Arkansas Advocates for Children & Families
State Fiscal Analysis Initiative

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PAYCHECK$ and POLITICS

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SUMMARY

In May 2001, Judge Collins Kilgore issued a historic ruling in the *Lake View School District* case – the state's current school-funding formula is unfair to poorer school districts and provides inadequate funding for education. The case is expected to have major implications for education funding, other programs serving children and families, and tax equity and fairness.

This brief from the Arkansas State Fiscal Analysis Initiative (SFAI) is the sixth in a series devoted to *Lake View*. It examines the impact of recent federal changes on the Arkansas estate tax and the potential impacts on funding for education. Upcoming briefs will examine lotteries, early childhood financing and low-income tax issues. Major findings of this study include:

- Because of its link to the federal estate tax, the Arkansas estate tax may be gradually phased out over the next three years and cease to exist by 2005.
- The state revenue loss from the elimination of the federal estate tax will be $55 million over the next four years ($4.7 million in 2003 and gradually increasing to $23.4 million in 2006).
- Elimination of the Arkansas estate tax would make the state and local tax system even more regressive and unfair to low- and middle-income families.
- Arkansas could save its estate tax by "decoupling" or not conforming to changes in the federal estate tax. Sixteen states are currently decoupled from the federal estate tax.

The Slow Death of the Arkansas Estate Tax

Does Eliminating the Estate Tax Mean Less Money for Education?

By Richard Huddleston

Unknown to many Arkansans, last year's decision by Congress to gradually repeal the federal estate tax could further harm the state's efforts to reform public education and provide essential services to children and families. Because of changes to the federal estate tax, Arkansas stands to lose more than $55 million in state tax revenues over the next four years.[1] By 2007, the state revenue loss will likely approach $25 million annually. This revenue loss comes at a time when the state can least afford it. An upcoming Arkansas Supreme Court ruling in the *Lake View* school-financing case, coupled with anticipated shortfalls in future Medicaid funding, could increase the demand for new state revenue by more than $1 billion. Unless Arkansas acts now, it will lose its state estate tax and potential funding for education and health care in 2005.

The Arkansas Estate Tax

The Arkansas estate tax is a tax on the real and personal property transferred upon the death of an Arkansas resident (or a non-resident with real and personal property located in Arkansas). Like many Arkansas taxes, the estate tax is directly linked to its federal counterpart.

Under federal law, when a person dies, any Arkansas taxes the estate has to pay are offset by lower federal taxes. Here's how it works. The estate can claim a credit or "write-off" against the federal estate tax for any Arkansas estate taxes it pays. The write-off is a dollar-for-dollar credit against its federal estate tax liability, up to a certain amount. The amount written off depends on the size of the estate and is determined by a schedule in the federal tax code. In 2001, for example, federal law allowed an estate with a taxable value of $5 million to claim a write-off of up to $391,600 against its federal tax liability for the Arkansas estate taxes it paid.

Arkansas, like many other states, sets the level of its estate tax equal to the amount of state taxes taxpayers are allowed to write off on their federal returns under federal law.[2] In the above example, an estate worth $5 million was allowed to write off up to $391,000 against their federal taxes if it paid $391,000 in Arkansas estate taxes. Since $391,000 was the maximum credit the estate could claim under federal law, this was the amount it was required to pay in Arkansas estate taxes.

This arrangement was very advantageous to states. It allowed Arkansas to collect additional state tax revenue without requiring taxpayers to pay more taxes than they would otherwise have had to pay under the federal estate tax.

Recent Federal Changes[3]
The 2001 federal tax law made important changes to the federal estate tax, such as gradually increasing the value of the estate exempt from the tax (from $1 million in 2002 to $3.5 million in 2009) and phasing out the tax over 10 years.[4] More importantly for Arkansas, however, is that the new law phases out the federal credit allowed for state estate taxes paid over the next four years. The credit is scheduled to decline in value by more than 25 percent in 2002, 50 percent in 2003, 75 percent in 2004, and will cease to exist in 2005. *The Arkansas estate tax, which is linked to this federal credit, will also cease to exist in 2005 unless the state takes steps to keep it.*

Impact on Arkansas Revenues
The recent changes in the federal estate tax could have major implications for Arkansas tax revenue. According to estimates from the Department of Finance and Administration (DF&A), Arkansas will lose $55.4 million in state tax revenue over the next four years, including $26.8 million in general revenue and $29.4 million in special revenue dedicated to a special fund for economic development. The impact will be greatest in 2006, with general revenue and special revenue hits of $13.4 and $10 million, respectively.

Impact on Tax Fairness
The Arkansas tax system is regressive; low- and middle-income families pay a higher percentage of their income in state and local taxes than do wealthier families. According to a 2000 study by Arkansas Advocates for Children & Families, the poorest 20 percent of Arkansas families pay more than 10 percent of their income in taxes, while the richest 1 percent pay less than 6 percent.[5]

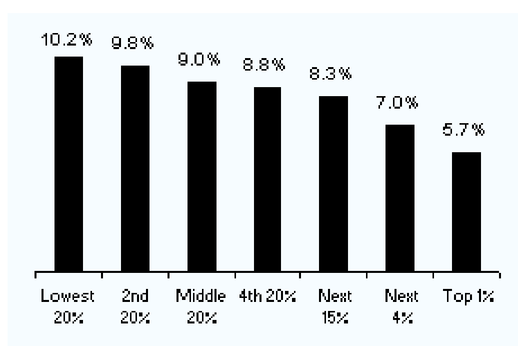
While the Arkansas tax system is regressive, it would be even more so if not for the Arkansas estate tax. Across the country, the estate tax is the one tax overwhelming borne by those with the greatest ability to pay. According to federal IRS data, the richest 5 percent pay over 91 percent of federal estate taxes nationwide.[6] (In Arkansas, the average income of the top 5 percent of taxpayers was $221,280 in 1999.) Historically, the estate tax added a degree of fairness to the Arkansas tax system. Eliminating one of the state's few progressive taxes would only increase the unfairness of the existing system for low- and middle-income families.

ARKANSAS REVENUE LOSS FROM CHANGES IN 2001 FEDERAL LAW
In Millions

	General Revenue	Special Revenue	TOTAL
SFY 2003	3.1	1.6	4.7
SFY 2004	3.1	7.8	10.1
SFY 2005	7.2	10.0	17.2
SFY 2006	13.4	10.0	23.4
Over 4 years	26.8	29.4	55.4

Source: Arkansas DF&A

1999 ARKANSAS TAXES AS SHARES OF FAMILY INCOMES



Source: Institute on Taxation and Economic Policy, Microsimulation Tax Model, March 8, 2000

JUST THE FACTS, MA'AM: Estate Tax Myths

Any effort to keep the Arkansas estate tax would likely generate a very emotional public debate among policy-makers and citizens. Unfortunately, many of the facts concerning estate taxes have been lost in the rhetoric and have been replaced by accepted, but inaccurate, myths. Just what are the facts about the estate tax?

Myth #1: Estate Taxes Hurt Family Farms and Businesses

A major justification often given for getting rid of the estate tax is to save family farms and businesses – to assure families don't have to sell the farms they inherit to pay the estate taxes.

The Facts: This claim may sound good in a political ad to those unfamiliar with how estate taxes really work, but it ignores two critical facts. First, family farms and businesses represent a small fraction of the value in estates and a small share of the cases in which estate taxes have to be paid. Consider the following:

- Few family farms are ever subject to the estate tax. According to IRS data for 1999, only 6.8 percent of all estate tax filers had any farm assets. Less than 3 percent of estate tax filers had farm assets and paid estate taxes.[11]
- Farms and family-owned businesses generally make up very little of the value of the assets for smaller estates. According to IRS data for 1999, farm and family-owned business assets accounted for less than 3 percent of the total value of taxable estates valued at less than $5 million.[12]
- Even for estates subject to taxes, family-owned businesses and farms comprise a very small portion of their value. A U.S. Treasury Department study of 1998 data found family-owned business assets equaled at least half of the gross estate in only 1.6 percent of the estates subject to taxes. Farm assets equaled half of the gross estate in only 1.4 percent of taxable estates.[13]
- A representative of the American Farm Bureau Federation in an interview to *The New York Times* acknowledged it could not cite one case of a farm having to be sold to pay estate taxes.[14]

Secondly, estates with family farms and businesses are already eligible for special treatment under current federal tax law, in most cases, eliminating or substantially reducing tax liability. Here are two examples of favorable treatment:

- The real estate that is part of a family farm or business is typically appraised at a much lower value than it is usually worth on the open market. Estate taxpayers are allowed to calculate the taxable value of the real estate in a family farm or closely held business on the basis of its current use value, rather than its market value. In layman's terms, "current use value" is an estimate of the extent to which the land contributes to the value of the farm or business on which it is located. This value is usually much less than what the land would be worth if it was sold on the open market. This special treatment lowers the taxable value of the land for estate tax purposes.
- Unlike other types of estate tax liability, any estate tax liability resulting from a family farm or business can be paid in installments over a 14-year period.[15] Only interest is charged for the first four years. The interest rate on estate tax liability resulting from the first $1 million in taxable assets is only 2 percent, with higher (but still below market interest) rates on assets in excess of $1 million.

JUST THE FACTS, MA'AM: Estate Tax Myths

Myth #2: Estate Taxes are Double Taxation

Opponents claim estate taxes are unfair because the assets in an estate have already been taxed as regular income and should not be taxed again.

The Facts: A significant portion of an estate's value, and the majority of the value in the largest estates, has never been taxed as regular income because the value is in the form of unrealized capital gains. A "capital gain" is the income occurring when the value of an asset, such as a stock holding or a house, increases over time. Typically, a capital gain is taxed as income only when it is "realized" or sold and the increase in value is available as new income to the owner.

Without an estate tax, the capital gains that are part of an estate would never be taxed and available as state revenue. If an individual holds an asset until she dies, the gain in the asset's value from the time she purchased it is never taxed as regular income. Under estate accounting rules, however, untaxed capital gains are included in a decedent's estate, and if the estate is large enough, will be taxed through estate taxes.

What portion of estates are capital gains and have never been taxed as regular income? Recent estimates suggest capital gains comprise 37 percent of the value of estates worth more than $1 million and about 56 percent of estates worth more than $10 million.[10] Eliminating or reducing the state's estate tax would reduce Arkansas' ability to tax these previously untaxed capital gains.

Myth #3: Estate Taxes Hurt Working Arkansans

Opponents claim estate taxes penalize those hard-working families who simply want to pass the fruits of their labor on to their children.

The Facts: The estate tax is overwhelming paid by those with the greatest ability to pay. Because of the generous exemptions offered as part of the estate tax, it is a tax few low- and middle-income families, and relatively few upper-income families, ever have to pay. Estates less than $1 million are exempt from estate taxes. By 2009, estates less than $3.5 million will be exempt.

During the 2000 tax year, only 664 federal estate tax returns were filed in Arkansas.[16] Of these, only 263 claimed the credit for state estate taxes (meaning they paid Arkansas estate taxes), while only 229 filers had any net federal estate tax liability. Compare this with the number of taxpayers who have to pay other taxes, such as the personal income tax: in 2000, Arkansans filed over 1.1 million federal individual income tax returns: of these, 76 percent (884,458) had some individual income tax liability.[17]

Myth #4: Arkansas Must Conform to the Federal Estate Tax Changes

If Arkansas doesn't conform to the 2001 federal estate tax changes, it will create major problems for DF&A in its future efforts to administer Arkansas estate taxes.

The Facts: It is an accepted principle of state tax administration that, whenever practical and appropriate, state taxes should conform to federal tax law to improve consistency and administration. However, given the small number of estate tax returns filed each year (less than 700 in Arkansas), as well as the existing complexity (estate tax law is already a complex field of specialization for accountants and lawyers), it is unlikely decoupling from the federal law would make the Arkansas estate tax much more complex or costly to administer. Moreover, estate taxes are collected from the executors of estates through a filing of estate tax returns, not through the much more commonly used state individual income tax form.

Protecting the State Estate Tax

To protect state revenues, Arkansas could take steps to keep its state estate tax as it existed prior to the 2001 federal tax law. Such a process is known as "decoupling." Under decoupling, the state would protect its estate tax from changes in the federal tax law by keeping the link to the federal estate tax that existed prior to the 2001 law.

Arkansas law is currently written in such a way that Arkansas' estate tax could already be decoupled from the 2001 federal tax law if the state chose to do so. Under current Arkansas law, the amount of the state estate tax is equal to the federal credit allowable under federal estate tax laws in effect January 1, 1999 (A.C.A. 26-59-106 et seq.). This language suggests the Arkansas estate tax could be based on the federal law in effect prior to the 2001 federal tax changes.

According to an October 8 press release, DF&A is not interpreting state law this way. Rather than using language in state law allowing Arkansas to base its estate tax on federal law in effect as of 1999, DF&A is administering the state estate tax based on changes contained in the 2001 federal tax law. DF&A officials argue the real intent of the law, even if not explicitly clear, is to conform to federal law. They further say a strong legal argument can be made giving the state enough flexibility to administratively conform to the 2001 federal tax changes until the 2003 General Assembly adopts new conforming legislation.

Regardless of how DF&A interprets the current state estate tax law for the rest of 2002, the 2003 Arkansas General Assembly could pass legislation to decouple the Arkansas estate tax from the new federal law. A growing number of states across the country have already decoupled from the federal estate tax. In Washington, D.C., and five states – Kansas, New York, Oregon, Virginia and Washington – the state estate tax laws were already written in such a way the states were automatically decoupled from the federal law and will remain so unless they take steps to conform to the new changes.[7] (Oregon is considering legislation to conform to the new federal law.)

Eleven states have recently taken steps to decouple from the 2001 federal tax changes. Seven of those states – Maryland, Massachusetts, New Jersey, North Carolina, Pennsylvania, Rhode Island and Vermont – have enacted legislation linking their states estate taxes to the federal estate taxes in place prior to 2001. Three other states – Minnesota, Maine and Wisconsin – have passed legislation decoupling, at least for now, from the recent federal changes. An 11th state – Nebraska – has decoupled by creating a separate tax on estates exceeding $1 million based on the federal estate tax as it existed before 2001. Most states, including Arkansas, could decouple through legislative action.

If Arkansas decoupled from the 2001 federal tax law, taxpayers would pay no more in state estate taxes than they would have under the old federal tax law.[8] Most taxpayers would still pay less in federal estate taxes because of large reductions in tax rates and the amount of the estate exempt from taxation.

The vast majority of estates in 2003 and 2004 and all estates in 2005 and beyond would pay less in combined federal and state estate taxes. In 2003, only estates worth more than $29 million (less than 1 of every 5,000 estates) would pay more in combined state and federal estate taxes than they would have under prior law. In 2004, only estates worth more than $9 million (less than 1 in 1,000 estates) would pay more in combined state and federal estate taxes.

2003 TAX LIABILITY OF ESTATE AFTER STATE DECOUPLING
Estate Worth $2 Million

	Pre-2001 Law	Post-2001 Law	CHANGE
A. Federal Estate Tax Before State Credit	$551,000	$410,100	-$140,900
B. Allowable State Credit	$99,600	$49,800	-$49,800
C. Federal Tax After State Credit	$451,400	$360,300	-$91,100
D. State Estate Tax	$99,600	$99,600	$0
TOTAL TAX (C+D)	**$551,000**	**$459,900**	**-$91,100**

Source: Center on Budget and Policy Priorities, "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," June 7, 2001

In 2005, however, all estates, regardless of size, would pay less in combined state and federal estate taxes, even if Arkansas decoupled from the 2001 law.[9] Beginning in 2005, the credit taxpayers can claim against their federal taxes for state estate taxes paid will be changed to a deduction. Rather than claiming a dollar-for-dollar credit against state estate taxes paid, taxpayers will be able to deduct those taxes from the value of their estate in calculating their federal estate taxes. This, combined with lower rates and higher exemptions, will guarantee all estates have lower combined state/federal estate tax liability than under the old law.

The Bottom Line

Given the state's current fiscal woes and the large demands being placed on the state's budget because of unmet needs for health care and education, Arkansas can ill afford to lose the revenue generated by its estate tax. While the estate tax is often mistakenly criticized because of the lack of understanding about how the tax really works, it is one of the few progressive revenue sources the state already has in place. *If Arkansas decoupled from the federal estate tax, it would not significantly increase the current tax burden of any group in the state, nor would it have any major negative impacts on economic development*. If the state quietly sits by while the tax is eliminated because of actions taken by Congress, it will not only hurt vital programs serving children and families, it will also make the state's already regressive tax system even more unfair.

The bottom line is the state is already facing tight economic conditions forcing it to make tough choices; it should not let federal policy changes create even greater hardships for children and families when such hardships could be easily avoided. Allowing this important revenue source to slip away at a time when it is needed most will only further hurt the state's most vulnerable children and families.

For More Information

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Notes

1. Arkansas Department of Finance and Administration, Federal Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), memo presented to the Arkansas Interim Committees on Revenue and Taxation, no date.
2. See Arkansas Code Annotated (A.C.A. 26-59-106 et seq.). Federal estate tax laws are at 26 U.S. C. § 2001 et seq. Also see Elizabeth C. McNichol, Iris J. Lav and Daniel Tenny, *States Can Retain Their Estate Taxes Even As The Federal Estate Tax is Phased Out*, Center on Budget and Policy Priorities, Washington, DC, May 10, 2002.
3. Joint Committee on Taxation, Summary of Provisions Contained in the Conference Agreement for H.R. 1836, the Economic Growth and Tax Relief Reconciliation Act 0f 2001, JCX-50-01, May 26, 2001.
4. Although the federal estate tax will be repealed in 2010, it will be reinstated in 2011 unless the U.S. Congress acts before then to extend the repeal of the tax beyond 2010.
5. Richard Huddleston, "How Fair Are Arkansas Taxes," *Paycheck$ and Politics*, Issue 4, Arkansas Advocates for Children & Families, April 2000.
6. IRS data as cited in Leonard E. Burman and William G. Gale, "The Estate Tax is Down But Not Out," *Tax Policy Issues and Options*, No. 2, The Urban Institute, Washington, DC, December 2001.
7. Elizabeth C. McNichol and Daniel Tenny, *Many States are Decoupling from the Federal Estate Tax*, Center on Budget and Policy Priorities, Washington, DC, October 2, 2002.
8. Daniel Tenny, *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, Washington DC, June 7, 2002.
9. Ibid.
10. James Poterba and Scott Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death," *Rethinking Estate and Gift Taxation*, Brookings Institution, 2001.
11. Joel Friedman and Andrew Lee, *Permanent Repeal of the Estate Tax Would Be Costly, Yet Would Benefit Only a Few, Very Large Estates*, Center on Budget and Policy Priorities, Washington DC, June 3, 2002.
12. Friedman and Lee.
13. Friedman and Lee.
14. David Clay Johnston, "Talk of Lost Farms Reflects Muddle of Estate Tax Debate," *The New York Times*, April 8, 2001.
15. Burman and Gale.
16. Barry W. Johnson and Jacob M. Mikow, "Federal Estate Tax Return, 1998-2000, *Statistics of Income Bulletin*, U.S. Internal Revenue Service, Washington, DC, Spring 2002.
17. IRS Web site.