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WHY STATES SHOULD ACT NOW TO PRESERVE THEIR ESTATE AND INHERITANCE TAXES

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State governments have long relied on estate and inheritance taxes for a small but significant share of their revenue. Prior to 1980, most states levied both a "pickup tax" that allowed them to share in federal estate tax revenue collections and a separate estate or inheritance tax with rates and definitions determined by the individual state. Since then, a number of states have repealed their separate estate or inheritance taxes, but all continue to levy a pickup tax. In fiscal year 2001, states collected a total of $7.5 billion in estate, inheritance, and gift taxes.[1] This represented 1.3 percent of state tax revenue.

In June 2001, President Bush signed federal legislation to phase out the federal estate tax. As a result, states stand to lose some or all of their estate tax revenues, since the elimination of the federal estate tax effectively repeals most state pickup taxes. Furthermore, although the legislation does not fully repeal the federal estate tax until 2010, it effectively repeals state pickup taxes by 2005.

This revenue loss does not have to happen. In a separate report, we explain in detail how states can retain their estate taxes even as the federal tax is phased out by "decoupling" from the federal changes. To date, 17 states and the District of Columbia have decoupled from the federal changes. Eleven states took affirmative action to "decouple" from the phaseout of the federal estate tax; the estate taxes of another six states plus the District of Columbia are written in such a way that the state will not conform to the federal change unless it takes legislative action, and none of these states has acted to conform to the federal change. In addition, twelve states continue to levy an estate or inheritance tax in addition to the pick-up tax. These separate taxes will not be eliminated by the federal changes.

In total, close to half the states will continue to levy some form of estate or inheritance tax even if no other states act to decouple from the federal changes. This paper explains why it makes sense for additional states to act now to retain their estate and inheritance taxes by decoupling from the federal changes or instituting a separate tax.

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1 State taxes can take one of two forms ─ an inheritance tax or an estate tax. An estate tax is a tax levied on the estate and collected from the assets of the estate before it is transferred to the heirs of the estate. An inheritance tax, on the other hand, is a tax on the amount of the estate inherited by each heir and is levied on and collected from the heirs. A gift tax is a related tax on gifts from the owner of an estate that occur during the lifetime of the owner. A handful of states levy a gift tax in addition to estate or inheritance taxes. Gift tax collections are included in this total because the Census Bureau does not collect information on these three taxes separately.

1. At a time of fiscal crisis, states cannot afford the significant revenue loss that would result from cutting the estate tax.

Few states would consider cutting taxes during this time of fiscal crisis. However, unless states act, the federal estate tax legislation will continue to result in cuts in state estate taxes. Under the law prior to the 2001 federal tax legislation, states would have received approximately $6.5 billion from their pickup taxes in fiscal year 2003. This would have grown to more than $9 billion by 2010, the year the federal estate tax will be fully repealed

States around the country continue to struggle with dismal fiscal conditions. State revenues have declined for four consecutive quarters. According to the Rockefeller Institute, revenues for the period April-June 2002 — the final quarter of the fiscal year in most states — were 10.4 percent below revenues for the same period in 2001. This decline is the sharpest since at least the 1980s. (While revenues have begun to grow again, that growth is very slow and below estimates in many states.)

It is thus not surprising that states faced deficits that exceeded $50 billion as they enacted their fiscal year 2003 budgets, on top of the approximately $40 billion in deficits with which states coped in fiscal year 2002. According to the National Conference of State Legislatures, one-quarter of the states had 2003 budget deficits that exceeded 10 percent of their general fund budgets. Struggling to meet balanced budget requirements, states have cut spending and imposed tax increases. Nevertheless, a combination of a continued decline in revenue collections in the current quarter in many states and a resurgence of the growth of health care costs is leading to the reopening of substantial deficits. Because most states are prohibited by constitution or statute from running deficits, most of these new gaps between revenues and budgeted spending will have to be closed during fiscal year 2003 through additional program cuts or tax increases.

The phase-out of the estate tax has the potential to cost states a total of $23 billion over state fiscal years 2003-2007. Because a number of states have acted to decouple from the federal changes, the amount of revenue still at risk is smaller — $15 billion — but is nonetheless substantial. (Table 1 shows the amount of potential revenue loss by state.)

In addition, eliminating the estate tax could serve to worsen the ability of states to finance services in the future even after economic growth has returned. One long-recognized flaw of state revenue systems is that because of their heavy reliance on consumption taxes, they tend to erode relative to the size of the economy over time. State estate taxes serve to offset some of the erosion in state revenue relative to economic growth. In particular, they capture some of the increase in the income of higher-income taxpayers, whose income has been rising more quickly than that of moderate- and low-income families. Thus, eliminating the estate tax would cause state revenues to erode even further.

2. Reducing taxes on the wealthy is inappropriate when states are instituting budget cuts that affect people at all income levels.

Eliminating the state estate tax would be a tax cut solely for the nation's wealthiest families. Financing the elimination of the estate tax would require cuts in government services that benefit residents of all income levels. (See page 5 for data on who pays the estate tax.)

The recent economic downturn has already resulted in significant cuts in government services. Preliminary data from a survey of the states conducted by the Center suggest that if spending in FY 2002 and FY 2003 had grown at the long-term trend rate, an additional $20 billion would have been expended in each fiscal year. In fact, overall state spending grew much more slowly in state fiscal years 2002 and 2003 than would be necessary to simply maintain existing programs.

In order to reduce spending by this "missing" $40 billion, states have adopted a variety of strategies. Many states have restricted eligibility for health insurance, child care, and income support services for low-income families. States have reduced Medicaid benefits, cut job training programs for people trying to move from welfare to work, and significantly raised the cost of child care for low- and moderate-income families. These steps harm the families that are most in need of assistance during an economic downturn.

States also have made cuts in other programs and services such as public universities, state aid for public schools and local governments, parks, museums, libraries, public health, and public safety. The additional revenue losses that would result from the elimination of the estate tax would increase pressure for further spending cuts.

3. Eliminating state estate taxes would worsen the disproportionate burden of state taxes on low-income taxpayers.

Since the 1970s, wealth has become increasing concentrated in the hands of a relatively small share of families in the United States. The wealthiest one percent of all households control about 38 percent of national wealth while the bottom 80 percent hold only 17 percent. The estate tax is the only state tax that is paid almost entirely by the wealthy. This progressive tax is just one part of state and local tax systems that economists generally recognize are "regressive"; that is, lower-income families pay a greater share of their income in taxes than do higher-income families.

This regressivity results largely from states' substantial reliance on consumption taxes. Poor families spend a larger share of their income on items that are subject to tax than higher-income families do, so consumption taxes take a larger share of poor families' income. The estate tax, by contrast, is the most progressive state tax because only the wealthiest families pay it. Therefore, eliminating a state's estate tax would make a state's tax structure even more regressive.

4. Estate taxes have no impact on the vast majority of taxpayers; they have little impact on family farms and small businesses and are paid only by a small number of very wealthy families.

The estate tax affects only a small minority of families, and those it does affect are the families who least need a tax break. The federal estate tax — and thus the state pickup tax that is part of the federal tax — is paid solely by the wealthiest two percent of people who die each year. (The portion of estates that owe estate tax varies by state. Table 2 shows the number and percent of estates claiming the state credit for each state.)

Decoupling from Phase-out of the Federal Estate Tax: Tax Increase, Tax Cut, or Status Quo?

Under the longstanding provisions of the federal estate tax, taxpayers receive a dollar-for-dollar credit against their federal estate tax liability for state estate and inheritance tax payments, up to a specified amount. The maximum amount of the credit varies by the size of the estate. This credit for state estate taxes is being reduced by 25 percent each year starting in 2002 and will be eliminated completely by 2005.

Currently, every state has a tax on estates equal to at least the value of the credit that can be taken against federal liability. In most states, the estate and inheritance taxes are designed in such a way that states will face either a full or partial loss of revenues as the federal estate tax is phased out.

Decoupling From the Federal Changes Will Not Result In A State Tax Increase

States can rewrite their estate tax laws so that the repeal of the federal estate tax does not result in the automatic and unplanned phaseout of a state's estate tax. Retaining a state estate tax in this way is not a state tax increase. States that decouple from the federal changes are merely retaining a tax that they already levy.

It is true that taxpayers would continue to pay the state tax but would not receive a credit against federal taxes for the payment. This is not, however, an increase in state taxes. The amount of state estate taxes owed would not change compared to prior law. Rather, federal estate taxes would increase due to the potential loss of the credit and the subsequent conversion of the credit for state taxes paid to a deduction.

Even if a State Retains its Estate Tax, Combined Federal and State Estate Taxes Will Decline for the Vast Majority of Estates

Combined federal and state estate taxes will decline for the vast majority of estates even if a state retains its estate tax. For all but the very largest estates, the various estate tax provisions of the 2001 federal legislation more than offset the increase in federal estate taxes that results from the phase-out of the state credit.

- By 2005, the dollar-for-dollar credit against federal estate taxes owed that estates had received for state estate taxes paid will be replaced with a deduction. Once the credit is replaced with a deduction, the total federal and state estate tax bill for an estate of any size will be lower than under 2001 law, even if a state retains its estate tax by decoupling from the federal law. This new deduction will offset some of the cost to the taxpayer of the state tax paid by reducing the amount of federal taxes owed. The benefit of the deduction to these wealthy estates will be just under half the benefit the credit would have provided.[a]

- In the next two years, the vast majority of estates will pay lower taxes. In 2003, only estates over $29 million — less than one in 5,000 — will pay more in total federal and state estate taxes than they would have under prior law, even if the state decouples from the federal changes. Thus, very few estates are sufficiently large to see tax increases. In 1999, only 467 taxable estates exceeded $20 million. In 2004, only estates over $9 million — less than one in 1,000 — will have some increased combined liability.

[a]Estates will be able to deduct the amount of state estate taxes paid from the value of an estate subject to the federal estate tax. For example, an estate with a value of $2 million would owe $99,600 in state estate taxes in a state that decoupled from the federal changes. This estate would no longer be eligible for a credit -- a direct reduction of federal taxes owed -- of $99,600, rather the deduction would serve to reduce the total value of the taxable estate by $99,600, thus reducing its federal estate tax bill by $48,812 ($99,600 times the top marginal rate of 47 percent.)

In addition, most estate taxes are paid on the estates of people who not only had very substantial wealth, but also had high incomes around the time they died. A recent Treasury Department study found that 91 percent of all estate taxes are paid by the estates of people whose annual incomes exceeded $190,000 around the time of their death. Less than one percent of estate taxes are paid by the lowest-income 80 percent of the population, those with incomes below $100,000.[2]

Proponents of repealing the estate tax argue that repeal is necessary to ensure that family businesses and farms do not have to be liquidated to pay estate taxes. This claim makes a good sound bite, but there is little evidence to support it. The American Farm Bureau Federation acknowledged to the *New York Times* that it could not cite a single example of a farm having to be sold to pay estate taxes.[3]

In fact, only a very small fraction of small family farms or businesses are subject to the estate tax, and for those few that are subject to the tax, the business or farm usually does *not* constitute the majority of the estate.

- IRS data show that in 1999, farm and family-owned business assets — including closely-held stocks, limited partnerships, and non-corporate businesses — counted for *less than three percent* of the total value of estates valued at less than $5 million. Estates valued at less than $5 million made up 93 percent of all taxable estates.[4]

- A Treasury Department tabulation of 1998 data shows that of the approximately 2.3 million people who died that year, 47,482 estates were taxable. Family-owned business assets equaled at least half of the gross estate in only 776 of these taxable estates (or 1.6 percent), while farm real estate and other farm assets equaled at least half the gross estate in only 642 of these taxable estates (or 1.4 percent).

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[2] The figures in the two paragraphs above were based on the federal estate tax in 1999, when estates under $650,000 were exempt from the tax. Because the exemption has increased since then, these figures overestimate the number of estates subject to the tax. States that retain their estate tax can choose to retain the tax as determined under 2001 federal law, in which case estates under $675,000 would be exempt. Alternatively, they can adopt the increases in the federal exemption contained in the 2001 legislation, under which the exemption rises in steps to $3.5 million by 2009.

[3] David Cay Johnston, "Talk of Lost Farms Reflects Muddle of Estate Tax Debate," *The New York Times,* April 8, 2001.

[4] In large estates, such as those over $20 million, family-owned business assets accounted for more than 20 percent of the value of all taxable estates. These figures imply that in some large estates family-owned businesses are not necessarily "small" businesses. Some of the country's largest businesses are family owned. Examples of large family-owned businesses include Mars Candy, Levi Strauss, Hallmark Cards, Enterprise Rent-a-Car, and Gallo Winery.

Moreover, family-owned businesses and farms already are eligible for special tax treatment under current law.[5] For instance, family-owned businesses and farms may use special valuation rules to reduce or eliminate estate tax liability and, when the enterprise accounts for at least 35 percent of an estate, tax payments can be deferred for up to 14 years. Any problems that may remain in the taxation of small family-owned businesses and farms under the estate tax can be specifically identified and addressed at a modest cost to states. Elimination of the estate tax is not needed for this purpose.

5. Retaining an estate tax can promote — not harm — a state's economic growth.

A recent study of the ability of state and local governments to attract retirees found the impact of taxes in general — and state estate taxes in particular — to be small at best. Other factors such as climate, availability of hospital services, and the share of population that is elderly all had larger effects. The authors concluded, "Our results suggest that states should focus on marketing their amenities, rather than using fiscal policy to recruit retirees."[6]

Yet, some critics argue that a state estate tax will harm a state's economy by causing retirees and elderly people to leave the state or discouraging them from moving to the state. This argument ignores the fiscal impact of allowing the estate tax to disappear. People consider many factors in deciding where to live, such as climate or proximity to relatives. The quality of government services has been shown to have a significant effect on relocation decisions, and these services depend on the funds raised by taxes like the estate tax.

In addition, as of the fall of 2002, half the states have either decoupled from the phaseout of the federal estate tax or have a separate inheritance or estate tax. The fact that large numbers of states retain an estate tax encourages retirees to base their decision on other factors.

Finally, eliminating the state estate tax will reduce state revenue. In the current fiscal climate, this is very likely to result in more service cutbacks than would otherwise occur. These cutbacks, in turn, discourage businesses, and individuals — both retirees and others — from locating in a state and will likely have a larger negative impact on a state's future economic growth than any small positive impact that eliminating the estate tax could have.

6. The estate tax provides a way to tax income that otherwise would not be taxed.

Very wealthy people often are able to accumulate very large estates without ever having paid income taxes on the content of those estates. They do so by keeping that wealth in the form of unrealized capital gains. The estate tax is the only way to subject that wealth to taxation comparable to the taxes that other families pay on other forms of income. Without an estate tax, a very small number of very wealthy families will be able to pass along large concentrations of wealth from generation to generation tax-free.

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[5] When a family-owned businesses or farm constitutes more than half of the estate, the exemption is $1.3 million, higher than the current $1 million exemption for other estates. This special treatment is repealed in 2004, when the general exemption rises to $1.5 million.

[6] Aging Studies Program Paper No. 22, "Chasing the Elderly: Can State and Local Governments Attract Recent Retirees?", William Duncombe, Mark Robbins, and Douglas Wolf, Center for Policy Research, Maxwell School of Citizenship and Public Affairs, Syracuse University, September 2000.

Opponents of the estate tax claim that the tax is unfair because an estate's assets have already been taxed once as income under the income tax and should not be taxed again. This "double taxation" claim is based on an inaccurate premise.[7]

A significant portion of the value of estates — and the majority of the value of the largest estates — has *not* been taxed as income because it is in the form of unrealized capital gains. Without the estate tax, capital gains included in an estate would never be taxed.

Under current law, the gain from the appreciation of an asset is subject to income tax only when the asset is sold. When an individual sells an asset, the capital gains tax calculation is based on the profit from the sale — that is, the difference between the amount received when the individual sells the asset and the individual's investment in the asset. (That original investment is known as the "basis.") In many cases, the basis is simply the original purchase price. When heirs inherit an asset, the basis of the asset is increased, or "stepped up," to equal the value of the asset at the time the decedent passed away. Under these "step-up basis" rules, if an individual holds an asset until he dies, the gain in the asset's value from the time the individual purchased the asset to the time the individual dies is never taxed under the income tax. The appreciated value of the asset is included in the decedent's estate, however, and if the estate is large enough, it will be subject to estate tax.

A substantial proportion of assets subject to the estate tax appear to be capital gains that have never been taxed. Estimates recently made by economists James Poterba and Scott Weisbenner, based on data from the Survey of Consumer Finances, suggest that these untaxed capital gains make up about 37 percent of the value of estates worth more than $1 million and about 56 percent of estates worth more than $10 million.[8] Elimination of the estate tax would remove this backstop to a state's income tax code.

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[7] The charge of "double taxation" is used by some to imply that the estate tax is unfair and can distort economic decisions about work, savings, and investment. However, economists William Gale and Joel Slemrod point out that the double taxation argument is "an exercise in *rhetoric*, and has no economic significance"; they use the following example to explain their point: "[I]n a value-added tax, goods are taxed at each stage of production; in a retail sales tax, they are only taxed once, at the retail level. Yet economists understand that — aside from administrative features — the two systems are economically equivalent, and the difference in the number of times the item is taxed is economically meaningless." See "Rhetoric and Economics in the Estate Tax Debate," paper presented at the National Tax Association spring symposium, May 22, 2001.

[8] James Poterba and Scott Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death," *Rethinking Estate and Gift Taxation*, Brookings Institution, 2001.

Table 1
Amount of Revenue Loss States Can Avoid By Decoupling From Federal Changes
Cumulative Total: 2003-2007

	Fully Decoupling (millions)	Partially Decoupling (millions)
Alabama	213.3	178.5
Alaska	10.1	8.4
Arizona	282.7	236.0
Arkansas	85.3	71.2
California	5,229.3	4,426.7
Colorado	216.8	181.0
Connecticut	463.0	386.7
Delaware	122.3	102.1
District of Columbia	240.2	201.1
Florida	2,599.8	2,170.7
Georgia	422.0	352.3
Hawaii	110.7	92.5
Idaho	38.9	32.5
Illinois	1,488.0	1,242.9
Indiana	64.3	53.7
Iowa	119.8	100.1
Kansas	197.6	164.8
Kentucky	181.9	151.8
Louisiana	81.0	67.7
Maine	106.2	88.8
Maryland	596.8	497.9
Massachusetts	608.1	507.7
Michigan	565.0	473.4
Minnesota	230.3	192.3
Mississippi	107.9	90.1
Missouri	565.6	471.8
Montana	21.8	18.2
Nebraska	59.0	49.3
Nevada	144.5	120.9
New Hampshire	102.4	85.5
New Jersey	729.7	609.3
New Mexico	85.8	71.6
New York	2,530.0	2,110.3
North Carolina	430.7	360.2
North Dakota	19.3	16.1
Ohio	125.2	104.5
Oklahoma	48.2	0.0
Oregon	189.6	158.8
Pennsylvania	278.3	232.7
Rhode Island	67.4	56.3
South Carolina	190.5	159.2
South Dakota	18.7	15.6
Tennessee	70.9	59.1
Texas	1,112.0	929.0
Utah	56.6	47.3
Vermont	49.7	41.5
Virginia	487.7	407.2
Washington	365.9	305.6
West Virginia	65.9	55.0
Wisconsin	462.6	386.3
Wyoming	34.6	28.9
TOTAL	22,764.0	18,971.0

Note: States in italics are already decoupled from the federal changes

Table 2
Number of Estates Claiming State Credit, By State

	Deaths in 2000	Estates Claming State Death Tax Credit in 2000[1]	Percentage[2]
Alabama	45,062	542	1.2%
Alaska	2,914	56	1.9%
Arizona	40,500	915	2.3%
Arkansas	28,217	263	0.9%
California	229,551	8,861	3.9%
Colorado	27,288	662	2.4%
Connecticut	30,129	1,116	3.7%
Delaware	6,875	237	3.4%
District of Columbia	6,001	250	4.2%
Florida	164,395	4,777	2.9%
Georgia	63,870	800	1.3%
Hawaii	8,290	333	4.0%
Idaho	9,563	87	0.9%
Illinois	106,634	3,142	2.9%
Indiana	55,469	1,295	2.3%
Iowa	28,060	648	2.3%
Kansas	24,717	691	2.8%
Kentucky	39,504	655	1.7%
Louisiana	41,138	680	1.7%
Maine	12,354	176	1.4%
Maryland	43,753	1,237	2.8%
Massachusetts	56,681	1,501	2.6%
Michigan	86,953	1,720	2.0%
Minnesota	37,690	801	2.1%
Mississippi	28,654	340	1.2%
Missouri	54,865	1,359	2.5%
Montana	8,096	156	1.9%
Nebraska	14,992	671	4.5%
Nevada	15,261	99	0.6%
New Hampshire	9,697	140	1.4%
New Jersey	74,800	2,281	3.0%
New Mexico	13,425	215	1.6%
New York	158,203	4,752	3.0%
North Carolina	71,935	1,156	1.6%
North Dakota	5,856	104	1.8%
Ohio	108,125	2,287	2.1%
Oklahoma	35,079	721	2.1%
Oregon	29,552	424	1.4%
Pennsylvania	130,813	3,006	2.3%
Rhode Island	10,027	177	1.8%
South Carolina	36,948	400	1.1%
South Dakota	7,021	160	2.3%
Tennessee	55,246	671	1.2%
Texas	149,939	2,779	1.9%
Utah	12,364	208	1.7%
Vermont	5,127	185	3.6%
Virginia	56,282	1,323	2.4%
Washington	43,941	1,223	2.8%
West Virginia	21,114	284	1.3%
Wisconsin	46,461	855	1.8%
Wyoming	3,920	103	2.6%

Sources: National Vital Statistics Report, Vol. 50, No. 15, IRS Statistics of Income Bulletin, Spring 2002.
See notes on following page.

Notes to Table 2:

The united credit has increased since 2000, exempting more estates from taxation. A similar table based on more recent figures would therefore likely show lower percentages.

[1]This column shows the number of estates that claimed the state death tax credit. This includes estates that had federal estate tax liability and estates for which the state credit eliminated all federal liability. In states with a pickup tax only, this column shows the number of estates that paid the pickup tax. In states with their own estate or inheritance taxes, this column may include some estates that paid the state's own tax and did not pay the pickup tax. For these states, this column provides and upper bound for the number of estates subject to the pickup tax.

[2]Due to the lag in filing of estate tax returns, the time periods in the first two columns do not match exactly. Since the rate of deaths is relatively stable, this is unlikely to affect the percentage significantly.