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Impact on States of Federal Estate Tax "Repeal"

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Surprisingly little response is being made by the 50 states and the District of Columbia to the devastating impact upon them of the Federal Government's socalled "repeal" of the Federal Estate Tax. Even more surprising is how few members of Congress seem to understand what Congress has done in this regard.

FEDERAL LEGISLATION

Everyone understands that the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act") (i) drops the maximum gross transfer tax rate from 55% to 45%, and increases the unified credit, or applicable exemption amount, for estate and generation skipping transfer ("GST), but not gift, tax purposes from $1 million to $3.5 million, on a back-loaded basis, through 2009; (ii) repeals the estate and GST tax, freezes the gift tax at 35% with a $1 million exemption, and eliminates basis step-up for inherited property in 2010; and then (iii) sunsets all of these provisions and restores the estate, gift and GST tax to their 2001 levels in 2011. Not everyone understands, however, that this was a tax *increase,* not a decrease, for the Federal government, and in turn a tax *increase* for many Americans; and that 100% of the burden of the Federal estate tax phase-out has been placed on the states. While state estate tax revenues decrease and then disappear (in the case of those states that limit their death tax to the amount of the credit for state death taxes (*i.e.,* a so-called "pick-up" tax), Federal estate tax revenues will actually *increase* over the

Relevant Rates

	Gross Federal Rate	Conforming Credit	Net Federal Rate	New Deduction	Frozen Credit	Frozen Pick-Up State
2001	55	-16	= 39	NA	+16	= 55
2002	50	-12	= 38	NA	+16	= 54
2003	9	-8	= 41	NA	+16	= 57
2004	48	-4	= 44	NA	+16	= 60
2005	47	-0	= 47	-7.52	+16	= 55.48
2006	46	-0	= 46	-7.36	+16	= 54.64
2007	45	-0	= 45	-7.20	+16	= 53.80
2008	45	-0	= 45	-7.20	+16	= 53.80
2009	45	-0	= 45	-7.20	+16	= 53.80
2010	0	-0	= 0	NA	+16	= 16
2011	55	-16	= 39	NA	+16	= 55

As the above chart demonstrates, the net Federal estate tax rate drops by only 1% in 2002, when the credit for state death taxes (and therefore the state estate tax rates of all pick-up states) drops by 4%. In every year from 2003 through 2009, the net Federal estate tax rate is higher than 2001 levels (by as much as 8% in 2005), while the Federal credit for state death taxes, and therefore many states' death taxes themselves, phases out to zero. By extension, total death taxes will rise for everyone who lives in a state whose pick-up tax is frozen at 2001 levels (although starting in 2005, this will be somewhat mitigated by a Federal deduction for state death taxes, which replaces the repealed credit).

next nine years until the scheduled "repeal" in 2010, as the net Federal estate tax rate will be *greater* than it was when it was enacted in every year but one.

EXISTING STATE LEGISLATION

Many states automatically incorporate Federal estate tax changes as they occur. Some states, such as New York, do not and are therefore required affirmatively to enact conforming legislation. As a result, the states' death tax systems divide themselves into roughly three categories: automatically conforming pick-up states; non-automatically conforming, or "frozen," pick-up states; and independent death tax states. From 1926 until 2001, the Federal credit for state death taxes served the important public policy of curtailing deathtime forum shopping by keeping the 50 (plus D.C.) states' death tax systems more or less compatible. With the repeal of the credit for state death taxes, 75 years of uniformity has been eradicated with a pen stroke. The states now face a "Sophie's Choice" between apparent immediate economic loss on the one hand (by conforming to the 2001 Act), and population (and therefore long-term economic) loss on the other hand (by freezing pre-2001 law). It will be virtually impossible for the states to make the same choice because of each state's individual circumstances. Consequently, both apparent options presented by allowing the 2001 Act to take effect as scheduled should, if possible, be rejected, and different choices should be made.

CONFORMING PICK-UP STATES

A significant portion of the pick-up states are conforming pick-up states, so that the Federal changes will take effect automatically and their state death tax will phase out over the next three years absent affirmative action on their part. These states face the politically unpalatable prospect of enacting death tax increases to stem revenue losses—either by freezing death taxes at 2001 levels or enacting an independent death tax. In some of these states, such as Florida, that would require a popular vote—a virtual impossibility to secure. Since those popular vote states will in all events remain conformed to the Federal repeal of the credit for state death taxes, there will be intense pressure on the remaining conforming pick-up states to stay conformed (although at least four states so far have affirmatively decoupled from the Federal credit for state death taxes by freezing their version of the Federal credit at 2001 rates; more states are considering doing the same; and Connecticut has suspended the pending phase-out of its independent death tax). Assuming that the Federal legislation remains in place in 2010, those states that do not have an income tax will be hardest hit, as they will not see increased income tax revenues from carry-over basis that year.

FROZEN PICK-UP STATES

The balance of the pick-up states are frozen pickup states, with the result that the Federal changes will not take effect and they will no longer be pick-up states absent affirmative action on their part. As a result, their death taxes will be in excess of those in many other states. In order to stem loss of population, loss of jobs and loss of social services provided by charities (as charities will lose funds as people leave), as well as to stem the long-term economic loss that these population losses entail, these states face the seemingly "suicidal" choice, as an alternative to doing nothing, of affirmatively conforming to the 2001 Act – which, if not amended, will reduce and then eliminate their death taxes in a time of growing budget deficits.

One might argue that conforming to the 2001 Act and incurring a short-term temporary economic loss is in any event preferable to not conforming to the 2001 Act and incurring a long-term, permanent economic loss. As a practical matter, however, most of these states will in fact have no choice but to conform voluntarily or else put their frozen pick-up death taxes at risk. Because these states are frozen pick-up states, even when their death tax exceeds the then current Federal credit for state death taxes, they will still charge a tax equal only to the pre-2001 Federal credit. That credit is a percentage of the "adjusted taxable estate," which does not include adjusted taxable gifts. Thus, in those frozen pick-up states that do not have a gift tax, it will become standard operating procedure to make large deathbed gifts, either by a competent terminally ill person, or by an incompetent terminally ill person's attorney-in-fact pursuant to a power of attorney that authorizes gifts. The Federal gift tax so triggered will be no more than the estate tax in the absence of the gift (and less if the donor survives the gift by 3 years). There will be no state gift tax in most states, however, and the state death tax will be avoided in its entirety on the property so gifted. While a basis step up would be lost for the gifted property, either high basis property could be gifted, or one could borrow against low basis property and gift cash. The only way to avoid taxpayer self-help would be to adopt an independent estate or inheritance tax at the same time as the Federal government is "repealing" the Federal estate tax—a political nightmare. Thus, those frozen pick-up states that have no gift tax will lose revenues anyway, whether from population loss or from selfhelp. Those few such states that have a gift tax will in all events force their affluent residents to leave if they do not affirmatively conform to the 2001 Act.

INDEPENDENT DEATH TAX STATES

Those nine or so states that still have not repealed, or scheduled a repeal of, their independent death taxes will not have to worry about raising their death taxes to stem revenue losses, since the phase-out of the credit for state death taxes will generally affect them only in those cases where the pre-2001 credit would have been more than their independent death tax. They will, however, have to worry about becoming even less competitive than they already are for retaining affluent taxpayers and driving everyone of means out of their states due to the dramatically escalating disparity between their state death taxes and those in conforming pick-up states, *i.e.,* zero by the year 2005.

SHORT-TERM SOLUTION

There is one obvious short-term solution. Since the conforming pick-up states will lose revenues automatically and the frozen pick-up states will lose revenues through self-help and population exodus, the frozen pick-up states (and perhaps even the independent death tax states) should consider conforming to the 2001 Act with a December 31, 2004 sunset. In this manner, such states will not risk unnecessary population and revenue loss pending corrective legislation. And as a safety net, in the event that the problem is not legislatively addressed on a permanent basis, at either the Federal or the state level, these states will not have prejudiced themselves, as their 2001 level of death tax will be automatically reinstated in 2005.

PERMANENT SOLUTION

There are two possible permanent solutions: Federal reform and model state death tax legislation.

Federal Reform

Federal reform, if possible, is the obvious and only realistic choice. A Federal change carelessly created this problem for the first time in 75 years – as Federal legislation carefully cured this problem in 1926 – and another Federal change can most easily cure it. Obviously, when the Federal surplus is disappearing and the Federal government is hoping to find ways to enact further tax cuts to stimulate the economy (perhaps also at state expense), it might seem to be a hard time to ask the Federal government to reduce its own tax revenues. In this case, however, the Federal government would not be giving up (or, more properly, returning) revenues it currently enjoys. In fact, its revenues are scheduled to drop by 1% in 2002. Rather, the Federal government would simply be asked to forego an increase, currently scheduled to begin in 2003 (so that increased revenues would not otherwise begin to appear until 2004 or 2005), which it does not now enjoy and has never enjoyed. Given that the 2001 Act created a new unified credit that is not unified, taxes that disappear then reappear, and a tax incentive to hoard wealth (with all of the attendant, adverse social consequences that this entails), it is clear that the 2001 Act requires amendment in any event. When it has been amended, the fundamental policy of state revenue sharing should be restored, and the devastating social and economic harm that threatens the states and their residents can be readily averted.

Model State Death Tax Legislation

This is a solution of last resort. If for any reason it should evolve that the 2001 Act is not fixed, starting in 2005, a Federal deduction for state death taxes is created (and then repealed for 2010 and 2011). Temporary legislation could be enacted to cover this five-year period whereby the states would enact a uniform death tax, which would be partially offset by a Federal deduction. While uniform state legislation is hard enough to enact as it is, it will be even harder in this case, since in some states it would require a popular vote and in any event the need for it appears to be temporary. But at least the states would have three years to work on this solution if the Federal solution fails.

POLITICAL CONCERNS

A Federal cure would not necessitate a political about-face on the part of the Administration. The 2001 Act repeals estate taxes for only 365 days and then restores them to 2001 rates. A restoration of the credit for state death taxes coupled with a $3 to $5 million unified credit against a 55% Federal rate could be heralded as a "permanent" repeal of the estate tax for 99.9% of all Americans. A 50% maximum Federal rate, if affordable, could be billed as a substantial reduction for the remaining . 1% of Americans. Since (i) the 2001 Act created the problem, (ii) the 2001 Act is flawed because among other things, it causes death taxes for its citizens who live in frozen pick-up states to go up, not down as advertised, (iii) no current Federal revenues would be lost to cure the problem, (iv) the cure would be consistent with the stated purpose of the 2001 Act (*i.e.,* true repeal of the estate tax for most Americans), (v) the cure would prevent the potential bankruptcy of several states, whose death taxes represent a significant portion of total revenues, posed solely by the enactment of the 2001 Act, and (vi) nearly all modern nations employ a death tax on transfers in excess of an exempt amount in order to foster important economic, political and social objectives, it seems obvious that all possible efforts should be focused on Washington.

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