ILLINOIS ECONOMIC
and
FISCAL COMMISSION

FEDERAL AND STATE ESTATE TAX REPORT

Impact of Federal H.R. 1836

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SPRINGFIELD, ILLINOIS 62706

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EXECUTIVE SUMMARY

On June 7, 2001, the United States Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (H.R. 1836). Although income tax relief garnered the majority of media attention, the resolution contained additional provisions related to children, the marriage penalty, education incentives, death taxes, retirement, and various other taxes. While several of the provisions impact Illinois residents, the changes associated with the federal estate tax will adversely affect State revenues. In response, the Illinois Economic and Fiscal Commission created the following report in an effort to assist in the understanding of H.R. 1836 and its impact on federal and State death tax revenue. The major conclusions of the report are summarized below:

- The State of Illinois currently administers an estate tax and a generation-skipping transfer tax. These taxes are commonly referred to as "pick-up" taxes, because the State taxes equal the maximum state credit permitted against federal estate and generation-skipping tax liability.

- Between FY 1991 and FY 2001, State estate tax revenue increased from $113 million to $361 million.

- In FY 2001, estate tax revenues comprised 1.50 percent of the State's general funds revenue.

- In FY 2000, estate taxes comprised 1.53 percent of the State's total tax revenues, which was very close to the national average of 1.48 percent.

- In FY 1999, Illinois' estate tax burden per death equaled roughly $3,200, which slightly exceeded the national average of $3,141.

- H.R. 1836 outlines a ten-year phase out and repeal of the federal estate tax. In doing so, it repeals the federal estate tax rates in excess of 50 percent in CY 2002, 49 percent in CY 2003, 48 percent in CY 2004, 47 percent in CY 2005, 46 percent in CY 2006, and 45 percent in CY 2007 through CY 2009. The federal estate tax is eliminated in CY 2010.

- H.R. 1836 also increases the unified credit effective exemption amount associated with a decedent's estate to $1 million in CY 2002 and CY 2003, $1.5 million in CY 2004 and CY 2005, $2 million in CY 2006 through CY 2008, and $3.5 million in CY 2009. The unified credit is eliminated effective CY 2010.

- Effective January 1, 2002, H.R. 1836 reduces the state death tax credit by 25 percent per calendar year until it is completely eliminated in CY 2005.

- The Commission estimates that State estate tax revenue will equal $376 million in FY 2002, $301 million in FY 2003, $191 million in FY 2004, $109 million in FY 2005, and $30 million in FY 2006 prior to being completely eliminated somewhere around FY 2007.

WHAT ARE DEATH TAXES?

The term "death taxes" is used to refer to a number of taxes that are imposed upon the transfer of wealth or income, particularly at the time of an individual's death. Although these taxes are primarily levied at the time of death, additional taxes target transfers that occur in anticipation of death; those transfers made three years prior to death. The following paragraphs provide background regarding the various death taxes.

Inheritance taxes are generally regarded as taxes upon beneficiaries and, as such, are levied against the amount transferred by the decedent to the beneficiary. These taxes are levied at graduated rates based upon the amount of the bequest and upon the beneficiary's relationship to the decedent. Since the federal government does not impose inheritance taxes, they are strictly the domain of the states.

Estate taxes are generally regarded as taxes upon the decedent's estate. These taxes are levied at graduated rates based upon the value of the estate, with certain amounts exempted from taxation. Estate tax rates are imposed on the estate as a whole and do not vary based upon the relationship of the beneficiary to the donor. However, exceptions exist and many estate taxes exempt all portions of the estate transferred to a spouse.

The **"pick-up" tax** is a variation of the estate tax that is based on a link between federal and state death taxes. Federal law allows a dollar-for-dollar credit – up to a predetermined amount – against federal liability for state death taxes paid. Although the states may levy death taxes that exceed the federal credit, 38 states levy estate taxes using the same schedule utilized by the federal government when determining the state death tax credit. In these states, the "pick-up" tax does not affect taxpayer liability because the states are collecting revenue that would have otherwise gone to the federal government. All 50 states currently utilize the "pick-up" tax.

A **gift tax** is a levy on wealth given by living donors. The rates imposed and exemptions allowed under gift tax statutes are similar to rates and exemptions under the inheritance tax. But donors, rather than recipients, are liable for gift taxes. Gift taxes are imposed on the transfer of wealth so even tax-exempt property is subject to the tax.

DEATH TAXES IN THE UNITED STATES

History

For much of the nation's history, estate taxes were the exclusive domain of the states. This changed in 1916 when Congress passed a permanent federal estate tax. Although the states disapproved of the intrusion, the federal government offered little compromise. This changed in 1924, when Congress increased federal estate tax rates while simultaneously allowing taxpayers to credit up to 25 percent of their state death tax payment against their federal estate tax liability. This credit was increased from 25 to 80 percent by the Federal Estate Tax Act of 1926. Additional changes affecting the federal estate tax resulted from the U.S. Tax Reform Act of 1976, the Economic Recovery Tax Act of 1981, and the Taxpayer Relief Act of 1997.

The Federal Estate Tax

The federal estate tax is a liability against a deceased person's estate. The amount of the tax is dependent on the value of the assets held at death, how the assets are held, and deductions and credits available. Calculation of the federal estate tax begins with the determination of a deceased person's gross estate. The gross estate includes the fair market value of all real and personal property owned at death, transfers with retained life estate, transfers taking effect at death, revocable transfers, annuities, joint interests, powers of appointment, proceeds of life insurance and certain transfers occurring within three years of death.

Once the gross estate has been calculated, it is necessary to determine the taxable base of the decedent’s estate. Federal law defines the taxable base as the gross estate minus all appropriate deductions, which include the estate’s administrative costs, any allowable losses, any charitable contributions, the marital deduction, and the family-owned business deduction (if necessary). The remaining amount comprises the taxable estate, and is subject to the federal government’s graduated tax schedule. All applicable credits – including the unified credit and the State tax credit – are subtracted after the federal estate tax is computed. A taxable estate that falls at or below the unified credit will owe no federal estate tax because the liability will be covered by the unified credit.

In the spring of 2001, Congress overhauled the federal estate tax with the passage of H.R. 1836. As it relates to the estate tax, the resolution outlines a ten-year phase out and repeal of the federal estate tax. Although the estate tax is not eliminated until CY 2010, the resolution affects nearly every aspect of the tax including the federal unified rate schedule, the tax base, and numerous related credits. The following section outlines the major provisions of H.R. 1836.

HOUSE RESOLUTION 1836

H.R. 1836 phases out and repeals the federal estate and gift taxes over a ten-year period. Prior to the legislation, estates with a taxable value greater than $2.5 million were subject to a marginal tax rate of between 53 and 55 percent. Furthermore, the federal government levied an additional 5 percent surtax against estates with a taxable value exceeding $10 million. The resolution gradually reduces the highest marginal tax bracket and eliminates the surtax. In doing so, it repeals the federal estate tax rates in excess of 50 percent in CY 2002, 49 percent in CY 2003, 48 percent in CY 2004, 47 percent in CY 2005, 46 percent in CY 2006 and 45 percent in CY 2007 through CY 2009. The federal estate tax is eliminated in CY 2010.

H.R. 1836 also increases the unified credit effective exemption amount associated with a decedent's estate. The unified credit is the amount of wealth that the IRS allows a person to transfer without incurring various tax obligations. Previous provisions required the executor of an estate to file a federal estate tax return within nine months of a person's death if the gross estate exceeded $675,000. While H.R. 1836 maintains the nine-month time period, it increases the credit amount to $1 million in CY 2002 and CY 2003, $1.5 million in CY 2004 and CY 2005, $2 million in CY 2006 through CY 2008, and $3.5 million in CY 2009. The unified credit is eliminated in CY 2010. Furthermore, H.R. 1836 repeals the family-owned business deduction in CY 2004.

An additional provision of H.R. 1836 repeals the state death tax credit. Currently, federal statutes permit a dollar-for-dollar credit – up to a limit that is tied to the size of the estate – against the federal liability for state death taxes paid. This credit, commonly referred to as the "pick-up" tax, does not affect taxpayer liability since the revenue is shifted from the federal government to the state. H.R. 1836 reduces the state credit by 25 percent in CY 2002, 50 percent in CY 2003, and 75 percent in CY 2004. The state death tax credit is eliminated in CY 2005.

These components combine to eliminate the State's portion of the federal estate tax in CY 2005, while maintaining the federal portion through December 31, 2009. In the interim, the federal government will collect all estate tax revenues including the portion that previously comprised the State "pick-up." Table 1 summarizes the implementation schedule associated with H.R. 1836.

TABLE 1: H.R. 1836 IMPLEMENTATION SCHEDULE			
Calendar Year	Exemption Amount	Top Estate Tax Rate	State Death Tax Credit Reduction
2002	$1.0 million	50 percent	25 percent
2003	$1.0 million	49 percent	50 percent
2004	$1.5 million	48 percent	75 percent
2005	$1.5 million	47 percent	repealed
2006	$2.0 million	46 percent	n/a
2007	$2.0 million	45 percent	n/a
2008	$2.0 million	45 percent	n/a
2009	$3.5 million	45 percent	n/a
2010	repealed	repealed	n/a

Once the federal estate tax is eliminated (CY 2010), H.R. 1836 repeals the present-law rules providing for a fair market value basis for property passed from a decedent to a beneficiary. Under current law, the basis of property passing from a decedent's estate generally is "stepped-up" to the fair market value on the date of the decedent's death. H.R. 1836 replaces this procedure with a modified carryover basis, which defines the basis of transferred assets according to the acquisition cost of the decedent rather than the beneficiary. However, the new law provides that the basis may be stepped-up for a limited amount of property transferred at the time of death. In this case, the basis for that property will equal the lesser of the adjusted basis or the fair market value of the property on the date of the decedent's death.

Despite the fact that all of these provisions are aimed at permanently eliminating federal death taxes, it is interesting that H.R. 1836 contains a "sunset" provision that allows for the automatic reinstatement of CY 2001 estate tax rules effective January 1, 2011. Although this provision was added as a means of addressing budgetary restrictions, it is noteworthy based on the fact that a permanent repeal will require additional congressional action. Given this uncertainty, it is important to examine the Illinois estate tax and the impact that H.R. 1836 will have on State revenue.

DEATH TAXES IN ILLINOIS

History

Until recently, Illinois imposed two death taxes – an inheritance tax and an estate tax. The inheritance tax, imposed on the decedent's heirs, was abolished as to persons dying after 1983. The State's "pick-up" estate tax dates back to 1949. It was originally set at 80 percent of the estate taxes imposed by the federal government, minus any inheritance taxes due to the State. This changed in 1955 when an amendatory law set the amount of estate taxes at the maximum tax credit against estate taxes allowed by the federal government, minus the amount of inheritance tax due to the state. Since the State inheritance tax was abolished, the latter is now zero. The revenue generated via death taxes is distributed to the General Revenue Fund (96 percent) and the Estate Tax Distributive Fund (4 percent).

Current Legislation

The State of Illinois currently administers an estate tax and a generation-skipping transfer tax. The Illinois estate tax is imposed on a decedent's estate prior to its distribution. The State generation-skipping transfer tax is imposed on bequests in which the transferor is two or more generations removed from the transferee. These taxes are commonly referred to as "pick-up" taxes, because the State taxes equal the maximum state credit permitted against federal estate and generation-skipping tax liability. This relationship is governed by the Illinois Estate and Generation-Skipping Transfer Tax Act (35 ILCS 405/), which defines these taxes according to the following definitions:

- The **Illinois Estate Tax** is defined as the tax due to this State with respect to a taxable transfer that gives rise to a federal estate tax.

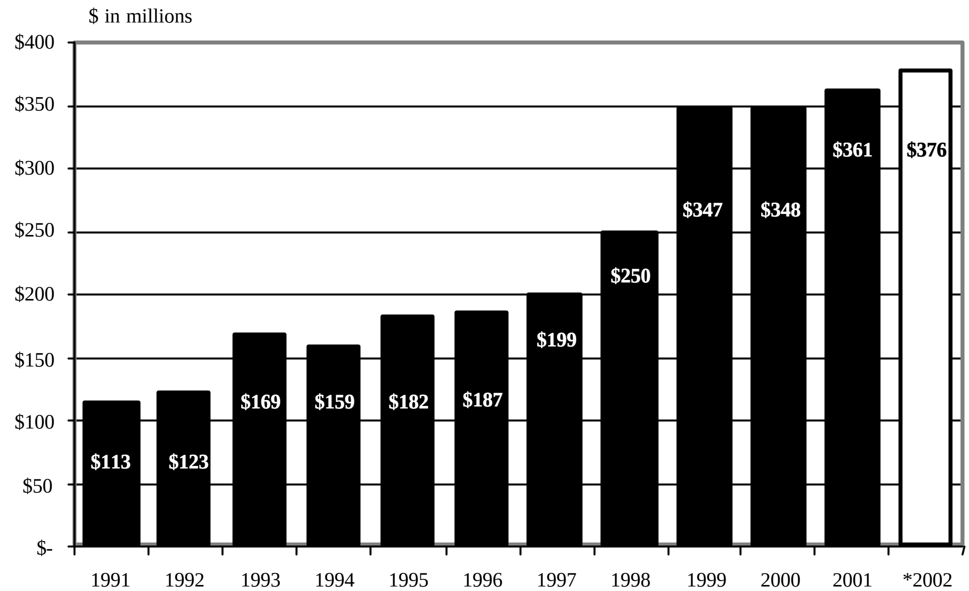
- The **Illinois Generation-Skipping Transfer Tax** is defined as the tax due to this State with respect to a taxable transfer that gives rise to a federal generation-skipping transfer tax.

The federal estate tax and the federal generation-skipping transfer taxes and, therefore, the associated Illinois taxes, contain provisions that exclude certain property from taxation. The federal statute exempts all property that is passed to the decedent's spouse from federal estate taxation. In addition, H.R. 1836 levies the federal estate tax only if the gross estate exceeds the previously-mentioned unified credit amounts. The generation-skipping transfer tax is rarely levied, because it exempts the first $1 million of generation-skipping transfers.

THE ESTATE TAX AS A REVENUE SOURCE

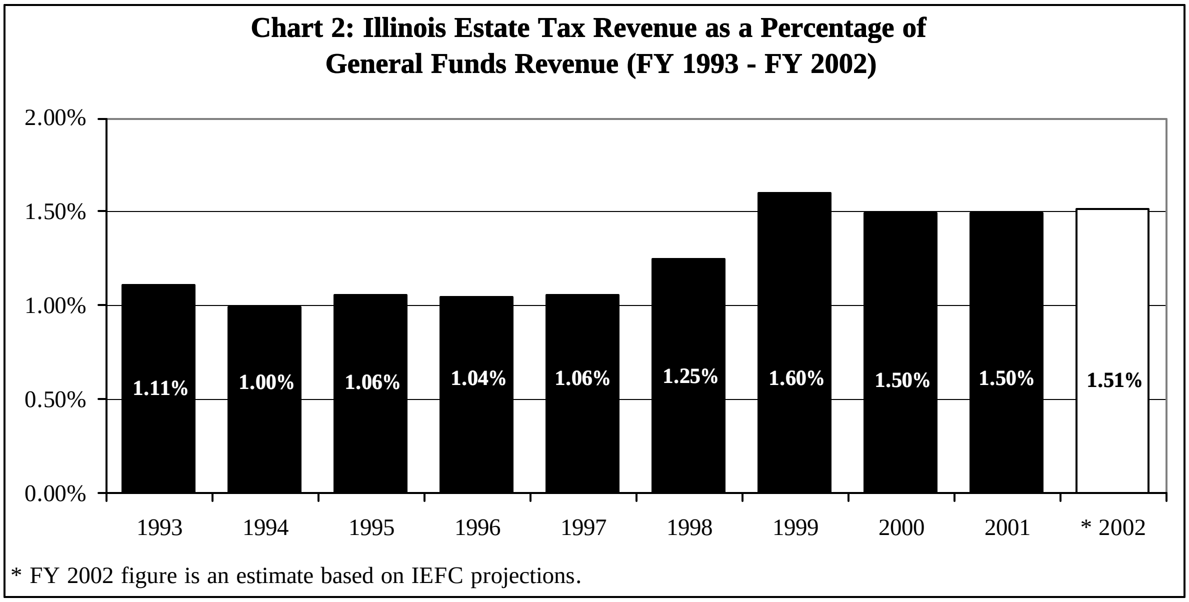
Illinois estate tax revenues increased steadily over the past ten years. Between FY 1991 and FY 2001, State estate tax revenue increased from $113 million to $361 million yielding an annual growth rate of approximately 22 percent. Despite this ten-year average, growth has slowed over the past two fiscal years resulting in a 4.00 percent increase between FY 2000 and FY 2001 and an increase of less than 1.00 percent between FY 1999 and FY 2000. As a result, the Commission is estimating estate tax revenue to equal $376 million in FY 2002. Chart 1 illustrates the growth associated with the Illinois estate tax.

Chart 1: Illinois Estate Tax Revenue by Fiscal Year



* The FY 2002 figure is an estimate based on a 4 percent growth rate.

Although estate tax revenue increased significantly over the past ten years, it remains a small percentage of the State's general funds revenue. Between FY 1993 and FY 2001, estate tax revenues averaged approximately 1.24 percent of the State's general funds revenue. During this time, the estate tax comprised as little as 1.00 percent in FY 1994 and as much as 1.60 percent in FY 1999. Despite these variations, the estate tax comprised 1.50 percent of the State's general funds revenues in each of the past two fiscal years. Chart 2 details Illinois estate tax revenue as a percentage of general funds revenue.



In addition to analyzing the estate tax's portion of general funds revenue, it is useful to examine what percentage the death tax comprises of total state tax collections. Table 2 identifies state death and gift taxes as a percentage of total tax collections as well as on a per-capita basis. The data in the table reveal that death taxes comprised 1.53 percent of the State's total tax revenues in FY 2000. This figure is worth noting as it was very close to the national average of 1.48 percent, although it was higher than the percentages associated with 35 states.

Table 2: A Comparison of FY 2000 Death and Gift Taxes in the Fifty United States: Per Capita Totals and as a Percentage of Total Tax Revenues

	State Population (in thousands)	Total State Tax Revenues (in thousands)	Death & Gift Tax Revenues (in thousands)	% of Total Tax Revenues	Per Capita	* Type of Tax
Alabama	4,447	$6,438,438	$66,763	1.04%	$15.01	P
Alaska	627	1,423,287	2,455	0.17%	3.92	P
Arizona	5,131	8,100,737	85,238	1.05%	16.61	P
Arkansas	2,673	4,870,561	23,821	0.49%	8.91	P
California	33,872	83,807,959	928,148	1.11%	27.40	P
Colorado	4,301	7,075,047	61,873	0.87%	14.39	P
Connecticut	3,406	10,171,242	237,608	2.34%	69.76	I
Delaware	784	2,132,131	41,124	1.93%	52.45	P
Florida	15,982	24,817,263	739,490	2.98%	46.27	P
Georgia	8,186	13,511,275	148,255	1.10%	18.11	P
Hawaii	1,212	3,334,743	22,874	0.69%	18.87	P
Idaho	1,294	2,377,251	11,083	0.47%	8.56	P
Illinois	**12,419**	**22,788,799**	**348,009**	**1.53%**	**28.02**	P
Indiana	6,080	10,104,353	140,173	1.39%	23.05	I
Iowa	2,926	5,185,394	99,487	1.92%	34.00	I
Kansas	2,688	4,865,305	62,888	1.29%	23.40	P
Kentucky	4,042	7,694,610	74,490	0.97%	18.43	I
Louisiana	4,469	6,512,382	95,577	1.47%	21.39	I
Maine	1,275	2,661,080	58,804	2.21%	46.12	P
Maryland	5,296	10,354,447	156,976	1.52%	29.64	I
Massachusettes	6,349	16,152,874	166,511	1.03%	26.23	P
Michigan	9,938	22,756,403	185,528	0.82%	18.67	P
Minnesota	4,919	13,338,532	82,516	0.62%	16.77	P
Mississippi	2,845	4,711,594	21,960	0.47%	7.72	P
Missouri	5,595	8,571,548	129,872	1.52%	23.21	P
Montana	902	1,410,760	19,039	1.35%	21.11	I
Nebraska	1,711	2,981,047	19,022	0.64%	11.12	P
Nevada	1,998	3,717,255	76,002	2.04%	38.04	P
New Hampshire	1,236	1,696,085	61,146	3.61%	49.47	I
New Jersey	8,414	18,147,604	485,948	2.68%	57.75	I
New Mexico	1,819	3,743,178	16,087	0.43%	8.84	P
New York	18,976	41,735,841	1,054,669	2.53%	55.58	P
North Carolina	8,049	15,216,066	188,081	1.24%	23.37	P
North Dakota	642	1,172,373	6,077	0.52%	9.47	P
Ohio	11,353	19,676,365	155,103	0.79%	13.66	E
Oklahoma	3,451	5,851,814	87,510	1.50%	25.36	E
Oregon	3,421	5,945,675	43,907	0.74%	12.83	P
Pennsylvania	12,281	22,466,906	801,164	3.57%	65.24	I
Rhode Island	1,048	2,034,909	34,207	1.68%	32.64	P
South Carolina	4,012	6,381,391	43,085	0.68%	10.74	P
South Dakota	755	927,245	28,429	3.07%	37.65	I
Tennessee	5,689	7,739,590	92,449	1.19%	16.25	I
Texas	20,852	27,424,142	278,486	1.02%	13.36	P
Utah	2,233	3,978,697	64,559	1.62%	28.91	P
Vermont	609	1,470,828	13,550	0.92%	22.25	P
Virginia	7,079	12,648,071	150,120	1.19%	21.21	P
Washington	5,894	12,567,383	82,573	0.66%	14.01	P
West Virginia	1,808	3,343,266	21,103	0.63%	11.67	P
Wisconsin	5,364	12,643,015	133,261	1.05%	24.84	P
Wyoming	494	963,650	50,779	5.27%	102.79	P
United States	280,850	539,640,411	7,997,879	1.48%	28.48	N/A

*Effective January 1, 2000. Key: P (Pick-Up Tax Only), I (Separate State Inheritance Tax), E (Separate State Estate Tax)

SOURCE: Bureau of the Census: State Government Tax Collections, Calculations by IEFC

Table 2 also compares the per-capita figures associated with the fifty states for FY 2000. At that time, per-capita death taxes in Illinois equaled $28.02. This figure was comparable to the national average of $28.48 despite the fact that it was greater than the per-capita figures associated with 34 other states.

Although death taxes traditionally have been evaluated on a per-capita basis, examining state death tax burden per death serves as a more relevant indicator. This assumption is based on the fact that the majority of states, including Illinois, levy taxes that are generally regarded as taxes upon decedent's. Since the estate tax is levied against the decedent's estate, it is useful to examine this relationship. (When analyzing this relationship, it is important to keep in mind that death rates are not uniformly distributed across the country.)

In FY 1999, Illinois collected approximately $347 million via the estate tax. During that time, approximately 108,000 Illinois resident passed away. As a result, the Illinois death tax burden per death equaled roughly $3,200. For comparative purposes, this figure was slightly above the national average of $3,141. Table 3 details the state death tax burden per death for FY 1995 and FY 1999.

Table 3: FY 1995 and FY 1999 State Death Tax Burden Per Death for the Fifty United States

	Death & Gift Tax Revenues (in thousands)		Number of Deaths (in thousands)		Death & Gift Tax Burden Per Death	
	1995	1999	1995	1999	1995	1999
Alabama	$34,705	$62,784	42	45	$818	$1,401
Alaska	1,158	1,726	3	3	456	637
Arizona	48,771	89,088	35	40	1,380	2,224
Arkansas	21,667	32,572	27	28	813	1,166
California	466,214	877,901	223	229	2,089	3,827
Colorado	27,628	65,391	25	27	1,105	2,412
Connecticut	212,853	250,171	29	29	7,368	8,496
Delaware	27,969	27,058	6	7	4,455	4,059
Florida	409,253	649,521	154	163	2,664	3,979
Georgia	74,762	111,192	58	62	1,281	1,793
Hawaii	16,438	28,738	8	8	2,152	3,475
Idaho	7,350	11,128	8	10	865	1,162
Illinois	**179,513**	**346,978**	**109**	**108**	**1,651**	**3,200**
Indiana	106,055	148,712	52	55	2,033	2,687
Iowa	89,224	72,836	26	28	3,434	2,563
Kansas	56,604	70,239	24	24	2,380	2,870
Kentucky	79,512	81,483	38	39	2,090	2,072
Louisiana	61,232	95,973	40	41	1,548	2,327
Maine	17,124	29,768	12	12	1,473	2,428
Maryland	92,218	126,168	42	43	2,208	2,928
Massachusettes	209,281	173,867	56	56	3,734	3,114
Michigan	73,372	174,891	84	87	879	2,005
Minnesota	35,415	58,132	37	39	949	1,508
Mississippi	12,264	30,767	27	28	454	1,092
Missouri	71,923	118,670	59	56	1,227	2,122
Montana	15,382	18,302	8	8	2,021	2,252
Nebraska	7,409	17,449	15	16	484	1,120
Nevada	23,389	41,472	13	15	1,870	2,749
New Hampshire	29,065	49,368	9	10	3,136	5,176
New Jersey	275,824	423,015	74	74	3,727	5,718
New Mexico	8,962	21,912	13	14	714	1,601
New York	759,377	1,071,464	168	160	4,518	6,700
North Carolina	118,457	182,851	65	70	1,823	2,627
North Dakota	6,394	7,416	6	6	1,049	1,215
Ohio	83,362	141,456	106	109	786	1,304
Oklahoma	70,666	88,796	33	35	2,157	2,559
Oregon	26,014	47,979	28	29	921	1,631
Pennsylvania	563,093	760,698	128	130	4,395	5,839
Rhode Island	12,155	46,854	10	10	1,260	4,826
South Carolina	26,980	57,190	33	36	830	1,586
South Dakota	22,427	26,427	7	7	3,284	3,801
Tennessee	44,482	89,127	51	54	872	1,658
Texas	171,606	256,277	139	147	1,236	1,743
Utah	24,956	8,238	11	12	2,305	683
Vermont	9,748	23,358	5	5	1,934	4,678
Virginia	77,676	154,078	53	55	1,469	2,785
Washington	41,972	69,701	41	44	1,036	1,589
West Virginia	8,513	27,325	20	21	420	1,297
Wisconsin	40,784	116,898	45	47	905	2,505
Wyoming	3,282	9,731	4	4	875	2,407
United States	4,904,480	7,493,136	2,305	2,386	2,127	3,141

SOURCE: National Center for Health Statistics, State Rankings: A Statistical View of the Fifty United States, U.S. Census Bureau

HOW WILL H.R. 1836 AFFECT ILLINOIS ESTATE TAX REVENUE?

Background

Forecasting the fiscal impact of the federal estate tax repeal is difficult because death tax revenue is dependent on numerous underlying factors. Two of these determinants include the number of wealthy residents who die and leave large estates and the changes in value of estates subject to taxation. The interplay between these, and other factors contribute to wide annual fluctuations in state death tax revenue. This is especially the case in small states where the death of one very wealthy person affects statewide totals. As a result, most forecasters are conservative in projecting revenues and treat large collections as a windfall.

The phase-out of the federal estate tax will eliminate the State of Illinois' ability to collect estate tax revenues. This is due to the fact that Illinois, like 37 other states, does not administer an independent inheritance or estate tax. Instead, the State relies exclusively on the previously-mentioned "pick-up" tax in which Illinois residents receive a credit against their federal estate tax liability for state tax payment up to a specified amount. Since repealing the federal estate tax will eliminate the state tax credit, it will simultaneously eliminate Illinois estate tax revenues.

Although H.R. 1836 eliminates the state death tax credit in CY 2005, it contains three provisions that will reduce Illinois estate tax revenues in the years prior to the repeal. First, the Act reduces federal estate tax revenues by gradually reducing the highest federal marginal tax bracket. Since the federal estate tax is the basis of the state credit, any reduction in the federal tax will have a trickle down effect on the state credit. Second, it reduces the number of estates that are subject to the federal estate tax by increasing the unified credit effective exemption amount. Third, H.R. 1836 reduces the state death tax credit by 25 percent per year (from present law amounts) until it is completely eliminated in CY 2005. Thus, State estate tax revenue will be reduced by the reduction in the federal estate tax base and compounded by the adjusted state credit.

Estimates

Prior to the passage of H.R. 1836, the Commission estimated that State estate tax collections would increase by approximately 4 percent per year. In FY 2001, the estate tax generated $361 million. Therefore, the Commission expected estate tax revenue to be $376 million in FY 2002, $391 million in FY 2003, $407 million in FY 2004, $423 million in FY 2005, $440 million in FY 2006, and $458 million in 2007. (Keep in mind that the figures associated with FY 2003 – FY 2007 are estimated based on a 4 percent annual growth rate.)

With these estimates serving as a backdrop, it is necessary to examine the impact that H.R. 1836 will have on State tax revenues. H.R. 1836 should not affect FY 2002 estate tax revenues. This result is facilitated by the combination of two timing issues. First, the effective date of the Act is January 1, 2002; the seventh month of FY 2002. In addition, federal and State law permit the decedent's estate nine months to file an estate tax return. Assuming that the majority of filers utilize this grace period, the State would not begin collecting CY 2002 estate tax revenues until approximately September of 2002; the third month of FY 2003. Therefore, FY 2002 State tax revenues generated via the estate tax should meet the Commission's $376 million estimate.

However, State revenues will be affected in FY 2003. At that time, estate tax revenues will decrease as a result of the 25 percent reduction in the state death tax credit, the reduction in the highest marginal federal estate tax rate and the increased unified credit exemption amount. These changes will reduce State revenues to approximately $301 million in FY 2003. As the additional provisions are gradually phased in between CY 2003 and CY 2005 (and accounting for the nine-month lag time), these changes will further reduce estate tax revenues. Current estimates reveal that estate tax revenues may fall to $191 million in FY 2004, $109 million in FY 2005, and $30 million in FY 2006 prior to being completely lost somewhere around FY 2007. Table 4 highlights the annual reductions in State revenue as a result of H.R. 1836.

Table 4: The Impact of H.R. 1836 on Illinois Estate Tax Revenue
($ in millions)

Fiscal Year	* Initital Estimate	Revised Estimate Based on H.R. 1836	Revenue Loss
2002	$376	$376	$0
2003	$391	$301	-$90
2004	$407	$191	-$216
2005	$423	$109	-$314
2006	$440	$30	-$410
2007	$458	$0	-$458

* Estimates based on 4 percent growth

CONCLUSION

Illinois estate tax revenues have increased significantly over the past ten years. Between FY 1991 and FY 2001, State death tax revenue increased from $113 million to $361 million. While these revenues continue to grow, the annual growth rate has slowed over the past two fiscal years. As a result, the Commission estimates that FY 2002 estate tax revenues will equal $376 million.

Although these figures present an optimistic outlook for the estate tax, various analyses presented earlier in this report reveal that this revenue is short lived. On June 7, 2001, Congress passed H.R. 1836 completely overhauling the federal estate tax. It repeals federal estate and gift taxes over a ten-year period. It also increases the unified credit effective exemption amount associated with a decedent's estate. Furthermore, it reduces the state death tax credit by 25 percent per calendar year until it is completely eliminated in CY 2005. These provisions are effective January 1, 2002.

The federal estate tax repeal ultimately will eliminate State estate tax revenue. This loss of revenue is based on the nature of the Illinois estate tax. Currently, the State administers an estate tax and a generation-skipping transfer tax. These taxes are commonly referred to as "pick-up" taxes because the State taxes equal the maximum state credit permitted against federal death tax liability. Since the federal estate tax repeal includes the elimination of the state death tax credit, it simultaneously eliminates the Illinois estate tax and its associated revenue.

Although H.R. 1836 eliminates the state death tax credit in CY 2005, State revenue will be affected in the years prior to the repeal. Before the federal change, the Commission assumed a 4 percent growth rate as a means of forecasting estate tax revenue. Applying this percentage, the Commission expected estate tax collections to equal $376 million in FY 2002, $391 million in FY 2003, $407 million in FY 2004, $423 million in FY 2005, $440 million in FY 2006, and $458 million in FY 2007. Since the change, the Commission modified its forecast and it is now expected that the estate tax will yield $376 million in FY 2002, $301 million in FY 2003, $191 million in FY 2004, $109 million in FY 2005, $30 million in FY 2006, and $0 in FY 2007.

The repeal of the federal estate tax not only will affect Illinois, it will effectively eliminate estate tax revenues in 40 states and significantly reduce them in the remaining 10 states. The National Governor's Association estimates that total state losses could equal anywhere from $50 billion to $100 billion over a ten-year period. Despite this potential, most states (including Illinois) have done little to prepare for this loss of revenue. Although a response to this problem has yet to be devised, it is possible that the states may ask Congress to replace the money through grants or other funding mechanisms. Another option available to the states is the implementation of state-operated estate and/or inheritance taxes. State legislatures will have to consider these and other options when deciding how to respond to the loss of this revenue.

BACKGROUND

The Illinois Economic and Fiscal Commission, a bipartisan, joint legislative commission, provides the General Assembly with information relevant to the Illinois economy, taxes and other sources of revenue and debt obligations of the State. The Commission's specific responsibilities include:

1) Preparation of annual revenue estimates with periodic updates;

2) Analysis of the fiscal impact of revenue bills;

3) Preparation of "State Debt Impact Notes" on legislation which would appropriate bond funds or increase bond authorization;

4) Periodic assessment of capital facility plans; and

5) Annual estimates of the liabilities of the State's group health insurance program and approval of contract renewals promulgated by the Department of Central Management Services.

The Commission also has a mandate to report to the General Assembly ". . . on economic trends in relation to long-range planning and budgeting; and to study and make such recommendations as it deems appropriate on local and regional economic and fiscal policies and on federal fiscal policy as it may affect Illinois. . . ." This results in several reports on various economic issues throughout the year.

The Commission publishes two primary reports. The "Revenue Estimate and Economic Outlook" describes and projects economic conditions and their impact on State revenues. "The Illinois Bond Watcher" examines the State's debt position as well as other issues directly related to conditions in the financial markets. The Commission also periodically publishes special topic reports that have or could have an impact on the economic well being of Illinois.

These reports are available from:

Illinois Economic and Fiscal Commission
703 Stratton Office Building
Springfield, Illinois 62706
(217) 782-5320
(217) 782-3513 (FAX)

Reports can also be accessed from our Webpage:

http://www.legis.state.il.us/commission/ecfisc/ecfisc_home.html