across Kansas.

Assessment & Taxation
Date 1-18-06
Attachment # 9

(New Regulation)

92-12-4a. Resident individual. (a) As used in this regulation, the term "Kansas resident" shall have the same meaning as that assigned to the term "resident individual" in K.S.A. 79-32,109, and amendments thereto.

(b) This subsection shall apply in determining whether a natural person is a "resident individual," as the term is defined in K.S.A. 79-32,109 and amendments thereto, on the basis that the person's domicile is within Kansas.

(1) Subject to the further conditions and requirements in this subsection, "domicile" shall mean that place in which a person's habitation is fixed, without any present intention of removal, and to which, whenever absent, that person intends to return.

(2) Each person shall have only one domicile at any particular time. Once shown to exist, a domicile shall be presumed to continue until the contrary is shown. The absence of any intention to abandon an existing domicile shall be considered to be equivalent to the intention to retain the domicile.

(A) A person who leaves that person's domicile to go into another jurisdiction for temporary purposes shall not be considered to have lost the domicile. The mere intention to acquire a new domicile, without the fact of physical removal, shall not change a person's domicile, and the fact of physical removal from a person's domicile, without the intention to remain absent, shall not change that person's domicile.

(B) If a person whose domicile is in Kansas is absent from Kansas for more than six months of the tax year, that person shall not be presumed to have lost that domicile. If a person leaves this state to accept a job assignment in another jurisdiction, that person shall not be presumed to have lost that person's domicile in this state.

(C) A person who is temporarily employed within this state shall not be deemed to have acquired a domicile in this state if, during that period, the person maintains that person's domicile outside of the state of Kansas.

(3) A person shall be considered to have established that person's domicile in Kansas on the date that the person arrives in the state for other than temporary or transitory purposes. A person shall be considered to have abandoned that person's domicile on the date that the person leaves the state without any intention to return to Kansas.

(4) Any citizen of a foreign country may acquire a domicile for Kansas tax purposes without surrendering that person's rights as a citizen of that country.

(5) Except for a person who is covered by the provisions of the soldiers' and sailors' civil relief act of 1940, 50 U.S.C. app. § 574, there shall be a presumption that the place where a person's family is domiciled is that person's domicile. The domicile of a person who is married shall be the same as the person's spouse unless there is affirmative evidence to the contrary, the husband and wife are legally separated, or the marriage has been dissolved. When a person

has made a home at any place with the intention of remaining there indefinitely and the person neither lives at the home in which the person's family lives nor intends to do so, then that person shall be deemed to have established a domicile separate from that person's family.

(6) If a minor child is not emancipated, the domicile of the child's parents shall be the domicile of the child. The domicile of the parent who has legal custody of the child shall be the domicile of the child.

(7) The following factors shall be considered in determining whether or not a person's domicile is in this state for the tax years in question:

(A) The location of the person's domicile for prior years;

(B) the location at which the person votes or is registered to vote, except that casting an illegal vote shall not establish a domicile for income tax purposes;

(C) the person's status as a student;

(D) the location of the person's employment;

(E) the classification of the person's employment as temporary or permanent;

(F) the location of the person's newly acquired living quarters and whether the newly acquired living quarters are owned or rented;

(G) the present status or disposition of the person's former living quarters, including whether those living quarters have been sold, offered for sale, rented, or made available for rent to another;

(H) the person's ownership of other real property;

(I) the jurisdiction in which the person has been issued a valid driver's license;

(J) the jurisdiction from which any professional licenses were issued to the person;

(K) the location of the person's union membership;

(L) the jurisdiction from which any motor vehicle registration was issued to the person and the actual physical location of the person's vehicle or vehicles;

(M) the purchase of any resident or nonresident fishing or hunting licenses by the person;

(N) the filing by the person of a Kansas tax return, report, or application as a Kansas resident or a nonresident individual;

(O) the fulfillment or failure to fulfill by the person of the tax obligations required of a Kansas resident;

(P) the location of the person's bank accounts. In considering the application of this factor, the greatest weight shall be given to the location of the most active checking account;

(Q) the location of other financial institutions with which the person conducts transactions;

(R) the location of the place of worship where the person is a member or attends regularly;

(S) the location of the person's business relationships and the place or places where the person's business is transacted;

(T) the location of any lodge, country club, or social, fraternal, or athletic organizations or clubs of which the person is a member;

(U) the address where mail is received by that person and not subsequently forwarded;

(V) the percentage of time that the person is physically present within the state of Kansas and the percentage of time that the person is physically present in each jurisdiction other than the state of Kansas;

(W) the location of the jurisdiction from which any unemployment compensation benefits are received by the person;

(X) the location of schools that the person or the person's spouse or children attend and whether resident or nonresident tuition was charged;

(Y) the representations made to any insurance company concerning the person's residence and on which any insurance policies are issued;

(Z) the location and contents of each of the person's homes and the value of each home;

(AA) the address associated with a person's name in a telephone directory listing;

(BB) the location of each physician, dentist, osteopath, optometrist, other health provider, or veterinarian utilized by the person, the person's spouse, or the person's children;

(CC) the location of each law firm, accounting firm, or other similar professional firm or business utilized by the person, the person's spouse, or the person's children;

(DD) the location where the person, the person's spouse, or the person's children participate in sporting events, group activities, or public performances; and

(EE) any other fact relevant to the determination of that person's domicile.

(8) None of the factors listed in paragraph (b)(7) shall, by itself, be a determinant of a person's domicile.

(9) The location of any organizations to which charitable contributions are made by a person shall not be considered in determining whether or not that person is domiciled in Kansas.

(c) This subsection shall apply in determining whether a natural person is a "resident individual," as the term is defined in K.S.A. 79-32,109 and amendments thereto, based on the presumption that a natural person who spends, in the aggregate, more than six months of the taxable year within the state of Kansas is a resident individual in the absence of proof to the contrary.

(1) In counting the number of days spent in Kansas, the person shall be treated as present in Kansas on each day that the person is physically present in Kansas at any time during that day.

(2) The length of time that a person spends in Kansas during a taxable year shall not be used to determine whether the person is a resident individual if that person is deemed not to be a resident of Kansas under the soldiers' and sailors' relief act of 1940, 50 U.S.C. app. § 574.

(3) The presumption that a person who spends, in the aggregate, more than six months of the taxable year within the state of Kansas is a resident individual in the absence of proof to the contrary shall be deemed to be rebutted if the person is temporarily employed within this state but maintains that person's domicile outside of the state of Kansas.

(d) Each natural person who is deemed not to be a resident of Kansas using criteria established under other statutes, regulations, or policies regarding residency shall nonetheless be deemed a resident individual if the person meets the conditions and requirements established by this regulation.

(e)(1) Each Kansas resident who moves at any time during the tax year to another jurisdiction without any intention to return to Kansas shall be considered a part-year Kansas resident for that tax year.

(2) Each person whose domicile is outside of Kansas, but who moves that person's domicile to Kansas at any time during the tax year, shall be deemed to be a part-year Kansas resident. (Authorized by K.S.A. 79-3236; implementing K.S.A. 79-32,109; effective P-_______________.)

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Senate Assessment & Taxation Committee

January 18, 2006

Topeka, Kansas

SB 356 - Repeal of the Kansas Estate Tax.

Chair Allen and members of the Senate Assessment & Taxation Committee, thank you for the opportunity to share our support for SB 356 repealing the Kansas Estate Tax. I am Leslie Kaufman and I serve the Kansas Cooperative Council as Executive Director.

The Kansas Cooperative Council represents all forms of cooperative businesses across the state -- agricultural, utility, credit and consumer cooperatives. A unique feature of cooperative businesses is the fact they are member owned and member controlled. Thus, our businesses interest as a cooperative entity is tied to our member-owner's success in their individual capacity.

Many co-op members are business owners, farmers and ranchers. They work hard to build and improve their business operations and provide for their families. They pay income taxes on revenue generated by the operations. They pay property taxes. And yes, many of these businesses are impacted by estate tax when the proprietor passes. Often the impacts are extremely significant on the remaining family members.

We support repeal of the estate tax. A loved-one's death should not trigger a taxable event. We encourage this committee to act favorable on SB 356 and repeal the estate tax.

Thank you for your consideration. Should you have questions or comments regarding our statement, please feel free to contact me at 785-220-4068.

Leslie Kaufman, Executive Director
Kansas Cooperative Council

Assessment & Taxation
Date 1-18-06
Attachment # 10

#1

Estate Tax Receipts Under Current Law, SB 365, and SB 356

($ in millions)

	SGF Receipts- Current Law	SGF Receipts- SB 365 Stand-Alone	SB 365 F Note	SGF Receipts- SB 356 Repeal	SB 356 F Note	F Note Difference Between SB 365, 356
FY 2007	$52.0	$52.0	$0.0	$39.0	-$13.0	$13.0
FY 2008	$43.0	$52.0	$9.0	$0.0	-$43.0	$52.0
FY 2009	$32.0	$52.0	$20.0	$0.0	-$32.0	$52.0
FY 2010	$15.0	$52.0	$37.0	$0.0	-$15.0	$52.0
FY 2011	$5.0	$52.0	$47.0	$0.0	-$5.0	$52.0
FY 2012	$0.0	$52.0	$52.0	$0.0	$0.0	$52.0
thru FY 12	$147.0	$312.0	$165.0	$39.0	-$108.0	$273.0

Assessment & Taxation
Date 1-18-06
Attachment # 11