COMMON SENSE Policy Roundtable

Economic Impacts of Eliminating Colorado's Fiduciary Tax on Resident Trusts

March 2013

Nathan Associates Inc. was engaged by Common Sense Policy Roundtable to examine the economic impacts associated with removing Colorado's fiduciary tax on resident trusts.

While nearby states have no taxes on trusts, Colorado's trust tax laws are unfavorable for setting up and managing trusts. Indeed, estate planners have been advised to avoid Colorado-based trustees. This is borne out by the following empirical observations:

- **The state's fiduciary tax has contributed to a decline in Colorado's trust business**. The number of trust accounts in Colorado has declined over the past decade with the state losing an average of approximately 500 accounts a year.
- **Colorado is losing trust business to more competitive states**. Since 2001, Colorado has lost 60 percent of its trust accounts and 6 percent of its assets. Over the same period, the states of South Dakota, Texas, and Wyoming combined have seen the number of trust accounts more than triple and their trust assets quadruple.
- **Eliminating the fiduciary tax would not noticeably affect the state budget**. In 2012, fiduciary tax collections provided only $26 million of revenues for the state, accounting for less than one-half of one percent of total state collections.

Our analysis is based on the assumption that removing the tax would reverse the decline in the Colorado trust industry and boost growth in trust assets over the next decade. We employ a widely used model to calculate the impacts each year as Colorado trust assets are anticipated to grow. We also calculate the net fiscal impacts, with the following results after a decade.

- 9,330 to 21,755 more full- and part-time jobs.
- $1.68 billion to $3.90 billion in additional economic activity.
- $440 million to $1.03 billion in additional payroll and self-employment income.

- Eliminating the tax would “pay for itself” with increased tax collections relatively quickly.

Thus, if the state can attract sufficient trust assets by eliminating its fiduciary tax on resident trusts, the Colorado economy would experience improved employment and incomes over the next decade.

Economic Impacts of Eliminating Colorado's Fiduciary Tax on Trusts

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March 2013

Nathan Associates Inc. was engaged by Common Sense Policy Roundtable to examine the economic impacts associated with removing Colorado's fiduciary tax on trusts. Our analysis is based on the assumption that removing the tax would reverse the decline in the Colorado trust industry and boost growth in trust assets to as much as $150 billion over the next decade. Our analysis employs a widely used input-output model to calculate the impacts each year as Colorado trust assets are anticipated to grow. The model reports output, earnings, and employment impacts. We also employ a proprietary data set and statistical model to calculate the extent to which eliminating Colorado's fiduciary tax would affect state tax collections. All figures and tables are at the end of this report.

1 Introduction and Background

A trust is a legal entity and can be thought of as an account into which one can transfer assets. The assets become legally owned by the trust and are no longer considered part of the estate of the person transferring the assets. The creator of the trust appoints a trustee who is legally responsible for managing and distributing assets in the trusts according to the trust's directions. The trustee can be the creator of the trust, a family member, a friend, or financial services firm.

Advantages of trusts

The most common reason for setting up a trust is to reduce estate taxes. In 2013, the tax laws for estates changed to increase the maximum federal tax rate to 40 percent. However, the laws create an exclusion at the death of each spouse, allowing up to $5.25 million of assets per spouse to be passed on to future generations estate tax free and creating an incentive to use trusts to avoid estate taxation. Take a family with more than $10.5 million of assets. If the husband dies first, his assets would pass to his wife estate

tax free. Additionally, he could use his exclusion to set up a generation skipping trust (GST) with up to $5.25 million, which would be passed on to future generations and pay lifetime income to the surviving spouse, while avoiding the estate tax for l00 years or more.

At the surviving spouse's death, she would have the ability to set up another $5.25 million GST trust for the future generations of their family, with the income or principal being paid out from time to time at the discretion of the trustee. This irrevocable trust format allows for up to $10.5 million to pass estate tax free from one generation of a family to many future generations. Combined with the high estate tax rates, the exclusion creates a strong incentive for families to set up this type of trust, and will create a number of jobs in the industry over the coming years as large amounts of wealth are transferred between generations.

Trusts can also protect life insurance proceeds from estate taxes. If a life insurance policy is in an individual's name, proceeds would be subject to estate taxes. However, if the insured created a trust to own the life insurance policy, then the beneficiaries can avoid having their benefits reduced by estate taxes.

There are a number of nontax reasons that have made trusts more attractive to those in the middle-class. For example, trusts can be used to protect assets, clarify lines of inheritance, help charities, and provide for children with special needs.

Individuals concerned about someone else laying claim to his or her assets can find some protection in a trust. In this way, a trust can protect someone from a creditor, an ex-spouse, a former business partner, or even against a personal injury judgment. Once the assets are transferred to a trust they are no longer in the creator's name, making it difficult for anyone to get at them. For example, with the passage of the Sarbanes-Oxley Act—which makes top executives and directors accountable for their company's financial results—more executives are looking into asset protection trusts.

With death, divorce, and multiple marriages, the lines of inheritance can get muddied. A trust known as a qualified terminable interest property (QTIP) trust is one way to make the lines of inheritance—who gets what—more clear. For example, say that a husband is concerned that after he dies, his spouse will remarry and decide to name not only his children but also her new stepchildren as beneficiaries. A QTIP trust lets the husband specify that his estate will ultimately end up going only to his children.

Trusts can be used to benefit charity while shielding the trust creator's estate from tax. For example, a charitable remainder annuity trust provides annual income from property transfer into the trust. At the end of the term, assets that remain in the trust go to charity. The trust's creator gets the benefit of an immediate tax deduction for the present value of what will go to charity.

The most common nontax reason to create a trust is to provide for either a dependent with special needs or a child under age 18. If the inheritance is given to such heirs outside a trust, their guardians may have to go to court once a year to get authorization to administer assets. A trust allows the assets to be administered outside the court. For a child with a disability, a trust can also be a way to ensure continued government assistance for programs. Eligibility for some programs is based on a child's assets and income. With a special needs trust, distributions can be structured in a way to allow the child to be eligible for assistance.

Colorado's taxation of trusts

Trusts are regarded as essential tools for estate planning largely because of the potential for federal estate and gift tax savings if structured properly.[1] Many states, however, impose their own taxes on estates, gifts, and trusts. In particular, some trusts may be treated by a state as separate, stand-alone taxable entities themselves subject to state fiduciary income tax in one or more states.

Colorado's trust tax laws are unfavorable for setting up and managing trusts. An attorney specializing in estate planning, estate and trust administration, and estate and trust-related litigation advises estate planners to avoid Colorado-based trustees.[2]

> The advisor must ensure that the steps taken to change a trust's tax residency do not inadvertently cause the trust to be subject to state income tax elsewhere. *For example, the advisor would presumably seek to avoid designation of a new trustee situated in, say, Colorado, whose laws subject a trust to income taxation if the trust has its place of administration there*. [emphasis added]

Nearby states such as Wyoming, South Dakota, Nevada, and Texas have no taxes on trusts. Colorado's estate and trust income tax (also known as a "fiduciary" income tax) is a flat 4.63 percent. If a trust is administered in Colorado it is considered a resident estate or trust. In addition, nonresident trusts that are not administered in Colorado must

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[1] Prior to 2005, Colorado, along with many other states, employed a "pickup" tax policy. The pickup is a legal mechanism that allows a state to receive a portion of federal estate tax revenue by making use of the IRS's state estate tax credit. In 2005, the pick up tax was phased out under the provisions of the Economic Growth and Tax Relief Reconciliation Act. As a result, Colorado has not received estate tax revenue for deaths occurring in 2005 through 2012. In 2010, the Taxpayer Relief Act of 2010 was signed into law. This law overrides the provisions of EGTRRA with regard to estate taxes and the pickup tax was not reinstated. However, the provisions of the Taxpayer Relief Act are set to sunset on December 31, 2012, in which case the pick up tax, as well as the Colorado estate tax, will return beginning with deaths that occur in 2013.

[2] Redd, C. A. (2011). State income tax issues with trusts. The 2011 Estate Planning Teleconference Series. Cannon Financial Institute, Inc.

file a return if they have Colorado source income. The Colorado tax on a nonresident trust is based on the ratio of the Colorado taxable income to the modified federal taxable income. In this way, some nonresident trusts are subject to double taxation.

Colorado fiduciary tax collections are widely variable from year to year. Figure 1 shows that, on average, the state collects $27 million a year from the fiduciary tax. The figure also shows that collections can be nearly double the previous year's collections or a less than half the previous years' collections. In addition to the wild swings in Colorado's fiduciary tax collections, the tax itself makes up a miniscule portion of the state's total tax collections. As shown in Figure 2, on average fiduciary tax collections make up less than 0.4 percent of the state's total tax collections. In 2012, the most recent year for which information is available, fiduciary tax collections were only 0.3 percent of total tax collections by the state.

The decline of Colorado's trust industry

Figure 3 shows that the number of trust accounts in Colorado has declined over the past decade, losing an average of approximately 500 accounts a year.[3] In addition, the assets in Colorado trusts have also seen a decline over the past decade (Figure 4). In contrast, the number of accounts in the rest of the US has been relatively stable (Figure 6) as have the amount of assets (Figure 7).[4]

Colorado's trust industry has declined relative to nearby states. Figure 8 shows that the number of accounts in Colorado has declined by 58 percent since 2001, South Dakota, Texas, and Wyoming combined have seen an increase of 276 percent over the same period. Similarly, Figure 9 shows that trust assets in Colorado have declined by 12 percent while trust assets in the nearby states have increased by 473 percent.

2 General Research Approach

In this study, we examine the likely effects on the Colorado economy if the state were to eliminate the fiduciary tax on resident trusts. Market participants have noted that Colorado has established financial services industry and professional expertise. In addition, several Colorado locations such as Vail and Aspen have reputations for attracting indi-

[3] Information on the number of trust accounts and assets by state are from the Federal Deposit Insurance Corporation. For these data, the location of the accounts is reported for where the bank's main office is. Thus, tax data from the State of Colorado is different from account and asset data from the FDIC.

[4] For data from the Federal Deposit Insurance Corporation, the location of the accounts is based on where the trust's main office is. Thus these data represent an approximation.

viduals with relatively high net worth. We consider a hypothetical case in which, within a decade from now, removing the tax would allow for Colorado trusts to accumulate $65 billion in assets, or approximately the same amount of assets currently in South Dakota trusts. Some observers project that, by 2020, $12 trillion in assets will be transferred across generations.[5] Thus, we also consider the hypothetical case that Colorado trusts capture a little more than one percent of this transfer, in which case the state would have approximately $150 billion in trust assets.

This study uses RIMS II to calculate how eliminating Colorado's fiduciary tax on trusts would impact the state's employment, earnings, and output. RIMS II was developed and is maintained by the US Bureau of Economic Analysis. It is widely used in both the public and private sector. According to empirical tests, the estimates based on RIMS II are similar in magnitude to the estimates provided by other input-output models, such as IMPLAN.

RIMS II is based on an accounting framework called an input-output table. For each industry, an input-output table shows the distribution of the inputs purchased and the outputs sold. A typical input-output table in RIMS II is derived mainly from two data sources: BEA's national input-output table, which shows the input and output structure of nearly 500 US industries, and BEA's regional economic accounts, which are used to adjust the national input-output table in order to reflect a region's industrial structure and trading patterns.

Economic impacts can be measured in several ways. This report focuses on three of the most common and useful measures:

1. **Employment**: the number of people working full- or part-time jobs;
2. **Output**: the value of goods and services produced, also described as economic activity;[6] and
3. **Income**: the total payroll costs (including bonuses and benefits) paid to workers as well as self-employment income earned by individuals.[7]

[5] Community Foundation R&D Incubator (2002). *Family Philanthropy and the Intergenerational Transfer of Wealth*.

[6] RIMS II output multipliers are used to produce estimates of changes in total gross output, which is different from gross domestic product (GDP). Gross output reported by RIMS II incudes spending on intermediate inputs, which are goods and services that are used in the production process of other goods and services and are not sold in final-demand markets. GDP, in contrast, excludes the impact of spending on intermediate inputs.

[7] Personal contributions to social insurance and employee pension plans are excluded because the model accounts for only the portion of personal income that is currently available for households to spend.

In addition to the estimating employment, earnings, and output, this study uses a proprietary data set and statistical model to calculate the extent to which eliminating Colorado's fiduciary tax would affect state tax collections.

3 Effects on Employment and Income and State Tax Collections

Impacts are based on the assumption that by eliminating Colorado's fiduciary tax on resident trusts, trust assets in the state would grow over the next decade. Table 1 shows the net impacts over time if assets grow to $65 billion by 2024. Table 3 shows the net impacts over time if assets grow to $150 billion by 2024.

The impacts throughout this report are *net* impacts in that they measure the *difference* in impacts relative to an alternative in which Colorado's fiduciary tax remains unchanged and the state's trust business continues its slow decline. For example, if Colorado's fiduciary tax remains unchanged and continues to lose assets at the current rate, it is expected that by 2024, trust assets in the state would be approximately $1.19 billion. Thus, the *difference* between $65 billion and $1.19 billion provides a *net* change of $64.25 billion. Dollar amounts in this report are in current dollars, meaning the dollar amount in the time period being examined without any adjustment for inflation or the time value of money.[8]

Table 2 and Table 4 provide detail for a single year. If removing the state's fiduciary tax on trusts increased state trust assets to $65 billion by 2024, then the input-output model indicates that output in the state would be $1.675 billion higher. If removing the state's fiduciary tax on trusts increased state trust assets to $150 billion by 2024, then the input-output model indicates that output in the state would be $3.895 billion higher. Approximately three-quarters of additional output would be associated with direct and indirect effects; approximately one-quarter of the additional output would be associated with increased spending by households.

Direct and indirect impacts are based on Type I multipliers, which account for the supply of goods and services in the region. Induced impacts are derived from Type II multipliers which account for direct and indirect impacts, as well as impacts associated with the purchases made by employees.

The last column of Table 2 and Table 4 shows that an increase in Colorado trust assets would be associated with an additional 9,330 to 21,755 full- and part-time jobs in the state. Earnings in the state would increase by $440 million to $1.03 billion.

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[8] Note that the RIMS II employment multipliers are based on output in 2008 dollars. This study makes the appropriate adjustment to account for this feature of the model.

The finance and insurance industry would experience approximately two-thirds of the expected increase in economic activity, with additional output of $1.1 billion to $2.6 billion and 5,800 to 13,500 more full- and part-time jobs. Measured by output, the real estate and rental and leasing industry would see the next largest impacts, with an additional $117 million to $272 million in output.

In addition to estimating employment, earnings, and output, this study calculates the extent to which eliminating Colorado's fiduciary tax would affect state tax collections. The anticipated increased economic activity associated with removing Colorado's fiduciary tax on resident trusts would be transmitted into additional state tax collections. Indeed, much of the variation in Colorado's state tax collection can be attributed to variations the state's economy. Using a proprietary data set and statistical model to quantify the relationship, this study calculates the fiscal impacts of eliminating Colorado's fiduciary tax.

The last column of Table 1 and Table 3 shows the calculated net impacts on state tax collections. It provides the difference between (1) increased tax collections resulting from the increased economic activity associated with removing Colorado's fiduciary tax on resident trusts and (2) the projected taxes that would be collected if the fiduciary tax remains in place. The table shows that in less than 10 years, removing the fiduciary tax on all trusts would pay for itself with additional state collections elsewhere. The table assumes that the state would not collect any fiduciary tax. However, if the fiduciary tax were eliminated only on resident trusts, any negative impacts on tax collections would be reduced because the state would still collect taxes on non-resident trusts with Colorado source income. Also, recall, that Colorado's fiduciary tax collections make up less than 40 cents of every $100 the state collects. Thus, even if removing the fiduciary tax on all trusts did nothing to "replace" the "lost" tax revenues, the amount would be so small as to be virtually unnoticeable.

4 Conclusion

While nearby states have no taxes on trusts, Colorado's trust tax laws are unfavorable for setting up and managing trusts. Indeed, estate planners have been advised to avoid Colorado-based trustees. This is borne out by the following empirical observations:

- The state's fiduciary tax has contributed to a decline in Colorado's trust business. The number of trust accounts in Colorado has declined over the past decade with the state losing an average of approximately 500 accounts a year.
- Colorado is losing trust business to more competitive states. Since 2001, Colorado has lost 60 percent of its trust accounts and 6 percent of its assets. Over the same period, the states of South Dakota, Texas, and Wyoming combined have

seen the number of trust accounts more than triple and their trust assets quadruple.
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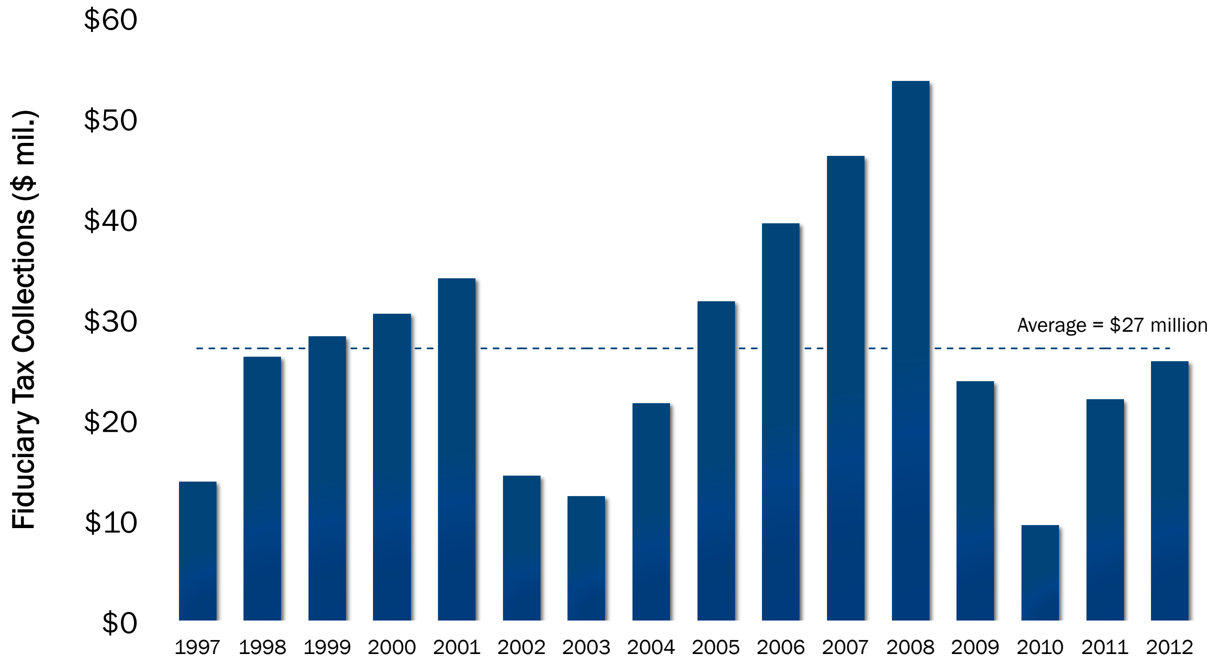
- Eliminating the tax would “pay for itself” with increased tax collections relatively quickly.

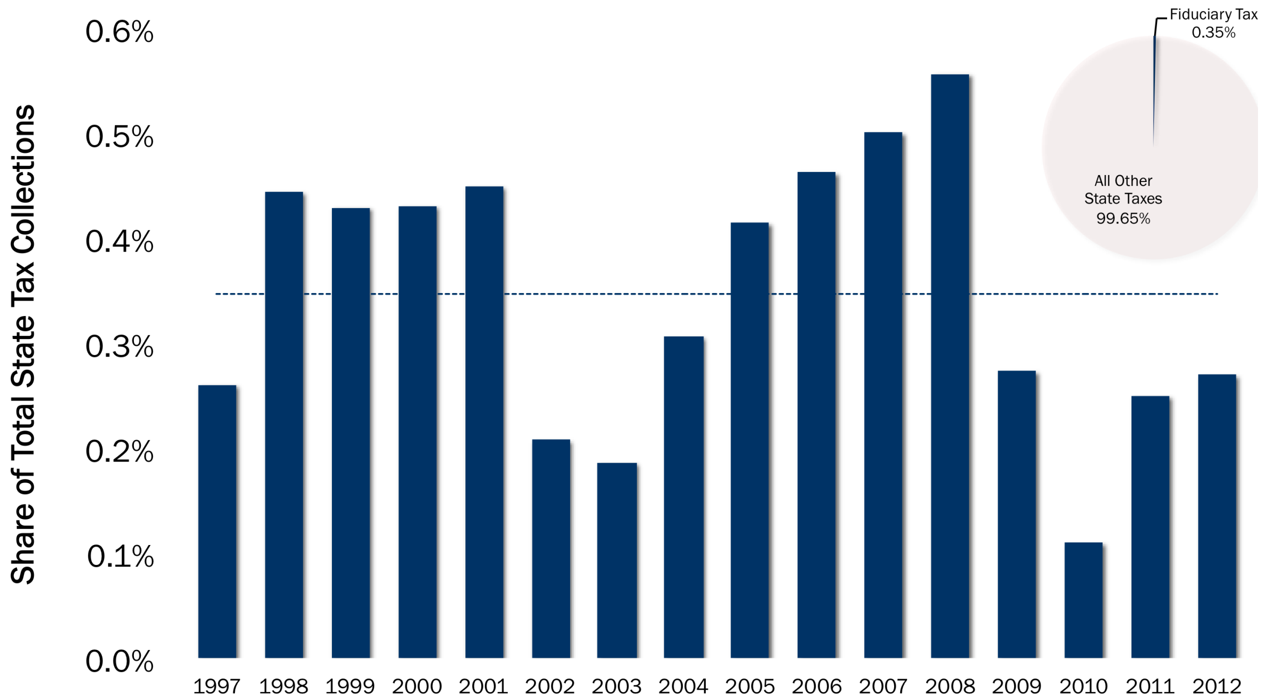
Thus, if the state can attract sufficient trust assets by eliminating its fiduciary tax on resident trusts, the Colorado economy would experience improved employment and incomes over the next decade.

Figure 1: Colorado fiduciary tax collections



Source: Colorado Department of Revenue

Figure 2: Colorado fiduciary tax as share of total state tax collections



Source: Colorado Department of Revenue; US Census Bureau

Figure 3: Colorado personal trust and agency accounts

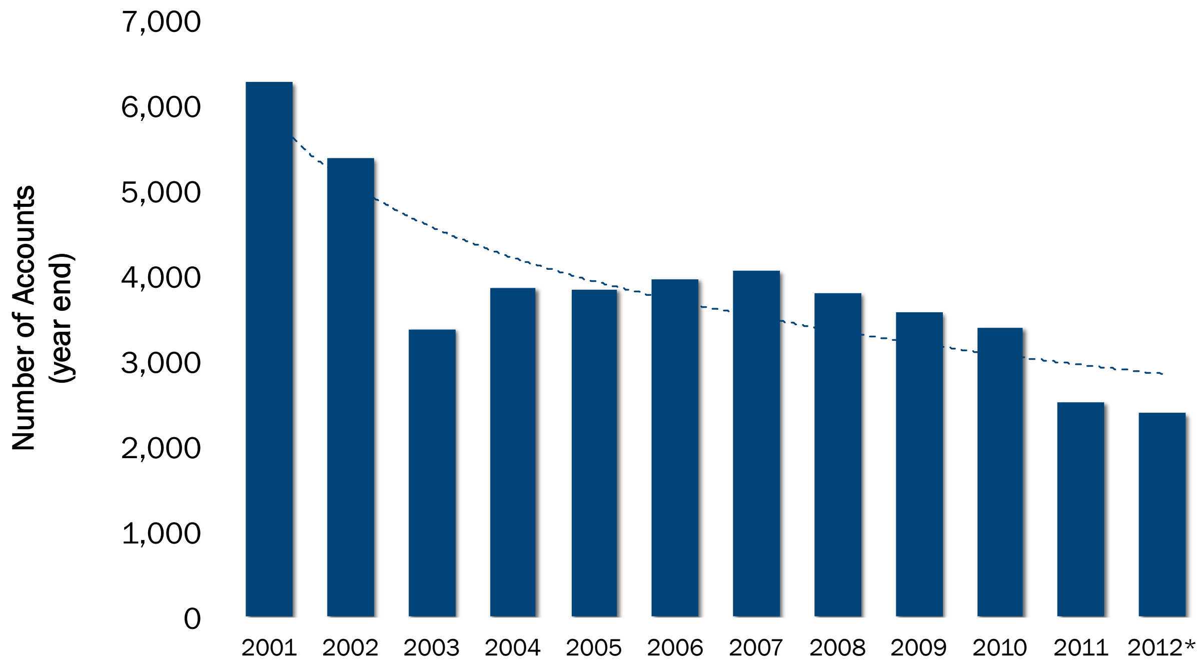


Figure 4: Colorado personal trust and agency assets

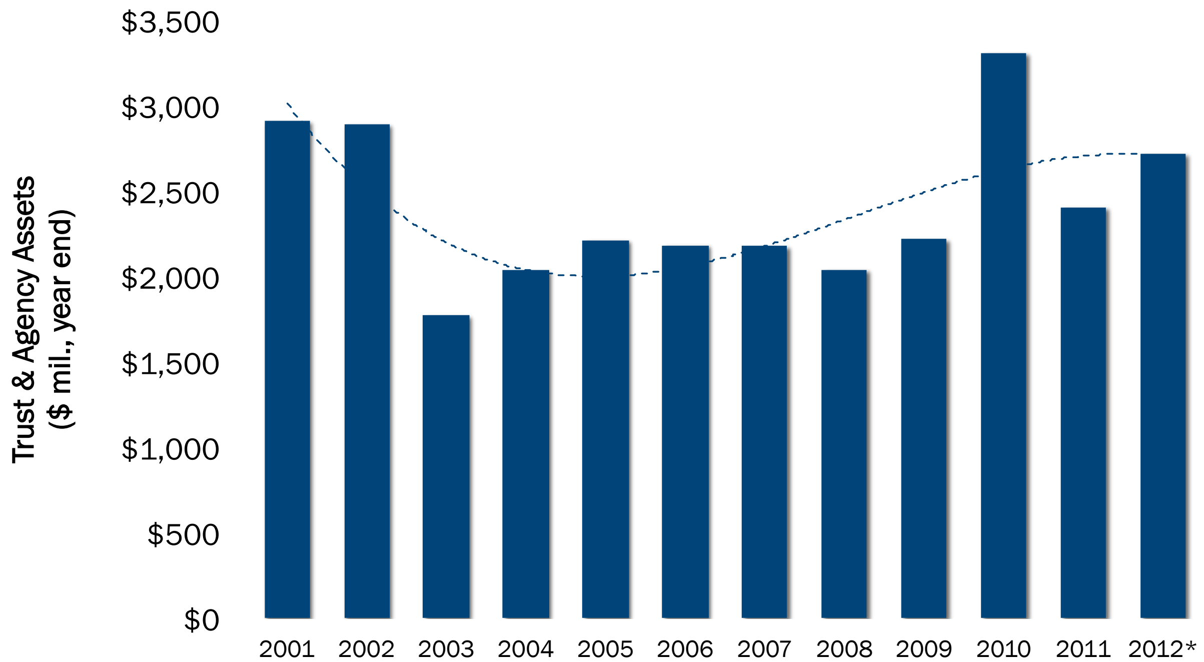
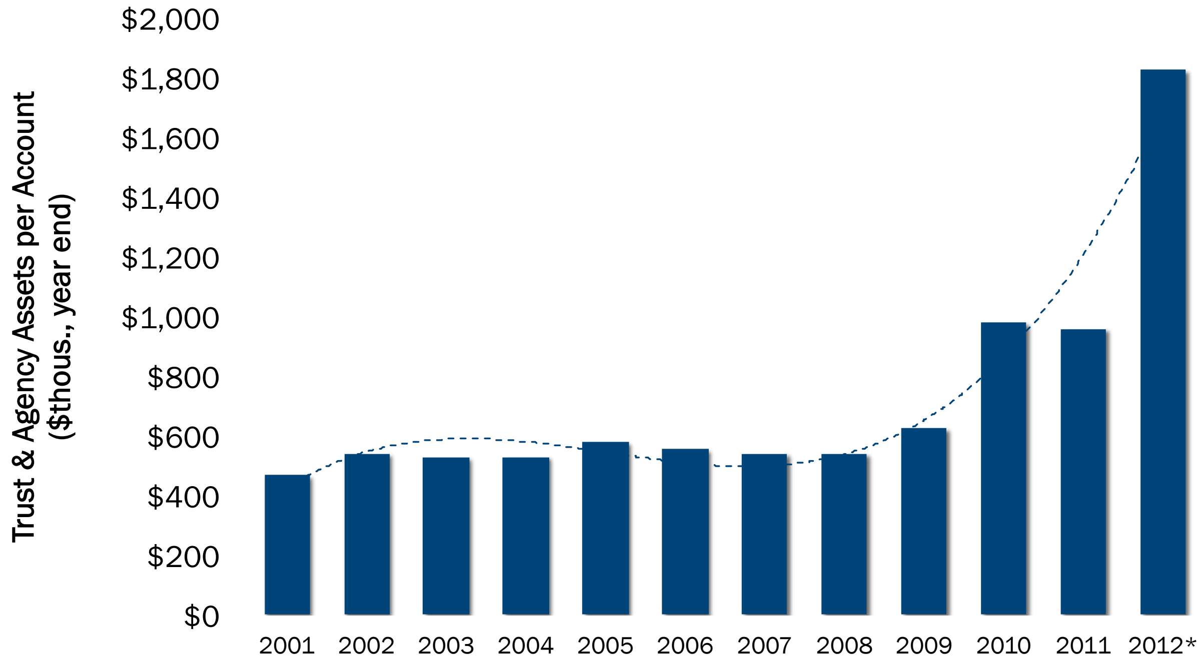
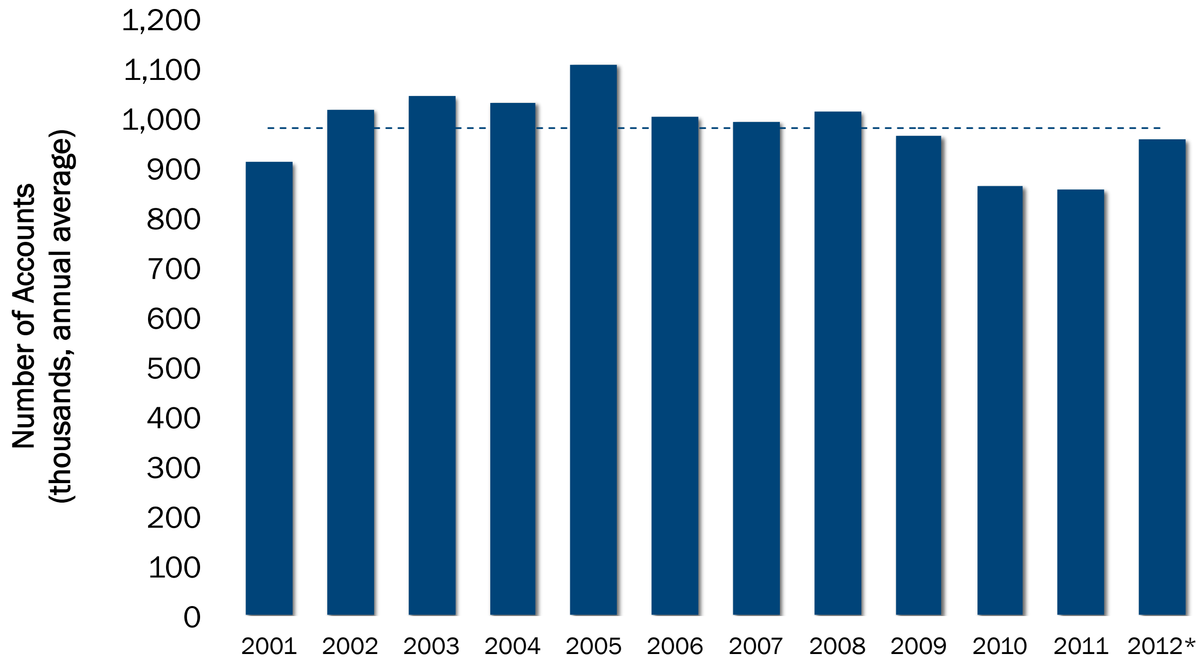


Figure 5: Colorado personal trust and agency assets per account



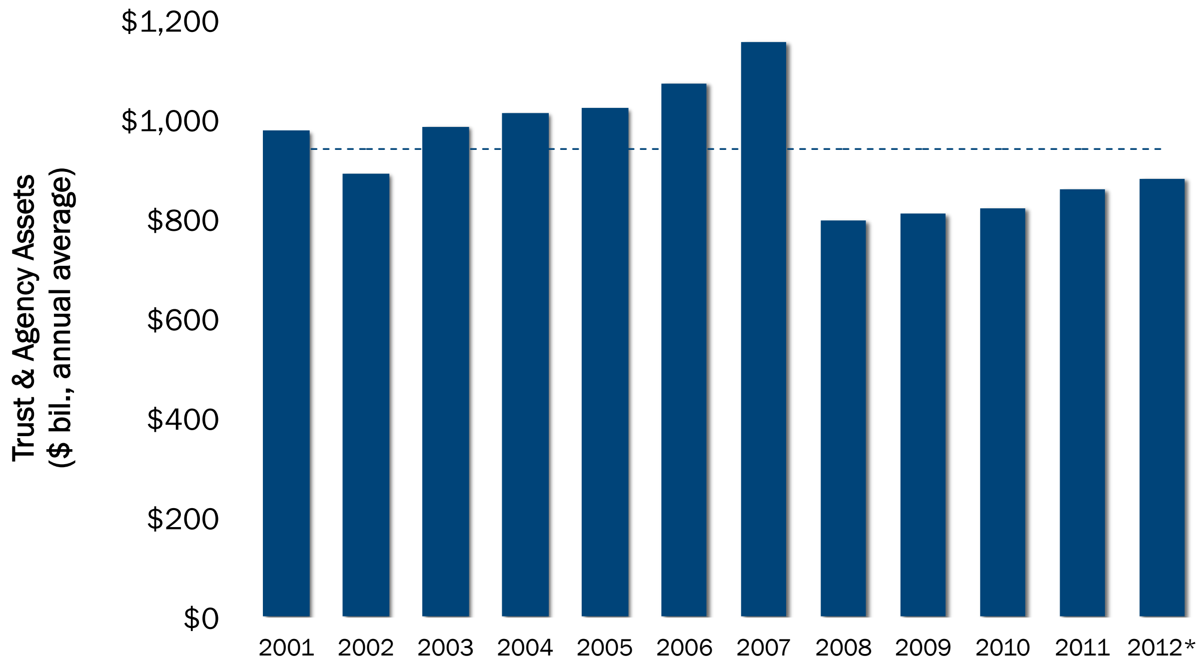
Source: US Federal Deposit Insurance Corporation *Partial year

Figure 6: US personal trust and agency accounts, excluding Colorado



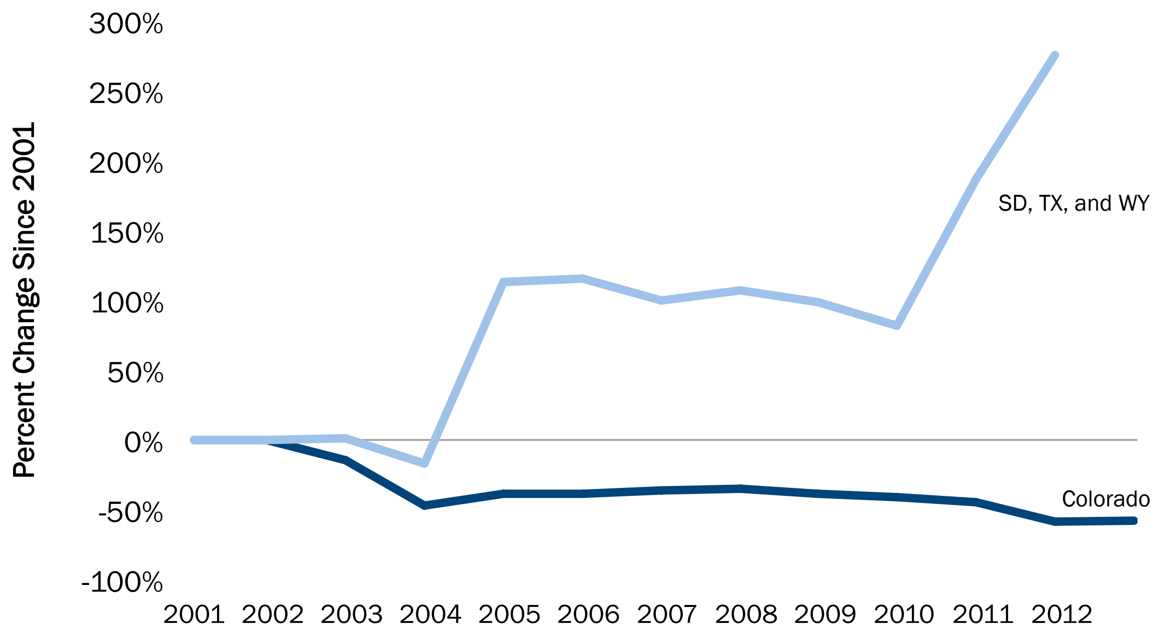
Source: US Federal Deposit Insurance Corporation *Partial year

Figure 7: US personal trust and agency assets, excluding Colorado



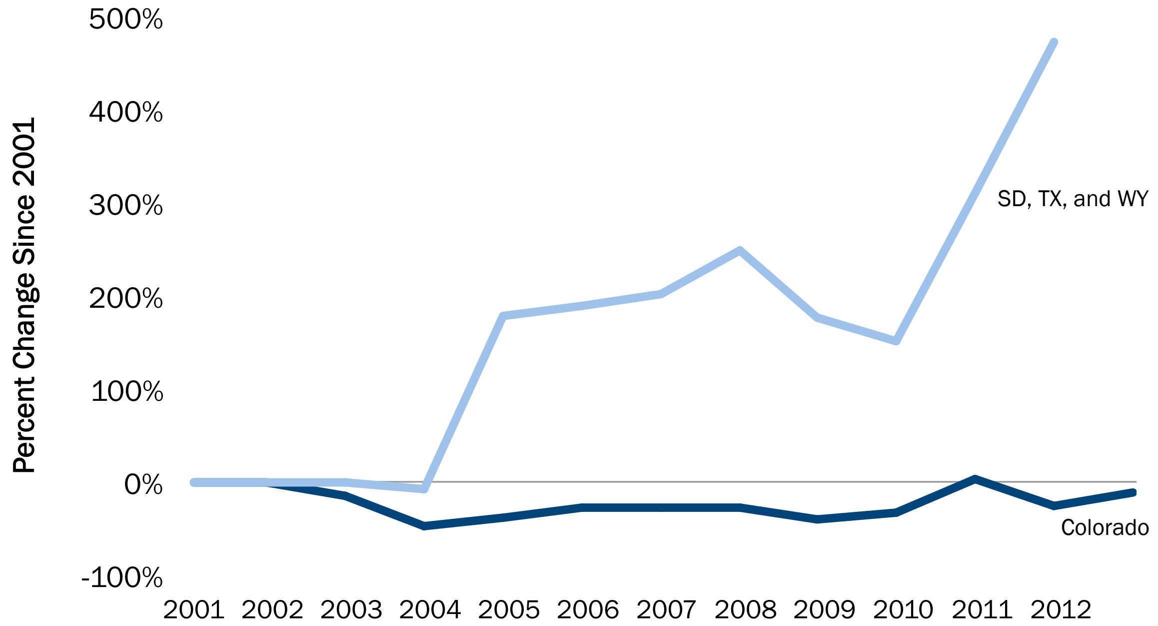
Source: US Federal Deposit Insurance Corporation *Partial year

Figure 8: Change in number of trust accounts, Colorado vs. South Dakota, Texas, and Wyoming



Source: US Federal Deposit Insurance Corporation *Partial year

Figure 9: Change in trust assets, Colorado v. South Dakota, Texas, and Wyoming



Source: US Federal Deposit Insurance Corporation

*Partial year

Table 1: Net economic and state tax impacts over 10 years associated with elimination of Colorado fiduciary tax on estates in 2014 and $65 billion in trust assets by 2024

Year	Colorado Trust Assets	Output	Earnings	Employment	Tax Collections
	($ mil.)	($ mil.)	($ mil.)	(full- and part-time)	($ mil.)
2014	$1,120	$30	$10	190	($37.6)
2015	2,530	65	15	430	(34.0)
2016	4,330	115	30	720	(30.4)
2017	6,660	175	45	1,095	(26.7)
2018	9,700	255	65	1,570	(22.8)
2019	13,700	355	95	2,180	(18.6)
2020	18,970	495	130	2,970	(13.7)
2021	25,940	675	180	3,990	(8.1)
2022	35,190	920	245	5,325	(1.4)
2023	47,470	1,240	330	7,060	6.9
2024	63,810	1,665	440	9,330	17.4

Table 2: Net economic impacts in 2024 associated with $65 billion in trust assets in Colorado

	Output	Earnings	Employment
	($ mil.)	($ mil.)	(full- and part-time)
Direct & Indirect	$1,230	$315	6,565
Induced	445	125	2,765
Total	**$1,675**	**$440**	**9,330**

Table 3: Net economic and state tax impacts over 10 years associated with elimination of Colorado fiduciary tax on estates in 2014 and $150 billion in trust assets by 2024

Year	Colorado Trust Assets	Output	Earnings	Employment	Tax Collections
	($ mil.)	($ mil.)	($ mil.)	(full- and part-time)	($ mil.)
2014	$1,410	$35	$10	240	($37.4)
2015	3,330	85	25	565	(33.6)
2016	6,000	155	40	1,000	(29.5)
2017	9,750	255	65	1,600	(25.0)
2018	15,060	395	105	2,435	(19.9)
2019	22,620	590	155	3,600	(13.6)
2020	33,420	870	230	5,230	(5.8)
2021	48,900	1,275	340	7,525	4.6
2022	71,110	1,855	490	10,755	18.5
2023	103,000	2,690	710	15,315	37.6
2024	148,810	3,885	1,030	21,755	64.3

Table 4: Net economic impacts in 2024 associated with $150 billion in trust assets in Colorado

	Output	Earnings	Employment
	($ mil.)	($ mil.)	(full- and part-time)
Direct & Indirect	$2,860	$735	15,315
Induced	1,015	295	6,440
Total	**$3,875**	**$1,030**	**21,755**