Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Wiener	Analyst:	Jon Feenstra	Bill Number:	SB 726
Related Bills:	See Legislative History	Telephone:	845-4870	Amended Date:	March 23, 2017
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Repeal and Replacement of California Estate Tax

SUMMARY

This bill would repeal and recast the state's estate tax provisions.

RECOMMENDATION – NO POSITION

Summary of Amendments

The March 23, 2017, amendments removed the bill's provision that would have made a nonsubstantive change to a section of the Revenue and Taxation Code and replaced them with the provisions discussed in this analysis. This is the department's first analysis of the bill.

REASON FOR THE BILL

The reason for this bill is to counter-balance federal tax cuts by recapturing the lost funds and investing them in California's schools, healthcare system, and roads and public transportation systems.

EFFECTIVE/OPERATIVE DATE

This bill would become effective immediately with regard to the call for a special election. Upon approval by the voters, the estate tax provisions would be specifically operative on January 1, 2019.

FEDERAL LAW

Estate Tax

The federal estate tax is a tax on the right to transfer property at an individual's death. It consists of an accounting of everything an individual owns or has certain interests in at the date of death. The fair market value of these items is used, not necessarily what was paid for them or what their values were when they were acquired. The total of all of these items is the "gross estate." The gross estate includes all property in which the decedent had an interest (including real property outside the United States). It also includes:

- Certain transfers made during the decedent's life without an adequate and full consideration in money or money's worth,
- Annuities,
- The includible portion of joint estates with right of survivorship,

- The includible portion of tenancies by the entirety,
- Certain life insurance proceeds (even though payable to beneficiaries other than the estate),
- Property over which the decedent possessed a general power of appointment,
- Dower or curtesy (or statutory estate) of the surviving spouse, and
- Community property to the extent of the decedent's interest as defined by applicable law.

Once the gross estate has been accounted for, certain deductions (and in special circumstances, reductions to value) are allowed in arriving at the "taxable estate." These deductions may include mortgages and other debts, estate administration expenses, property that passes to surviving spouses and qualified charities. The value of some operating business interests or farms may be reduced for estates that qualify.

After the net amount is computed, the value of lifetime taxable gifts (beginning with gifts made in 1977) is added to this number and the tax is computed. The tax is then reduced by the available unified credit.

Most relatively simple estates (cash, publicly traded securities, small amounts of other easily valued assets, and no special deductions or elections, or jointly held property) do not require the filing of an estate tax return. A filing is required for estates with combined gross assets and prior taxable gifts exceeding $5,490,000 in 2017.

Beginning January 1, 2011, estates of decedents survived by a spouse may elect to pass any of the decedent’s unused exclusion to the surviving spouse. This election is made on a timely filed estate tax return for the decedent with a surviving spouse. Note that simplified valuation provisions apply for those estates without a filing requirement absent the portability election.

Gift Tax

The gift tax applies to lifetime transfers of property from one person (the donor) to another person (the donee). A gift is made if tangible or intangible property (including money), the use of property, or the right to receive income from property is given without expecting to receive something of at least equal value in return. If something is sold for less than its full value or if a loan is made without interest or with reduced (less than market rate) interest, a gift may have been made.

The general rule is that any gift is a taxable gift. However, there are many exceptions to this rule. Generally, the following gifts are not taxable gifts:

- Gifts, excluding gifts of future interests, that are not more than the annual exclusion for the calendar year,
- Tuition or medical expenses paid directly to an educational or medical institution for someone else,
- Gifts to your spouse,

- Gifts to a political organization for its use,
- Gifts to certain tax-exempt organizations,[1] and
- Gifts to charities.

Annual exclusion. A separate annual exclusion applies to each person to whom a gift is made. The gift tax annual exclusion is $14,000 for 2017 and is subject to cost-of-living increases.

Generation-Skipping Transfer Tax

The generation-skipping transfer tax (GST) may apply to gifts during the decedent's life or transfers occurring at the decedent's death, called bequests, made to skip persons. A skip person is a person who belongs to a generation that is two or more generations below the generation of the donor. For instance, the decedent's grandchild will generally be a skip person to the decedent and his or her spouse. The GST tax is figured on the amount of the gift or bequest transferred to a skip person, after subtracting any GST exclusion allocated to the gift or bequest at the maximum gift and estate tax rates. Each individual has a GST exclusion equal to the basic exclusion amount, as indexed for inflation, for the year the gift or bequest was made. GSTs have three forms: direct skip, taxable distribution, and taxable termination.

A direct skip is a transfer made during an individual's life or occurring at their death that is:

1. Subject to the gift or estate tax,
2. Of an interest in property, and
3. Made to a skip person.

A taxable distribution is any distribution from a trust to a skip person which is not a direct skip or a taxable termination. A taxable termination is the end of a trust's interest in property where the property interest will be transferred to a skip person.

Exclusion Amounts and Applicable Tax Rates

A unified credit is available with respect to taxable transfers by gift and at death.[2] The unified credit offsets tax computed at the lowest estate and gift tax rates.

The estate and gift taxes are fully unified, such that a single graduated rate schedule and a single effective exclusion amount of the unified credit applies for purposes of determining the tax on cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. The highest estate and gift tax rate is 40 percent. The unified credit effective exclusion amount for 2017 is $5.49 million for combined estate and gift tax purposes.

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[1] IRC sections 501(c)(4), 501(c)(5) and 501(c)(6).
[2] IRC section 2010.

The GST tax is imposed using a flat rate equal to the highest estate tax rate on cumulative GSTs in excess of the exclusion amount in effect at the time of the transfer. The GST tax exclusion for a given year is equal to the unified credit effective exclusion amount for estate tax purposes.

State Death Tax Credit; Deduction for State Death Taxes Paid

Phase-out of state death tax credit; deduction for state death taxes paid

Under EGTRRA,[3] the amount of allowable state death tax credit was reduced from 2002 through 2004. For decedents dying after 2004, the state death tax credit was repealed and replaced with a deduction for death taxes actually paid to any state or the District of Columbia, in respect of property included in the gross estate of the decedent.[4] Such state taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under Internal Revenue Code (IRC) section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or generally 60 days after a decision of a court in which such refund suit has become final.

Transfers to a Surviving Spouse

A 100-percent marital deduction generally is permitted for estate and gift tax purposes for the value of property transferred between spouses.[5] Transfers of “qualified terminable interest property” are eligible for the marital deduction. “Qualified terminable interest property” is property: (1) that passes from the decedent; (2) in which the surviving spouse has a “qualifying income interest for life”; and (3) to which an election applies. A “qualifying income interest for life” exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during the spouse’s life; and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

Transfers to surviving spouses who are not U.S. citizens

A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States.[6] A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution.

[3] "EGTRRA" refers to the Economic Growth and Tax Relief Reconciliation Act of 2001, PL 107-16.
[4] IRC section 2058.
[5] IRC sections 2056 and 2523.
[6] IRC sections 2056(d)(1) and 2523(i)(1).

The estate tax is imposed on: (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse; and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

Conservation Easements

An executor generally may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $500,000.[7] The exclusion percentage is reduced by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

Provisions Affecting Small and Family-Owned Businesses and Farms

Special-use valuation

An executor may elect to value for estate tax purposes certain “qualified real property” used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value.[8] The maximum reduction in value for such real property was $1.12 million for 2017.

Installment payment of estate tax for closely held businesses

Estate tax generally is due within nine months of a decedent’s death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely-held business in two or more installments (but no more than 10).[9]

Estate and Gift Taxation of Nonresident Noncitizens

For estate and gift tax purposes, a nonresident noncitizen is generally someone who was not domiciled in the United States and not a U.S. citizen at the time of death or transfer. A person acquires a domicile by living in a place for even a brief period of time, as long as the person had no intention of moving from that place.

Nonresident noncitizens are subject to gift tax with respect to certain transfers by gift of U.S.-situated property. Such property includes real estate and tangible property located within the United States. Nonresident noncitizens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

[7] IRC section 2031(c).
[8] IRC section 2032A.
[9] IRC section 6166.

Estates of nonresident noncitizens generally are taxed at the same estate tax rates applicable to U.S. citizens, but the taxable estate includes only property situated within the United States that is owned by the decedent at death. This includes the value at death of all property, real or personal, tangible or intangible, situated in the United States. Special rules apply which treat certain property as being situated within and without the United States for these purposes. Unless modified by a treaty, a nonresident who is not a U.S. citizen generally is allowed a unified credit of $13,000, which effectively exempts $60,000 in assets from estate tax.

Tax on Gifts and Bequests Received by U. S. Citizens and Residents from Expatriates

A special transfer tax applies to certain “covered gifts or bequests” received by a U.S. citizen or resident. A covered gift or bequest is any property acquired (i) by gift directly or indirectly from an individual who is a covered expatriate at the time of such acquisition, or (ii) directly or indirectly by reason of the death of an individual who was a covered expatriate immediately before death. A covered gift or bequest, however, does not include (i) any property shown as a taxable gift on a timely filed gift tax return by the covered expatriate, (ii) any property included in the gross estate of the covered expatriate for estate tax purposes and shown on a timely filed estate tax return of the estate of the covered expatriate, and (iii) any property with respect to which a deduction would be allowed under estate and gift tax provisions.[10]

The special transfer tax applies to any U.S. citizen who relinquishes citizenship and any long-term resident who terminates U.S. residency, if such individual (“covered expatriate”): (1) has an average annual net income tax liability for the five preceding years ending before the date of the loss of U.S. citizenship or residency termination that exceeds $162,000 (as adjusted for inflation in 2017); (2) has a net worth of $2 million or more on such date; or (3) fails to certify under penalties of perjury that he or she has complied with all U.S. federal tax obligations for the preceding five years or fails to submit such evidence of compliance as the Secretary may require.

STATE LAW

Estate “Pick-Up” Tax

California does not conform to the federal estate and GST taxes, but instead imposes what is referred to as the estate "pick-up" tax. The estate “pick-up” tax is a tax equal to the maximum federal estate tax credit allowed. The federal estate tax credit was repealed for decedents dying after 2004, thus the state’s pick-up tax is zero.

The California estate “pick-up” tax is administered by the State Controller’s Office.

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[10] IRC sections 2055, 2056, 2522 or 2523, whichever is appropriate (these sections allow deductions for transfers for charitable purposes or to spouses, for purposes of determining estate and gift taxes).

THIS BILL

This bill would repeal the provisions of the California estate “pick-up” tax and add provisions that would conform, with modifications, to the federal estate, gift and GST taxes. The modifications to federal law are as follows:

- The basic exclusion amount of $5,490,000 would be substituted for the federal amount of $5,000,000.
- The basic exclusion amount would be subject to an inflation adjustment under the formula prescribed in the Personal Income Tax Law (PITL) for the imposition of tax rates and brackets.
- The term “taxpayer” would be substituted for the terms “executor,” “decedent,” or any combination of those terms in each place they appear.
- The term “Franchise Tax Board” would be substituted for the term “Secretary” in each place it appears.
- The phrase “the taxable estate of each individual” would be substituted for the phrase “transfer of the taxable estate of every decedent who is a citizen or resident of the United States.”

If passed by the voters, as discussed below, the estate tax provisions would apply on or after January 1, 2019.

On or before July 1, 2019, the Franchise Tax Board (FTB) would be required to develop a return for the payment of the taxes imposed by this bill.

The bill specifies that the following penalties would be applicable:

- Delinquent Penalty (failure to file a timely return),
- Underpayment penalty (failure to timely pay), and
- Fraud Penalty (filing a false or misleading return).

The FTB would be authorized to promulgate regulations to implement the bill’s provisions.

The bill includes off-code language specifying:

As an amendment of an initiative statute, the bill’s tax provisions would become effective only upon approval by the voters at a statewide election. The bill calls for a special election and specifies that it is to be consolidated with the next statewide election.

If enacted, the bill’s provisions could be amended by a majority vote of both houses of the Legislature, unless otherwise required by the California Constitution.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation considerations for purposes of a high-level discussion; additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

If passed by the Legislature, this measure could be approved by the voters on the November 6, 2018 ballot and become operative in January of the 2019 taxable year. The provisions of this bill establish an estate tax which would require a return to be filed beginning after the decedent's date of death. As a result, the FTB would have less than two months to implement extensive filing programs, systems, and tax forms. It is recommended that the author amend the bill to substitute an operative date of January of 2020.

The bill's provisions fail to make clear whether the estate tax would apply to estates being administered as of the operative date of January 1, 2019. It is recommended that the author amend the bill to be transactionally operative to estates of decedents dying after December 31, 2018.

It is unclear if it is the author's intent that the provisions of this bill would be applicable only in the case of revisions to the federal estate, gift, and GST tax. If so, it is recommended that the author amend the bill to become operative upon enactment of specified federal revisions to the estate, gift and GST tax.

This bill uses terms that are undefined, i.e., "taxpayer" and "the taxable estate of each individual." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this bill. The author may want to amend the bill to clearly define the terms.

This bill substitutes the phrase "the taxable estate of each individual" for the phrase "transfer of the taxable estate of every decedent who is a citizen or resident of the United States." It is recommended that the author change the substituted phrase to "transfer of the taxable estate of every decedent who is a resident of this state." If it is the author's intent to include transfers of estates, gifts and GST of U.S nonresidents, it is recommended to additionally substitute the phrase "the taxable estate of every decedent who is a nonresident of this state" for the phrase "taxable estate of every decedent nonresident not a citizen of the United States".

This bill substitutes the word "taxpayer" with the words "decedents", "executor" or any combination of those terms. Substituting the word "executor" for the word "taxpayer" would create ambiguity when applying provisions that are specific to executors and could lead to disputes with taxpayers. It is recommended that the author amend the bill to eliminate substitution of the word "executor".

Because the bill fails to specify otherwise, the FTB would be subject to the rulemaking procedures required under the Administrative Procedures Act (APA). Following these procedures may delay the implementation of this bill. To prevent any delay, it is recommended that the author add a provision exempting the FTB from the APA when the FTB is prescribing rules, guidelines, or procedures necessary or appropriate to carry out the purpose of this bill.

Nexus is a constitutional requirement that must be satisfied before a state can properly exercise its power to tax. It is established by a level of presence or activity within a state that is sufficient to establish a connection between the state and an individual that allows the state, under the U.S. Constitution, to exercise jurisdiction over the individual and impose a tax. How would the department and taxpayers determine that constitutional nexus to tax exists?

This bill lacks administrative details necessary to implement the bill and determine its impacts to the department's systems, forms, and processes. The bill is silent on the following issues:

1. Interest, issuance of refunds, collection of tax, suit for tax, and lien of tax under California law. Federal law, which is being incorporated by this bill, refers to provisions to which California does not conform.
2. Audit, assessment, protest and appeal under California law. Federal law, which is being incorporated by this bill, refers to federal provisions to which California does not conform.

This bill would require that the FTB would administer estate, gift, and GST taxes. The State Controller's Office administers the California estate and GST taxes. As such, the FTB does not have the expertise to administer the provisions of this bill or computer systems with the current ability to accommodate such returns. The author may wish to amend the language to require the State Controller's Office to administer the provisions of this bill.

TECHNICAL CONSIDERATIONS

On page 3, line 18, substitute "Part 10.2 (commencing with Section 18041)" for "Part 10 (commencing with Section 17001)".

LEGISLATIVE HISTORY

Research of California legislation found no legislation similar to the provisions of this bill.

OTHER STATES' INFORMATION

Review of *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York* laws found no comparable conformity to federal estate and gift taxes. These states were selected and reviewed due to their similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

Department staff is unable to determine the costs to administer this bill until the implementation concerns have been resolved, but anticipate the costs to be significant.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in an annual estimated revenue gain of greater than $5 billion, beginning with the 2019 tax year.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

This bill proposes to conform to the federal estate, gift and GST taxes, with modifications.

This estimate is based on the proration of the Joint Committee on Taxation's (JCT) report on the federal wealth transfer tax system published on March 18, 2015. In this report, the JCT stated that the federal revenue from estate, gift, and GST taxes were $19 billion in 2014. Data available shows the majority of this revenue stems from the estate tax. Using this baseline, it is estimated that federal revenues would be $23 billion in 2019. To determine California's share of the federal gain, federally reported data was used to calculate that 25 percent, or $6 billion, of nationally reported estate taxes would be attributable to California. Since this bill does not modify the federal tax rates, the rates imposed by California would be equal to the federal tax rates. As a result, this amount would represent the estimated revenue gain to California. The department was unable to identify federal estimates for the special valuation rules and for gifts and bequests from expatriates. As a result, the department estimates the annual revenue gain from conforming to modifications to the federal estate and gift tax would be greater than $5 billion annually, beginning with the 2019 tax year.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that implementing additional California estate and gift taxes would offset proposed federal tax cuts that disproportionately benefit wealthy taxpayers, thereby reducing the impact of a tax burden shift on lower-income Californians.

Opponents: Some may argue that establishing an estate and gift tax based on the federal regime without modification of federal tax rates would impose an onerous tax burden on Californians.

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