POLICY brief

Washington Research Council

PB 06-18 October 13, 2006

BRIEFLY

Estate taxes drive away wealthy citizens, with a negative impact on the state economy.

DEATH AND TAXES: I-920 GOES TO VOTERS

Initiative 920 on the November ballot would repeal Washington State's estate tax.

Until recently federal law allowed state estate taxes up to a certain level to be credited against an estate's federal tax obligation. Washington's estate tax was specified in law to be the maximum amount that qualified for credit. So specified, the tax imposed no incremental burden on Washington estates. Each dollar collected in Washington estate taxes was offset by a one dollar reduction in federal estate taxes.

When Congress rewrote federal estate tax law to eliminate the credit for state estate taxes, Washington State's estate tax automatically sunsetted. In 2005, the Washington legislature enacted a free-standing state estate tax, which I-920 now seeks to repeal.

Unlike the previous tax, the current Washington estate tax provides an incentive for wealthy citizens to move away from the state. This will reduce the tax's yield in the long run, as well as reducing the state's receipts of other taxes that the out-migrant's would have paid to the state. This out-migration will reduce the overall wealth of the state, with implications for the vitality and dynamism of the state's economy.

THE CURRENT WASHINGTON ESTATE TAX

Washington's current estate tax was enacted in 2005 (SB 6096). The tax features a 9-bracket schedule of marginal tax rates, as shown in Table 1. The first $2 million of estate value is exempt from taxation. The highest marginal rate, 19 percent, applies to amounts in excess of $11 million. These rates are levied against the taxable value of the estate as calculated for federal estate tax purposes, except that (1) the federal deduction for state estate taxes is ignored; (2) there is a deduction for certain farm property; and (3) an apportionment system is applied so as to shield property located out of state from the Washington tax.

THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT

The journey to I-920 began with the enactment on the federal level of the Economic Growth and Tax Relief Reconciliation Act in 2001, which made sweeping changes to a number of federal taxes. With respect to the federal estate tax, the Act set up both a phased decrease in estate tax rates and a phased increase in the unified credit (which effectively exempts estates below a certain value from taxation). In 2010 the federal estate tax completely disappears—for one year. Most provisions of the Act sunset, so in 2011 the federal estate tax will reappear with the rates and most

Washington Research Council
108 S Washington St., Suite 406
Seattle WA 98104-3408
206-467-7088
fax: 206-467-6957
www.researchcouncil.org

Table 1: Washington's Estate Tax

If the Value of the Estate is		The Amount of Tax Equals		
At Least	But Less Than	Initial Tax Amount	Plus this Rate Times	The Value Greater Than
$0	$2,000,000	$0	-	-
$2,000,000	$3,000,000	$0	10.0%	$2,000,000
$3,000,000	$4,000,000	$100,000	14.0%	$3,000,000
$4,000,000	$5,000,000	$240,000	15.0%	$4,000,000
$5,000,000	$6,000,000	$390,000	16.0%	$5,000,000
$6,000,000	$8,000,000	$550,000	17.0%	$6,000,000
$8,000,000	$9,000,000	$890,000	18.0%	$8,000,000
$9,000,000	$11,000,000	$1,070,000	18.5%	$9,000,000
Above $11,000,000		$1,440,000	19.0%	$11,000,000

Source: DOR

provisions that applied in 2001. (Some wags have dubbed 2010 the "throw Momma from the train year.")

The significant feature of the 2001 federal act for state estate and inheritance (E/I) taxation is the way the act changed the treatment state E/I taxes in the calculation of liability for the federal tax. Prior to the Act, estates received a credit against federal estate taxes for state E/I taxes paid, up to a maximum that depended on the value of the estate. Up to the maximum credit, state taxes reduced dollar for dollar the federal estate tax obligation and were effectively borne by the federal government rather than by the estate. A state estate tax whose schedule was set to equal the maximum credit available was called a "pick-up" or "soak-up" tax. In 2001 Washington, like most states, levied just a pick-up tax.

The Act phased out the federal credit for state E/I taxes, allowing instead a deduction for state taxes paid. At the 2006 federal estate tax rate—46 percent—each dollar of state tax paid by an estate reduces the federal tax by 46 cents and increases the total tax on the estate by 54 cents. State E/I taxes now "bite."

THE CREATION OF THE FEDERAL CREDIT TO CURB TAX COMPETITION

The modern federal estate tax was enacted in 1916, in the run-up to World War I. The credit for state taxes paid was added to the federal estate tax in 1924 and greatly expanded in 1926. Jeffry Cooper tells the story of the establishment of this credit in a Pepperdine Law Review article.

The period following the First World War was a time of vigorous "tax competition" between the states, with Florida a notably aggressive competitor:

> The State of Florida, in particular, endeavored to create a domestic 'tax haven' free from the evils of winter snowstorms, income taxation, and death taxation. Florida's efforts to attract wealthy citizens, as well as similar efforts in Alabama and Nevada, worried politicians elsewhere. In the age of automobiles, taxpayers were becoming increasingly mobile." (Cooper 2006, p. 383)

President Calvin Coolidge took a personal interest in the emerging tax competition between the states and in early 1924 issued a call for state leaders to devise a legislative solution to the problem. The Revenue Act of 1924 provided a measure of relief, in the form of a credit for state taxes paid up to 25 percent of the federal taxes due. In 1924 and 1925, state and federal officials convened with academic tax policy experts at three national conferences on inheritance and estate taxation. President Coolidge and Treasury Secretary Andrew Mellon attended the second of these conferences, which met in Washington D.C. The final convention, on November 10, 1925, endorsed a report calling for the federal credit for state taxes to be raised substantially. In February 1926, Congress accepted this recommendation and raised the maximum credit to 80 percent of the federal tax rates then in effect, ceding most of the revenue from the federal estate tax to the states—a most remarkable event.

In the years immediately following 1926, the competitive situation with respect to state estate taxes stabilized. Many states' existing E/I taxes failed to fully absorb the credit available against the federal tax, and most of these states revised their E/I taxes to pick-up the "free" revenue. Often the states added a pick-up tax in parallel to the existing idiosyncratic E/I taxes and required estates to pay the greater of the two levies. State E/I tax revenue increased from $80 million in 1924 to $120 million in 1930, growing at a much more rapid rate than other state tax revenues. Even Florida added a pick-up tax. Often the pick-up tax derived from the federal statute imposed a lesser burden on small estates and a greater burden on large estates than did the existing state E/I taxes. Thus, the increase in state E/I revenue was largely derived from increasing the taxes paid by bigger estates.

After 1970, a number of states reformed their E/I tax systems to eliminate all but the pick-up tax. A paper by Karen Conway and Jonathon Rork shows that the geographic pattern of these reforms can be explained by competition among states for high wealth individuals (Conway and Rork 2004).

Washington was one state that eliminated all but the pick-up tax in this period.

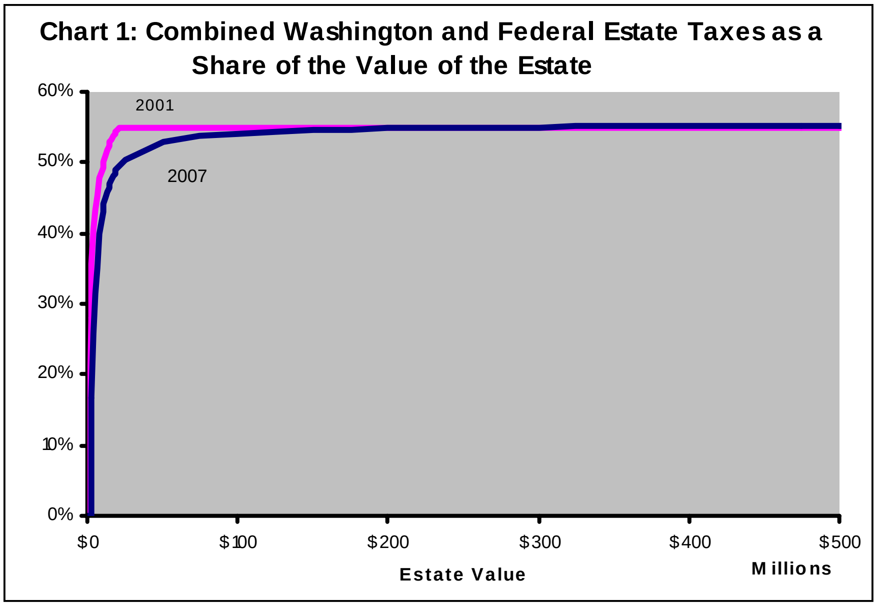
WASHINGTON

An inheritance tax was first imposed in Washington State in 1901, fully 15 years before the establishment of the modern federal estate tax. The state grafted a parallel pick-up tax onto the existing inheritance tax shortly after the introduction of the federal credit. A companion gift tax was imposed in 1941, at a rate equal to 90 percent of the inheritance tax. A major legislative reform of the state system occurred in 1979. Then in 1981, the people through initiative 402 repealed the idiosyncratic aspects of Washington's inheritance and gift taxes, leaving only a pick-up tax in place.

Some states with pick-up taxes simply specified in state law that their states' estate taxes were to be equal to the maximum amount creditable against the federal tax, whatever that might be. In those cases, the 2001 federal act effectively phased-out the state tax as it phased out the credit. The Washington Department of Revenue argued that the state's tax did not phase out with the federal credit. However, the Washington Supreme Court disagreed, unanimously, in Estate of Hemphill v. State (153 Wn.2d 544), announced on February 3, 2005.

In April 2005, acting at the request of Governor Chris Gregoire, both the House and the Senate passed SB 6096, which established a free standing Washington estate tax. Compared with the pick-up tax that preceded it, the new tax is more progressive, with a standard exemption of $2 million rather than $675,000 and a top marginal rate of 19 percent rather than 16 percent.

Chart 1 shows the average combined federal and Washington estate tax rates for 2001 and 2007. Estates with taxable values in excess of $300 million will actually pay a bit more tax overall in 2007 than they would have paid in 2001. This may seem surprising, given the cut in the top federal rate from 55 percent to 45 percent. The benefit of the lower federal rate, however, is more than offset by the shift from a credit to a deduction for tax paid to Washington State and the boost in the top state rate. The federal estate tax cut was somewhat of a shell game. Congress was able to claim a substantial cut in statutory estate tax rates; but the benefit to taxpayers (and the revenue loss to the federal government) was lessened significantly by the replacement of the credit for state E/I taxes with the deduction.



Revenue and Other Impacts

The state Department of Revenue currently estimates that the state will receive $222.5 million in estate tax revenues during the 2007–09 biennium. If I-920 passes, OFM estimates that $185 million of this will be lost. (The state would get some revenue in 2007–09 because of the 9-month lag between the date of death and the date that estate taxes are due.) This is a static estimate that assumes that the new estate tax regime will not change the number and value of estates subject to the Washington tax.

In the longer run, however, the revenue loss would be somewhat less than this current forecast suggests. A recent study by Jon Bakija and Joel Slemrod demonstrates that the number of federal estate tax returns filed from a state is sensitive to the effective E/I tax imposed by the state. Bakija and Slemrod explore a number of different statistical specifications. On average they find that a one percentage point increase in the average effective state E/I tax rate decreased the number of returns filed from the state by about 2 percent. The effect is bigger for larger valued estates. When they estimate the effects separately for estates worth more than $5 million, they find that a 1 percentage point increase in the effective E/I tax rate decreases the number of returns in the former category by 4 percent. In contrast, the number of returns worth less than $5 million decreases by 1.8 percent for each 1 percentage point increase in the effective tax rate.

Based on these coefficients, Bakija and Slemrod calculate that for a state E/I tax with the rate structure equal to that of the 2001 pick-up tax, the decrease in the number and value of returns would reduce revenue by about 13.5 percent from the static estimate. Rough calculations of the loss in other tax revenues as the result of migration from the state by wealthy residents increases the reduction in revenue to as high as 33 percent of the static estate tax revenue estimate.

The economic impacts would go well beyond these simple revenue calculations. Recall the way Florida sought, in the 1920s, to position itself as a haven for the wealthy. This was fundamentally an economic development strategy. Although the number of wealthy may be small, their spending will support a good number of local jobs. Perhaps more importantly, to the extent that the wealthy invest in the state, their wealth will make the state's economy more vital and dynamic. This effect is hard to measure, but it certainly exists.

Beyond the general impacts of wealth, there is the special burden of the estate tax on family-owned businesses. The problem of succession, the passing of a business from one generation to the next, is greatly complicated by the estate tax. Often, the need to pay these taxes, or even the anticipation of this need, forces families to sell out. This also hurts the vitality and dynamism of the state's economy.

Earmarking the Estate Tax for Education

Estate tax revenues go into the Education Legacy Trust Account, which also receives 42.9 cents per pack of the state cigarette tax. State law allows money from this account to be transferred into the Student Achievement Fund, or to fund new enrollments and financial aid at the state's colleges and universities or for "other educational improvement efforts." The Student Achievement Fund was established by Initiative 728. Its funds are to be used to support K-12 education. Besides transfers from the Education Legacy Trust Account, the Student Achievement Fund receives a portion of the state property tax, transfers from the State Lottery Account and transfers from the Emergency Reserve Account.

The bill establishing the Education Legacy Trust Account (ESHB 2314) also redirected some property tax revenue from the Student Achievement Fund to the general fund. In this way, the earmarking of the estate and cigarette taxes for education through the Education Legacy Trust Account was a bit of a sham. The addition of the estate and cigarette taxes ultimately increased spending capacity in the general fund.

The dedication of the estate tax proceeds to the Education Legacy Account continues the trend of recent years where revenues and spending programs that had run through the state's general fund have been moved to special accounts. We have regularly decried this practice as bad fiscal policy. As the National Conference of State Legislators (NCSL) observes: "For most fiscal analysts and budget experts, there is little, if anything, to be said in favor of earmarking taxes." Often, NCSL notes the real justification for earmarking is to secure public support for new or higher taxes. This certainly appears to be the case here. (WRC 1996, 2006; WashACE 2005; Perez and Snell 1995)

Discussion

The estate tax touches few Washingtonians directly. Some may be inclined to vote against I-920 (and to continue the tax) simply because they do not pay it. Others will base their decisions on how to vote on their perceptions of the "fairness" of the estate tax.

But the decision on the whether to continue Washington's estate tax is not simply about the distributions of either wealth or the tax burden. By eliminating the credit against the federal estate tax for state estate taxes, the Economic Growth and Tax Relief Reconciliation Act opened up the estate tax as a front in the ongoing tax competition among the states. Estate taxes drive away wealthy citizens, with a negative impact on the state economy.

And the situation may get worse in the future. Proposals circulating in Congress to further cut the federal estate tax rate call in addition for the elimination of the deduction of state E/I taxes for calculation of the federal estate tax. If this comes to pass, the incentive to migrate in order to avoid state estate taxes will nearly double.

References

Bakija, Jon and Joel Slemrod. 2004 "Do the Rich Flee from High Tax States? The Evidence from Federal Estate Tax Returns." National Bureau of Economic Research Working Paper No. 10645.

Conway, Karen Smith and Jonathan C. Rork. 2004. "Diagnosis Murder: The Death of State Death Taxes." Economic Inquiry Vol. 42, No. 4. 537-559.

Cooper, Jeffrey A. 2005-2006. "Interstate Competition and State Death Taxes: A Modern Crisis in Historical Perspective." Pepperdine Law Review. Vol. 33. pp 835-881.

Perez, Arturo and Ronald Snell. 1995. "Earmarking State Taxes." National Conference of State Legislatures. April.

Washington Alliance for a Competitive Economy (WashACE). 2005. "Wallowing in Sin Taxes." CB 05-05. March 21.

Washington Research Council. 1996. "Too Much Earmarking, Dedicating Funds." Special Report. July 31.

Washington Research Council. 2006. "Restoring the General Fund in 2007." Policy Brief 06-19. Forthcoming.