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Repealing Federal Estate Tax Would Likely Deprive States of Needed Revenues and Tilt Tax Systems Toward Wealthy

By Iris J. Lav

Repealing the federal estate tax on large inheritances, as congressional Republicans favor and President Trump proposed in his new tax reform plan, would make it difficult for states to maintain their own estate taxes, which will raise an estimated $3.0 billion in 2017. Of the 14 states and the District of Columbia that levy estate taxes, all but one (Washington State) depend on federal estate tax rules for administering their own estate tax. Eliminating state estate taxes would enrich a handful of wealthy, powerful families at the expense of resources for schools, roads, health care, and other building blocks of thriving communities and opportunity.

Republican Congressional Leaders Favor Repeal

House Ways and Means Chairman Kevin Brady and Senate Finance Chairman Orrin Hatch recently have repeated their desire to repeal the federal estate tax. House Speaker Paul Ryan and Senate Majority Leader Mitch McConnell have indicated their support for repeal, and repeal is part of the House GOP's "Better Way" tax plan. Repeal could easily pass the House, and could pass the Senate with 50 out of 52 Republican votes if part of a reconciliation bill.

The federal estate tax raises approximately $5.5 billion a year. It affects only the wealthiest of estates, roughly 2 of every 1,000 estates, so it is the most progressive part of the tax code.[1]

State Estate Taxes Provide Needed Revenue in Progressive Way

Despite the many changes in federal estate tax law in recent years, and the temporary repeal of the federal estate tax in 2010, 14 states plus the District of Columbia have chosen to maintain an estate tax. At the state level, like the federal level, an estate tax provides a progressive means to raise funds for public services, falling entirely on the highest-income households. Only the wealthiest taxpayers pay estate taxes — fewer than 2.5 percent of estates, in the states with the tax, on average.

While the state estate tax is not a major revenue source, it still is significant. For example, the $3 billion in estate tax revenue that these states will raise in 2017 exceeds their spending on tuition assistance grants for college students.[2] The vast majority of that student aid goes to low-income students, while repealing the estate tax would only benefit very high-income residents. The $285 million that Illinois raises from the estate tax exceeds the $237 million it appropriated for 2017 for foster homes and specialized foster care and for adoption and guardianship services. The $375 million that Massachusetts raises from the estate tax exceeds the $352 million the state is spending in 2017 on a constellation of services for homeless people, programs to prevent homelessness, and rental vouchers and subsidies. And the $147 million that Maryland raises from the estate tax is only slightly less than the $152 million cost in 2017 of programs to treat behavioral health issues in the community, including inpatient and outpatient treatment for issues that include addiction treatment.

State and local tax systems overall are regressive. Non-elderly families in the lowest 20 percent of the income distribution pay 10.9 percent of their income in state and local taxes, while families in the top 1 percent pay only 5.4 percent.[3] Yet incomes are growing far faster at the top of the income distribution than at any other income level. The top 1 percent's share of income rose in every state and the District of Columbia, and it doubled nationally — from 10 percent to 20 percent — between 1979 and 2013.[4] Tax systems overall do less to push back on inequality stemming from market forces than they used to, so the loss of a major progressive element of state tax systems would further exacerbate inequality. The deterioration of broadly shared prosperity in the country as a result of these trends is of great concern.[5]

State Estate Taxes Rely on Federal Rules

Repealing the federal estate tax would threaten states' ability to maintain an estate tax, since most of them rely entirely or substantially on the federal tax as the basis for their own estate taxes.

Measuring the assets in a large estate is no simple matter. For example, the federal estate tax includes several alternatives for valuing property. It has special rules for defining and valuing closely held businesses (those with only a limited number of shareholders) and paying estate tax on them. It sets out complex rules for valuing partnership interests or businesses in which a decedent might have a partial interest, depending in part on the degree of control a decedent might have exercised over the firm's assets or operations. The rules surrounding some of the deductions allowed against the asset amounts are similarly complicated.

Without a federal estate tax, states would have to recreate and update these rules for themselves. If they are loath to take on that task, as they may well be, they could lose an important component of their tax systems.

Five States Are Fully Dependent on Federal Law

Three states with an estate tax — Delaware, Hawaii, and Maine — conform closely to the federal estate tax. They use the same exemption used by the federal tax, which currently is $5,490,000 per person and is scheduled to rise with inflation each year. And they use the federal definitions of the assets subject to the tax and the allowable deductions in calculating the amount of the taxable estate. For example, the Maine law says that the "Maine taxable estate means the federal taxable estate" and then lists three small adjustments particular to Maine. Hawaii and Delaware have similar provisions. If the federal estate tax were fully repealed, these states' estate taxes apparently would be repealed *automatically*. If these states wanted to retain their estate taxes, they would have to reenact them in a different form.

Two other states — Maryland and New York — are gradually phasing up their estate tax exemptions to match the federal exemptions by 2019. (The District of Columbia passed a law to phase up if sufficient revenue becomes available.) These states also depend on federal estate tax law and definitions. The Maryland estate tax return begins with the federal total gross estate and the allowable deductions from the federal form. New York's return is similar, with adjustments to the federal for a few New York-specific issues.

Other States Rely on Federal Definitions and Forms

While the other states with an estate tax use a lower exemption level than the federal tax, their taxes, too, are often tied to the federal tax. Connecticut, D.C., Illinois, Massachusetts, Minnesota, Oregon, and Vermont require estates to file with their state estate tax return either their federal estate tax return or the extensive schedules of assets from the federal return. This requirement exists even if the estate is below the federal filing threshold and thus does not need to file a federal estate tax return. In these states, estates with no obligation to file a federal return must file a pro forma federal return or provide information from the federal estate tax return schedules, computed according to federal rules. In other words, these states rely on the federal forms and the federal definitions of assets and deductions to calculate their own estate taxes.

Only two states with estate taxes — Rhode Island and Washington State — use their own forms and schedules of assets. And even Rhode Island advises filers that "Form RI-100A is modeled after Federal Form 706. For guidance in completing Form RI-100A, follow the links below to the Internal Revenue Service website."

TABLE 1

Estimated Fiscal Year 2017 Revenue from State Estate Taxes

	Millions of dollars
Connecticut	183
Delaware	4
Hawaii	50
Illinois	285
Maine	16
Maryland	147
Massachusetts	375
Minnesota	72
New Jersey*	410
New York	1,114
Oregon	152
Rhode Island	20
Vermont	17
Washington	150
District of Columbia	30
Total	$3,027

* The New Jersey estate tax will be repealed after 2017.

Source: State budget and revenue forecast documents. New Jersey estimate from conversation with the Office of Legislative Services.

Burden of Developing Own Forms Could Lead States to Eliminate Important Revenue Source

If the federal estate tax were fully repealed, the states would have to develop their own forms and, over time if not immediately, their own definitions. A state could do that; Washington State, for example, uses its own forms and schedules of assets without reference to the federal tax. However, states would find it burdensome to develop their own forms and instructions. The federal estate tax return runs to 31 pages, and its instructions are 54 pages long. Most states resist creating such complicated components to their own tax systems.

In addition, conservative advocacy groups and legislators have pushed in a number of states for repealing the estate tax. Eliminating the federal tax could bolster arguments against the tax.

Thus, repealing the federal estate tax could mean that many states would lose an important, progressive revenue source with which they support state services. This could occur at a time of significant cuts in federal funding for a wide range of state programs and services, leaving states unable to meet their responsibilities.

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[1] CBPP, "Repealing Estate Tax Would Provide Windfall to Heirs of Wealthiest Estates," April 20, 2017, http://www.cbpp.org/research/federal-tax/repealing-estate-tax-would-provide-windfall-to-heirs-of-wealthiest-estates.

[2] National Association of State Student Grant and Aid Programs, *46th Annual Survey Report on State-Sponsored Student Financial Aid, 2014-2015 Academic Year*, https://www.nassgap.org/viewrepository.aspx?categoryID=3#collapse_421.

[3] Institute on Taxation and Economic Policy, *Fairness Matters: A Chart Book on Who Pays State and Local Taxes*, January 26, 2017, http://itep.org/itep_reports/2017/01/fairness-matters-a-chart-book-on-who-pays-state-and-local-taxes.php#.WJjVplMrJaQ.

[4] Elizabeth McNichol, "Inequality Has Grown in all 50 States," CBPP, June 28, 2016, http://www.cbpp.org/blog/inequality-has-grown-in-all-50-states.

[5] See CBPP's Income Inequality series, http://www.cbpp.org/tags/income-inequality-series.