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Revised June 23, 2006

ESTATE TAX "COMPROMISE" PROPOSALS MAY ENDANGER STATE ESTATE AND INHERITANCE TAXES

By Elizabeth C. McNichol

On June 22, the House of Representatives approved an estate tax proposal introduced by House Ways and Means Chairman Bill Thomas. While supporters of the proposal describe it as a "compromise," it would in fact eliminate the vast bulk of estate tax revenue and has been more aptly characterized as "near repeal." The Senate is now expected to vote on this measure before it adjourns for the July 4 recess. (This follows the Senate's rejection on June 8 of a motion to consider legislation that would repeal the estate tax permanently.)

Estimates by the Joint Committee on Taxation indicate that the Thomas proposal would cost at least three-quarters as much as full repeal over the long term. It could add more than $750 billion to deficits over the first ten years that its budgetary effects would be fully felt (2012-2021), when the costs of the added interest payments on the national debt are included.[1] Similarly expensive "compromise" proposals previously have been floated in the Senate by, for instance, Senator Jon Kyl.

The Thomas and Kyl proposals both include a provision intended to make them a little bit less costly without preserving any more of the estate tax — and at the expense of state budgets. This provision would *repeal the existing federal tax deduction for state estate and inheritance taxes* that estate or heirs pay. Currently, as a result of this deduction, federal estate tax liability is based on the value of an estate *after* state estate or inheritance taxes have been subtracted.

The repeal of the deduction for state estate and inheritance taxes could pose a substantial problem for the 24 states that levy estate or inheritance taxes.[2] State estate and inheritance taxes are an important revenue source for these states, bringing in a total of approximately $4.5 billion per year. Most of these dollars are deposited in state general funds, which principally pay for education, health care, and public safety.

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[1] Joel Friedman and Aviva Aron-Dine, "Thomas Estate Tax Proposal Still 'Near Repeal:' Instead of Compromising, Proposal Tries to Have It Both Ways," Center on Budget and Policy Priorities," revised June 23, 2006.

[2] The states include Connecticut, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island. Tennessee, Vermont, Virginia, Washington and Wisconsin. In some states, these taxes will expire in the next few years. For more details see Elizabeth McNichol, "State Taxes on Inherited Wealth Remain Common," Center on Budget and Policy Prioities, revised June 23, 2006, http://www.cbpp.org/5-31-06sfp.htm.

Without the federal deduction, however, a number of these state estate and inheritance taxes — which already are under fire in a number of states — may have difficulty surviving, since repeal of the deduction would increase the burden of state taxes. It also would lead to charges of unfair double taxation, because the federal estate tax would be leveled on the portion of estates that had already been taxed away at the state level.

State income, sales, and property taxes are deductible for federal tax purposes, but state estate taxes would be treated differently, with deductibility denied. Table 1 shows the estimated estate or inheritance collections for fiscal year 2006 for each of these 24 states. These amounts would be placed at risk.

Estate and inheritance taxes also are one of 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.

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.

TABLE 1: ESTIMATED STATE ESTATE AND INHERITANCE TAX COLLECTIONS (FISCAL YEAR 2006) (ONLY STATES WITH ESTATE OR INHERITANCE TAXES ARE SHOWN.)

	FY2006 estimated collections (in millions)	Type of Tax*
Connecticut	$155.0	Estate
Illinois	$285.0	Estate
Indiana	$140.0	Inheritance
Iowa	$70.9	Inheritance
Kansas	$53.0	Estate
Kentucky	$47.0	Inheritance
Maine	$30.6	Estate
Maryland	$245.9	Estate plus Inheritance
Massachusetts	$218.0	Estate
Minnesota	$210.0	Estate
Nebraska	$68.7	Estate plus Inheritance
New Jersey	$580.0	Estate plus Inheritance
New York	$855.0	Estate
North Carolina	$154.3	Estate
Ohio	$310.5	Estate
Oklahoma	$64.1	Estate
Oregon	$59.0	Estate
Pennsylvania	$725.5	Inheritance
Rhode Island	$28.0	Estate
Tennessee	$84.0	Inheritance
Vermont	$26.1	Estate
Virginia	$144.0	Estate
Washington	$39.9	Estate
Wisconsin	$124.0	Estate
D.C.	$21.4	Estate
US total	$4,740.0	

Source: State budget documents or calls to state budget offices.

*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.

Conclusion

The elimination of the federal credit has already made it difficult for many states to maintain their estate and inheritance taxes. Serious proposals emerged this year to eliminate or significantly reduce these taxes in six of the 24 states that have maintained them.

Eliminating the deduction that replaced the old federal credit may pull the rug out from under states that have tried to maintain 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.