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By: Frank J. Doti and Kevin B. Morriss*

ABSTRACT: As a consequence of the Economic Growth and Tax Reconciliation Act of 2001 (2001 Tax Act), the federal government eliminated the estate tax credit for state death taxes paid after 2004. Due to an anomaly in California constitutional law, the legislature is prohibited from imposing a California estate tax as it had in the past because the California Estate Tax was tied to the federal death tax credit. The authors discuss the details of the problem and suggest alternatives to overcome the significant loss of revenue from wealthy estates.

California leads the nation in state budget deficits. Steps have been taken to reduce the enormous deficit, but much more needs to be accomplished. The problem has been exacerbated by an often overlooked but significant change in federal tax law. As part of the Economic Growth and Tax Reconciliation Act of 2001 (2001 Tax Act), the federal government eliminated the estate tax credit for state death taxes paid.

Before the 2001 Tax Act, the federal government shared a portion of the federal estate tax with the states. 26 USC 2011. This credit allowed the states to share as much as 16% of a taxable estate. Commonly referred to as the “pickup tax,” the credit does not increase the liability of the taxpayer; it simply allocates a portion of the federal tax to the states. Under the 2001 Tax Act, the pickup tax sharing arrangement was totally eliminated in 2005.

Estate taxes have generated a lot of revenue for California. Since the state began relying on the federal credit in 1982, California has generated nearly $12 billion. According to
the Governor’s Budget Summary, in 2000-2001 the pickup tax accounted for more than $934 million in revenue. In 2001-2002, the last year the state received the full amount of the pickup tax, California brought in more than $890 million. Due to the 2001 Tax Act’s gradual phasing out of the state credit, pickup tax revenue has dropped significantly in the last few years: to approximately $647 million collected in 2002-2003 and $367 million in 2003-2004. No estate tax revenue will be generated in 2005 and later unless a viable alternative is found.

As the realities of the 2001 Tax Act sank in, many states reorganized their estate tax structure to make up for the lost revenue. Generally, the states reacted in one of three ways. First, many states completely separated their estate tax from the federal estate tax structure by imposing a tax that is equal to the pre 2001 Tax Act credit, referred to as “decoupling.” Second, some states have created a hybrid structure whereby a tax is imposed equal to the 2001 pickup tax, but subject to annually increased unified credit amounts specified in the Internal Revenue Code. Finally, the larger states of California, Florida, and Texas have so far taken no action.

Due to the peculiarities of the 2001 Tax Act, reacting to it may not be worth the time and effort of the states. The federal estate tax is set to sunset in 2010 and return in 2011 as it existed before the 2001 Tax Act, unless repeal is made permanent by Congress. Thus, the states that changed their estate tax may well have to revert back to the former structure. California, however, should not be so complacent. The state stands to lose $5 billion over the next five years.

Since California has an enormous deficit and other states have reacted quickly to recoup lost revenue, why has California not responded? The answer may be surprising. The legislature
simply cannot impose a replacement estate tax. Under California law, the only estate tax that the
state may collect is that generated by the former federal estate tax credit.

In 1982, two estate tax-prohibiting initiatives were on the ballot: Propositions 5 and 6. At
the time, California law provided that of the two initiatives, the one with the highest number of
affirmative votes would prevail. Both propositions were passed overwhelmingly. Proposition 6
received a higher number of affirmative votes and was, accordingly, codified. The codified
language makes it very clear that anything remotely resembling an estate tax is prohibited.
Neither the state nor any political subdivision can impose any gift, inheritance, succession,
legacy, income, or estate tax, or any other tax, on gifts or on the estate or inheritance of any
person or on or by reason of any transfer occurring by reason of death. However, both
propositions allowed the state to collect a death tax limited to no more than the federal estate tax
credit.

Given this prohibition, coupled with the legislature’s anticipated difficulty in imposing
anything that resembles an estate tax, it is no wonder that California has stood by while billions
of dollars of revenue are lost. The only way an estate tax can again be imposed in California is
by voter approval or if Congress retains the 2001 Tax Act sunset provision after 2010.

There are, of course, many problems associated with attempting to pass a proposition.
First and foremost, the California voters have historically been reluctant to approve tax increases.
Second, time is of the essence; in the time it would take a proposition to go through all the
necessary procedural steps, the issue may become moot if the federal sunset is not eliminated.
The governor has vowed to fight any tax hikes to raise revenue to pay down the deficit. Despite
the historical resistance for more taxes, the California voters recently approved a proposition that
increased taxes on the wealthy. Proposition 63 levied an additional 1% income tax on Californians who earn more than a $1 million a year. The revenue generated is allocated to a special fund that will be used to help the mentally disabled. While it appears that Californians may be willing to raise taxes on the wealthy, it should be noted that this proposition had an emotional appeal that an estate tax proposition would probably lack. Additionally, an estate tax would affect a much larger portion of the population than proposition 63. An estate tax would be levied on the entire corpus of an estate versus income for one year, and there are far more decedents with estates that exceed the current $1.5 million exemption under the federal estate tax than those with annual incomes exceeding $1 million.

Senate Finance Committee Chair, Charles Grassley, recently announced that there is a zero chance of Congress repealing the estate tax. The enormous federal costs of hurricane relief, homeland security, and the Iraq war certainly mitigate against any tax relief for wealthy estates. What is more likely is an increase in the amount exempt from tax from $1.5 million in 2005 to $3 - 5 million per decedent and a reduction and spreading out of the rates from 47% in 2005 to 15% - 35%. Nevertheless, it is doubtful that Congress will reinstate the state pick up tax credit.

Although a proposition reinstating an estate may not be feasible, California may be able to make up the lost estate tax revenue by eliminating asset basis step up under its own income tax structure. The step up in basis for property transferred at death is aimed at relieving individuals from being taxed under both an estate and income tax on the same property. Thus, from a tax equity perspective, there is no need for asset basis step up for large estates if there is no estate tax. So it follows that California should not permit a basis step up for property transferred at death as long as it is prohibited from imposing any death tax. If the legislature were to eliminate
basis step up, the state would generate much more revenue through the income tax. We believe the legislature has power to amend the law regarding income tax basis of property without voter approval.

This solution is, of course, not without problems. First, there are administrative hassles in determining the decedent’s basis. Second, California Revenue & Taxation § 13301 may possibly prohibit the legislature from increasing the income tax in this manner. Lastly, such a change in the state tax law could lead to a migration of wealthy residents out of the state.

There is little doubt that eliminating the basis step up for property transferred at death will be an administrative hassle. In most cases, heirs will have to determine what the decedent paid for the property, which could be a difficult process, especially if the property was acquired many years ago. Determining correct basis requires specific information that may be extremely difficult to obtain due to the unavailability of the decedent. In 1976, Congress did eliminate the § 1014 step up in basis advantage. It turned out to be such an administrative disaster and so was repealed shortly after passage as if it had never been enacted.

Despite the potential administrative problems of eliminating basis step up, California is faced with the realities of the 2001 Tax Act. The administrative problems of nearly thirty years ago when Congress tried to impose carry over basis may not be as severe today. Much of our record keeping, which was primarily done manually, is now done electronically. Although today’s technology may not completely fix the administrative nightmares, it may make the process easier to accomplish.

The prohibition of an estate tax creates a possible hurdle to eliminating the basis step up in California. California Revenue & Taxation § 13301, which is a codification of Proposition 6,
eliminates any legislative loopholes that might undo the strictures of Proposition 6. It reads: “Neither the state nor any political subdivision of the state shall impose any gift, inheritance, succession, legacy, income, or estate tax, or any other tax, on gifts or on the estate or inheritance of any person or on or by reason of any transfer occurring by reason of death” (emphasis added). Would eliminating the basis step up be the same as the state imposing an income tax “on or by reason of any transfer occurring by reason of death?” Eliminating basis step up would not result in an excise tax that is imposed on the transfer of property at death. Instead, the tax is imposed on the heir when he disposes of the property. Based on the intent of the provision, we believe that eliminating the basis step rules would not run afoul of Proposition 6.

Eliminating the basis step up might encourage people to migrate out of California, because the state would be unique in not permitting it. Suppose an heir has just inherited a large block of appreciated stock due to her father’s death. If the taxpayer moved outside California for a year or so and became a citizen of another state, she could sell her stock with a stepped up basis and simply move back to California, thereby circumventing the basis step up elimination law.

It may be useful to limit the no step up rule to real property located in California. If so, records for basis determinations should be easier to locate because California imposes a transfer tax based on the purchase price of real property. Also, moving out of the state would not adversely effect the ability of the state to tax sales of California real property.

A potentially serious problem, however, is that elimination of basis step up may discourage the disposition of California property received in a testamentary disposition. That could have a chilling effect on real estate development in California. In 2003, California real
estate accounted for 17% of all property transferred in the nation at death subject to federal estate tax.

If California fails to react, either by not getting a proposition passed to allow a replacement estate tax or by failing to eliminate basis step up, it stands to lose at least $1 billion per year in much needed revenue. Most other states have been able to make up the lost revenue from the pick up tax repeal by enacting a replacement estate tax. Unfortunately, the California legislature cannot do the same without a voter initiative.

Eliminating the step up in basis for property transferred at death would cause administrative hassles and could lead to resident migration to other states. In the final analysis, much needed revenue generated by elimination of basis step in California may, however, outweigh the disadvantages. There is no easy solution to a major fiscal problem that Congress created, no doubt, without regard to the adverse impact on California.

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