

February 18, 2004

ASSESSING THE IMPACT OF STATE ESTATE TAXES

By Elizabeth C. McNichol

In June 2001, President Bush signed federal legislation to phase out the federal estate tax. This legislation repeals the federal estate tax by 2010 and also effectively repeals by 2005 the state “pickup” taxes through which states share in federal estate tax collections. States can prevent this loss of revenue by “decoupling” from the federal change and, to date, 17 states plus the District of Columbia are decoupled from the federal changes.

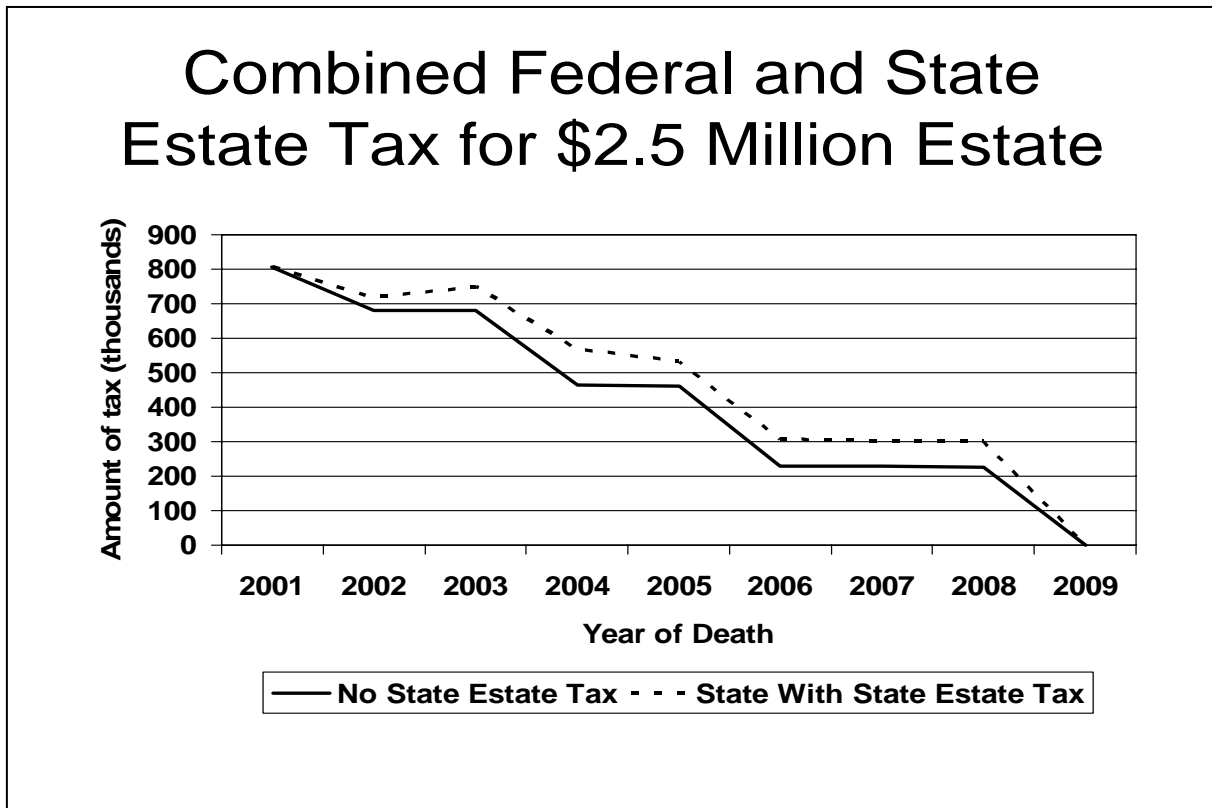
In recent weeks, there have been a number of reports concerning the impact of state estate taxes in states that have decoupled from the federal changes. This is a complicated topic; the effect on individual estates varies over time and is very dependent on the size of a person’s estate. If examined out of context, the effects of maintaining a state estate tax can be significantly overstated and lead one to erroneous conclusions.

For example, some reports suggest that people — especially elderly people — should be very concerned about where they live because of the potential impact of state taxes on their ability to pass along accumulated savings and property to their heirs. In fact, however, the vast majority of people are unaffected by these taxes. For those whose estates are large enough to be affected, the difference between living in a state with or without an estate tax can be small. Other reports give the impression that estate taxes are increasing rather than declining over time in states that have retained their state estate tax. This also is incorrect. This report addresses some facts about state estate taxes that will help put their actual impact in perspective.

A state’s estate tax — like the federal estate tax — will have no effect on the vast majority of people. Very few people are affected by estate taxes — state or federal. Nationally, only 2 percent of estates — those of the wealthiest people — are large enough to have any estate tax liability. The 98 percent of people who will leave a net estate that is valued at less than the minimum required to trigger state estate taxes — \$675,000 to \$1.5 million depending on the state — will not be affected by the state tax. In addition, anyone passing their estate on to a spouse will not owe any estate tax — state or federal.

Total estate taxes will decline for all estates, whether the person leaving the estate lived in a state that has retained an estate tax or not. No matter how large a person’s estate is, the 2005 federal and state combined estate tax bill for that estate will decline compared to prior law. The reduction in the bill is smaller in states that retain an estate tax than in other states, but this is because the federal government eliminated the credit for state estate taxes, not because states have raised their estate taxes. Even in those states that are retaining their state tax,

Figure 1



the amount that federal estate taxes are going down outweighs the fact that the federal government will no longer give a credit for state estate taxes.

The fact that the state estate tax is being retained by some states but not by others should not affect where people live. Studies show that most people choose their residence based on things such as closeness to a good job and family members, the state’s climate, and access to services such as health care, not because of the estate tax rate of a state. A state’s decision to retain an estate tax won’t change these features. In fact, the revenue that the state keeps could help pay for public services — nurses and state troopers’ salaries, roads, arts centers, housing and more that can make a state more attractive. And, it could allow the state to avoid raising other taxes such as sales or income taxes that affect many more people.

The amount of state estate tax owed by estates that are large enough to be taxable is less than it might appear based on the rate schedule. States that have retained an estate tax based on the federal credit continue to use the schedule for the “state death tax credit” that was part of the federal estate tax law in 2001. This is a graduated rate schedule that sets the credit — and thus the amount of the state tax — to a proportion of the value of the estate. The tax rate increases as the size of the estate increases. (See Appendix table 2.) The top marginal rate is 16 percent and this rate is often cited as the bite that state estate taxes will take. In fact, this significantly overstates the impact of the tax.

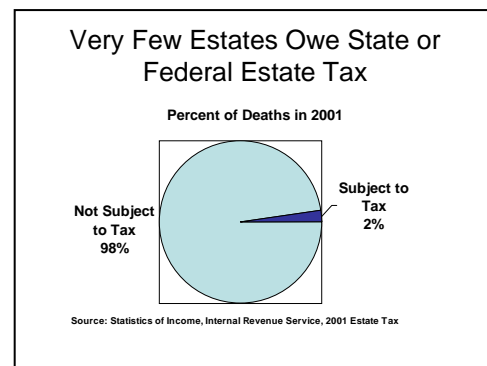
- The top state rate only applies to the portion of the estate that is greater than \$10 million and the vast majority of all estates large enough to be subject to the tax at all are less than \$10 million. Only 2.6 percent of the estates that owe any estate tax have a value of more than \$10 million.
- While the federal government is repealing the credit for state estate taxes paid, they are replacing it with a deduction against the value of the estate.¹ As a result, the effective state estate tax rate will be much less than 16 percent. (See below for more detail.)
- For example, consider someone with \$2.5 million in assets to pass on to their heirs. If this person dies in 2005 while living in a state that has retained its tax, the state tax will equal 2.9 percent of the estate. This effective rate of 2.9 percent of the estate is well under 16 percent.
- Some 83 percent of the estates that owe any estate tax are valued at less than \$2.5 million and will face effective state estate tax rates of no more than 3 to 5 percent. Even for extremely large estates, the effective rate of the state tax will be less than 9 percent.

In sum, the fact that some states are retaining their estate taxes even though the federal government is eliminating the credit for state taxes and replacing it with a deduction will affect very few people. For those who are affected, the impact is not one that is significant enough to prompt major life style changes such as moving to another state.

What Will a State's Estate Tax Cost a Typical Estate?

The amount of combined federal and state estate tax that an estate will owe depends on many factors, including whether the death occurs in a state that has retained its state estate tax or not. The sections below discuss the effect of the retention of a state estate tax on an estate's tax bill. This effect — like the total estate tax bill — varies by year of death and by the size of the estate. Review of existing data on estates and analysis of the provisions of the federal estate tax law lead to the following conclusions.

Figure 2



¹ Under 2001 law, estates received a dollar-for-dollar credit for state estate taxes paid up to a specified maximum. This credit is being phased out. Once it is completely eliminated in 2005, estates will be able to take a deduction for state estate taxes paid. That is, they can subtract the amount of state estate taxes paid from the value of the estate that is subject to federal taxes. The value of this deduction to the estate is the amount of the tax paid times the estate's marginal tax rate. Under the new law the top marginal rate will equal 45 percent and will apply to the value of estates that exceeds \$1.5 million. This deduction will reduce the cost of a state's estate tax by the marginal rate times the amount owed to the state. So, an estate subject to the highest state rate of 16 percent will effectively be paying only 8.8 percent.

The vast majority of estates will owe no federal or state estate tax. According to figures from the Internal Revenue Service for deaths occurring in 2001 – the most recent data available — some 51,841 estates owed some estate tax. These estates made up just 2.1 percent of deaths. Put another way, fully 97.9 percent of estates owed no estate tax.²

The vast majority of estates that do owe tax are valued at less than \$10 million so they are not subject to the top marginal rate of state estate taxes. Table 1 shows the breakdown of taxable estates by size of estate. Only a small fraction of taxable estates – 2.6 percent — are valued at more than \$10 million. More than nine of ten estates are valued at less than \$5 million and 83 percent of these estates are valued at less than \$2.5 million. The median value for an estate subject to tax in 2001 was between \$1 and \$1.5 million. Most taxable estates are clustered at the lower values and pay far less than the maximum state rate.

**Table 1
Distribution of Estates by Size of Estate - 2001**

Size of Estate	Number	Percent of Total	Cumulative
\$625,000 to \$1 million	18,198	35.1 %	35.1 %
\$1 million to \$2.5 million	24,591	47.4 %	82.5 %
\$2.5 million to \$5 million	5,551	10.7 %	93.2 %
\$5 million to \$10 million	2,165	4.2 %	97.4 %
\$10 million to \$20 million	868	1.7 %	99.1 %
\$20 million plus	469	0.9 %	100.0 %
Total	51,842	100.0 %	

- As noted above, the typical estate owes no state or federal estate tax and is not affected by the level of those taxes. An estate must be valued at more than \$1.5 million to be subject to the federal estate tax. The minimum value for an estate to owe a state’s estate tax ranges from \$675,000 to \$1.5 million.
- According to the Federal Reserve Board’s Survey of Consumer Finances, the median net worth of U.S. families was \$86,000 in 2001. This figure includes the value of their home, personal belongings and financial assets such as savings accounts reduced by any outstanding debt such as mortgages and auto loans. The typical family in the U.S. has a net worth that is far below the level that would trigger any estate tax liability.

The two examples below illustrate the effect of state estate taxes on the small minority of estates that are potentially subject to estate taxes.

² The data from 2001 are the most recent available from the Internal Revenue Service. They provide a good estimate of the estates that could possibly be subject to state estate taxes as states that have decoupled from the federal estate tax cut have generally tied their estate tax to 2001 law. States that have decoupled will be taxing estates of the size that would have been subject to the federal tax in 2001 or have adopted higher exemptions, so the number of estates subject to state taxes should be similar to the number subject to the federal tax in 2001.

Impact on Estate Valued At \$2.5 Million

First, the effect of retaining a state estate tax on an estate of \$2.5 million in a state that has ‘partially decoupled’ from the federal changes is considered. (A state that has partially decoupled has retained its estate tax by setting the amount of the tax equal to the credit as it stood in 2001 but has adopted the higher federal exemptions of the current federal law.)

By next year – 2005 – the combined federal and state estate taxes owed by an estate of this size will have dropped from \$805,250 to \$533,564 – a substantial reduction of \$271,686 (33.7 percent) in a state that has retained its estate tax. In a state that did not retain its tax, the reduction is \$345,350 (42.9 percent).

Figure 1 shows the change in estate tax liability for an estate of \$2.5 million in a state that has retained its state tax compared to one that has not. In both cases the estate taxes owed are declining dramatically. By 2009, an estate of this size will owe no tax in either case.³

Starting in 2005, the retention of a state estate tax raises the effective rate of the estate tax by about 3 percent for an estate of this size. Table 1 shows the additional amount of tax that would be owed by a \$2.5 million estate in 2003, 2004 and 2005. The reason the rate is higher in 2004 is because this is the last year that the credit for state taxes paid remains in the federal law and it will equal 25 percent of taxes paid. A 25 percent credit is of less value to an estate than the deduction that will replace it in 2005 and beyond. Thus the effective rate of state estate taxes is higher in 2004 than in 2003 and also higher than in 2005 and beyond.

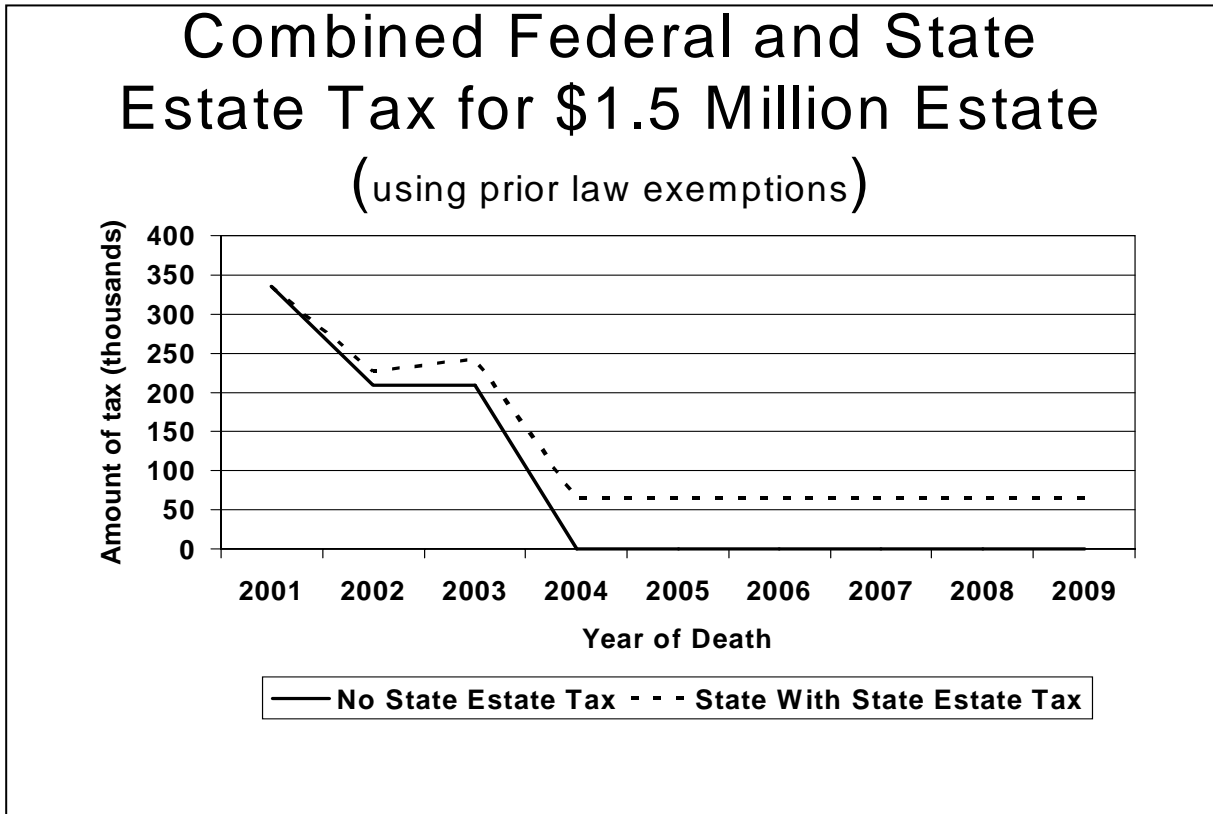
Year	Tax (as percent of estate)
2003	2.8%
2004	4.2%
2005	2.9%

Impact on Estate Valued At \$1.5 Million

The effect of retaining a state estate tax on an estate of \$1.5 million in a state that has ‘completely decoupled’ from the federal changes will be somewhat larger relative to the size of the estate. (A state that has completely decoupled is one that has retained its estate tax by setting the amount of the tax equal to the credit as it stood in 2001 and is also using the federal exemptions that were in effect in 2001 rather than the higher ones of current law.) The effective rate will be greater because the federal exemption equals \$1.5 million in 2004 and will increase further in 2006. As a result, there is no federal estate tax liability for an estate of this size. So, the federal deductibility of state estate taxes is of no benefit.

³ This example assumes that the state has adopted the increases in the federal unified credit that were part of the federal tax law of 2001. This assumption does not affect year 2002 through 2008. However, if the state has not adopted these increases an estate of \$2.5 million will continue to owe state estate tax in 2009. The amount will equal \$138,800 and will not be offset by a deduction against the federal tax as the estate will not owe federal tax.

Figure 3



By next year – 2005 – the combined federal and state estate taxes owed by an estate of this size will have dropped from \$335,250 to \$64,400 – a reduction of \$ 260,850 (80.1 percent) in a state that has retained its estate tax. In a state that did not retain its tax, the reduction is \$335,250 (100.0 percent). In both cases, as Figure 3 shows, the estate taxes owed decline dramatically.

Starting in 2005, the retention of a state estate tax raises the effective rate of the estate tax by about 4.3 percent for an estate of this size. Table 2 shows the additional amount of tax that would be owed by a \$1.5 million estate in 2003, 2004 and 2005. The reason the rate is higher in 2004 and beyond is because the federal exemption rises to \$1.5 million in 2004 so there is no federal tax to be offset by the credit or deduction for state estate taxes paid.

Table 2

Additional tax owed by \$1.5 million estate in state that has retained a state tax.	
Year	Tax (as percent of estate)
2003	2.1%
2004	4.3%
2005	4.3%

Impact On Larger Estates

For the small minority of estates with a value of more than \$2.5 million, the effective rate of a state estate tax will range from 3 percent for estates valued at just above \$2.5 million to about 9 percent for the very few estates valued at \$100 million or more.

Impact In 2010 And Beyond

These examples show the effect of a state estate tax on “typical” taxable estates between now and 2009. The effect in 2010 and beyond depends on whether the federal government acts to further modify the federal estate tax between now and 2010.

As the law currently stands, the federal estate tax is repealed in 2010. As a result, the effective rate of state estate taxes will be higher in 2010 than in 2009 because of the loss of federal deductibility. However, in 2011 and beyond the federal estate tax will return at the 2001 level. If this stands, the effective rate of state estate taxes will again be zero starting in 2011 as the full credit for state estate taxes will be in place again.

There are a variety of proposals to modify the path currently set in law. Until this debate comes to a conclusion, it is not possible to determine the impact of a state estate tax in 2010 and beyond.

Appendix

Provisions of the 2001 Federal Estate Tax Cut

The federal tax cut of 2001 made three major changes to the estate tax that affect the amount of federal and state taxes owed.

- First, the law gradually lowers the top rate for federal taxes owed. In 2001, the top rate equaled 55 percent. By 2009, it will have declined to 45 percent. (See Appendix table 1.) In 2001, the federal top rate applied to the value of estates that exceeded \$3 million. As the rate declines, the size of the estate subject to the top rate will also decline.
- Second, the size of estates that are exempt from the federal tax is being increased. The exemption equaled \$675,000 in 2001 and will increase in steps to \$3.5 million by 2009. The exemption equals \$1 million for 2003 and \$1.5 million for 2004 and 2005.
- In addition, the federal government is repealing the dollar-for-dollar credit it traditionally allowed against federal estate tax liability for state estate and inheritance tax payments.

The state credit is being repealed on a much faster timeline than the repeal of the federal tax. The credit is being phased out over four years and will be eliminated for deaths that occur in 2005. Starting that year estates will instead be able to deduct the amount of state and inheritance taxes from the value of their estate to determine the amount subject to the federal estate tax.

The effect of the repeal of the state credit is different depending on how the state is linked to federal law. In many states, the amount of the state estate tax is set to be equal to the amount of the credit that can be taken against federal taxes. So, the repeal of the credit effectively repeals those states' estate taxes.

By contrast, some 17 states and the District of Columbia are not directly linked in this way. (This is the result of legislation passed since the federal estate tax repeal passed or because of the way their estate tax laws are written.) These states will retain their estate tax in the amount of the credit as it stood in 2001. Estates in these states can take a declining portion of the state tax as a credit against federal estate taxes owed. In 2003, that credit equals 50 percent of the state taxes paid and in 2004 it equals 25 percent. Starting in 2005, estates will be able to take a deduction against their federal estate taxes for the amount of the state credit.⁴

⁴ It should be noted that for estates in states that have decoupled from the federal changes, the deductions allowed in 2005 will be worth more than the 25 percent credit in 2004 because the top marginal rate is 47 percent in 2005. The value of the deduction is the amount of the state tax paid times the marginal tax rate — in this case, 47 percent — which results in a reduction in federal taxes owed that is almost twice as large as a 25 percent credit.

**Appendix - Table 1
Federal Estate Tax Rate Schedule for Deaths before 12/31/2001**

Taxable Estate (in thousands)		Base	Marginal Rate
At Least	But Less Than		
\$0	\$10	\$0	18%
\$10	\$20	\$1,800	20%
\$20	\$40	\$3,800	22%
\$40	\$60	\$8,200	24%
\$60	\$80	\$13,000	26%
\$80	\$100	\$18,200	28%
\$100	\$150	\$23,800	30%
\$150	\$250	\$38,800	32%
\$250	\$500	\$70,800	34%
\$500	\$750	\$155,800	37%
\$750	\$1,000	\$248,300	39%
\$1,000	\$1,250	\$345,800	41%
\$1,250	\$1,500	\$448,300	43%
\$1,500	\$2,000	\$555,800	45%
\$2,000	\$2,500	\$780,800	49%
\$2,500	\$3,000	\$1,025,800	53%
\$3,000	\$10,000	\$1,290,800	55%
\$10,000	\$17,184	\$5,140,800	60%
\$17,184		\$9,451,200	55%

For example, for a taxable estate between \$1 million and \$1.25 million, tax equals \$345,800 plus 41 percent of the amount that the size of the estate exceeds \$1 million.

NOTE: This schedule includes the effect of the surtax on estates over \$10 million. The surtax of 5% of the value of the estate between \$10 million and \$17,184 million has the effect of increasing the marginal tax rate on estates between \$10 million and \$17,184 million to 60%. This has the effect of removing the effect of the graduated rates for large estates. In other words, estates of \$17,184 and higher are subject to a flat rate of 55% of the entire value of the estate (after which any applicable credits, including the unified credit and the state death tax credit, are applied).

Under the 2001 federal tax bill, this schedule changed as follows:
For deaths occurring on or after January 1, 2002, the surtax is repealed and rates above 50 percent are lowered to 50 percent. So taxable estates over \$2.5 million are subject to a tax of \$1,025,800 plus 50 percent of the amount over \$2.5 million.

In subsequent years, the top rate is scheduled to be lowered as follows:

Calendar Year of Death	Top Rate
2002	50%
2003	49%
2004	48%
2005	47%
2006	46%
2007	45%
2008	45%
2009	45%
2010	Tax repealed
2011	Tax reinstated at 2001 level

Appendix - Table 2
State Death Tax Credit Rate Schedule for deaths before 12/31/2001

Adj. Taxable estate ¹ (in thousands)		Base	Marginal Rate
Over	Not over		
0	\$40	\$0	0.0%
40	\$90	\$0	0.8%
90	\$140	\$400	1.6%
140	\$240	\$1,200	2.4%
240	\$440	\$3,600	3.2%
440	\$640	\$10,000	4.0%
640	\$840	\$18,000	4.8%
840	\$1,040	\$27,600	5.6%
1,040	\$1,540	\$38,800	6.4%
1,540	\$2,040	\$70,800	7.2%
2,040	\$2,540	\$106,800	8.0%
2,540	\$3,040	\$146,800	8.8%
3,040	\$3,540	\$190,800	9.6%
3,540	\$4,040	\$238,800	10.4%
4,040	\$5,040	\$290,800	11.2%
5,040	\$6,040	\$402,800	12.0%
6,040	\$7,040	\$522,800	12.8%
7,040	\$8,040	\$650,800	13.6%
8,040	\$9,040	\$786,800	14.4%
9,040	\$10,040	\$930,800	15.2%
10,040		\$1,082,800	16.0%

For example, for an adjusted taxable estate between \$1.04 million and \$1.54 million, tax equals \$38,800 plus 6.4 percent of the amount that the size of the estate exceeds \$1.04 million.

¹The adjusted taxable estate is equal to the taxable estate minus \$60,000.

Appendix - Table 3
Exemption Amounts

Year	Prior Federal Law	Current Federal Law
2002	\$700,000	\$1,000,000
2003	\$700,000	\$1,000,000
2004	850,000	1,500,000
2005	950,000	1,500,000
2006	1,000,000	2,000,000
2007	1,000,000	2,000,000
2008	1,000,000	2,000,000
2009	1,000,000	3,500,000

**Appendix - Table 4
Federal and State Estate Taxes Owed For Estates of \$2.5 million and \$1.5 million
For Deaths Occurring in 2001 through 2009**

\$2.5 million Estate				
Combined Federal and State Estate Tax (assumes state adopts current federal exemptions)				
Year of Death	In state with no state tax	In state that retained state tax	Difference	Difference as percent of estate
2001	805,250	805,250	0	0%
2002	680,000	714,700	34,700	1.4%
2003	680,000	749,400	69,400	2.8%
2004	465,000	569,100	104,100	4.2%
2005	460,000	533,564	73,564	2.9%
2006	230,000	304,952	74,952	3.0%
2007	225,000	301,340	76,340	3.1%
2008	225,000	301,340	76,340	3.1%
2009	0	0	0	0.0%

\$1.5 million Estate				
Combined Federal and State Estate Tax (assumes state uses prior law federal exemptions)				
Year of Death	In state with no state tax	In state that retained state tax	Difference	Difference as percent of estate
2001	335,200	335,250	0	0%
2002	210,000	226,100	16,100	1.1%
2003	210,000	242,200	32,200	2.1%
2004	0	64,400	64,400	4.3%
2005	0	64,400	64,400	4.3%
2006	0	64,400	64,400	4.3%
2007	0	64,400	64,400	4.3%
2008	0	64,400	64,400	4.3%
2009	0	64,400	64,400	4.3%