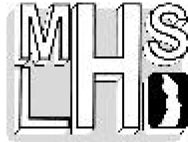
Michigan League for Human Services



November 2003

Decoupling From the Federal Estate Tax Phase-out

In June 2001, just as Michigan was experiencing its first revenue decline in eight years due to a slowing economy and large multi-year Personal Income and Single Business Tax reductions, Congress adopted and the President signed legislation designed to reduce federal estate taxes over time with full repeal scheduled for calendar year 2010. The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 specified a gradual increase in the minimum size of a taxable estate and a gradual decline in the maximum tax rate over a nine year period while phasing out the tax credit that distributes approximately 20 percent of related revenues to the states on an accelerated four year schedule as follows:

Calendar Year	Estate Tax Filing Threshold	Highest Estate & Gift Tax Rate	State Credit Percentage
2001 (Base year)	$675,000	60%	100%
2002	$1,000,000	50%	75%
2003	$1,000,000	49%	50%
2004	$1,500,000	48%	25%
2005	$1,500,000	47%	0%
2006	$2,000,000	46%	
2007	$2,000,000	45%	
2008	$2,000,000	45%	
2009	$3,500,000	45%	
2010	Tax repealed	35% (Gift Tax only)	

When fully implemented in 2010, the Congressional Budget Office estimates that approximately $50 billion in related federal revenues will be foregone. If no additional federal legislation regarding the estate tax is adopted in the interim, however, EGTRRA will sunset in 2011 and the federal tax code will revert back to provisions in place in 2001. If the estate tax is ultimately repealed it will be the first time since its institution in 1916 that the United States choose not to tax the estates of its wealthiest citizens.

Who Pays the Estate Tax?

Since its inception in 1916 the federal estate tax has been levied on a relatively limited number of high value estates. Through the end of World War II this equated to approximately 1 percent of the estates settled in a given year. Beginning in 1946, with the national debt of the United Sates exceeding its annual Gross Domestic Product due to the tremendous costs of the war, the percentage of taxed estates grew steadily, peaking in 1976 at 7.6 percent (approximately 140,000 estates). Tax reforms instituted in 1977 increased the filing threshold in increments from the $60,000 established in 1943 to $500,000 in 1986, and resulted in a rapid decline in the percentage of estates subject to taxation. From the early 1980s

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through 2001 the percentage of estates subject to the tax ranged from approximately 1 percent to 2 percent.

Of those having a liability under the estate tax code in place in 2001, virtually all had incomes in the top 20 percent of U. S. households with 96 percent of the taxes paid by households in the top 10 percent.

Revenue Implications of Decoupling From the Federal Estate Tax Phase-out

Because the estate/inheritance tax codes of most states are directly tied to the federal tax code, unless those states choose to partially or fully decouple from the provisions of EGTRRA, they will experience a rapid decline in estate tax revenues culminating with their complete elimination. To date eighteen states and the District of Columbia have chosen to fully or partially decouple, and several others are actively considering this option. In Michigan, legislation has been drafted that would partially decouple Michigan's Estate Tax from the provisions of EGTRRA. The following table, developed by the League based on October 2003 Consensus Revenue Forecasting Conference estimates of FY2003 and FY2004 revenue losses due to the phase-out of the Federal Estate Tax, reflects the annual estate tax revenues that Michigan could preserve if such action were taken.

Revenues (in millions)	**FY2004** (9 months)	**FY2005**	**FY2006**	**FY2007**
Fully Decouple	$98	$177	$225	$236
Partially Decouple	$78	$141	$180	$189

The League's revenue estimate assumes, in the case of partial decoupling, that Michigan would adopt the phased increase in the filing threshold (the minimum value of an estate subject to the tax) to $3.5 million for an individual and $7 million for a couple reflected in current federal law. This would have the effect of reducing the percentage of Michigan estates with a tax liability from less than 2 percent to approximately 0.5 percent while preserving approximately 80 percent of the revenues collectable under the estate tax provisions in place in FY2001. Alternatively, increasing the threshold to $2 million for an individual and $4 million for a couple would decrease taxable estates to approximately 1 percent of the annual total and preserve approximately 90 percent of the revenues collectible under the FY2001 federal tax code.

A review of recent state and federal wealth and demographic trends suggests that the values cited above are likely to grow rapidly over the next two decades as the "baby boom" generation matures. During the 1990s, for example, Internal Revenue Service statistics indicate that the incomes of the top 20 percent of U.S. households grew by 38 percent. It also appears that recent declines in revenues associated with Michigan's estate tax may be counter to underlying growth patterns. In the FY2002 Comprehensive Annual Financial Report (CAFR) published by the Michigan Department of Management and Budget, for example, it is reported that estate taxes declined by nearly 30 percent from $185.5 million in FY2000 to $131 million in FY2002 while longer term trends suggest significant growth. This variability in Michigan's estate tax revenues is likely the result of the relatively small number and the wide range in value of estates subject to the tax in a given year. In support of this premise, a March 2001 report on federal and state tax trends published by the Michigan Senate Fiscal Agency notes that Michigan's estate tax revenues have had many significant peaks and valleys from 1978 to 1999 while the trend in federal collections has been consistently and significantly upward. Over this twenty-two year period federal estate tax collections rose by 525 percent from $5.285 billion to $27.782 billion. Adjusting for inflation, this represents revenue growth of approximately 250 percent over an extended period, equivalent to real grow of over 4 percent per year.

In its research on this subject, the Center on Budget and Policy Priorities, a Washington D.C. budget and tax policy think-tank, indicated that the elimination of the federal estate tax could result in the loss of over $9 billion annually to the states by 2010. This estimate appears consistent with a return to the growth patterns cited above after adjusting for the most recent economic downturn, and suggests that Michigan could be foregoing over $300 million in annual revenues by 2010 if it fails to decouple from the federal Estate Tax phase-out.

The Effect of Estate Taxes on Small Family Owned Business and Farms

A prominent argument advanced by opponents of the estate tax is that it adversely affects the economy by forcing heirs of family owned businesses and farms to liquidate these assets to cover the resulting tax liability. As a report by the Center on Budget and Policy Priorities notes, however, family-owned businesses and farms made up the majority of an estates' value in less than two percent of estates having a tax liability under the rules in place in 2001. As the exemption is increased to $3.5 million for an individual and $7 million for a couple, the percentage of family-owned enterprises subject to estate taxes is expected to fall significantly. In the case of family farms, the U.S. Department of Agriculture's Economic Research Service projects that less than one percent of all farm estates will be subject to taxation.

To help relieve the burden on the relatively few family-owned businesses and farms that would continue to be subject to the estate, special rules regarding the valuation of property for tax purposes have significantly reduce the estate tax liability. In an effort further mitigate the impact on family businesses, estates in which the family enterprise composes at least thirty-five percent of its value are permitted to defer taxes for up to fourteen years. To the extent that additional problems regarding the taxation of small family-owned business are identified, targeted tax code amendments could be instituted to address the issue. The wholesale repeal of the estate tax in an effort to address potential problems associated with a limited and declining number of estates which have benefited from significant efforts to address such problems in the past, appears of questionable merit.

The Effects of the Repeal of the Federal Estate Tax on Charitable Giving

A recently published study by Brookings Institute economists Jon Bakija and William Gale indicates that the existence of an estate tax provides a strong incentive for tax deductible charitable giving and that its repeal could result in the loss of as much as $10 billion in annual contributions. They note that this equates to approximately 60 percent of annual bequests to charitable organizations and is roughly equivalent to the annual grants made by the largest 100 foundations in the United States. The report also indicates that repeal of the estate tax can be expected to significantly reduce charitable gifts from wealthy individuals during their lifetimes since there would be no incentive to reduce the size of an estate to limit the tax burden of heirs. Retaining the estate tax, even if the threshold on the value of taxable estates is raised and/or indexed to inflation, would preserve an important incentive for wealthy individuals, both during their lifetime and in their estate planning, to continue to make the contributions which charities have assumed would be available as they determined their missions and built their service delivery structures.

Summary and Conclusion

Since FY2001 Michigan has experienced a severe and persistent fiscal crisis, resulting in the depletion of over $2 billion in Budget Stabilization, Medicaid Trust Fund, and School Aid reserves and approximately $2 billion in state program reductions. It now appears that the FY2004 budget adopted in July has a $1 billion structural shortfall due to declining revenues and increasing Medicaid costs,

and that the FY2005 structural deficit will exceed $1.4 billion. While the loss of approximately $275 million in estate tax revenues over this two-year period is only an incremental contributor to these dramatic deficits, it represents a significant loss of revenues currently funding already reduced state programs. As eighteen states to date have demonstrated, decoupling from the federal estate tax phase-out is a relatively straight-forward means of preserving a portion of those General Fund revenues. Absent action that would ***retain*** a tax on only the very wealthiest of Michigan's estates, the state will be forced to further reduce programs and services, such as revenue sharing to local units of government that supports critical services such as local police and fire protection, and a variety of health, education, and other programs intended to protect and aid low and moderate-income families and individuals.

Bill Gates Senior, the father of perhaps the wealthiest American and a strong advocate for the restoration of the federal estate tax, suggests that it should be viewed as an opportunity cost – a contribution by those who have benefited most from a free and stable society for the maintenance and improvement of its institutions and infrastructure, and for the provision of important services to all of its citizens – so that they too can become full and strong participants in a society that purports to value merit and initiative over wealth and privilege. Mr. Gates also notes, given the large and growing federal deficit, that a decrease in taxes on the wealthiest 2 percent of American families is effectively a tax shift to the other 98 percent of families and their heirs.

Equally compelling is the observation noted above that the elimination of the federal estate tax could result in a decline in tax deductible contributions to charities and other non-profit organizations of approximately $10 billion annually. At a time when more is being asked of these organizations, it appears inconsistent to change the federal tax code in a manner that will profoundly reduce their ability to maintain the scope and effectiveness of critical services, let alone expand them.

As several studies on the subject note, since estates are not subject to capital gains, the elimination of the federal Estate Tax would permit the appreciation of inherited assets to escape taxation altogether. This appears particularly troubling given census data indicating that by 2000 the wealthiest 1 percent of families in the United States owned over 40 percent of the nation's private assets, up from approximately 20 percent in 1976. This data also suggests that the Estate Tax, which was intended to help limit the accumulation of a disproportionate share of the nation's wealth in the hands of a few in an effort to limit undue political and societal influence, has not succeeded. Its elimination, however, would only make a bad situation worse.

These important considerations, together with the state and federal fiscal crises which will be exacerbated if the Estate Tax is permanently eliminated, suggest that policy makers and the public should carefully consider the implications and impacts of this significant tax policy decision before making a final determination on its retention or elimination. ■

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