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**COMBINED FEDERAL AND STATE ESTATE TAXES WILL  
DECLINE FOR THE VAST MAJORITY OF ESTATES EVEN  
WHEN A STATE DECOUPLES FROM THE FEDERAL ESTATE TAX CUT**

by Daniel Tenny

Most states currently tax estates exclusively through a “pickup” tax linked to the federal tax code. The amount of this tax in most states equals the “state death tax credit”, a provision of the federal estate tax law that allows taxpayers to subtract the amount of estate tax paid to a state from their federal estate tax liability, up to a limit. A pickup tax imposes a tax equal to the maximum amount that can be subtracted from federal liability. This amount varies depending on the size of the estate and is determined by a schedule in the federal tax code.

The 2001 federal tax law phases out the federal estate tax over 10 years but eliminates the state credit over four years. As a result, states that retain their link to the federal tax code will see their pickup taxes reduced, and eliminated by the fourth year. During this time of fiscal crisis, states cannot afford this revenue loss imposed on them by the federal government. To address this problem, about a dozen states have fully or partially “decoupled” from the federal changes and retained their state estate taxes as they were in effect before the federal tax bill was enacted. Other states are considering similar actions. Some opponents of the decoupling have argued that states that decouple are undermining federal efforts to reduce estate taxes by subjecting some estates to a tax increase when combined federal and state estate taxes are considered. This brief analysis responds to this concern.

- **Decoupling maintains but does not increase state estate taxes.** States that decouple from the federal tax code will impose taxes as if the federal tax bill had never been enacted. Thus, decoupling does not increase state taxes for any taxpayer compared to their level before the federal tax bill was enacted. The phaseout of the state credit will cause *federal* taxes to increase since the amount that can be subtracted from federal tax liability as a credit is going down. As discussed below, in the vast majority of estates this increase is more than offset by other reductions in federal estate taxes leading to a reduction in net estate taxes. A small minority of very large estates do pay more under the new system for the two years of the phase-in period, but that is the result of a *federal*, and not a state, tax increase.
- **The vast majority of estates in 2003 and 2004, and all estates in 2005 and beyond will pay less in combined federal and state estate taxes even in states that fully decouple.** In addition to phasing out the state credit, the federal tax bill

reduces estate tax rates and gradually increases the amount that is completely exempt from taxation. These changes result in significant reductions in federal estate taxes, which more than make up for the increases due to the phaseout of the state credit for almost every estate. Only very large estates will experience some combined net increase in 2003 and 2004. All estates will have combined net decrease in 2005 and beyond compared to current law. (See the example below of a two million dollar estate.)

- 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.
- **Starting in 2005, estates in states that decouple will benefit from a new federal tax deduction for estate taxes.** Under the new federal tax law, the state credit will be converted to a deduction beginning in 2005. Instead of taking a dollar-for-dollar credit for state estate taxes paid, taxpayers will deduct their state estate taxes from the size of their estate before applying the federal estate tax rate schedule. This deduction, combined with the other changes in the federal tax bill, is sufficient to guarantee that all estates face lower combined state and federal tax burdens than under prior law. In other words, beginning in 2005, all estates of any size will pay less in estate taxes than they would have under prior law.
- The vast majority of estates — some 98 percent nationwide — are unaffected by any of these changes because even under prior law they did not owe tax under either the federal estate tax or the state pickup tax.

<b>Example: Federal and State Tax Liability for Estate Of \$2 Million in 2003 in State That Decouples</b>			
	<b>Pre 2001 law</b>	<b>Post 2001 law</b>	<b>Change</b>
A. Federal estate tax before state credit	\$551,000	\$435,000	-\$116,000
B. Allowable State credit	\$99,600	\$49,800	-\$49,800
C. Federal tax after state credit (A - B)	\$451,400	\$385,200	-\$66,200
D. State estate tax	\$99,600	\$99,600	\$0
<b>TOTAL TAX (C + D)</b>	<b>\$551,000</b>	<b>\$484,800</b>	<b>-\$66,200</b>