Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

May 20, 2010

STALLED ESTATE TAX PROPOSAL COULD THREATEN STATE REVENUES THAT SUPPORT EDUCATION, PUBLIC SAFETY, AND OTHER KEY SERVICES

By Elizabeth C. McNichol

A provision that several senators were reportedly considering for a now-stalled estate tax proposal could squeeze state revenues that support education, public safety, and other vital services to help cut taxes on the estates of the wealthiest one-quarter of 1 percent of Americans.

The proposal, which several Senators (including Jon Kyl, Max Baucus, Charles Grassley, and Blanche Lincoln) were developing before negotiations broke down this week, would shrink the estate tax beyond the parameters that were in place in 2009 by (1) raising the amount of an inherited estate that's exempt from taxation, and (2) reducing the tax rate.[1] Since the estates of 99.75 percent of Americans who die already are fully exempt from the tax under the 2009 parameters, further reductions in the tax would benefit only the estates of the top one-quarter of 1 percent of Americans.

At the state level, meanwhile, 21 states and the District of Columbia now impose their own estate or inheritance taxes. Those taxes provide more than $4.5 billion a year in state revenues (see Table 1, p. 3). Those taxes are among the most progressive sources of revenue that states have, helping to offset the regressivity of other state and local taxes. Nearly all state tax systems are regressive overall.

Currently, individuals who pay state-level estate and inheritance taxes can deduct them from their federal taxes. The proposal the senators were negotiating, however, reportedly included a provision that — to reduce its overall costs — would end the federal deduction that taxpayers can take for state-level estate and inheritance tax payments.

If wealthy taxpayers who face state-level estate or inheritance taxes no longer can get a federal deduction against those taxes, those taxpayers almost certainly will pressure state lawmakers to reduce or repeal those taxes.

At the moment, states may not be in a position to repeal their estate or inheritance taxes. All but two of them faced shortfalls in fiscal years 2009 and 2010. Very large budget gaps are projected for

[1] Under current law, the federal estate tax is not in effect for calendar year 2010. It will be reinstated in 2011 at the 2001 level — a 55 percent top rate on estates over $1 million (effectively $2 million for couples). As an alternative, the Administration has proposed continuing the estate tax at the 2009 level — a 45 percent rate on estates over $3.5 million (effectively $7 million for couples.)

TABLE 1: ESTIMATED STATE ESTATE AND INHERITANCE TAX COLLECTIONS (Fiscal Year 2008 except where noted) (Only States with Estate or Inheritance Taxes Are Shown)		
	FY2008 Collections (in millions)	**Type of Tax***
Connecticut	$166.3	Estate
Delaware**	$5.0	Estate
Hawaii**	$19.6	Estate
Indiana	$165.6	Inheritance
Iowa	$79.8	Inheritance
Kentucky	$51.0	Inheritance
Maine	$39.9	Estate
Maryland	$243.4	Estate plus Inheritance
Massachusetts	$254.0	Estate
Minnesota	$115.5	Estate
Nebraska**	$24.7	Inheritance
New Jersey	$698.7	Estate plus Inheritance
New York	$1,037.5	Estate
North Carolina**	$176.3	Estate
Ohio	$306.8	Estate
Oregon	$109.5	Estate
Pennsylvania	$803.4	Inheritance
Rhode Island	$35.0	Estate
Tennessee	$103.5	Inheritance
Vermont	$15.7	Estate
Washington	$110.6	Estate
D.C.	$21.4	Estate
Total***	$4,561.9	

Source: U.S. Bureau of the Census.

*State taxes can take one of two forms — an estate tax or an inheritance 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.

** The **Delaware** and **Hawaii** amounts are estimates of FY2010 collections. **Nebraska** amount is for FY2007. **North Carolina**'s estate tax is not in effect while there is no federal estate tax.

*** The total for all states including those that no longer have an estate or inheritance tax is $5.3 billion.

fiscal year 2011, which begins in most states on July 1, 2010. Total shortfalls for 2010 and 2011 combined will likely reach $280 billion.[2]

But if this provision is enacted, then once state budgets begin to recover from the recent recession, states may face the choice of restoring the deep cuts they were forced to make in K-12, higher education, public safety, and other key services — or eliminating or reducing their estate or inheritance taxes.

Since the recession began, states have enacted large program cuts that have affected low- and middle-income families and substantially reduced a number of needed services. At least 45 states

[2] The $280 billon figure is the projected shortfall remaining after accounting for federal Recovery Act aid.

plus the District of Columbia cut services in 2008 and 2009, and those cuts touched all major areas of state budgets including health care, services to the elderly and disabled, K-12 education, and higher education.

How the Deduction Works

Under the current federal tax deduction, the estate or inheritance tax payments made to a state are deducted from the value of an estate that is subject to taxation under the federal estate tax. Prior to enactment of the 2001 federal tax-cut legislation, a federal *tax credit* was provided for state estate and inheritance taxes paid. Every state had some form of estate tax, with most states simply setting their state estate tax at the amount allowed under the federal credit. Because of the credit, state estate taxes generally did not result in any increase in the total amount of taxes an estate paid. For each dollar in state estate taxes paid up to the full credit amount, federal estate taxes were lowered by a dollar.

The 2001 tax-cut legislation eliminated this credit, however, and established the existing deduction in its place; the deduction was meant to substitute, in part, for the credit. Because of the loss of the credit, half of the states let their estate taxes expire. The other half retained an estate or inheritance tax, with the amount of tax paid being deducted from the value of the estate when the federal estate tax is computed.

In the states that have retained an estate or inheritance tax, the federal deduction has played an important role in keeping these taxes politically viable. Without the deduction, the survival of this state revenue source would be in question.

- The deduction significantly reduces the cost of the state estate tax for estates that are subject to the federal estate tax. It gives large estates an effective "discount" on the state estate tax. This is of crucial importance, since the owners of large estates are often the most vocal and active critics of state estate taxes.

- Without the deduction, opponents of state estate taxes can claim there is double taxation of estates, since the *same* value of an estate would be taxed at *both* the state and federal levels. Stated another way, without the deduction, the federal estate tax would be levied on a portion of an estate that had already been used to pay the state taxes.

- A deduction for the amount of state taxes paid is a standard feature of federal taxes. When income is subject to the income tax at both federal and state levels, the state income taxes that are paid are deductible for federal tax purposes. State sales taxes and state or local property taxes also are deductible under the federal personal income tax, and state corporate income taxes are treated similarly under the federal corporate income tax.

- A deduction also dampens the "race to the bottom" among states to eliminate their estate taxes. One of the major arguments used by opponents of state estate taxes is that a state with an estate tax is a less attractive place for seniors to live than a state with no estate tax. The deduction answers this argument in part because it reduces the effective rate of the state tax and thus reduces the differential between states with the tax and those without. While the statutory rates of state estate taxes range up to 16 percent for the largest estates (those over $10 million), the

average *effective* tax rate is only 4.5 percent. The federal deduction plays a major role in lowering the effective rate for the largest estates.

Conclusion

The elimination of the federal credit has already made it difficult for many states to maintain their estate and inheritance taxes. Eliminating the deduction that replaced the old federal credit may pull the rug out from under states that have maintained this progressive tax in the face of powerful opposition. The opposition to these state taxes is expected to intensify if deductibility is denied and estates must pay federal tax on the portion of an estate that has already been paid in tax at the state level.