Friendly Fire: Unintended Consequences of NJ's Death Tax

A Report for the Garden State Initiative by Danielle Zanzalari, Ph.D. - April 2022

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Our Mission

The Garden State Initiative is a 501(c)3 nonprofit organization dedicated to strengthening New Jersey by providing an alternative voice and commonsense policy solutions in the state -- solutions that promote new investment, the growth of jobs, the creation of economic opportunities, and innovation to the benefit of all New Jerseyans.

GardenStateInitiative.org

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Dr. Zanzalari has taught many classes at UNT Dallas, Clemson University, and Boston College such as Principles of Microeconomics, Principles of Macroeconomics, Intermediate Microeconomics, Intermediate Macroeconomics, Money and Banking, International Trade, MBA Managerial Economics, Masters- Asset Pricing, Masters- Stress Testing of Financial Institutions. She has won multiple awards for her teaching with Faculty Teacher of the Year at UNT Dallas in 2019 and the department's nominee for Graduate Teacher of the Year at Clemson University in 2013.

Executive Summary

As Benjamin Franklin said, “nothing is certain except death and taxes,” which is especially true in New Jersey, one of only six remaining states with an inheritance tax, also called a death tax.[i] The New Jersey law states that if one dies and wants to leave money to their sibling or niece/nephew, the beneficiary must pay an inheritance tax on the value. However, if the relationship to the decedent is different, such as a child, then no inheritance tax may be levied. While basing a tax on relationships is morally questionable, New Jersey’s inheritance tax:

- creates economic inefficiencies for individuals
- incentivizes relocation of retirees
- disproportionally impacts individuals that are not wealthy
- is an unreliable revenue source for the state

An inheritance tax is economically inefficient as it alters the behavior of individuals and leads to less economic growth. One of the ways people alter their behavior is by moving to avoid state-levied death taxes. If people leave the state there is not only a loss in inheritance tax revenue but also other tax revenues, which has an even larger impact on the state. Beyond losing tax dollars, New Jersey also loses an economic base that spends money and owns businesses. Research shows the inheritance tax causes owners to sell their businesses early and leads to a decrease in new businesses started, both of which impede economic growth.

Those that can afford accountants and lawyers are the ones that can avoid the inheritance tax by moving out of state or setting up gifts and trusts ahead of their death. As a result, those that cannot afford to do this (the less wealthy and elderly) or individuals who die unexpectedly bear the burden of the inheritance tax. A study from Iowa showed that 92.5% of all inheritance taxes were assessed on households with an adjusted gross income of $80,000 or below. Iowa legislators have realized that an inheritance tax does not target the rich, as they recently repealed their inheritance tax leaving just 5 states with an inheritance tax.

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[i] New Jersey is one of only 6 remaining states with an inheritance tax. Iowa repealed their inheritance tax in 2021 and will phase out their inheritance tax by January 1, 2025.

Another inefficiency created by the inheritance tax is that beneficiaries who inherit property, like a farm, may be forced to sell it quickly in order to pay off the tax. This may affect many individuals as there are over 9,000 farms in New Jersey and a house a primary asset for most individuals.

Lastly, the inheritance tax is not a reliable tax revenue source as there are large differences in tax collections relative to predicted collections year-to-year. By taxing inheritances, New Jersey creates economic inefficiencies. Repealing the inheritance tax would not only make New Jersey a more competitive place for retirees, but it would also lead to an increase in economic growth.

Background on New Jersey's Inheritance Tax

New Jersey has had an Inheritance Tax since 1892 and levies it based upon who receives a decedents' assets and how much they receive. [ii] When a person dies, the assets they owned are transferred from the decedent to the beneficiary. During this transfer, New Jersey imposes a tax of 11% to 16% if the assets are worth $500 or more, depending on what class the beneficiary falls under.[1] Those in Class A and E are exempt from inheritance tax, while those in Class C and D are not. [2]

Exempt from the inheritance tax:	Not exempt from the inheritance tax:
Class A: the decedent's spouse, civil union partners, children, great-grandchildren, grandchildren, step-children, parents, and grandparents.	**Class C:** includes the decedent's siblings, half-siblings, sons-in-law, daughters-in-law, and any widows of deceased children. The taxes levied are: 0% up to $25,000 11% over $25,000- $1,075,000 13% over $1,075,000-$1,375,000 14% over $1,375,000-$1,675,000 16% over $1,675,000
Class E: charities and non-profit organizations	**Class D:** includes anyone who is not in Class A, C, or D. This includes nephews, nieces, cousins, fiancés, friends, and a non-civil union partner. The taxes levied are: 0% up to $500 15% over $500-$700,000 16% over $700,000

*Note: life insurance payouts are exempt from NJ inheritance tax regardless of the recipient, so long as it is paid directly to the beneficiary.[3]

[ii] While the estate tax was repealed in January 2018, the estate tax was only levied over and above the amount of any inheritance tax due. More New Jersey residents pay an inheritance tax than estate tax.

Why The Inheritance Tax Should Be Repealed

The inheritance tax is based not the upon the value of the property but based on the relationship one has with the decedent. If a decedent does not have any children or a remaining spouse but has a close relationship with his/her niece, then they must pay an inheritance tax. While there is a *moral question* of whom New Jersey legislatures feel is a "close enough kin" and worthy of a tax-free inheritance, there also remain many economic reasons for why the inheritance tax should be repealed. The inheritance tax affects many individuals, such as decedents of varying levels of wealth and age, those with illiquid assets, or those that die unexpectedly. The inheritance tax encourages moving, discourages entrepreneurship, is not a reliable source of tax revenue, and makes New Jersey less friendly to retirees.

Increases the Number of People Moving Out of New Jersey

Economic research on death taxes shows that people move away to avoid them. Bakija and Slemrod (2004) find that state death taxes result in a 1.4-2.7% decline in federal estate tax returns filed in a state.[4] This is particularly problematic for a state like New Jersey, as it is one of the few places in the country where it is easy to move to a different state without leaving social ties of friends and family due to the proximity to other states and intense regional tax competition.[5]

While moving out of state due to taxes may seem unlikely, a recent poll by the Rutgers University's Eagleton Center for Public Interest Polling (ECPIP) found that 36% of respondents want to move out of state and 48% of respondents rated the state as a poor place to settle down and retire.[6] Thus, people are considering the option of leaving the state of New Jersey due to cost.

The issue with tax-induced migration is that it leads to a loss of revenue for the state. Bakija and Slemrod (2004) find that moving reduces revenue from other taxes, not just revenue from death taxes. This impact is substantial as revenue loss from other tax sources is 1.73x larger than the revenue loss from death taxes alone. This leads to economic inefficiencies—as more residents move, fewer residents are remaining who shop, eat, and start businesses within the state.

Another problem with inheritance taxes is they impact an individual's decision to move based on the level of one's wealth and age. Those who are less wealthy are less likely to move when facing an inheritance tax.[7] Conway and Hountenville (2001) also find that the elderly are less likely to migrate out of states than those that are younger, but if they do move they are less likely to move into a state that has an inheritance tax.[8]

Poorer Individuals Cannot Afford to Avoid Taxes

Since inheritance tax only applies once a decedent dies, there is a prolonged period for people to plan what happens to their assets when they die. A large amount of money at stake and a long planning period makes it relatively easy to avoid taxes for some of New Jersey's richest individuals. However, tax avoidance strategies force individuals to make decisions they would not otherwise do, leading to inefficiencies.

One way for the rich to avoid inheritances tax is to gift money to nieces and nephews during their lifetime. Gifts may be through an irrevocable trust or they may be in the form of payment for education or medical bills. One could also set up a life insurance plan to avoid inheritance taxes. These advanced tax planning techniques are costly as accountants and lawyers are usually consulted to help set up the gifts or plans, which make them not only an inefficient use of resources but more likely to be used by the rich.

This leads to a bigger share of the inheritance tax burden being placed on less wealthy individuals. In fact, a study from Iowa showed that 92.5% of all inheritance taxes were assessed on households with adjusted gross incomes of $80,000 or below. Iowa legislators have realized that an inheritance tax does not target the rich, as they recently repealed their inheritance tax in 2021 with a reduction in taxes of 20% per year over four years.[9]

Has a Greater Impact on Those that Die Unexpectedly

While the benefits of preplanning to avoid taxes are clear, some people die before they expect to bequest assets to descendants. Individuals who do not have a plan for their assets at death are more likely to be less wealthy and younger. Research shows that those who die from an illness lasting months to years, reduce their estates by 15-20% in the time preceding their death, relative to those who die suddenly.[10] This result shows that preplanning, which those who die unexpectedly are less likely to do, is important to preserving wealth when facing death taxes, like an inheritance tax.

Forces Sales of Illiquid Assets

The inheritance tax is assessed on almost anything owned by the decedent. This includes housing, real estate, bank accounts, stocks, bonds, cars, and other tangible property. If a decedent has their net worth tied up in hard assets that are illiquid this becomes a problem for the beneficiary receiving the inheritance. If the inheritance comes in the form of land, then the beneficiary either must have enough cash on hand to pay the inheritance tax or sell the land in order to pay the inheritance tax.

For example, if a cousin is the main beneficiary of a decedent and the decedent has a farm worth $5,000,000, then the cousin must have $800,000 on hand to pay New Jersey's inheritance tax. If they do not have that amount of money, they will have to sell the farm in order to come up with enough cash to pay the tax. Selling a farm quickly in order to afford the inheritance tax, may mean settling for a lower price on the property or selling in a real estate market that may not be conducive to buyers. This creates economic inefficiency as it may force a profitable business to close to afford taxes. While this may seem unlikely, the 2019 Annual Report on Agricultural Statistics shows that New Jersey is home to 9,883 farms, and farm real estate assets account for 82% of farm sector assets in 2022. [11] [12]

In fact, Nebraska recently passed a bill on February 11, 2022, to cut their inheritance tax rate. This is partially due to their neighboring state, Iowa, eliminating their inheritance tax as well as the negative impact it has on family farms and businesses in Nebraska. Nebraska has the fourth-highest income from farming in the United States.[13] While the impact on farmers with large amounts of their wealth tied up in land is clear, inheritance tax affects most Americans. This is due to primary residences being the largest asset for most people.[14] If most of a decedent's wealth is tied up in a physical

property, this will force many beneficiaries to make economically inefficient decisions to sell the property to afford the inheritance tax.

The Tax Revenue Source is not Reliable

Since inheritance taxes are levied only upon death and dependent on the relationship between the beneficiary and the decedent, inheritance taxes are not a reliable source of revenue for the state of New Jersey. For example, inheritance tax revenues increased 38.9% from January 2020 to January 2021 likely due to the larger amount of deaths during the first year of the pandemic. In January 2021, the State Treasury predicted the inheritance tax growth rate would be 8.1% for the year, but inheritance tax revenues were up 18.3% year-to-date in January 2022—over 10 percentage points different than the prediction.

Interestingly, the Department of Treasury forecasts inheritance taxes will end up 14% lower in 2022, which is the exact opposite of Governor Murphy's budget proposal which shows about a 7% *increase* in the inheritance tax collected in 2022.[15] This demonstrates that it is very difficult to rely on inheritance tax as a primary source of tax revenue due to the difficulties in predicting death rates, and how likely people are to move out of the state or employ tax avoidance strategies.

It Deters Business Continuity and Entrepreneurship

Eliminating the inheritance tax can increase entrepreneurship in the state by encouraging people to start businesses and continue them throughout their life. A study by the Tax Policy Center at the Urban Institute and Brookings Institute finds that when business owners face inheritance taxes they are more likely to retire early or sell their business. [16] The age of a business is found to be more important for job growth (and thus economic growth) than the size of the business.[17] An inheritance tax discourages business longevity. Moreover, since wealthy individuals are more likely to start a business, inheritance taxes may discourage individuals from even starting them in New Jersey.[18]

Since inheritance taxes reduce the size of a beneficiary's inheritance, it also indirectly affects entrepreneurship. When a decedent dies and bequests funds to a beneficiary, this capital can serve as a new investment for potential entrepreneurs. Inheritance tax lowers the amount of capital

available for new investment. In the study from the Tax Policy Center at the Urban Institute and Brookings Institute, a $1 million reduction in the size of inheritance is found to reduce the likelihood of owning and managing a business by one percentage point.

It Makes NJ an Unfriendly State to Retirees

Inheritance tax, along with state income tax and property tax, makes New Jersey particularly unfriendly to individuals in or nearing retirement. New Jersey is on Forbes' *Where Not to Die List*[19] and on the Kiplinger's *Least Tax-Friendly States for Retirees List.*[20] This is not a list that a state wants to be on if they are looking to keep residents from fleeing in retirement. Another recent poll from the New Jersey Society of CPAs (NJCPA) found that 70% of accountants advised a client to relocate out of New Jersey due to the high cost of living.[21]

New Jersey already has laws that allow taxpayers over the age of 62 that make less than $150,000 in income to exclude some or all of their income from retirement plans like an IRA or annuity from tax. This is better than a number of other neighboring states like New York and Connecticut, both of which have estate taxes and fewer income tax exemptions. If New Jersey eliminates the inheritance tax it will make them more competitive in retaining individuals from the Northeast that are approaching retirement—individuals who buy goods that contribute to the overall economic growth of our state.

Conclusion

The inheritance tax is economically inefficient as it forces individuals to alter their behavior to comply with the tax. It hurts decedents of different income and age levels, as well as beneficiaries who inherit illiquid assets. It hurts beneficiaries that want to become business owners that could use the additional inheritance to start businesses and beneficiaries of decedents who die unexpectedly. Inheritance taxes also are found to cause business owners to retire early, hurting economic growth. Moreover, inheritance taxes are not a reliable source of tax revenue for the state due to the difficulties in predicting death rates and tax avoidance.

Repealing the inheritance tax would go a long way to making New Jersey a friendlier option for retirees and a more economically efficient state. The inheritance tax could also be phased out in stages, similar to Iowa and similar to what New Jersey has done with the former estate tax, to allow the state to better prepare for a loss in tax revenue. Repealing the inheritance tax will solve many economic inefficiencies and encourage more business investment and business continuity in the state of New Jersey.

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