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States Can Avert the Loss of Revenue from Federal Estate Tax Repeal

The full report can be viewed at http://www.cbpp.org/12-20-02sfp.htm. A Center report on how states can avert the loss of revenue can be found at http://www.cbpp.org/1-31-02sfp.pdf.

A new report from the Center on Budget and Policy Priorities, *Why States Should Act Now to Preserve Their Estate and Inheritance Taxes,* explains why states should protect themselves from the effects of the phaseout of the federal estate tax. The 2001 federal tax legislation repeals the 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.[1] The Center's report explains that other states should follow suit because:

- **At a time of fiscal crisis, states cannot afford the significant revenue loss that would result from cutting the estate tax.** The states that have not decoupled stand to lose a combined $15 billion from estate tax repeal between 2003 and 2007. With deficits likely to exceed $70 billion for next year, states cannot afford to lose more revenue.
- **Reducing taxes on the wealthy is inappropriate when states are cutting services that affect people at all income levels.** Only the estates of the *wealthiest two percent* of people who die each year pay the estate tax. In contrast, the spending cuts that states would have to make to compensate for the loss of estate tax revenue would affect the entire state — not only low-income families who receive health care or job training, but any residents who use state or local schools or universities, parks, libraries, or health or public safety services.
- **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.** It has been claimed that estate tax repeal is necessary to ensure that family farms and businesses do not have to be liquidated to pay estate taxes. 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, the business or farm usually does not constitute the majority of the estate. 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.
- **Retaining an estate tax can promote — not harm — a state's economic growth.** Critics argue that an estate tax will harm a state's economy by discouraging retirees from living there. Yet a recent study found that state tax systems had only a small effect on retirees' choice of where to live. Moreover, cutting government services to pay for estate tax repeal could discourage both individuals and businesses from locating in the state, which could inhibit future economic growth.

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[1] Eleven states have acted to decouple. In addition, 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 have done so. Also, 12 states continue to levy an estate or inheritance tax as well as a pickup tax.

- **Eliminating state estate taxes would worsen the disproportionate burden of state taxes on low-income taxpayers.** Since much of states' revenue comes from consumption taxes, and since lower-income families spend a larger share of their income on items that are taxed than higher-income families do, state tax systems impose a heavier burden on lower-income families. Eliminating a tax that is paid *only* by very wealthy families — that is, the estate tax — would tilt state tax systems even more heavily against low-income families.
- **The estate tax provides a way to tax income that otherwise would not be taxed.** Opponents of the estate tax claim that an estate's assets have already been taxed once as income under the income tax and should not be taxed again under the estate tax. But such is not the case with capital gains income, which is taxed only when the asset is sold, not when it is passed on to an heir. (When the heir sells the asset, the gain in its value under the prior owner is not taxed.) A significant portion of the value of estates — and the majority of the value of the largest estates — is in the form of unrealized capital gains that would only be taxed through the estate tax.