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ISSUE BRIEFS: HOW STATES CAN TAX WEALTH

State Taxes on Inherited Wealth

By Elizabeth McNichol

A historically large share of the nation's wealth is concentrated in the hands of a few. As a result, millions of American families have less wealth, and therefore fewer opportunities, than they otherwise would. Further, since wealthy people are overwhelmingly white, this extreme wealth concentration reinforces barriers that make it harder for people of color to make gains. State taxes on inherited wealth — estate and inheritance taxes — can be a powerful tool for building a more broadly shared prosperity.

Most state and local tax systems are upside down: the wealthy pay a *smaller* share of their income in these taxes than low- and middle-income people do, even though they are best able to afford it. State taxes on inherited wealth are an exception, since they apply only to the wealthiest individuals and are the primary state tax on wealth. But these taxes have gradually eroded even as wealth and income have become more concentrated. States with these taxes should maintain them, and states without them should consider enacting them — or consider taxing inheritances as income. State taxes on inherited wealth do not depend on the existence of the federal estate tax.

What Is an Estate or Inheritance Tax?

An **estate tax** is a tax on property (cash, real estate, stock, and other assets) transferred from deceased persons to their heirs. A state applies a tax rate to the value of an estate that exceeds a certain threshold; both the rate and the exemption threshold differ by state. A typical state with an estate tax exempts $2 to $5 million per estate and applies rates ranging from 1 percent to 16 percent to the value of property left to any heirs except a spouse. On average, fewer than 3 percent of estates — very large ones owned by the wealthiest individuals — owe state estate taxes.

Some states levy an **inheritance tax** rather than an estate tax. It is levied on the recipients of the estate (the heirs) instead of the deceased person's estate.

For example, consider an unmarried woman who owns a house, stocks, cash, and other assets worth $30 million. She leaves those assets to her three children in equal shares upon her death. In a state with an estate tax, the tax is based on the value of the entire $30 million estate and is subtracted from the value of the estate before its distribution to the heirs. In a state with an inheritance tax, the children each receive their $10 million bequest and then owe inheritance tax on that bequest.

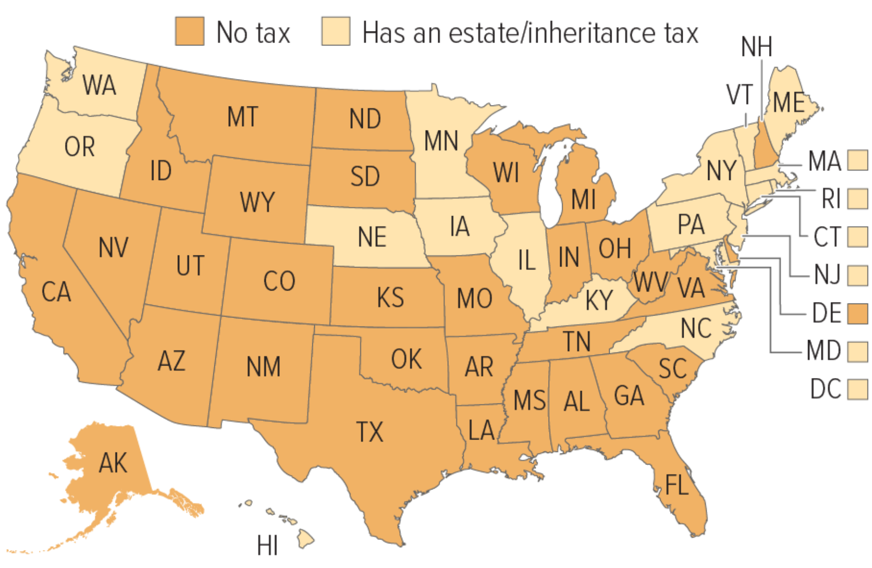
How Many States Tax Inherited Wealth?

The federal government has levied an estate tax since 1916. Until 2001, every state also levied a tax that allowed them to "pick up" a share of federal estate tax revenues. The "pick-up" taxes didn't increase an estate's total estate tax liability because estates received a dollar-for-dollar federal credit that reduced their federal estate tax liability by the amount they paid to the state. In addition, a dozen states levied a separate inheritance tax.

In 2001, policymakers cut the federal estate tax and eliminated the federal credit. Most states had set their estate taxes to equal the amount of the federal credit, and after its elimination, a number of states simply allowed their estate taxes to disappear as well, while others affirmatively either repealed or retained their estate taxes. As of September 2019, only 17 states and the District of Columbia still levy an estate or inheritance tax. (See Figure 1.) These taxes generate about $4.5 billion per year. (See Table 1.) If all states reinstated an estate tax, they could generate an additional $3.5 to $11 billion. (See Table 2.)

FIGURE 1

Only 17 States Plus the District of Columbia Tax Inherited Wealth



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How Does an Estate or Inheritance Tax Affect State Economies?

States spend most of their tax revenues on three major building blocks of thriving communities: K-12 and higher education, health care, and public safety. State estate and inheritance taxes, by increasing the share of state revenues paid by the wealthy, allow states to keep taxes lower on people with moderate incomes, enabling them to spend more of their incomes to boost local economies.

Little credible evidence supports the claim that an estate or inheritance tax harms a state's economy by causing large numbers of elderly people to leave the state or by discouraging them from moving there. At most, academic studies find that these taxes have a small effect on the residence decisions of a few, very wealthy elderly people.[1] The revenue loss from reducing or eliminating the estate tax, in contrast, reduces a state's ability to make public investments that undergird economic growth and help produce an economy that works for everyone. Cuts in state services resulting from eliminating the tax can discourage businesses and individuals — both retirees and others — from remaining in or relocating to a state, likely doing more harm to the state's economic growth than any small potential benefit from having no estate or inheritance tax.

States With an Estate or Inheritance Tax Should Maintain It

States with an estate or inheritance tax[2] should resist efforts to eliminate or significantly weaken it. As noted, claims that these taxes harm a state's economy lack foundation.

States also should protect their estate taxes from the impact of cuts to the federal estate tax. For example, the tax law enacted in late 2017 doubled the federal estate tax exemption, from $11 million to $22 million per couple. At that time, the estate taxes of four states (Connecticut, Hawaii, Maryland, and Maine) and the District of Columbia were directly linked to the federal exemption, so their estate taxes would have been cut dramatically if they did nothing. Four of the five acted to break this link and avoid further erosion of their estate taxes.

States with an estate tax should consider lowering their exemptions to increase the amount of revenue the tax generates. The revenue boosts could be significant, especially in states that now exempt all but the very largest estates. (See Table 3.)

States Without an Estate or Inheritance Tax Should Consider Adopting One

States that no longer levy an estate or inheritance tax should consider restoring them. One option would be for states to set their estate tax at the same level as the federal credit before the 2001 federal tax law eliminated it. This has the advantage of statutory simplicity but reduces state flexibility.

States may instead prefer to enact estate taxes that are similar in structure to the pick-up tax but are not linked to the federal estate tax rules — as Connecticut, Hawaii, Maine, Oregon, and Washington have done. States that adopt such a stand-alone tax can customize the tax to fit their state's circumstances. They can choose exemption levels and tax rates and can exempt certain assets such as small farms if they desire.

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[1] See, for example, Karen Smith Conway and Jonathan Rork, "State Death Taxes and Elderly Migration: The Chicken or the Egg," *National Tax Journal*, March 2006; Conway and Rork, "No Country for Old Men (Or Women): Do State Tax Policies Drive Away the Elderly?" *National Tax Journal*, June 2012; Jon Bakija and Joel Slemrod, "Do the Rich Flee from High State Taxes? Evidence from Federal Estate Tax Returns," National Bureau of Economic Research Working Paper 10645, July 2004, http://www.nber.org/papers/w10645.

[2] These are Connecticut, Hawaii, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, Vermont, and Washington, plus the District of Columbia.

In a few states, however, there are additional barriers to reinstating an estate tax. For example, in California, restoring the estate tax would require a vote of the people; in Alabama, Florida, and Nevada, constitutional provisions restricting the amount of estate tax levied would need to be altered.[3] In addition, some states require a supermajority vote to raise taxes.

A New Approach to Taxing Inherited Wealth

Another way to preserve and expand state taxes on inherited wealth is to shift from an estate tax (a tax on the value of an estate) to a tax on the heirs to the estate that varies based on their incomes — essentially a form of inheritance tax. (A handful of states currently levy inheritance taxes, but these are generally small and are not tied to income.)

States would tax an heir's inheritance by treating some or all of it as income subject to the income tax. In a state with a progressive income tax, a wealthier heir would pay a higher tax rate on the inheritance than an heir of lesser means.

Economist Lily Batchelder, formerly deputy director of the National Economic Council, proposed a federal inheritance tax along these lines in 2007.[4] It would tax an heir's cumulative lifetime inheritances in excess of $2.3 million at the heir's federal income tax rate plus 15 percentage points and exempt up to $5,000 in gifts and $25,000 in bequests annually. It was designed to raise as much federal revenue each year as the federal estate tax under 2009 parameters.

A new approach to a state inheritance tax could be broadly similar to Batchelder's federal proposal, but adapting it to states would require resolving a number of issues:

- Should states adopt a uniform set of rates and definition of the tax base (that is, the assets to which the tax would apply)?
- How should the tax apply to assets inherited from a resident of a different state or left to someone in a different state? The alternatives include (1) taxing all inheritances by residents of the state as income regardless of the decedent's state, (2) taxing all bequests by residents of the state regardless of the heirs' state (the executor of the estate would withhold the tax owed by out-of-state heirs and pay it to the state before sending the bequest to the heirs, which is how existing state inheritance taxes operate), or (3) exempting interstate inheritances (with provisions to minimize tax avoidance).
- How should a state without an income tax administer the inheritance tax? Such states could set their own rates or use the federal income tax rates. Either way, in place of income tax

[3] California repealed an earlier version of the estate tax through a ballot initiative that included a provision requiring voter approval to levy any state estate tax other than a "pick-up" tax. The constitutions of Alabama, Florida, and Nevada limit any estate tax to a pick-up tax. In these states, restoring the estate tax would require amending the constitution. The amendment process requires some combination of a popular vote (or votes) and legislative approval, depending on the state (or a constitutional convention).

[4] "Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax," Lily L. Batchelder, The Hamilton Project, The Brookings Institution, Discussion Paper 2007-07, June 7, 2007, http://www.hamiltonproject.org/papers/taxing_privilege_more_effectively_replacing_the_estate_tax_with_an_inh.

returns, the state could require executors of estates to file returns listing recipients of bequests and the tax they owe.

Another way to tax inherited wealth that could either complement an estate or inheritance tax or stand on its own would be to eliminate the "stepped-up basis" for taxing capital gains, which often shields a significant share of accrued gains on inherited assets (such as stocks, bonds, and real estate) from taxation. See CBPP's issue brief on capital gains for details.[5]

TABLE 1

Estate and/or Inheritance Tax Collections in States

	FY2017	FY2018	FY2019	FY2020*
Connecticut	219	224	212	166
Hawaii	19	29	30	31
Illinois	261	358	375	305
Iowa	86	86	86	89
Kentucky	45	48	51	45
Maine	12	14	16	10
Maryland Estate**	175	156	119	108
Maryland Inheritance	53	58	58	56
Massachusetts	337	473	332	432
Minnesota	139	213	226	143
New Jersey Inheritance	355	374	415	395
New Jersey Estate	394	232	74	0
New York	1,091	1,308	1,068	1,094
Oregon	197	176	205	180
Pennsylvania	978	1,019	1,060	1,106
Rhode Island	85	51	35	34
Vermont	17	23	19	21
Washington	169	203	293	221
DC	41	36	14	21
Total	4,671	5,083	4,688	4,457

* Figures for fiscal year 2020 are estimates

.** Maryland Estate/Inheritance split estimated for 2019

Source: State budgets and other fiscal reports.

[5] Elizabeth McNichol, "State Taxes on Capital Gains," Center on Budget and Policy Priorities, December 12, 2018, https://www.cbpp.org/research/state-budget-and-tax/issue-brief-state-taxes-on-capital-gains.

TABLE 2

How Much Revenue Would Reinstating an Estate Tax Raise?

(Estimated annual collections, millions)

State	$1 million exemption	$3.5 million exemption	$5.25 million exemption	$11.4 million exemption
Alabama	$160	$110	$80	$50
Alaska	$10	$10	$10	$0
Arizona	$190	$130	$100	$60
Arkansas	$100	$70	$50	$30
California	$2,620	$1,770	$1,290	$850
Colorado	$170	$110	$80	$50
Connecticut	See Table 3	See Table 3	See Table 3	See Table 3
Delaware	$90	$60	$40	$30
Florida	$1,580	$1,070	$780	$510
Georgia	$290	$200	$140	$90
Hawaii	See Table 3	See Table 3	See Table 3	See Table 3
Idaho	$30	$20	$20	$10
Illinois	$690	$470	$340	$220
Indiana	$210	$140	$100	$70
Iowa*	$90	$60	$40	$30
Kansas	$90	$60	$40	$30
Kentucky*	$140	$100	$70	$50
Louisiana	$90	$60	$40	$30
Maine	See Table 3	See Table 3	See Table 3	See Table 3
Maryland	See Table 3	See Table 3	See Table 3	See Table 3
Massachusetts	See Table 3	See Table 3	See Table 3	See Table 3
Michigan	$360	$240	$180	$120
Minnesota	See Table 3	See Table 3	See Table 3	See Table 3
Mississippi	$70	$50	$30	$20
Missouri	$270	$180	$130	$90
Montana	$30	$20	$10	$10
Nebraska	$60	$40	$30	$20
Nevada	$110	$70	$50	$30
New Hampshire	$80	$50	$40	$30
New Jersey*	$570	$370	$280	$180
New Mexico	$70	$50	$30	$20
New York	See Table 3	See Table 3	See Table 3	See Table 3
North Carolina	$260	$180	$130	$90
North Dakota	$10	$10	$10	$0
Ohio	$480	$330	$240	$160
Oklahoma	$130	$90	$60	$40
Oregon	See Table 3	See Table 3	See Table 3	See Table 3
Pennsylvania*	$630	$430	$310	$210

TABLE 2

How Much Revenue Would Reinstating an Estate Tax Raise?

(Estimated annual collections, millions)

State	$1 million exemption	$3.5 million exemption	$5.25 million exemption	$11.4 million exemption
Rhode Island	See Table 3	See Table 3	See Table 3	See Table 3
South Carolina	$140	$100	$70	$50
South Dakota	$20	$10	$10	$10
Tennessee	$200	$140	$100	$70
Texas	$740	$500	$360	$240
Utah	$50	$40	$30	$20
Vermont	See Table 3	See Table 3	See Table 3	See Table 3
Virginia	$360	$240	$180	$120
Washington	See Table 3	See Table 3	See Table 3	See Table 3
West Virginia	$30	$20	$10	$10
Wisconsin	$180	$120	$90	$60
Wyoming	$30	$20	$10	$10
District of Columbia	See Table 3	See Table 3	See Table 3	See Table 3
Total Potential	**$11,430**	**$7,750**	**$5,610**	**$3,720**

Sources: CBPP calculations based on IRS Statistics of Income, Tax Policy Center

*State currently has an inheritance tax. See Methodology Note for further information on this table.

TABLE 3

Impact of Different Exemptions in States That Have an Estate Tax

(Assumes 2001 rate schedule; see Methodology Note below)

State	$1 million exemption	$3.5 million exemption	$5.25 million exemption	$11.4 million exemption
Connecticut	$350	$240	$170	$110
Hawaii	$40	$20	$20	$10
Maine	$60	$40	$30	$20
Maryland	$290	$200	$140	$90
Massachusetts	$400	$270	$200	$130
Minnesota	$180	$120	$90	$60
New York	$1,690	$1,140	$830	$550
Oregon	$140	$100	$70	$50
Rhode Island	$50	$40	$30	$20
Vermont	$30	$20	$10	$10
Washington	$290	$190	$140	$90
District of Columbia	$80	$50	$40	$30

Sources: CBPP calculations based on IRS Statistics of Income, Tax Policy Center

Methodology Note

Tables 2 and 3 show rough estimates of the potential revenue raised by state estate taxes at different exemption levels, based on the rates and brackets that were used for the State Death Tax Credit in 2001 federal law. Before the federal credit was eliminated, most states levied an estate tax equal to that credit which was calculated using a graduated rate schedule, with rates ranging from 0 percent for the smallest taxable estates up to 16 percent for estates of $10 million or more. The estimates in Tables 2 and 3 were calculated by applying the state's historical share of federal estate tax collections to federal collections for deaths in 2019 at various exemption levels estimated by the Urban-Brookings Tax Policy Center. Table 2 shows the potential revenue at selected exemption levels if states without an estate tax reinstated one with the 2001 state credit's rate schedule.

The 11 states and D.C. that have retained estate taxes shown in Table 3, however, do not all use the 2001 state credits' rate schedule and have often made other changes to the base of the tax (the taxable estate). For example, five states — Connecticut, Hawaii, Maine, Oregon, and Washington — levy stand-alone estate taxes not based on pre-2001 federal law and a number of states treat the exemption as a deduction rather than as a credit. The estimates in Table 3 assume the 2001 credit's rates and base, which could result in either higher or lower estimates compared to these states' current law for any given exemption level. However, the estimates in Table 3 can be used to approximate the potential revenue effect of states changing their exemption levels while retaining their current rate schedule and tax base.

Tables 2 and 3 represent rough estimates of potential revenue based on national data. Estimates prepared by individual state budget or legislative fiscal offices will be more precise.