STATE OF CALIFORNIA
Franchise Tax Board

Analysis of Amended Bill

Author: Wiener, et al.	Sponsor:	Bill Number: SB 378
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Subject: California Estate & Gift Taxes

Summary

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

This analysis only addresses the provisions that would impact the department.

Recommendation – No position.

Summary of Amendments

The March 25, 2019, amendments removed provisions of the bill related to the Business and Professions Code, added additional co-authors, and added provisions that would call for a special election that would propose to the voters the:

- Imposition of estate, gift, and generation-skipping transfer taxes.
- Creation of the Children's Wealth and Opportunity Building Fund as a special fund in the State Treasury.
- Requirement that all taxes, interest, penalties, and other amounts collected under this tax would be paid to the Franchise Tax Board (FTB).
- Amounts collected, less payments of refunds, would be deposited in the new fund.
- Appropriation of all moneys collected would be continuously deposited in the new fund to support programs and services that directly address and alleviate socio-economic inequality and build assets among people that have historically lacked them.

This is the department's first analysis of the bill.

Reason for the Bill

The reason for this bill is to create a Children's Wealth and Opportunity Building Fund to counterbalance the uneven effects of intergenerational wealth transfer.

Effective/Operative Date

This bill would become effective immediately due to the call for a special election. Upon approval by the voters, the estate tax provisions would be specifically operative for transfers occurring on and after January 1, 2021.

Federal/State Law

Under existing federal law, a gift tax is imposed on certain lifetime transfers, and an estate tax is imposed on certain transfers at death. A generation-skipping transfer tax (GST) generally is also imposed on transfers, either directly or in trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation younger than that of the transferor). Transfers subject to the GST include direct skips, taxable terminations, and taxable distributions.

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 (FMV) 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 (U.S.)).

It includes:

- All assets and interests, regardless of their locations.
- 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 courtesy (or statutory estate) of the surviving spouse.
- 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.

An estate tax return is required for estates with combined gross assets and prior taxable gifts exceeding $11,180,000 in 2018.[1] 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.

Gift Tax

The federal 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, excluding gifts of future interests, which 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.[2]
- Gifts to charities.

An annual exclusion applies to each person to whom a gift is made. The gift tax annual exclusion is $15,000 for 2019, adjusted for inflation.

Generation-Skipping Transfer Tax

The federal 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

[1] Internal Revenue Code (IRC) section 2010(c)(3)(C).
[2] IRC sections 501(c)(4), 501(c)(5) and 501(c)(6).

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 subject to the gift or estate tax, of an interest in property, and 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.[3] 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 2018 is $11,180,000 for combined estate and gift tax purposes.

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.

Deduction for State Death Taxes Paid

For federal purposes, 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, is allowed.[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

[3] IRC section 2010.
[4] IRC section 2058.

2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final;

   (b) Expiration of the period of extension to pay estate taxes over time under IRC section 6166; or

   (c) 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 to a surviving spouse.[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 Noncitizen Surviving Spouses

A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the U.S.[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 estate 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.

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.

[5] IRC sections 2056 and 2523.
[6] IRC sections 2056(d)(1) and 2523(i)(1).

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

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 FMV.[8] The maximum reduction in value for such real property was $1.14 million for 2018.

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 payments).[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 U.S. 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, including real estate and tangible property located within the U.S. 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.

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 U.S. 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 U.S. Special rules apply which treat certain property as being situated within and without the U.S. 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.

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

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 any property:

i) Shown as a taxable gift on a timely filed gift tax return by the covered expatriate.
ii) 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.
iii) 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 $165,000 (as adjusted for inflation in 2018);
(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 federal tax obligations for the preceding five years or fails to submit such evidence of compliance as the Secretary may require.

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, which is administered by the State Controller's Office (SCO). The estate "pick-up" tax is a tax equal to the maximum federal estate tax credit allowed. Because the federal estate tax credit was repealed, the state's pick-up tax is zero.

[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 Revenue and Taxation Code provision prohibiting California from imposing estate and gift taxes and add provisions that would conform, with modifications, to the federal estate, gift and GST taxes. The modifications to federal law includes:

- The basic federal exclusion amount of $11,180,000 would be replaced with $3,500,000.
- The basic exclusion amount would not be subject to an inflation adjustment.

If passed by the voters, as discussed below, these provisions would apply to any citizen or resident of the U.S. who is also a California resident. The estate tax provisions would apply to estates of decedents dying on or after January 1, 2021, and the gift and GST tax provisions would apply to transfers occurring on and after January 1, 2021.

The taxpayer would be granted a credit for any federal estate, gift and GST taxes paid.

The estate tax and the GST related to a transfer of a taxable estate, imposed by this section, would be paid by the executor, and would be due nine months after the date of death of the decedent. The gift tax and the GST related to a transfer of property by gift, imposed by this section, would be paid by the donor, and would be due by the deadline to submit state income tax returns for the year in which the transfer of property by gift was made.

A taxpayer may elect to extend the time to pay the estate, gift or GST taxes imposed by this part for any reason similar to that applicable for federal purposes. However, in no case will the time extended to pay the tax exceed 14 years from the date the tax is due.

The bill specifies that the following penalties would be applicable:

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

On or before July 1, 2021, the FTB would be required to develop a return for the payment of the taxes imposed by this bill.

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

If passed by the voters, the Children's Wealth and Opportunity Building Fund would be created as a special fund in the State Treasury. All taxes, interest, penalties, and other amounts collected and paid to the FTB pursuant to this part, less payments of refunds, would be deposited in the fund.

Notwithstanding Section 13340 of the Government Code,[11] the moneys deposited in the Children's Wealth and Opportunity Building Fund would be continuously appropriated, without regard to fiscal years, to programs and services that directly address and alleviate socio-economic inequality and that build assets among people that have historically lacked them.

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.

This bill uses terms that are undefined, i.e., "resident" and "resident decedent." 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.

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[11] California Government Code section 13340 provides that on and after July 1, 2018, no moneys in any fund that, by any statute other than a Budget Act, are continuously appropriated without regard to fiscal years may be encumbered unless the Legislature, by statute, specifies that the moneys in the fund are appropriated for encumbrance, except for limited disbursements, e.g., related to certain sales and use tax, certain transactions and use tax, certain bonds and related programs, certain California State University fiduciary funds, and certain license fees.

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 to carry out the purpose of this bill.

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 administer estate, gift, and GST taxes. The SCO 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 that the SCO administer the provisions of this bill.

Technical Considerations

On page 5, line 31, substitute "Part 10.2 (commencing with Section 18041)" for "Part 10 (commencing with Section 17001)".

Legislative History

SB 726 (Wiener, Chaptered 930, Statutes of 2018), in the version as amended March 23, 2017, would have repealed and recast the state's estate tax provisions. However, prior to enactment, the bill was amended on January 3, 2018, and the language related to the estate tax provisions was removed from the 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 the following revenue gain:

Estimated Revenue Impact of SB 378 of as Amended March 25, 2019
Assumed Enactment after June 30, 2019

($ in Millions)

Fiscal Year	Revenue*
2019-2020	$0
2020-2021	$2.7
2021-2022	$4.8

This estimate assumes the bill is approved by voters.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Revenue Discussion

This estimate is based on the proration of the Joint Committee on Taxation's federal wealth transfer tax system data as included in their February 7, 2018, report. It is estimated that federal revenue from estate, gift, and GST would be $29 billion in the 2021 taxable year. Federally reported data was used to determine that 25 percent, or $7.3 billion, of estate taxes would be attributable to California. This amount is increased to account for the difference between the federal and state exclusion amounts, resulting in a revenue gain of $9.4 billion in the 2021 taxable year. Because this proposal does not modify the federal tax rates imposed, the rates imposed by California would be equal to the federal rates.

A credit is allowed for all estate and gift taxes paid at the federal level resulting in an offsetting revenue loss of $5 billion in the 2021 taxable year. The net result is a revenue gain of $4.4 billion in the 2021 taxable year.

The tax year estimates are converted to fiscal year estimates and rounded to arrive at the amounts reflected in the above table.

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