

MONEY MATTERS...\$...\$...\$

FOR KIDS, FOR COMMUNITIES, FOR KENTUCKY

EXECUTIVE SUMMARY HOW TO HELP BALANCE THE BUDGET: KEEP KENTUCKY'S ESTATE TAX

What's an "Estate Tax"?

- An estate tax is a tax paid on the value of property (real and personal) left upon a person's death.
- It is pejoratively called a "death tax" because it is typically paid after a person dies.
- What is less well-known, though, is that estate taxes only fall upon two percent of all estates.
- An estate tax is different from an inheritance tax. An inheritance tax is paid by the beneficiary. An estate tax is paid by the estate (before it is passed to a beneficiary). KY has both taxes.

What's the Problem?

- Kentucky will lose more than \$160 million in estate tax revenue over the next five years due to the federal tax cut of 2001.
- Here is why:
 - Congress is phasing out the federal estate tax;
 - Kentucky's estate tax is tied to the federal estate tax;
 - As a result, Kentucky's estate tax is being eliminated along with the federal estate tax.
- Every other state faces the same problem.
- Several states have already "decoupled" (i.e., eliminated the connection between the state estate tax and the federal estate tax).
- States could lose up to \$9 billion annually in estate tax revenues if they do not decouple. (OSBD)

Who Pays Estate Taxes?

- Only a few, very large estates pay estate taxes (either federal or state).
- Only people who have estates valued at greater than \$1 million pay estate taxes—federal or state.

What Should Kentucky Do?

- To avoid losing tens of millions in annual tax revenue, Kentucky's Legislature must pass legislation decoupling Kentucky's estate tax from the federal estate tax.
- It must also establish a separate estate tax closely mirroring pre-2001 law.



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FOR KIDS, FOR COMMUNITIES, FOR KENTUCKY

A Fiscal and Budget Policy
Research Brief

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Special points of interest:

- Due to federal tax cuts in 2001, Kentucky will lose estate tax revenues, costing the state millions of dollars a year.
- Only about two percent of decedents, or those with estates valued at more than \$1 million, owe estate taxes.
- Kentucky should “decouple” from the federal estate tax, saving millions of dollars, and maintain its own progressive estate tax.



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HOW TO HELP BALANCE THE BUDGET: KEEP KENTUCKY'S ESTATE TAX

Kentucky is losing tens of millions of dollars annually due to a 2001 federal estate tax law change. Fortunately, Kentucky can stop this revenue loss by enacting simple legislation. The result would be a smaller budget shortfall and a more stable revenue base.

FEDERAL TAX CUTS OF 2001

Sweeping tax changes passed by Congress in 2001, titled Economic Growth and Tax Relief Reconciliation Act (EGTRAA), affected Kentucky's (and every other state's) estate tax (Endnote 1). Specifically, the federal legislation set in motion the repeal of the federal estate tax by 2010, but also eliminated every state's estate tax. Here's how.

When Congress created the federal estate tax in 1916 it allowed states to “pick-up”, or retain, a portion of the federal estate tax as state tax revenue. Every state did so (Endnote 2). Repeal of the federal estate tax, however, means the demise of the state pick-up tax and state estate tax revenues. Here's why.

The pick-up tax allows a state to retain a portion of a decedent's (i.e., deceased person's) federal estate tax bill. For example, assume that Har-

riet passes away and has a \$1,000,000 federal estate tax liability and a \$160,000 state estate tax. Her federal estate tax bill, therefore, would be reduced (i.e., credited) by \$160,000, or the amount of state estate taxes paid. The final tally would be a federal estate tax bill of \$840,000 and a state estate tax bill of \$160,000. Combined federal and state estate taxes would be \$1,000,000.

What makes the pick-up tax so attractive, and why every state enacted such a tax, is the fact that a decedent's total estate tax bill does not go up with the state pick-up tax. Any estate tax paid to the state (to a point) is subtracted from the federal estate tax bill. Because every state chose to

What is an “estate” tax?

An estate tax is a tax levied upon the value of assets (real and personal property) that an individual leaves behind at death. Estate taxes are typically based upon the value of real property (e.g., houses and cars), intangible assets (e.g., stocks and bonds), and life insurance policies.

Most people will never pay federal or state estate taxes, though. In 2002, the first \$1 million of assets are excluded from taxation. This means that only about two percent of the estates left behind each year will pay the estate tax.

“Unless state legislative changes are made, by 2005 all state estate tax revenues will be gone.”

“pick up” a portion of the federal estate tax, the elimination of the federal estate tax under the 2001 federal law change means the eventual elimination of state estate taxes as well.

More pressing for Kentucky and every other state, though, is the fact that Congress is more quickly phasing out the state “pick up” tax. By 2005, five years before the federal estate tax is eliminated, the pick up tax is eliminated. As a result, states that continue to rely on the pick up tax to determine their estate tax revenues will experience declining revenues beginning in 2002. Unless state legislative changes are made, by 2005 all state estate tax revenues will be gone, even before the federal estate tax is repealed. To understand these implications it is necessary to first explain who pays estate taxes and how the 2001 federal tax changes directly affect Kentucky.

WHO PAYS ESTATE TAX:

The federal estate tax is a progressive tax placed upon very few, but very large estates. Most estates will never pay the federal estate tax. In fact, only about two percent of estates left behind pay the estate tax (Endnote 5). The reason: only estates valued above \$675,000 in 2001 (and increasing to \$3.5 million through 2009) are taxed. This high tax threshold means fewer and fewer people will owe any estate taxes—federal or state. (See Table

Year	Value Exempt from Estate Tax
2001	\$675,000
2002	\$1,000,000
2003	\$1,000,000
2004	\$1,500,000
2005	\$1,500,000
2006	\$2,000,000
2007	\$2,000,000
2008	\$2,000,000
2009	\$3,500,000
2010	Fed. Estate Tax Repealed
2011	\$1,000,000

1.)

Who pays the federal estate tax? Nearly all (federal and state) estate taxes are paid from the estates of persons who have the highest incomes (Endnote 6). According to research, persons whose income is in the top twenty percent of all people pay 99.2 percent of the federal estate tax (Endnote 7).

Who pays state estate taxes? In Kentucky in 2000, 1,129 estate taxes were filed with \$2.1 billion in gross estate value (average value of \$1.9 million). After adjusting for credits, the total estate tax collected (federal and state) was \$259 million (average value of \$440,000). State tax credits (i.e., state estate tax revenue) totaled \$62 million (average of \$95,000). The average state estate tax to gross estate value, therefore, was about 5

Return of the Federal Estate Tax in 2011

As if the elimination of state estate tax revenues was not confusing enough, the 2001 federal tax changes included another curveball. Due to a quirky legislative rule, the federal estate tax will return to its original pre-tax change form in 2011 (Endnote 3). While that quirk explains the basis for debate over making the tax changes permanent, the discussion of this paper rests solely on the federal estate tax change and how it affects Kentucky. (Endnote 4)

percent (Endnote 8). (All figures are estimates based upon a sample.)

IMPLICATIONS FOR KENTUCKY

The federal tax changes implemented in 2001 affect Kentucky in three ways.

First, the estate value exempt from taxation increases from \$675,000 in 2001 to \$3.5 million in 2009. This means that any estate valued below these amounts for those respective years will not incur any federal or state estate tax. As a result, fewer and fewer estates will owe federal or state estate taxes.

The second important change is a reduction in the top marginal tax rate from 55 percent to 45 percent. Because the tax rates are being lowered, federal and state estate tax revenues will fall. This happens because the tax owed by a decedent decreases as the top tax rate falls (Endnote 9).

The third change will have the greatest effect on Kentucky—repeal of the pick up tax. Prior to the 2001 federal changes, states (including Kentucky) could assess a state estate tax, up to a point, that would be credited against the federal estate tax on a dollar-for-dollar basis. States could collect an estate tax, therefore, without raising the total amount of taxes owed.

The 2001 federal tax changes completely repeal the state tax credit by 2005. As a result, many states, including Kentucky, will lose millions of dollars in annual tax revenue. In 2003, expected revenue losses total \$15 million. Over the five year period, 2003-2007, the total revenue loss is projected at \$168 million (Endnote 10). (See **Table 2**,

Table 2
Estimated Estate Tax Revenue Loss to Kentucky

Fiscal Year	Amount (in millions)
2003	\$15.0
2004	\$25.0
2005	\$35.0
2006	\$45.0
2007	\$47.7
FY03-07 Total	\$167.7

Source: "Kentucky Could Avoid Losing Millions in State Revenue By Retaining its Estate Tax Despite Federal Repeal." Center on Budget and Policy Priorities. 2002.

“Estimated Estate Tax Revenue Loss to Kentucky.”)

KENTUCKY’S INHERITANCE TAX: AN EXCEPTION TO THE RULE

Kentucky also has an inheritance tax. The 2001 federal tax changes effect this tax as well. Here’s how.

If an inheritance tax is owed to the Commonwealth, the amount of that tax is subtracted from the Kentucky estate tax owed to determine the estate tax owed. If no estate taxes are owed because of the 2001 federal law changes, the amount of inheritance taxes paid will rise.

Sound confusing? It’s really not. But it does require some additional explanation. First, here are the details behind the inheritance tax.

An inheritance tax is assessed upon the beneficiaries of an estate. The closer the relationship between the deceased and the beneficiary the lower the inheritance tax rate.

Three beneficiary categories are provided by Kentucky law. Class A

Between 2003-2007, Kentucky stands to lose \$168 million in state estate tax revenues because of the 2001 federal law change.

In addition to the estate tax, Kentucky assesses an inheritance tax, but only on wealth transfers to people who are not part of the decedent's immediate family.

beneficiaries include: spouse, child, grandchild, brother, or sister. Transfers to any of these individuals are tax-free.

Class B beneficiaries include: niece, nephew, daughter- or son-in law, aunt, uncle, or great grandchild. These beneficiaries pay a graduated tax based upon the value of their inheritance. That is, the greater their inheritance, the more taxes they owe.

Class C beneficiaries are the most distant to the deceased. They include anyone not categorized under Class A or B. They too pay a graduated tax, though, slightly higher than the one paid by Class B beneficiaries.

Here are two examples of how the inheritance and estate tax work together in Kentucky.

For the first example, assume that Gretel passed away in 2002 and left a \$5 million taxable estate to her brother, Hansel. In this case, no inheritance tax would be owed since the transfer was to her brother—a Class A beneficiary who is exempted from the Kentucky inheritance tax. Gretel's estate, however, would pay both a federal and a state estate tax.

Now, let's assume that Gretel passes away and leaves her entire estate to her niece, Cinderella. In this situation, Cinderella would owe Kentucky inheritance taxes and Gretel's estate would owe federal estate taxes, but not a state estate tax. This is why.

Gretel's beneficiary, her niece, falls under the Class B category. As a result, her niece's inheritance is taxable in Kentucky. Using the tax table pro-

vided by the Kentucky Revenue Cabinet ("A Guide to Kentucky Inheritance and Estate Taxes"), we calculate Cinderella's inheritance tax to be \$899,000.

What about Gretel's estate tax? Given that Gretel's estate is greater than the \$1 million exemption amount, Gretel's estate will owe a federal estate tax of \$2.3 million, before any state estate tax credits are applied.

Why would the state estate tax be zero then? Because the inheritance tax is subtracted from the state estate tax bill. In this case, Gretel's estate would owe no Kentucky estate tax because the inheritance tax (\$899,000) is greater than the calculated Kentucky estate tax (\$273,000). Or, think of it as \$273,000 - \$899,000 is less than zero, so the tax is zero.

What's an "inheritance tax"?

An inheritance tax is a tax upon the value of assets transferred to a beneficiary. For example, if George passes away and leaves everything to Betty, Betty is the beneficiary and owes an inheritance tax (NOTE: Betty only owes an inheritance tax in Kentucky if she is NOT George's spouse, child, grandchild, brother, or sister.)

The difference between an "estate" tax and an "inheritance" tax is that the former is paid from the value of assets left by a deceased person, while the latter is directly paid by the beneficiary. The distinction is small, but consider the following example. If your employer paid you a salary *after* withholding taxes, that would look a lot like an estate tax (taxes are paid before reaching a beneficiary). If your employer paid you a salary *before* withholding taxes and you paid the taxes directly from your salary, that is similar to how an inheritance tax operates.

If, however, the inheritance tax had been less than the state estate tax, Gretel's estate would have owed a Kentucky estate tax as well as an inheritance tax. Let's assume, for instance, that the numbers were reversed. That is, the inheritance tax was \$273,000 and the state estate tax liability was \$899,000. In that event, the amount of inheritance taxes paid would not exceed the Kentucky estate tax bill. As a result, Gretel's estate would owe Kentucky estate taxes. The exact amount is calculated by subtracting the inheritance taxes from the state estate tax. The Kentucky estate tax bill, therefore, would be \$626,000, (\$899,000 - \$273,000).

To summarize: Kentucky's estate tax is determined by subtracting any inheritance tax owed from the state estate tax owed. The amount by which the state estate tax exceeds the inheritance tax is the amount of state estate taxes owed.

WHAT OTHER STATES ARE DOING

After Congress enacted legislation to repeal the federal estate tax, many states took action to limit their revenue losses. Eleven states decoupled from the federal estate tax and five others plus the District of Columbia did not take action to conform to the federal estate tax changes (Endnote 11).

"Decoupling" means that states have changed their laws so their state estate tax revenues are no longer based upon the pick up tax. By removing the link between the pick up tax and individual state estate taxes those sixteen states and the District of Columbia avoided significant revenue losses.

WOULD WEALTHY PEOPLE OWE MORE?

Residents of states that decouple from federal estate tax could realize lower state estate tax bills (Endnote 12). This occurs because the 2001 federal tax changes raised the amount exempt from taxation from \$675,000 to \$3.5 million (\$7 million for couples) and lowers the top marginal tax rates, from 55 percent to 45 percent. According to the Center on Budget and Policy Priorities, in 2003, only estates valued at more than \$29 million (less than one in 5,000) will pay more in total federal and state estate taxes than they would have under prior law, even if the state decouples from the federal changes (Endnote 13). In 1999, only 467 taxable estates exceeded \$20 million in the United States.

WHAT KENTUCKY SHOULD DO

Given the severe revenue shortfall that plagues Kentucky, stopping the loss of estate tax revenues is prudent and necessary. After all, Kentucky did not elect to repeal its state estate tax. Congress did that for us. And they did so without heeding warning signs that states' fiscal situations were rapidly deteriorating.

Kentucky's Legislature should promptly pass legislation that decouples Kentucky's estate tax from the federal estate tax. Delay or inaction will cost the state tens of millions dollars in lost revenue. Enacting legislation based upon pre-2001 federal law will have little to no effect on Kentucky residents.

Kentucky should "decouple" from the federal estate tax, saving millions of dollars annually, and maintain its own revenue neutral progressive estate tax.

ENDNOTES

1. Estate taxes are typically referred to as “wealth taxes” or what is pejoratively referred to as “death taxes.” Wealth taxes go back to 1797 in the United States.
2. Federation of Tax Administrators. “State Responses to Estate Tax Changes Enacted as Part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).” October 28, 2002.
3. Friedman, Joel and Andrew Lee. “Permanent Repeal of Estate Tax Would Be Costly, Yet Would Benefit Only a Few, Very Large Estates.” Center on Budget and Policy Priorities. June 3, 2002.
4. Although the federal estate tax could reappear in 2011 in its pre-EGTRRA form, it is still vitally important that Kentucky act now to eliminate the connection between its estate tax and the federal government’s. Here’s why. State estate tax revenues begin to decline in 2002 and are completely gone by 2005 if Kentucky remains tied to the federal estate tax. Even assuming that the federal estate tax comes back in 2011, to not act now would mean that Kentucky would lose more than \$100 million in estate tax revenues between 2002, when the pick up tax starts being phased out and 2011, when the federal estate tax re-emerges.
5. Tenny, Daniel “Combined Federal and State Estate Taxes Will Decline For the Vast Majority of Estates Even When A State Decouples from the Federal Estate Tax Cut.” Center on Budget and Policy Priorities. June 28, 2002.
6. Ibid.
7. Burman, Leonard E. and William G. Gale. “The Estate Tax Is Down, But Not Out.” The Urban Institute. No. 2. September 2001. Based upon “family economic income”, a broad-based income concept developed by the Treasury Department and used since the 1980’s.
8. IRS, Statistics of Income Bulletin. Publication 1136. Spring 2002
9. Recall that the state estate tax is based upon the federal estate. As a result, if the federal estate tax bill is lowered, so too will the state estate tax.
10. McNichol, Elizabeth C. , Iris Lav, and Daniel Tenny. “Kentucky Could Avoid Losing Millions in State Revenue by Retaining its Estate Tax Despite Federal Repeal.” January 31, 2002.
11. McNichol, Elizabeth C. “Many States are Decoupling from the Federal Estate Tax Cut.” Center on Budget and Policy Priorities. October 2, 2002.
12. Tenny, Daniel “Combined Federal and State Estate Taxes Will Decline For the Vast Majority of Estates Even When A State Decouples from the Federal Estate Tax Cut.” Center on Budget and Policy Priorities. June 28, 2002.
13. Ibid.

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