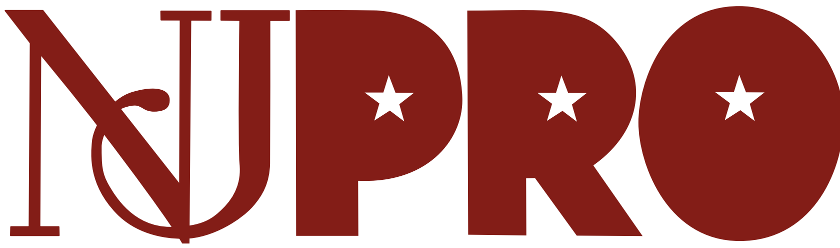
NEW JERSEY POLICY RESEARCH ORGANIZATION FOUNDATION



Fall 2014
FACTS FOR DISCUSSION

COMMITTED TO QUALITY RESEARCH ON BEHALF OF NEW JERSEY EMPLOYERS

New Jersey: An Outlier in Death

Examining the Estate and Inheritance Taxes

Since 2008, businesses and state economies have been suffering from the economic slowdown. As a result, policymakers have revised tax policies in an effort to balance state budgets. Simultaneously, more than ever before, taxpayers are closely examining how tax policies are impacting their overall wealth and are taking steps to mitigate their tax liabilities. Strategies to lessen the impact of taxes and develop an effective plan to pass down a family business or accumulated assets are no longer limited to the wealthy. Rather, strategies are being utilized by small business owners, partners in LLC's and LLP's, and "ordinary citizens" who recognize that handing down a family business or leaving a home or assets to a relative can be an expensive and complex process. This is an especially burdensome issue in New Jersey, where there are over 800,000 small businesses, most of which are sole proprietors, employing half of the state's private sector workforce.[1]

To address this financial balancing act, policymakers are faced with weighing timely decisions to justify maintaining or increasing taxes against the potential impacts of those decisions. Furthermore, policymakers must contemplate New Jersey's competitiveness as the state strives to not only retain jobs and wealth, but incentivize job creation and investment in our state. This paper examines how the estate and inheritance taxes, also known as "death taxes," impact the decision making process of both the members of the general public and small business owners, and why New Jersey policymakers should be concerned about death tax policy now and in the future.

THE DEATH TAXES: WHAT ARE THEY?

The inheritance tax and the estate tax are the two most recognized types of death taxes. Since January 2014, New Jersey has been one of 14 states with an estate tax, one of seven states with an inheritance tax, and one of only two states with both an estate and an inheritance tax.[2] The easiest way to make a distinction between the two taxes is by exploring who they affect. The New Jersey Transfer Inheritance Tax is applicable to both residents and nonresidents while the New Jersey Estate Tax is only imposed on residents.[3]

INHERITANCE TAX

New Jersey has had an inheritance tax since 1892. While the rate and the affected parties have changed over the years, the tax currently is based on a sliding scale ranging up to 16 percent on the transfer of real and personal property with an aggregate value of $500 or more. Beneficiaries are categorized to help establish both the relationship to the deceased and the effective tax rates. The tax must be paid within eight months of the time of death.[4]

As part of the revisions to the law over time, spouses, partners, parents, grandparents, adoptees and direct descendants are exempt from New Jersey's inheritance tax. Beneficiaries of life insurance and charitable giving are also exempt from the inheritance tax. However, siblings and the spouse of a child of the decedent are taxed on any amount received in excess of $25,000. All other beneficiaries receive an exemption equal only to the first $500 of an inheritance; anything more is taxed at between 15 and 16 percent.[5]

EXEMPTIONS FROM THE TRANSFER INHERITANCE TAX INCLUDE:

- All transfers having an aggregate value under $500;
- Life insurance proceeds paid to a named beneficiary;
- Charitable transfers for the use of any educational institution, church, hospital, orphan asylum, public library, etc.;
- Transfers for public purposes made to New Jersey or any political subdivision thereof;

- Federal civil service retirement benefits payable to a beneficiary other than the estate, executor, or administrator;
- Annuities payable to survivors of military retirees; and
- Qualified employment annuities paid to a surviving spouse, civil union partner, or domestic partner.[6]

ESTATE TAX

Enacted in 1934, the New Jersey estate tax originally was designed to mirror the federal estate tax by collecting state estate, inheritance and succession taxes. In 1992, the law was updated to shorten the filing date from 18 months to 9 months after the death. The federal tax code was modified in 2001 and would have resulted in a three year phase-out of the New Jersey estate tax. Instead, state legislation was passed in 2002 that updated the New Jersey tax rates and decoupled them from federal law. While the federal estate tax applies to assets exceeding $5.34 million (and over $10 million for married couples) and is tied to the Consumer Price Index, New Jersey taxes assets exceeding $675,000.[7]

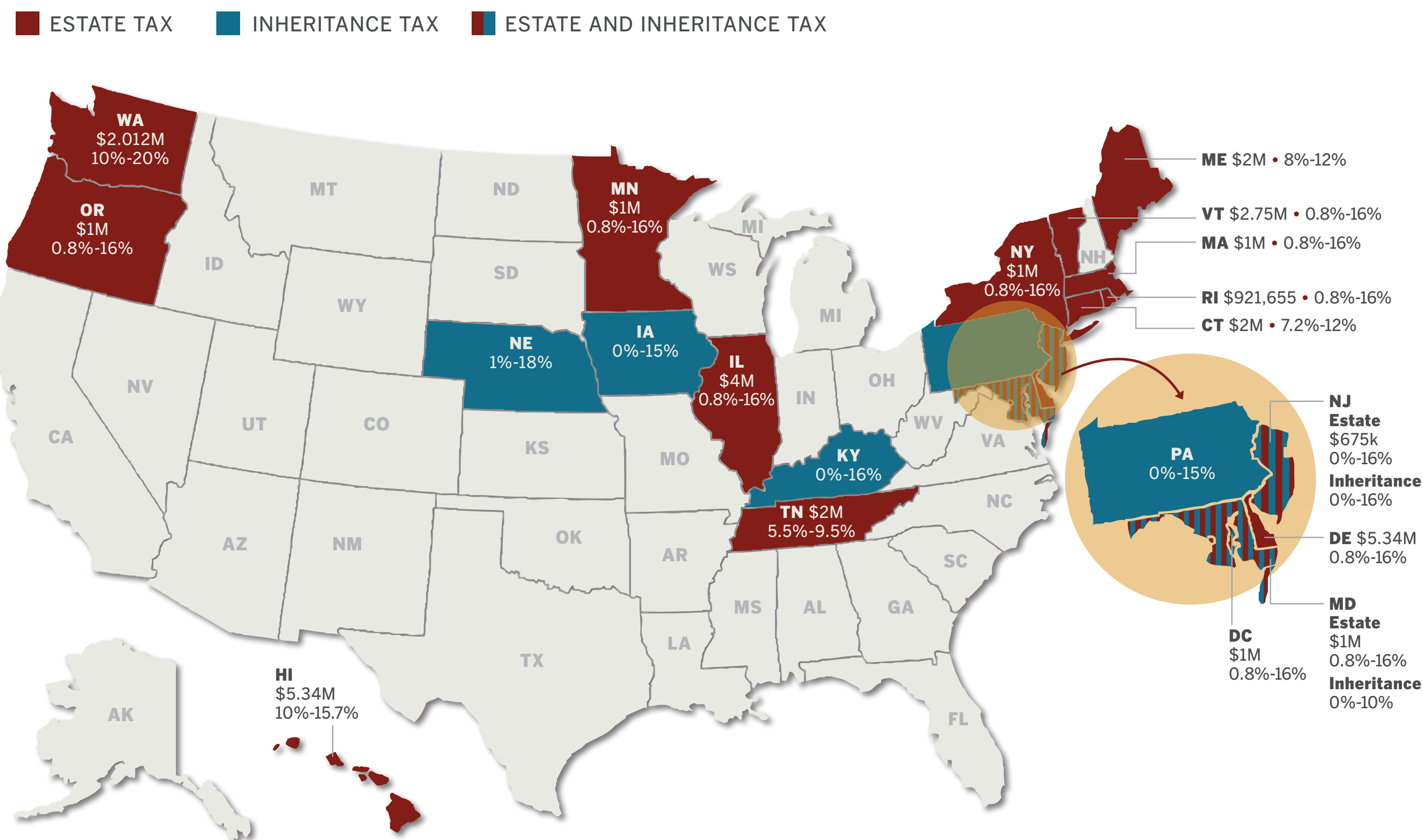
The tax is also progressive (i.e., the tax rate increases as the amount subject to taxation increases) and complex with 17 tax brackets and a top rate of 16 percent.[8] Additionally, while surviving spouses are exempt, the work necessary to comply with the tax law could cost beneficiaries thousands of dollars.[9]

Fortunately for taxpayers, the federal and state tax rates are not stacked on top of each other. The New Jersey inheritance tax is subtracted from the value of the estate before calculating the state estate tax. State inheritance and estate taxes are subtracted from the value of the estate when calculating the federal estate tax.[10]

HOW DOES NEW JERSEY COMPARE?

Both the location and tax climate of a state are important factors residents are likely to consider when deciding where to relocate. For example, states in the southern portion of the United

Estate and Inheritance Tax Rates in 2014



Note: Exemption amounts are shown for state estate taxes only. Inheritance taxes are levied on the posthumous transfer of assets based on relationship to the decedent; different rates and exemptions apply depending on the relationship.

Sources: Taxfoundation.org; U.S. Census Bureau, State Statutes; Schoening Strategies, NJ Division of Taxation

States have traditionally had the advantage of warm weather; however, favorable tax policies now serve as an additional incentive. Meanwhile, New Jersey has seen a recent decline in the influx of wealthy residents from surrounding states and has experienced an outward migration of some of its wealthiest residents.[11] A closer examination of neighboring states reveals changes in policy may be impacting the exodus from New Jersey.

The 2001 change in federal law to tax estates of over $5.34 million of a single person or $10 million of a couple prompted many states to amend their death taxes. Currently, there are 19 states with at least one death tax and the number is dwindling. In the past four years, five states – Ohio, Indiana, Kansas, North Carolina, and Oklahoma – all voted to phase out the taxes while the southern, southwestern and Rocky Mountain regions of the country have completely eliminated both forms of the taxes. The majority of the remaining states where death taxes exist are located in the northeast.[12] However, recent action in Pennsylvania, New York and Maryland to update their tax codes is demonstrating that states are cognizant of the impact of these taxes.

- Since July 2013, Pennsylvania's inheritance tax has not applied to certain businesses being handed down to a spouse, lineal descendant or sibling. The business must be at least five years old and have fewer than 50 full-time equivalent employees. It also must be valued at $5 million or less and must be completely owned by the family.[13]
- New York updated its estate tax by increasing its basic exclusion amount from $1 million per person to align with the federal exemption amount. Currently, the state exemption is over $2 million for fiscal year 2014 and will gradually increase each year until it matches the federal threshold.[14]
- Maryland also changed its estate and inheritance taxes. Like New York, Maryland is gradually increasing its estate tax threshold each year to match the federal standard. Currently, the tax exempts anything under $1 million and will match the federal threshold in 2019. However, Maryland's inheritance tax is imposed even when no estate tax is due. While spouses, children, parents, and siblings are exempt, other family members and friends are taxed at a rate of 10 percent.[15]

Overall, a majority of the 50 states do not have a state death tax, which directly impacts New Jersey's competitiveness from a tax perspective, as these taxes impact family-owned small businesses and middle class households.

MOVING BEFORE DEATH

High tax rates contribute to New Jersey's outflow of wealth. In fact, the Bureau of Economic Research has argued that death taxes do, in fact, negatively affect state economies and cause out-migration.[16]

According to several studies, New Jersey has lost billions of dollars in state revenue as hundreds of thousands of people have moved out of the state in the past decade. According to a 2010 report by Boston College, between 2004 and 2008, the state lost 302,779 households. During the same period, New Jersey's inflow of wealth dropped by $183 billion and declined in net wealth by $168 billion.[17]

Another study, issued in 2014 by RegentAtlantic, reported, "In 2010, there were 87,630 federal tax returns filed in states other than New Jersey by people who filed their 2009 tax returns in New Jersey. These 87,630 tax returns accounted for a loss of $5.5 billion in taxable income for New Jersey."[18]

Perhaps it is also no surprise where the New Jersey residents moved. Both the Boston College and RegentAtlantic studies found that over half of the residents moved to states without either an inheritance or an estate tax. Of the 87,630 New Jersey residents who filed in other states, 41 percent moved to Florida.[19] The Boston College study also found the in-migration of wealthy households coming from New York and Pennsylvania into New Jersey has greatly declined.[20]

Additionally, the state has acknowledged the importance of the wealthiest residents for tax collections. Appearing before the New Jersey Senate Budget and Appropriations Committee in May 2014, State Treasurer Andrew Sidamon-Eristoff noted that "just 400 high-earning households are responsible for nearly 10 percent of the state's income tax revenue because of their very high incomes and New Jersey's highly progressive tax structure. That very wealthy group could easily leave the state if their rates went up further." [21]

Furthermore, it is advantageous for the wealthy to claim residency in another state and commute to New Jersey for work, if necessary. Small businesses today are predominantly set up as LLC's and LLP's which allow business profits to be reflected in personal income tax filings. Small business owners concerned about estate planning may choose to relocate before death to avoid the tax implications of passing along the business to a family member. This in turn also impacts the state's revenue collections by the loss of a taxpayer.

WHAT POLICYMAKERS NEED TO CONSIDER

For New Jersey to remain competitive not only in the region but with the rest of the country, policymakers need to examine and reform the state's outdated tax policies. Recognizing that the state is still experiencing revenue problems, this is a discussion that must be held and action taken. Since tax returns of small businesses and the wealthy have a profound impact on our overall tax revenues, it is in the state's best interest to keep as many of

its upper tax bracket filers in state.

Following the example of numerous other states, one strategy would be to increase the tax thresholds and phase in increases incrementally over a period of time until they match federal policy. The increased levels of taxable assets would allow for a more competitive environment and encourage wealthy citizens to remain in state, while the phase in would help deal with state budget challenges.

Another way for New Jersey to increase its competitiveness and signal to residents that the state's tax climate is improving would be for policymakers to consider the elimination of one of the two death taxes, something 48 other states have already done.

Ultimately, these moves could prevent a further exodus of wealthy residents and possibly incent some who had left to return. This would allow New Jersey to realize the associated tax benefits and help spur economic growth in a state heavily dependent upon small businesses that are often passed down from one generation to another.

ENDNOTES

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