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No State Left Behind: An Analysis of the Post-EGTRRA Death Tax Landscape and An Argument for Kentucky to Repeal State Death Taxes

Mary Ellen Wimberly

INTRODUCTION

Wealth transfers are likely to surge as the baby boomer generation passes away over the next fifty-five years. For Americans wishing to pass on the maximum amount of their hard-earned wealth to selected beneficiaries, why die in Kentucky? At death, a Kentuckian’s property is subject to the Kentucky inheritance tax when the property is passed to certain beneficiaries. Although such a tax was once common, Kentucky is one of only a few remaining states that assesses any type of state “death” tax. The significant burden caused by this tax has resulted in Kentucky’s inclusion on Forbes’s list of “Where Not To Die” in 2012, 2013, 2014, 2015, and 2016.

Kentucky has not always been at such a competitive disadvantage for elderly taxpayers. For years, states collected revenue from the federal estate tax credit, which essentially gave states a portion of the tax that would have otherwise been paid to the federal government, but resulted in no additional tax liability for taxpayers. However, the credit was phased out by the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) and replaced by a deduction for

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1 University of Kentucky College of Law, J.D. expected May 2016.
3 KY. REV. STAT. ANN. § 140.010 (West, Westlaw through the 2015 Reg. Sess.).
9 Ebeling, supra note 4.
state death taxes in 2005. Consequently, many states that based the calculation of their state death taxes solely on the federal estate tax credit were left with no state estate tax revenue after the passage of the EGTRRA. Today, Kentucky is in the minority of states that continue to pursue state death taxes and is one of only six states with a state inheritance tax. Shockingly, Kentucky’s top tax rate of sixteen percent is second only to Nebraska’s top tax rate.

Part I of this Note discusses how both types of death taxes (inheritance and estate taxes) have progressed through history, the radical changes to the state death tax system caused by EGTRRA, and the increase in the federal estate and gift tax exemptions. Part II details the current death tax system in Kentucky and explores the trend to repeal state death taxes in other states. Finally, Part III argues that Kentucky’s minority approach is unfair for a number of reasons and advocates for state-level repeal to avoid the fleeing of valuable tax-paying individuals to retirement havens or border states without state death taxes. Specifically, Part III argues that Kentucky’s current inheritance tax unfairly targets certain individuals, encourages “ante-mortem capital flight,” and does not generate enough income to justify its enforcement. Furthermore, Part III discounts some of the popular arguments in favor of keeping state death taxes, such as decreasing income inequality, providing revenue to states, and encouraging charitable giving.

I. HOW DO DEATH TAXES WORK?

Kentucky’s death tax laws are complex. To begin, it is important to point out that the term “death tax” is a colloquial term that refers to two different types of taxes imposed upon the death of an individual, namely “estate taxes” and “inheritance taxes.” An estate tax is a tax imposed on the entirety of the decedent’s estate, whereas an inheritance tax (sometimes referred to as a “succession tax”) is a tax collected on the value of property that a person inherits from another. To better understand where the laws across the country stand today, this section provides background on the legislative history of both estate and inheritance taxes, together known as death taxes.

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12 See Ebeling, supra note 4.
13 See id.
14 See Death Tax, BLACK’S LAW DICTIONARY (10th ed. 2014).
15 Estate Tax, BLACK’S LAW DICTIONARY (10th ed. 2014).
16 Inheritance Tax, BLACK’S LAW DICTIONARY (10th ed. 2014).
A. Historical Analysis of State Death Taxes

When Congress enacted the modern federal estate tax in 1916, all but six U.S. states already imposed a state death tax. However, soon after, states began to recognize the competitive benefits of favorable tax rates due in large part to the advent of automobiles and thus, newly-mobile taxpayers. Florida, for instance, led this charge by eliminating its state death tax in an attempt to appeal to wealthy residents of other states by “create[ing] a domestic ‘tax haven’ free from the evils of winter snowstorms, income taxation, and death taxation.” Other states followed suit, and due to the success of the death tax repeal, “[m]any state leaders thus came to worry that imposing death taxes would precipitate an exodus of their most wealthy, and often most industrious, taxpayers.” This problem inspired three national conferences devoted to preventing the migration of states’ wealthiest taxpayers while still allowing states to collect death tax revenue. The conflict ultimately resulted in Congress amending the Internal Revenue Code to provide a dollar-for-dollar credit on a taxpayer’s federal estate tax return for state death taxes paid by the estate. This change allowed states to receive death tax revenue without burdening taxpayers.

In order to maximize potential income without burdening decedents, all states, including Florida, eventually adopted a death tax equal to the maximum federal credit. This tax was known as a “pick-up,” “sponge,” or “soak-up” tax because it enabled the state to collect the maximum available state death credit offered by the federal government. Thus, the state death tax credit served as a “great equalizer” among the states by enabling states to collect death tax revenue without causing a net tax burden on decedents’ estates.

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18 See Cooper, Interstate Competition, supra note 10, at 838.
19 Id.
20 Id.
21 See id. at 838–39.
22 See id. at 839; see also Revenue Act of 1924, ch. 234, § 301(b), 43 Stat. 253, 304.
24 Kaplan, supra note 23, at 29.
25 See Cooper, Interstate Competition, supra note 10, at 839.
B. Economic Growth and Tax Relief Reconciliation Act of 2001

In 2001, Congress passed EGTRRA, one of four legislative measures popularly referred to as the "Bush tax cuts." This Act provided American taxpayers with two major forms of federal estate tax relief by increasing the lifetime exemption amount and reducing the maximum marginal tax rate. Although EGTRRA was costly, resulting in a more than $1 trillion dollar reduction in federal revenue in the first ten years after passage, the overall cost was somewhat alleviated by a major revenue provision for the federal government contained in EGTRRA: the replacement of the state death tax credit with a state death tax deduction.

Historically, a taxpayer's estate benefitted from a credit against its federal estate tax for state estate, inheritance, legacy, or succession taxes. Everything changed with EGTRRA, which began phasing out the state death tax credit in 2001 until it was completely phased out and replaced with a deduction in 2005. This elimination of the state death tax credit in 2005 was made permanent in 2013. Professor Cooper, a practicing attorney and visiting law professor at Yale Law School, explained the reasoning behind the repeal of the state death tax credit in a 2004 journal article, noting that:

The federal government passed EGTRRA, but seemingly wasn't fully prepared to pay for it. Rather, by repealing the state death tax credit, the architects of EGTRRA placed much of the revenue burden on state governments. In fact, during most of the coming decade, the top net marginal federal estate tax rate may prove to be higher than it was prior to EGTRRA. Overall gross federal estate tax rates overtly decline, but it's the states that lose much of the revenue as a result.


27 Jeffrey A. Cooper et al., State Estate Taxes After EGTRRA: A Long Day's Journey Into Night, 17 QUINNIPIAC PROB. L.J. 317, 320 (2004). EGTRRA originally created a new 10% tax bracket for single filers, joint filers, and heads of household. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, §§ 101(a), 115 Stat. at 41 (codified at I.R.C. § 1(a)(1)(A) (2009)). The 15% bracket's lower threshold was indexed to the new 10% bracket. Id. The 28% bracket was lowered to 25% by 2006. Id. § 101, 115 Stat. at 42. The 31% bracket was lowered to 28% by 2006. Id. The 36% bracket was lowered to 33% by 2006. Id. The 39.6% bracket was lowered to 35% by 2006. Id.


29 Cooper et. al., supra note 27, at 318–19.

30 Economic Growth and Tax Relief Reconciliation Act of 2001 § 532 (codified at I.R.C. § 2058 (2009)).

31 Elaine Hightower Gagliardi, State Death Tax Considerations in Making Lifetime Transfers, 2014 EMERGING ISSUES 7271 (2014).

32 Cooper et al., supra note 27, at 320–21.
Furthermore, Professor Cooper explained the significance of the repeal:

In just four years, EGTRRA thus undermined eighty years of movement towards uniform national death taxation. The elimination of the state death tax credit eliminated a free source of revenue for the states and rekindled old fears of significant tax-motivated migration from states that impose death taxes to those who do not. No amount of state legislation can reverse what EGTRRA has wrought.33

The complex ramifications of the repeal of the state death tax credit were largely due to the fact that most state statutes specifically referenced the state estate tax credit in order to determine the state estate tax liability. For instance, in Kentucky, section 140.130 of the Kentucky Revised Statutes states that an estate tax in addition to the Kentucky inheritance tax is assessed when the state death tax credit allowed on the federal return exceeds the Kentucky inheritance tax.34 Essentially, the difference between the federal credit and the inheritance tax must be paid to Kentucky as an estate tax.35 Thus, because EGTRRA repealed the state death tax credit, it also repealed sponge state death taxes, like Kentucky’s, that were calculated by reference to the credit.36

Prior to the elimination of the state death tax credit in 2005, thirty-eight states imposed only an estate tax keyed to the federal state death tax credit.37 After EGTRRA, many of these states chose to simply let their sponge taxes expire without pursuing alternative state death taxes, while other states engaged in a process known as “decoupling,” and responded by imposing independent state death taxes.38 Of the remaining twelve states that imposed an inheritance or estate tax in addition to their pick-up tax that was tied directly to the federal estate tax credit, many states, like Kentucky, chose to continue to enforce these existing state death tax regimes that were not tied to the credit.39

Prior to the permanent repeal of the federal estate tax credit, experts estimated that repeal of the credit would cost states about $3 billion in annual state revenues.40 Similarly, a legislative analyst opined that post-EGTRRA, state governments would have the “worst of both worlds,” as they would collect about

33 Cooper, Interstate Competition, supra note 10, at 878.
34 KY. REV. STAT. ANN. § 140.130(1) (West, Westlaw through the end of the 2015 Reg. Sess.).
35 Id.
36 Cooper et al., supra note 27, at 319.
38 Id.; see also Cooper et al., supra note 27, at 319.
39 See MICHAEL, SURVEY supra note 37, at 4.
forty percent less revenue, but also force residents to pay higher taxes.\textsuperscript{41} In addition to the significance of eliminated state revenue, the state death tax deduction is also much less advantageous to taxpayers. While a credit reduces total tax liability by a dollar-for-dollar amount, a deduction only reduces the amount of money on which the taxpayer is taxed. For instance, if a taxable estate of $100,000 is taxed at a twenty percent rate, the taxpayer’s tax liability is $20,000. When the taxpayer receives a $1,000 credit, his or her tax liability is reduced by $1,000, resulting in a tax payment of $19,000. However, a $1,000 deduction would only decrease the taxpayer’s taxable income from $100,000 to $99,000. Assuming again a twenty percent tax rate on taxable income, the taxpayer would owe $19,800, meaning that the $1,000 deduction only provided $200 in tax savings.

The disadvantages of a deduction as opposed to a credit to the taxpayer are even more striking when considering that the federal estate tax exemption amount is often much higher than the state exemption. In 2010, Congress set the federal estate tax exemption at five million dollars.\textsuperscript{42} Because the vast majority of estates are worth less than $5 million and thus fall under the federal exemption, most estates are no longer taxed federally. Consequently, few taxpayers even benefit from the state estate tax deduction, which would be deducted from the amount to be taxed on the federal return.

More specifically, whereas state sponge taxes were only collected when the taxpayer paid federal estate taxes, and thus only when the state death tax credit was available, new state death taxes may be collected even when the taxpayer is unable to benefit from the state death tax deduction. This scenario could occur, for example, on a $3 million estate. The estate would not be required to pay federal estate tax because the estate value falls below the federal exemption amount, but it still may be required to pay state estate or inheritance taxes. Furthermore, some states have a state estate tax exemption amount of just $1 million, meaning the bequests of many estates that would fall under the $5 million federal exemption would still be subject to state inheritance taxes.\textsuperscript{43} In these scenarios, because no federal estate taxes were paid, the taxpayer would not be able to benefit from the deduction for state death taxes.

The effect of these changes and EGTRRA in general should not be underestimated. Despite eighty years of revenue sharing of estate taxes, “EGTRRA completely altered the prevailing state death tax landscape”\textsuperscript{44} and “[t]he result is a seemingly non-stop progression of new state estate tax laws, often enacted with concern only for preserving state revenue and without adequate consideration for


\textsuperscript{43} See Cooper, \textit{Interstate Competition}, supra note 10, at 865–68.

\textsuperscript{44} Id. at 876.
the complexities that result." Although the repeal of the state estate tax credit has resulted in some benefits to taxpayers, such as the gift tax loophole, this loophole also suggests that little thought was put into the long-term consequences of the repeal of the state credit, suggesting instead that the repeal was merely passed as a quick source of revenue to help lessen the financial burdens of a lofty political proposal.

This loophole allows conscientious taxpayers to avoid paying either state or federal taxes upon death due to the discrepancy between the federal and state estate tax exemption amounts, coupled with the increase in the federal gift tax exemption. Traditionally, the federal gift tax has served as a backstop to the estate tax to prevent taxpayers from avoiding estate taxes by simply giving their money away before death. This objective was accomplished by a gift tax exemption at or below the estate tax exemption. The federal gift tax exemption amount has continued to serve as a backstop to the federal estate tax, as both the federal estate tax and gift tax exemption amounts have increased to greater than $5 million, but many state estate taxes still have estate tax exemption amounts of around $1 million. Consequently, because many of these states do not have state gift tax restrictions, this increase in the federal gift tax exemption amount allows a taxpayer subject to state estate tax to simply give away an amount less than the federal gift tax exemption, potentially resulting in no gift tax or state estate tax liability.

In some states, though, this loophole does not exist due to state gift taxes or state "gift-in-contemplation-of-death" rules. In Kentucky, for instance, all transfers made in contemplation of death are subject to inheritance tax. A transfer of a material part of a donor’s estate made within three years of the donor’s death is presumed to be transferred in contemplation of death and is taxed under the inheritance tax statute unless the contrary is shown. Notably, this presumption is different from the federal rule, which "does not presume that the transfer was made in contemplation of death irrespective of when the transfer was made." Additionally, even transfers made beyond the three-year window may be determined to be in contemplation of death and thus subject to state inheritance tax in Kentucky.

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45 Cooper et al., supra note 27, at 319.
46 KY. REV. STAT. ANN. § 140.020 (West, Westlaw through the end of the 2015 Reg. Sess.).
47 Id. § 140.020(2); see also id. § 140.030 (relating to the imposition of tax on contracts in contemplation of death).
48 § J. MARTIN BURKE ET AL., MODERN ESTATE PLANNING § 70.22 (2d ed.), LEXIS (database updated 2015).
49 § 140.020(2) (Westlaw).
II. THE CURRENT DEATH TAX SCHEME IN KENTUCKY

A. Kentucky's (Lack of) Estate Tax

After the repeal of the state death tax credit in EGTRRA on January 1, 2005, there has been no state estate tax in Kentucky. Previously, Kentucky's estate tax was equal to the amount by which the credits for the state death tax allowed under the federal tax law exceeded the inheritance tax, less any discount.\(^\text{50}\) Importantly, although there is no current state death tax credit on the federal estate tax return from which to assess a Kentucky estate tax, the Kentucky estate tax remains on the books to be imposed if federal law reinstates a state death tax credit in the future.\(^\text{51}\) Notably, the retention of this pick-up tax means that taxpayers in Kentucky suffer from tax uncertainty that would result in the event that a federal estate tax credit ever resurfaces.

B. Kentucky's Inheritance Tax

Unlike the Kentucky estate tax, which has not been assessed since the repeal of the state death tax credit in EGTRRA, the Kentucky inheritance tax continues to be imposed on "each transfer of assets at death from a decedent to each particular individual heir, beneficiary, or other transferee."\(^\text{52}\) Specifically, the Kentucky inheritance tax is an excise tax on a beneficiary's right to receive property from a deceased person.\(^\text{53}\) Kentucky courts have specified that the "tax must have something upon which to operate [and] . . . the thing taxed is the privilege of transferring."\(^\text{54}\) Succinctly, the Kentucky inheritance tax is grounded upon four factors: (1) the passage of title, (2) by reason of death, (3) from the decedent, (4) to the beneficiary or beneficiaries.\(^\text{55}\) A Kentucky appellate court found that when the decedent specifies that the estate should pay any Kentucky inheritance taxes, the beneficiary must then pay inheritance tax on the portion of tax paid by the estate because it is an additional benefit or gift received by the beneficiary.\(^\text{56}\)

\(^{50}\) Inheritance and Estate Tax, KY. DEPT REVENUE (last updated Feb. 25, 2016), http://revenue.ky.gov/individual/inheritax.htm.

\(^{51}\) § 140.130 (Westlaw). An estate tax in addition to the Kentucky inheritance tax is assessed when the state death tax credit allowed on the federal return (attributable to Kentucky property) exceeds the Kentucky inheritance tax. The difference between the federal credit and the inheritance tax must be paid to Kentucky as an estate tax. Id.

\(^{52}\) See Jeffrey S. Dible, A Straight Path to Inheritance Tax Repeal, RES GESTAE, Apr. 2012, at 10, 10.

\(^{53}\) Martin v. Storry, 126 S.W.2d 445, 447 (Ky. 1939).

\(^{54}\) Id.

\(^{55}\) Dep't of Revenue v. Lanham's Adm'r's, 128 S.W.2d 936, 937 (Ky. 1939) (citing Helvering v. St. Louis Union Tr. Co., 296 U.S. 39 (1935)).

Property that is subject to the Kentucky inheritance tax includes all property belonging to a resident of Kentucky except for real estate located in another state.\textsuperscript{57} Real estate and personal property located in Kentucky and owned by a nonresident and not taxable elsewhere is also subject to Kentucky's tax.\textsuperscript{58} Intangible property of both residents and non-residents is subject to the inheritance tax if the property has a tax situs in Kentucky and is not taxable elsewhere.\textsuperscript{59}

Importantly, property transferred to certain beneficiaries falls under a statutory exception for certain types of transfers and is not subject to the Kentucky inheritance tax. Transfers to charitable, religious, or educational institutions, or on transfers to cities, towns, or public institutions in the state are not subject to the Kentucky inheritance tax as long as the transfer is for public purposes.\textsuperscript{60} Additionally, Kentucky also exempts from inheritance tax any payment made by the federal government to a decedent's surviving spouse or heir in respect of a decedent's war service.\textsuperscript{61}

Through its tax structure, Kentucky also exempts certain beneficiaries from all or part of the inheritance tax. The inheritance tax rate and amount of inheritance tax owed depends on the relationship of the beneficiary to the deceased person and the value of the property. Generally, the closer the relationship, the greater the exemption and the smaller the tax rate.\textsuperscript{62} Class A beneficiaries, which mainly include surviving spouses, parents, children, grandchildren, siblings, and half-siblings are exempt from paying Kentucky inheritance tax up to the amounts specified by the statute.\textsuperscript{63} Class B beneficiaries, which include nieces, nephews, half-nieces, half-nephews, children-in-law,\textsuperscript{64} aunts, uncles, and great-grandchildren, receive a $1,000 exemption and then are taxed at rates from four percent to sixteen percent.\textsuperscript{65} Class C beneficiaries, which include all persons not included as A or B beneficiaries, like cousins, receive only a $500 exemption and then are taxed at rates ranging from six to sixteen percent.\textsuperscript{66} The exact language of the members of each class and the relevant tax rates are included below.

\textsuperscript{57} KY. REV. STAT. ANN. § 140.010 (West, Westlaw through the end of the 2015 Reg. Sess.).
\textsuperscript{58} Id.
\textsuperscript{59} Id.
\textsuperscript{60} Id. § 140.060.
\textsuperscript{61} Id. § 140.015.
\textsuperscript{62} See generally id. § 140.070.
\textsuperscript{63} Id. § 140.080.
\textsuperscript{64} A house bill filed on July 15, 2014, proposed the removal of sons- and daughters-in-law from Class B beneficiaries and added them to the list of Class A beneficiaries. H.B. 17, 2015 Reg. Sess. (Ky. 2014).
\textsuperscript{65} Id. § 140.070(2); id. § 140.080(c).
\textsuperscript{66} Id. § 140.070(3); id. § 140.080(c).
Class A Beneficiaries\textsuperscript{67}

[P]arent, surviving spouse, child by blood, stepchild, child adopted during infancy, child adopted during adulthood who was reared by the decedent during infancy or a grandchild who is the issue of a child by blood, the issue of a stepchild, the issue of a child adopted during adulthood who was reared by the decedent during infancy, the issue of a child adopted during infancy, brother, sister, or brother or sister of the half-blood.

Class B Beneficiaries\textsuperscript{68}

[N]ephew, niece, or a nephew or niece of the half blood, daughter-in-law, son-in-law, aunt or uncle, or a great-grandchild who is the grandchild of a child by blood, of a stepchild or of a child adopted during infancy.

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<td>Exceeding $30,000, but not exceeding $45,000</td>
<td>8%</td>
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<td>Exceeding $45,000, but not exceeding $60,000</td>
<td>10%</td>
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<tr>
<td>Exceeding $60,000, but not exceeding $100,000</td>
<td>12%</td>
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<tr>
<td>Exceeding $100,000, but not exceeding $200,000</td>
<td>14%</td>
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<tr>
<td>Exceeding $200,000</td>
<td>16%</td>
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Class C Beneficiaries\textsuperscript{69}

[A]ny educational, religious, or other institutions, societies, or associations, or to any cities, towns, or public institutions not exempted by KRS 140.060, or to any person not included in either Class A or Class B.

<table>
<thead>
<tr>
<th>Amount of bequest</th>
<th>Tax Rate</th>
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<td>16%</td>
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\textsuperscript{67} Id. § 140.070(1).
\textsuperscript{68} Id. § 140.070(2).
\textsuperscript{69} Id. § 140.070(3).
C. The Trend in Other States

After EGTRRA, roughly half of the states imposed some form of state death taxes. However, by 2016 only four states still impose a state inheritance tax (Nebraska, Iowa, Kentucky, and Pennsylvania). Twelve states impose only a state estate tax (Connecticut, Hawaii, Illinois, Maine, Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont, Washington, and Washington, D.C.). Two states, Maryland and New Jersey, impose both estate and inheritance taxes. Recently, Tennessee, Indiana, Ohio, and North Carolina have phased out or repealed state death taxes, while other states like Connecticut and Maryland have decreased their exemption amounts. Steps have
also been taken in Oregon to repeal the state estate tax. The decreasing number of states that still enforce state death taxes indicates a clear trend of states are moving away from the collection of state estate and inheritance taxes.

Even in a time of budget shortfalls across the country, very few states have opted to increase state death taxes in recent years. However, although many states have repealed state death taxes, some outliers have chosen to implement lower exemption amounts or more severe state death taxes. In 2011, Connecticut lowered its state estate tax exemption amount from $3.5 million to $2 million per estate. Additionally, Illinois resurrected an estate tax in 2011. However, Illinois increased its estate tax exemption from an original $2 million exemption to $4 million as of January 1, 2013.

III. KENTUCKY NEEDS TO REPEAL STATE INHERITANCE TAX

As one of only four states with a state inheritance tax, Kentucky would be well-advised to follow the trends of nearby states like Indiana, Ohio, Tennessee and North Carolina and repeal the state death tax. Although the best solution for all states would be for the states to share in the federal estate tax revenue by Congress giving a credit for paid state death taxes again, this seems unlikely given current federal budget shortfalls. However, articles have been written urging Congress to opt for this revenue-sharing plan again. Given that the resurrection of the credit is unlikely, Kentucky must consider repeal or other solutions in order to remain competitive and attract wealthy retirees. By repealing the inheritance tax, Kentucky can attract wealthy taxpayers who will no longer have to worry about tax assessments on wealth transfers upon death. These taxpayers will also spend money and add to state sales tax and property tax revenue during their lives.

Currently, Kentucky’s maximum inheritance tax rates are the second highest in the country. In addition to being unpopular, Kentucky’s inheritance tax unfairly punishes certain individuals, like those with insufficient tax planning and non-traditional families, and encourages ante-mortem capital flight. Furthermore, the revenue generated from Kentucky’s inheritance tax does not outweigh the negatives that result. Finally, the supporters of the Kentucky inheritance tax lack persuasive

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96 Ebeling, supra note 6.
97 Id.
98 Id.
100 Ebeling, supra note 4.
reasons to keep the tax as the inheritance tax does not accomplish the supposed goals of death taxes like income redistribution.

A. The Kentucky Inheritance Tax Unfairly Targets Certain Individuals

The Kentucky inheritance tax unevenly impacts certain individuals by punishing those without sufficient tax planning, in non-traditional families, and who own family businesses. First, by carefully utilizing estate planning, many taxpayers who would otherwise subject their beneficiaries to the Kentucky inheritance tax are able to shield much of their income from taxation upon death by taking advantage of gifts during their lives and other tax planning strategies. The increase in the federal gift exemption has exacerbated this problem, as people with effective tax planning are able to make larger gifts during their lives and thus avoid paying any state estate or inheritance tax upon death. The people that tend to be hit the hardest by state death taxes are those who die unexpectedly or have their assets tied up in illiquid holdings. Thus, the Kentucky inheritance tax unfairly targets those individuals.

Furthermore, the Kentucky inheritance tax unfairly penalizes non-traditional families, such as unmarried couples, both heterosexual and homosexual, regardless of whether they have children.101 Because Kentucky’s classification of beneficiaries imposes a high tax rate on bequests to friends, caretakers, and all non-relatives,102 Kentucky’s inheritance tax scheme would result in high tax rates paid on a bequest to a domestic partner or other similar relationship. This issue is of particular importance to many Americans, and specifically, many Kentuckians.

Nontraditional families comprise a significant portion of the United States population.103 In fact, in 2010, forty-five percent of all households in the United States were unmarried.104 Closer to home, the 2010 U.S. Census indicated that Kentucky is similar to the national average number of U.S. households of unmarried partners with children.105 Moreover, in a 2012 Gallup Poll, 3.9 percent


103 See Statistics, supra note 101.

104 Id.

of Kentuckians identified as lesbian, gay, bisexual, or transgendered ("LGBT").106 With this percentage, Kentucky has the twelfth highest LGBT population by percentage in the United States.107 Similarly, both Lexington and Louisville, Kentucky have both been included on a list entitled “6 Surprising Places It’s Great To Be Gay.”108 The Kentucky inheritance tax also unfairly targets family businesses that are not transferred to Class A beneficiaries. The tax encourages firms to structure as corporations instead of as more closely-held entities like partnerships, because corporations do not pay taxes when the person leading the business changes.109 Family businesses that are not incorporated, however, may be subject to high Kentucky inheritance tax rates if transferred to family members not included as Class A beneficiaries.110 This can create special issues in the case of illiquid assets, where an asset, such as a farm, must be sold to pay the tax due.

B. The Kentucky Inheritance Tax Encourages Ante-Mortem Capital Flight

Perhaps most importantly, the repeal of the state death tax credit has resulted in a renewed interstate competition for wealthy retirees, just like in 1924 before the passage of the state death tax credit. The elimination of state death taxes in many states has encouraged “state-shopping” by taxpayers and has created a “race to the bottom” that will presumably leave states with increasingly less revenue from state death taxes.111 As Professor Cooper explained:

Amid this backdrop, state leaders seem to be presented with a choice: lose your state death taxes or lose your wealthy residents. A past generation of state leaders faced a similar conflict and confronted a similar decision. Presented with the choice of losing state residents or abandoning state death taxes, they were prepared to choose the latter. The Congress of 1926 preempted that decision. The Congress of [today] seems unlikely to take similar action.

As such, state leaders [today] may have no political choice but to finish what their predecessors started. Looking out across the new death tax landscape after

107 Id.
108 Heather Cronk, 6 Surprising Place It's Great To Be Gay, ALTERNET (June 2, 2011), http://www.alternet.org/story/151173/6_surprising_places_it%27s_great_to_be_gay_%28dallas%2C_texas%29.
110 See KY. REV. STAT. ANN. § 140.070(2)–(3) (West, Westlaw though the end of the 2015 Reg. Sess.).
EGTRRA, modern state leaders may consider it futile to compete with Florida and other death tax havens. They may simply decide that state death tax revenues come at too high a political cost and turn elsewhere for needed tax dollars.\(^{112}\)

Many state politicians have chosen to turn the fiscal challenge of disappearing death tax revenue into a marketing opportunity. Florida is a perfect example of this resourcefulness. After the passage of EGTRRA, “[w]hile leaders in many other states focused on drafting new tax legislation [to replace lost revenue], Florida Governor Jeb Bush appointed a ‘Destination Florida Commission’ . . . in order to ‘evaluate Florida’s competitive position in attracting retirees and to recommend ways to make Florida more retiree friendly.’”\(^{113}\) Among other recommendations, the Commission’s believed that Florida should continue its favorable tax policies.\(^{114}\)

As Professor Cooper noted, “The original tax haven is back in business.”\(^{115}\)

Kentuckians must already suffer through cold winters, allergies, and state income tax. In order to compete with states like Florida, Kentucky must remove the incentive of relocating and repeal the state inheritance tax. Although the action may initially result in less revenue, many studies indicate that high state death taxes may be “financially self-defeating” and cause a greater loss in income and property taxes due to capital flight.\(^{116}\) In fact, a 2011 study by a think tank in Rhode Island examined Census Bureau migration data and discovered that “from 1995 to 2007 Rhode Island collected $341.3 million from the estate tax while it lost $540 million in other taxes due to out-migration.” Not all of those people left because of taxes, but the study found evidence that “the most significant driver of out-migration is the estate tax.”\(^{117}\)

A 2008 study by the Connecticut Department of Revenue Services also supports this conclusion. The Department found that “the 26 states without an estate tax produced twice as many jobs from 2004–07 and had a growth rate 50% faster than those with estate taxes.”\(^{118}\) Furthermore, the study showed that the average taxable income of those leaving Connecticut was $446,000, and the average estate of those leaving was $7.5 million.\(^{119}\)

More generally, country-wide data suggests that the same migration trend in Rhode Island and Connecticut is true for other states with state death taxes. According to Tax Foundation data, nine of the fourteen states that had a state

\(^{112}\) Cooper, Interstate Competition, supra note 10, at 880.

\(^{113}\) Id. at 878–79.

\(^{114}\) Id. at 879.

\(^{115}\) Id.


\(^{117}\) Id.

\(^{118}\) Id.

\(^{119}\) Id.
estate tax had net outflows of both filers and adjusted gross income between 2000 and 2010.\textsuperscript{120} Similarly, "five of the seven states with a state inheritance tax had net outflows totaling $22.8 billion between 2000 and 2010."\textsuperscript{121} To the contrary, nineteen of the thirty-one states "without either [an inheritance or estate tax] had a net inflow of tax filers and [adjusted gross income]."\textsuperscript{122}

Beyond the hard data supporting this migration trend, anecdotal evidence also indicates that wealthy taxpayers are leaving states to avoid state death taxes. Speaking particularly about Indiana, the author of a legislative update claimed that even when there is no data to support capital flight, "every Indiana trust and estate lawyer can think of at least one wealthy business owner or retiree who has sought or followed advice on how to legally avoid the inheritance tax by changing his or her residence to another state."\textsuperscript{123}

Additionally, tax planning articles encourage clients who own a second home in a state that does not impose a death tax to change their domicile to result in a lower tax burden upon their death.\textsuperscript{124} By repealing the Kentucky inheritance tax, the incentive of relocating to avoid Kentucky's inheritance tax would disappear, and many people, their capital assets, and the income those capital assets generate would remain in Kentucky.

C. The Kentucky Inheritance Tax Revenue Amount Does Not Justify Its Continuance

When analyzing the effectiveness of the Kentucky inheritance tax, it is also important to consider the amount of revenue the tax collects. A large amount of revenue could possibly justify the tax's unfair targeting and the capital flight it causes, but the actual revenue collected from the tax is small. As shown in the table below, the inheritance tax revenue represents a very small percentage of the Kentucky general fund and has decreased markedly since the disappearance of the federal estate tax credit.\textsuperscript{125}

\textsuperscript{120} Diana Furchtgott-Roth, \textit{Where Not to Die}, 140 TAX NOTES 1470 (2013).
\textsuperscript{121} Id.
\textsuperscript{122} Id.
\textsuperscript{123} Dible, supra note 52, at 10.
\textsuperscript{124} Gagliardi, supra note 31. "The question of domicile is determined based on a number of factors and the taxpayer generally bears the burden to prove a change of domicile. The general common law test for domicile requires the establishment of a physical residence and the intent to permanently remain there." Id.
\textsuperscript{125} This table was created from data provided by the Kentucky Office of State Budget Director, see KY. OFFICE OF THE STATE BUDGET DIR., QUARTERLY ECONOMIC AND REVENUE REPORT: FOURTH QUARTER FISCAL YEAR 2011 ANNUAL REPORT (2011), http://osbd.ky.gov/Publications/Quarterly\%20Economic\%20and\%20Revenue\%20Reports\%20\%20Fiscal\%202011-4thQtrRevenue.pdf and KY. OFFICE OF THE STATE BUDGET DIR., QUARTERLY ECONOMIC AND REVENUE REPORT: FOURTH QUARTER FISCAL YEAR 2014 ANNUAL EDITION (2014),
Kentucky General Fund ($ million)
Revenue Sources for Fiscal Years 2005–2014

<table>
<thead>
<tr>
<th></th>
<th>Inheritance Tax Revenue</th>
<th>Total General Fund</th>
<th>% of General Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>83,359,872</td>
<td>6,560,216,551</td>
<td>1.27%</td>
</tr>
<tr>
<td>2003</td>
<td>95,864,480</td>
<td>6,783,458,295</td>
<td>1.41%</td>
</tr>
<tr>
<td>2004</td>
<td>66,083,705</td>
<td>6,977,623,200</td>
<td>0.95%</td>
</tr>
<tr>
<td>2005</td>
<td>63,174,866</td>
<td>7,645,046,634</td>
<td>0.83%</td>
</tr>
<tr>
<td>2006</td>
<td>45,990,266</td>
<td>8,376,083,216</td>
<td>0.55%</td>
</tr>
<tr>
<td>2007</td>
<td>43,578,107</td>
<td>8,573,819,250</td>
<td>0.51%</td>
</tr>
<tr>
<td>2008</td>
<td>51,001,299</td>
<td>8,664,336,663</td>
<td>0.59%</td>
</tr>
<tr>
<td>2009</td>
<td>41,234,240</td>
<td>8,426,351,594</td>
<td>0.49%</td>
</tr>
<tr>
<td>2010</td>
<td>37,201,611</td>
<td>8,225,127,620</td>
<td>0.45%</td>
</tr>
<tr>
<td>2011</td>
<td>41,350,929</td>
<td>8,759,442,646</td>
<td>0.47%</td>
</tr>
<tr>
<td>2012</td>
<td>41,312,904</td>
<td>9,090,954,645</td>
<td>0.45%</td>
</tr>
<tr>
<td>2013</td>
<td>41,326,220</td>
<td>9,348,326,000</td>
<td>0.44%</td>
</tr>
<tr>
<td>2014</td>
<td>45,843,849</td>
<td>9,462,035,017</td>
<td>0.48%</td>
</tr>
</tbody>
</table>

Moreover, the revenue generated from the Kentucky inheritance tax seems especially insignificant when considering the compliance costs generally associated with estate tax systems. A 2012 Senate Joint Economics Committee Report concluded that the compliance costs associated with the collection of the federal estate tax are actually higher than the amount of revenue that the tax collects.126 Therefore, some economists consider the entire estate planning industry as economic waste, because the high-skilled labor and capital utilized in the estate planning industry would be applied to other, more productive economic endeavors if the estate tax were repealed.127 This Joint Committee study conflicted with a 1999 study often cited by death tax supporters that claimed that estate tax

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127 Block & Drenkard, supra note 126.
administrative and compliance costs only cost about seven percent of total estate tax revenue.\textsuperscript{128}

Although no studies have specifically analyzed the compliance costs for Kentucky's inheritance tax, the costs are likely to be high given that the inheritance tax affects not only very wealthy people, but all who wish to leave assets to anyone other than a Class A beneficiary. In order to maximize these gifts, many Kentuckians may seek estate planning help to learn how to gift away assets during their lives instead. Even the costs of simply filling out death tax returns may be very costly. For example, in our neighboring state of Indiana, "it is not unusual for the costs of preparing and filing the inheritance tax return to be two to four times the net tax due on the return."\textsuperscript{129}

Additionally, the complexity of state death taxes and the possibility of being taxed in multiple states may also push some Kentuckians to seek estate planning guidance. This complexity is exacerbated by the fact that those in a state that imposes a state estate or inheritance tax may not take advantage of the portability election to minimize their exposure to state death taxes.\textsuperscript{130} This is especially significant because Congress hoped portability would make estate planning much simpler, with "[a] witness before the Senate Finance Committee in 2008 even assert[ing] that portability '[would] eliminate the need for many married individuals to have estate planning.'"\textsuperscript{131} Kentucky does simplify the process by allowing the filing of an Affidavit of Exemption when no Kentucky inheritance tax is due and where the estate does not have to be filed.\textsuperscript{132} The proper filing of an affidavit saves money and time that would otherwise have been expended to prepare inheritance and estate tax returns. However, this does not eliminate the inheritance tax planning costs for those on whose estates the Kentucky inheritance tax is due.

\textit{D. Current Arguments in Favor of Keeping Death Taxes are Weak}

Supporters of state death taxes argue that death taxes are favorable because they help to break up concentrated wealth, accomplish goals of redistribution, provide


\textsuperscript{129} Dible, \textit{supra} note 52, at 10.


\textsuperscript{131} Farrow, \textit{supra} note 130, at 956 (citing STAFF OF J. COMM. ON TAXATION, 110TH CONG., TAXATION ON WEALTH TRANSFERS WITHIN A FAMILY: A DISCUSSION OF SELECTED AREAS OF POSSIBLE REFORM 10 (Comm. Print 2008)).

\textsuperscript{132} KY. DEPT. OF REVENUE, KENTUCKY INHERITANCE AND ESTATE TAX FORMS AND INSTRUCTIONS (2008).}
much-needed revenue to states, encourage charitable giving, and place assets in the hands of buyers who will theoretically increase their economic efficiency. However, Kentucky’s inheritance tax does not significantly accomplish any of these objectives.

First, supporters argue that death taxes provide wealth redistribution. While high amounts of wealth concentration have been shown to correlate with lower national economic performance and harm the democratic process, most commentators agree that death taxes have largely failed to significantly break up targeted wealth concentration, and numerous studies have debunked the myth that estate taxes may, at any level, accomplish these goals. In fact, some research shows that estate taxes may actually increase income inequality by reducing savings and driving up returns on capital, both of which generally benefit wealthy holders of capital. This research supports the worldwide trend, which shows that as inequality has risen in the developed world, many governments have been dismantling—not increasing—estate taxes. Austria, Canada, and Sweden have recently abolished estate taxes outright.

Furthermore, studies have indicated a weak correlation between income inequality and inherited wealth. One study, for instance, found that only two percent of income inequality was attributed to inherited wealth. Even those arguing that inherited wealth creates unfair benefits for beneficiaries recognize that the strong correlation between parent and child income result from many different factors—not just inherited wealth. Specifically, “[t]here are many factors driving the high intergenerational correlation between parent and child economic status,” such as parental education, race, inherited personality traits, and financial inheritance.

The argument of an inheritance tax providing income distribution is especially dicey given that the current classification of beneficiaries promotes the accumulation the wealth within the close family as opposed to spreading the wealth around. Finally, this data ignores the morally reprehensible reasons for taking the accumulated wealth of one and giving it to others. Elizabeth Carter, a law professor at Louisiana State University, stated succinctly that, “by attempting to ensure equal

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133 See, e.g., Safford, supra note 111, at 127.
136 ALAN S. BLINDER, TOWARD AN ECONOMIC THEORY OF INCOME DISTRIBUTION, 123 n.5-7 (1974).
137 Batchelder, supra note 2, at 24.
138 Id.
access to the American dream by penalizing only those who have fulfilled its promise, the . . . estate tax places fundamental American values in irreconcilable conflict.\textsuperscript{140} Carter's work focused on federal estate tax, but the principle is equally applicable to state estate tax.

It is also important to note that estate and inheritance taxes were not developed for the purpose of reducing income inequality. Instead, state death taxes were first introduced simply because it was easier for governments to record the value of an estate than to track income on an annual basis.\textsuperscript{141}

Second, the argument that repealing the Kentucky inheritance tax would result in too much lost revenue for Kentucky provides little support. As previously explained, repealing the inheritance tax may decrease state revenue in the short term, but it would maintain the state's tax base and may increase state revenue in the long term by encouraging wealthy taxpayers to stay in Kentucky to die—and thus to continue paying more valuable state income and property taxes. Furthermore, the Kentucky inheritance tax represents a very small portion of the Kentucky general fund, so shortfalls in the short term would not be prohibitively large.

Third, supporters of death taxes argue that by eliminating the preferable tax-exempt status of charitable bequests, people are less likely to leave property to charities at their death. This argument has some weight, as the Congressional Budget Office speculated that the repeal of the federal estate tax would result in a decline of charitable bequests by sixteen to twenty-eight percent.\textsuperscript{142} However, some experts have argued against these dire predictions, stating instead that "the nation's wealthy have come to see philanthropy as a core part of their identity" and give more during their lifetimes and continue to do so in wills.\textsuperscript{143} Additionally, bequests represent less than ten percent of total charitable gifts,\textsuperscript{144} so even a small decrease in charitable bequests in Kentucky would not greatly hamper charities.

CONCLUSION

The passage of EGTRRA completely altered estate taxation in America, and what is perhaps the most fundamental change—the repeal of the state death tax credit—is far from the most obvious. The race to the bottom among states to decrease their state death taxes in order to attract wealthy retirees is reminiscent of

\textsuperscript{140} \textit{Id.} at 177–78.
\textsuperscript{141} Scheve & Stasavage, supra note 135.
the situation in 1924 before Congress passed the state death tax credit. However, the prospects of Congress stepping in today and protecting death-tax-imposing states like Kentucky are slim to none. Instead, to no longer be considered a "where not to die" state, Kentucky must follow the majority trend and repeal the state inheritance tax.

This issue is of incredible importance to Kentuckians, because unlike an estate tax, which affects only a small portion of individuals, nearly all Kentuckians will become subject to an inheritance tax at some point in their lifetime. Particularly, many Kentucky taxpayers who are subject to the state inheritance tax are not multimillionaires. Instead, they are people like family farmers that happen to own assets with an aggregate value above the exemption level. By no means are they rich. Most of the money they earn is reinvested toward farming-related assets. Thus, when the taxpayer dies and the asset is passed on to someone that owes Kentucky inheritance tax (meaning anyone but a Class A Beneficiary), the beneficiary often has little or no money to pay the required inheritance tax.

Furthermore, Kentucky's inheritance tax unfairly targets certain individuals, like non-traditional families, encourages ante-mortem capital flight, and does not generate enough revenue to justify its enforcement. To maintain its competitiveness, Kentucky must repeal the state inheritance tax and keep its wealthy tax-paying residents at home.

145 See Faulkner, supra note 102, at 285 (noting that almost every Nebraskan will be subject to the inheritance tax by Nebraska's similar inheritance tax statute).
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