LEGISLATIVE SERVICES AGENCY
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FISCAL IMPACT STATEMENT

LS 6899
BILL NUMBER: HB 1667

NOTE PREPARED: Dec 27, 2002
BILL AMENDED:

SUBJECT: Charitable Deduction from Inheritance Tax.

FIRST AUTHOR: Rep. Murphy
FIRST SPONSOR:

BILL STATUS: As Introduced

FUNDS AFFECTED: <u>X</u> **GENERAL**
<u>X</u> **DEDICATED**
FEDERAL

IMPACT: State & Local

<u>Summary of Legislation:</u> The bill provides that an individual receiving property subject to the Inheritance Tax may deduct from the individual's Inheritance Tax liability an amount equal to the value of that part of the property subject to the Inheritance Tax that the individual subsequently contributes to a charitable organization.

<u>Effective Date:</u> July 1, 2003.

<u>Explanation of State Expenditures:</u> Under the bill, the state will experience a reduction in Inheritance Tax revenue beginning in FY 2005. There will be a minimal compensating increase in Estate Tax revenue for one year, in FY 2005. In addition, the bill is expected to increase state General Fund expenditures for county Inheritance Tax replacement. The net state impact of the bill is summarized in the table below.

Fiscal Year	Inheritance Tax Revenues	Estate Tax Revenues	State Expenditures for County Replacement	Net Increase (Decrease)
2005	($3.5 M)	$38,000	($23,000 - $301,000)	($3.49 M - $3.8 M)
2006 and after	(3.5 M)	0	(23,000 - 301,000)	(3.52 M - 3.8 M)

<u>Explanation of State Expenditures:</u> The bill could potentially increase expenditures from the state General Fund for county Inheritance Tax replacement by $23,000 to $301,000 annually beginning in FY 2005. Necessary replacement funding could vary within this range depending upon whether, and by how much, each county's base revenue exceeds the amount guaranteed under current statute. (See *Explanation of Local*

Revenues, below, for explanation of county revenue loss and replacement procedure.)

Explanation of State Revenues: The bill is estimated to reduce Inheritance Tax revenue by $3.5 M annually beginning in FY 2005. The reduction in Inheritance Tax liabilities is estimated to have a minimal impact on revenue from the Indiana Estate Tax in FY 2005 only. This offset is expected to total only about $38,000 in FY 2005. Due to the relative impact on Inheritance Tax liabilities, the offset is expected to be negligible in FY 2006; and will decline to zero beginning in FY 2007 due to the phase-out of the state death tax credit under the federal Estate Tax. Thus, the estimated net revenue loss is $3.46 M in FY 2005, and $3.5 M annually beginning in FY 2006.

Charitable Giving and Deduction Claiming Estimates: The estimated impact of the charitable contribution deduction is based, in part, on findings from the Giving and Volunteering National Survey conducted by *The Independent Sector*. The survey was conducted biennially from 1987 to 1995, in 1998, and in 2001. The surveys provide an estimate of the percentage of households in the United States that make contributions to charity, the average contribution amount, and the percentage of household income that this contribution, on average, represents. Only preliminary results are available from the 2001 survey. Considering the first six surveys, the average percentage of households contributing to charity is estimated to be approximately 72%, and the percentage of household income contributed has been, on average, approximately 2.2%. The 2001 survey (utilizing a different sampling methodology) suggests that he contributing percentage is much higher, equal to 89%.

The fiscal impact estimates are based on 100% of a sample of property transferees contributing 2.2% of the total fair market value of their transfer to a charitable organization. Database limitations would not allow for selection of a subsample more reflective of the contributing percentages found in the survey research.. The fiscal impact estimates also assume that all transferees would claim the proposed Inheritance Tax deduction and forego taking the federal Income Tax deduction for charitable contributions. Since the federal Income Tax deduction is an itemized deduction, it can't be accessed by all federal filers. However, the assumption is problematic for those federal filers that do itemize. This group would be more likely to take the federal Income Tax deduction because it would likely provide a greater tax savings than the proposed Inheritance Tax deduction. According to the transferee sample, the Inheritance Tax as a percentage of gross transfer value is 2.23% for Class A transferees; 8.19% for Class B transferees; and 11.7% for Class C transferees. Federal Internal Revenue Service statistics for 1999 indicate that the federal income tax as a percentage of adjusted gross income exceeds 2.23% for all income ranges above $1,000; exceeds 8.19% for all income ranges above $25,000; and exceeds 11.7% for all income ranges above $75,000.

Background on Inheritance Tax: The bill would allow a transferee who receives a property interest transfer from a decedent to deduct from the total fair market value of the transfer for purposes of the Inheritance Tax any part of the transfer that they contribute to a charitable organization, provided that contribution is not deducted for purposes of federal Income Tax. The change would apply to transfers made by persons who die on or after July 1, 2003. Since the Inheritance Tax does not have to be paid until a maximum of 12 months after the decedent's death (within 9 months of the date of death to receive the 5% early payment discount), the full impact of the bill likely would not be experienced until FY 2005. The estimated impact of this change is based on the Office of Fiscal and Management Analysis (OFMA) Inheritance Tax database and the Revenue Technical Committee's FY 2005 forecast (December 18, 2002) for the Inheritance Tax totaling $120 M. The revenue forecast total is a combined amount including both Inheritance Tax and Estate Tax revenue. Approximately $118.0 M of the FY 2005 forecast amount is estimated to be attributable to the Inheritance Tax. The Inheritance Tax database is comprised of 112,951 records for transferees receiving property from a decedent who died between July 1, 1997, and June 30, 2000. Of the total tax liability for the transferees in the sample, 39.43% is attributable to Class A transferees; 35.35% is attributable to Class B transferees; and 25.22% is attributable to Class C transferees. The Inheritance Tax deduction reduced the sample Class A tax liability by 3.69%, the sample Class B tax liability by 2.49%, and the sample Class C tax liability by 2.45%. Applying these percentage reductions to the base yield, the revenue loss is estimated to be approximately $3.5 M.

Background on Estate Tax: Although the bill does not make changes to the Indiana Estate Tax, the reduction in Inheritance Tax liabilities for Class A transferees would affect Estate Tax revenues. Indiana Estate Tax is owed on the assets of an estate if (1) federal Estate Tax is owed on the estate and (2) the Indiana portion of the state death tax credit for federal Estate Tax purposes exceeds the total Inheritance Tax paid by transferees of the estate. Consequently, for some estates a reduction in the Inheritance Tax liability paid by transferees of the estate results in a compensating increase in the Indiana Estate Tax liability. The estimated impact of the bill on Estate Tax revenues is based on OFMA's Estate Tax database and the Revenue Technical Committee's FY 2005 forecast (December 18, 2002). It is estimated that no more than $2.0 M of the FY 2005 forecast is attributable to the Estate Tax. The Estate Tax database consists of 559 estates of decedents who died between July 1, 1997, and June 30, 2000, and that paid Indiana Estate Tax. The Inheritance Tax changes provided for in the bill increased the Estate Tax liability of the sample by only about 1.9% for FY 2005 and only 0.28% for FY 2006. It is estimated that Estate Tax revenue would otherwise total about $2.0 M in FY 2005 and $533,000 in FY 2006. This accounts for the phaseout of the Estate Tax in concert with the phaseout of the state death tax credit under the federal Estate Tax. As a result, the Inheritance Tax changes are estimated to increase Estate Tax revenue by roughly $38,000 in FY 2005 and $1,500 in FY 2006.

Explanation of Local Expenditures:

Explanation of Local Revenues: The bill would allow an Inheritance Tax deduction for charitable contributions from taxable property transfers. The revenue impact of this change coupled with county Inheritance Tax replacement could result in an annual net revenue loss to counties of as much as $301,000 beginning in FY 2005. This net impact is summarized in the table below.

	Annual Impact Beginning in FY 2005
Inheritance Tax Revenues (Local Share)	($301,000)
State Expenditures for County Replacement	23,000 - 301,000
Net Increase (Decrease)	(0 - 278,000)

Currently, counties retain 8% of the Inheritance Tax collected on transfers made by Indiana residents. About 99.3% of Inheritance Tax revenue is derived from the resident Inheritance Tax. Based on the FY 2005 forecast for state Inheritance Tax revenue totaling $118.0 M, annual county Inheritance Tax revenue is estimated to total about $10.2 M beginning in FY 2005. Applying the estimated percentage reduction for each transferee class to this base yield, the charitable contribution deduction is estimated to reduce county revenue by about $301,000. It is important to note that a reduction in the amount of Inheritance Tax retained by counties due to the bill may be reimbursed by the state under the replacement provision established by P.L. 254-1997. The replacement provision was established when the Class A exemption was increased on July 1, 1997. The replacement provision guarantees that in each fiscal year each county receives an amount under the Inheritance Tax that is equal to the five-year annual average amount of Inheritance Tax revenue retained by that county from FY 1991 to FY 1997, excluding the highest and lowest year. The maximum amount of county replacement for any year is approximately $7.5 M. Currently, most counties are retaining more revenue than is guaranteed under this replacement procedure. On average from FY 2000 to FY 2002, counties exceeded their guarantee amounts by about $3.8 M annually, with annual shortages subject to replacement totaling about $243,000. With base revenue to the counties totaling $10.4 M, the revenue loss covered by replacement funds would total about $23,000. Thus, about $278,000 in base revenue exceeding the guarantee amount would not be replaced. To the extent that base revenue is less than the estimate, replacement funding would increase and the net loss due to the bill would decline. Thus, county replacement would total $301,000 only if base revenue in each county is equal to the guarantee amount.

A copy of a spreadsheet showing the amount of Inheritance Tax replacement guaranteed to each county under P.L. 254-1997 is available from the Office of Fiscal and Management Analysis

State Agencies Affected: Department of State Revenue.

Local Agencies Affected: Counties

Information Sources: *State Revenue Forecast*, December 18, 2002. OFMA Inheritance Tax and Estate Tax databases. National Survey of Giving and Volunteering: 1987, 1989, 1991, 1993, 1995, 1998, 2001, *The Independent Sector*. 2000 Individual Income Tax Return Statistics, U. S. Internal Revenue Service.

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