CENTER ON BUDGET AND POLICY PRIORITIES
820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1080 center@cbpp.org www.cbpp.org

March 17, 2003

HOW STATES ARE RETAINING A STATE ESTATE TAX: LEGISLATIVE LANGUAGE USED

by Elizabeth McNichol

Introduction

This paper is a technical description of the ways in which states can preserve their estate taxes despite the phase-out of the federal "death tax credit" as a result of the 2001 federal tax law changes. Other Center reports — listed at the end of this report — provide more general information on estate tax policies and options as well as state-by-state estimates of the revenue implications of the various options.

Current Law

In 37 states, state estate tax liability is set by statute to equal the amount allowed as a credit against the federal estate tax, with there being *no other* state estate or inheritance tax. These states are referred to as having only a pickup tax.

The remaining states also have their own inheritance or estate taxes, a portion of which qualifies as a pickup tax.[1] In all of these states, the state laws specify that if the amount of the state tax is less than the credit allowed against federal taxes, the state tax is increased to the amount of the credit.

Under the federal tax law enacted in June 2001, the credit for state "death taxes" paid will be reduced to zero by 2005. As a result, the estate taxes of states that tie their estate taxes to the amount of the state credit allowed under federal law will be eliminated if they make no changes in their estate tax law.

How to Decouple

In both types of states — states with only a pickup tax and states with both a separate state tax and a pickup tax — the revenue that would have been lost as a result of the federal tax cut has been retained by "decoupling." Decoupling means breaking the automatic connection between the amount of the state estate tax credit in the federal law and the amount of tax an estate owes to the state.

[1] The states with a separate tax are Connecticut, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Nebraska, New Hampshire, New Jersey, Ohio, Oklahoma, Pennsylvania and Tennessee. The separate taxes in Connecticut, Louisiana, and New Hampshire are in the process of being phased-out.

In most of the decoupled states, the link has been broken by specifying that the state's pickup estate tax will be equal to the amount of the federal credit for state death taxes as it stood ***prior to*** the passage of the federal tax cut bill of June 2001.

For example, Rhode Island decoupled from the federal changes by adding the following section to its estate tax law:

> "For decedents whose death occurred on or after January 1, 2002, a tax is imposed upon the transfer of the net estate of every resident or nonresident decedent as a tax upon the right to transfer. The tax is a sum equal to the maximum credit for state death taxes allowed by 26 U.S.C. Section 2011 ***as it was in effect as of January 1, 2001***."

The last clause of this new section — "as it was in effect as of January 1, 2001" — ties Rhode Island's estate tax to federal law prior to the enactment of the federal estate tax changes for deaths occurring after January 1, 2002.

Exemptions by Size of Estate

Language similar to Rhode Island's will ensure that the state estate tax is not reduced as the state credit is phased out. However, this type of provision could have been interpreted as adopting the federal exemption schedule that was in effect under federal law prior to passage of the federal tax legislation. Under federal law as of January 2001, estates with values less than the following amounts would have been exempt from the estate tax: $700,000 for deaths occurring in 2002 and 2003, $850,000 in 2004, $950,000 in 2005 and $1 million for 2006 and the following years.

Rhode Island, instead chose to retain the exemption at the 2001 level of $675,000 and, thus, later added the following phrase, "provided, however, any scheduled increase in the unified credit provided in 26 U.S.C. Section 2010 in effect on January 1, 2001 or thereafter shall not apply."

Under the federal estate tax law adopted in June 2001, the exemption level increased immediately to $1 million and will further increase in steps to $3.5 million by 2010. As a result, in states that have decoupled by referencing federal law as of January 2001, some estates will be subject to the *state* estate tax and not to the *federal* tax. Some states felt this could result in administrative difficulties for the state revenue department or the executors of estates and have decided to decouple only partially. These states are retaining an estate tax equal to the full amount of the credit in the pre-2001 law but at the same time incorporating the federal exemption amount increases that were part of that law.

There are two ways that states have addressed this issue. The first is by adopting the federal filing thresholds as the filing threshold for the state estate tax. Estates are required to file a federal estate tax return if the gross value of the estate exceeds the federal exemption amounts. (The gross value is the value of the estate before deductions or credits are applied.) In states that have adopted the federal exemption amounts as a filing threshold only estates that must file a federal estate tax return are required to file and pay state estate taxes. For example, Virginia's estate tax law includes the following language which establishes state filing thresholds equal to the federal thresholds:

> "The personal representative of every estate subject to the tax imposed by this chapter who is required by the laws of the United States to file a federal estate tax return shall file with the Department, on or before the date the federal estate tax return is required to be filed: (i) a return for the tax due under this chapter; and (ii) a copy of the federal estate tax return."

If a state wants to adopt the higher federal exemptions and its estate tax law does not already include this type of provision, it could add similar language. With this language no estate will be required to complete a state estate tax form unless it is required to complete a federal form.

However, even with this type of provision, there could be some estates that will owe state estate taxes but no federal estate taxes. This could occur if an estate has a gross value before deductions that exceeds the federal exemption amount but has a value after deductions that is less than the federal exemption amount.[2] In this case, the estate would owe no federal tax but would owe state tax if the state has adopted the federal exemptions as the filing threshold but has not explicitly stated that the amount of the state estate tax cannot exceed the amount of federal tax owed. Some states that have decoupled wanted to avoid this situation as well and thus included language stating this explicitly in their decoupling language (see Maryland below). Other states that have decoupled accomplished this by changing their estate tax law to set the amount of the tax equal to the credit as it existed prior to the federal changes of 2001 but retained their reference to the remainder of the federal estate tax law as it exists on the date of death. This incorporates both the provisions of the federal tax change that increased the federal exemption and those that provide that the amount of the state death tax credit cannot exceed the amount of federal tax owed.

North Carolina accomplished this by adding the highlighted language below to its state estate tax law.

> "The amount of the estate tax imposed by this section for estates of decedents dying on or after January 1, 2002, is the maximum credit for state death taxes allowed under section 2011 of the Code ***without regard to the phase-out of that credit under subdivision (b) (2) of that section***."

Adopting the current federal exemption schedule would, of course, reduce the amount of revenue that a state would retain from its estate tax.

[2] For example, an estate with a gross value of $1.5 million could have deductions equaling $600,000 that would result in a taxable value of $900,000. Under federal law for deaths occurring in 2002, this estate would owe no federal tax as the amount of tax it potentially owed would be less that the unified credit amount which equals the amount of tax owed by an estate with a value of $1 million. However, the state death tax credit for an estate of this size would equal $27,600.

In addition, it should be noted that in 2011 — and the following years if the federal estate tax repeal is made permanent — no estates will be required to file a federal return or pay federal estate tax. As a result, the estate tax of a state with either of these provisions would be repealed as well. To avoid this, the state could require that starting in 2011 all estates above a certain value, say $3.5 million, must file a state estate tax return and pay a state tax equal to the pre-2001 credit regardless of whether they are required to file a federal return.

Alternative Language

Another way states have decoupled is by adopting legislation that explicitly lays out the state's intention to not conform to the federal changes. For example, Maryland's decoupling legislation added the following section to its state estate tax statute, which decouples, adopts the exemption schedule on the new federal law, and retains the Maryland estate tax when the federal tax is repealed.

> § 7-309
>
> (a) Notwithstanding an Act of Congress that repeals or reduces the federal credit under § 2011 of the Internal Revenue Code, the provisions of this subtitle in effect before the passage of the Act of Congress shall apply with respect to a decedent who dies after the effective date of the Act of Congress so as to continue the Maryland estate tax in force without reduction in the same manner as if the federal credit had not been repealed or reduced.
>
> (b) (1) Except as provided in paragraph (2) of this subsection, after the effective date of an Act of Congress described in subsection (a) of this section, the Maryland estate tax shall be determined using:
>
> (i) the federal credit allowable by § 2011 of the Internal Revenue Code as in effect before the reduction or repeal of the federal credit pursuant to the Act of Congress; and
>
> (ii) other provisions of federal estate tax law, including the applicable unified credit allowed against the federal estate tax, as in effect on the date of the decedent's death.
>
> (2) If the federal estate tax is not in effect on the date of the decedent's death, the Maryland estate tax shall be determined using:
>
> (i) the federal credit allowable by § 2011 of the Internal Revenue Code as in effect before the reduction or repeal of the federal credit pursuant to the Act of Congress; and
>
> (ii) other provisions of federal estate tax law, including the applicable unified credit allowed against the federal estate tax, as in effect on the date immediately preceding the effective date of the repeal of the federal estate tax.

Section 7-309 B 1 (ii) above is the part of Maryland's new law that determines that the current law federal unified credit will apply. (The unified credit is the provision of federal law that determines the exemption amount.) As noted earlier, one drawback of adopting the changes in the federal exemption amounts is that all estates would be exempted when the federal estate tax is repealed in 2010. To address this concern, Maryland added section (2) of this law in order to ensure that the Maryland estate tax would remain after the repeal of the federal tax.

For Further Information

Publications: The Center on Budget and Policy Priorities has prepared a number of papers on the decoupling issue. These are available in a special section of the Center's website: http://www.cbpp.org/decoupling.htm.

These papers include:

States Can Retain Their Estate Taxes Even as the Federal Estate Tax is Phased Out. This paper explains in more detail how states laws are linked to the federal law and includes state-by-state estimates of the revenue that states could retain by decoupling.

Many States are Decoupling from the Federal Estate Tax Cut — This fact sheet lists the states that are decoupled from the federal law.

Why States Should Act Now to Preserve their Estate and Inheritance Taxes — This paper details some of the reasons states should consider decoupling.

Contact for further assistance: Liz McNichol, a senior fellow with the State Fiscal Project of the Center on Budget and Policy Priorities, is familiar with the decoupling legislation that has been adopted in a number of states and is available to provide further information. She can be reached at mcnichol@cbpp.org.