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The Untimely Death of Arkansas' Estate Tax

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After a long battle with a debilitating phaseout, the fair, revenue raising Arkansas estate tax expires on December 31st, 2004 at midnight. The estate tax served Arkansas well in ways that many of its citizens are unaware. Estate tax revenue contributed to Arkansas' fund for economic development (the general improvement fund), a fund which not only provides for needed infrastructure and capacity, but promotes job growth and stability in our state. The estate tax was always there with a dollar for general revenue and only took from those with a real ability to pay. The Arkansas estate tax leaves a hole in the budget that will be difficult to fill. We will miss her.

Summary

- Because of federal tax changes, the Arkansas' estate tax expires on December 31, 2004 leaving Arkansas with yet another revenue gap. It is not too late to make the changes necessary to ensure that this fair tax remains a part of the Arkansas tax system.
- The estate tax is one of the fairest taxes that a state can levy – placing the burden on only those with the greatest ability to pay.
- Only 0.9 percent of Arkansans (less than one percent) would be affected by the estate tax.
- The estate tax reduces the amount of revenue that has to be raised from sales taxes that place a disproportionate impact on low- and middle-income families.
- Twelve states have recently decoupled from the federal government to keep their state income tax. In all, 18 states have their own estate tax.
- Arkansas could keep its estate tax by decoupling from recent federal estate tax changes.
- An Arkansas estate tax would raise an estimated $20 million dollars of much-needed revenue per year.

The estate tax will be missed for its ability to contribute to the funding of vital, necessary programs like education, ARKids First, and Medicaid; it will be missed for its contributions to the special fund for economic development; it will be missed for its progressivity and its inherent fairness.

So why will Arkansas no longer have an estate tax?

The federal government started the ball rolling in 2001 with the passage of legislation that phased out the federal estate tax by 2010. As a part of this phase out, Arkansas' estate tax ends in 2005. Arkansas and many other states have estate taxes tied to the federal system and when the federal estate tax was phased out, so too were these states' estate taxes.[1]

Individual states, like Arkansas, had (and still have) the option to go their own way and independently retain a state estate tax (to "decouple") or to stay "coupled" to the federal system and face the loss of estate tax revenue.

Arkansas chose the latter and stayed coupled to the federal system causing an anticipated average revenue loss of $20 million per year.[2] While revenue losses are always troubling for state governments, at this time in Arkansas with education facilities to fund and projected Medicaid shortfalls looming, this particular revenue loss will be widely felt.

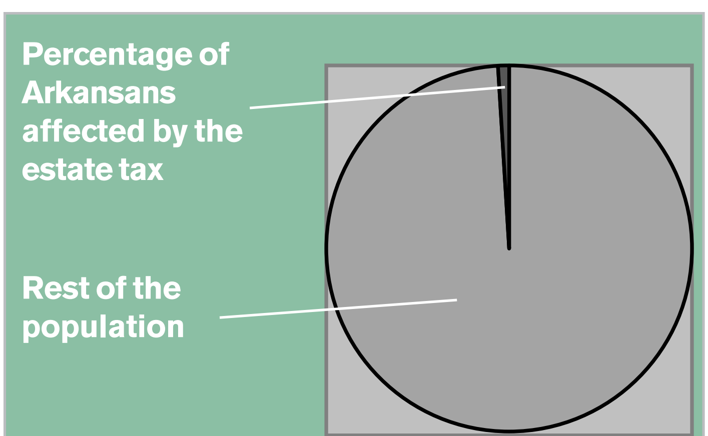
What's the impact on Tax Fairness?

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 Arkansas property). Under current law, in order for there to be **any** tax on the estate (the Arkansas property transferred at death), it would have to be worth 1,500,001 dollars. Even then, the tax would not apply to those first 1,500,000 dollars. In other words, if Major Holdings died with an estate valued at 1,500,001, his estate would only pay tax on that last dollar; the first 1,500,000 dollars would be completely exempt from tax. If Major was married at the time of his death and left his estate to his spouse, his estate would owe no tax no matter how large his estate. The bottom line is that no tax will be owed by anyone unless his or her estate is worth more than $1,500,000.

The estate tax is one of the fairest taxes that a state can levy - it taxes only those who are most able to pay. Fair taxes are often referred to as progressive taxes- the share of income paid in taxes rises as income rises, a progression up the income ladder. Progressive taxes are based on the belief that those with a greater ability to pay can and should pay a larger share of income in taxes and bear more of the burden. As such, the estate tax is the definition of a fair tax, it is only levied on those with the greatest ability to pay and it rises when income rises. In fact, the estate tax in Arkansas affects just 0.9 percent of the population.

Less than one percent of estates are subject to the Arkansas estate tax.[3] Additionally, a study from the Department of the Treasury shows that most estate taxes are paid by the estates of people who, in addition to having a great deal of wealth, were making greater than 190,000 dollars per year around the time of their deaths.[4]

The Arkansas tax system is clearly regressive (those who make the least pay the most in taxes as a percentage of income). The poorest 20 percent of our population pays 12 cents out of every dollar of income in taxes while the richest one percent of our population pays just 6 cents of every dollar of income in taxes.[5] The legislature, in the last special session, raised the sales tax 7/8 of a cent, a tax increase that has the most impact our low income working families. As the estate tax phases out, the loss of its progressivity makes our state tax system more regressive.



Source: Internal Revenue Service - National Vital Statistics Report, Vol. 50, No. 15, IRS Statistics of Income Bulletin, Spring 2002

Impact on Family Farms and Small Business: Few Farms Would Ever Pay the Estate Tax

According to the Economic Research Service of the United States Department of Agriculture, the average farm size in Arkansas is 305 acres.[6] The average value of farmland is approximately $1700 per acre. At these levels, the average farm is worth approximately $518,500. These values are asset values, not taking into account farm debt, which would reduce the overall value (typically referred to as farm equity). Just looking at this rough number (which overestimates value), a farm would have to be worth almost three times the amount of the average farm in Arkansas to be subject to the estate tax.

In other words, a farm would have to be 882 acres, by this measure, in order to be subject to the Arkansas estate tax. Only 14.5 percent of Arkansas farms are greater than 500 acres in size.

As well as not taking into account farm debt, the numbers above do not take into consideration the built-in valuation discount that farmers can use when calculating whether they owe any estate tax. The valuation discount allows farmers to base their calculations on the value of property as it is used rather than its fair market value. (Fair market value is the required measure for all other property when calculating the estate tax.) This "special use value" means that even a farmer with over 882 acres could pay no estate tax.

It is also important to mention that in the case of an individual with a spouse, each spouse can bequeath assets worth $1,500,000 dollars without the imposition of any estate tax. This means that married individuals (including farmers and small business owners) can actually pass **$3,000,000 dollars** worth of assets to the next generation with no estate tax. In our farm example, this would mean that a farm would have to be 1764 acres in order to potentially have even $1 of the value of their estate taxed. (Only 7.1 percent of Arkansas farms are greater than 1000 acres.)

Then, after the calculation of the farm's special use value, if the farmer is one of the very few that is required to pay the estate tax, she is entitled to use an installment method of payment to pay the tax. This method permits the farmer to pay the tax over a period of 14 years giving her the ability to pay without the necessity of selling assets. (In fact, the American Farm Bureau Federation could not cite one single farm which had sold its assets in order to pay the estate tax.[7]).

These same benefits (special use valuation and installment method of payment) are also available to the small business owner. These entrepreneurs and community stalwarts receive both the benefit of the special use valuation and the extended time to pay easing the pinch that could have resulted if the tax was immediately due.

It's simply untrue that either a family farmer or small businessperson will lose their livelihood due to the estate tax. Indeed, only a small fraction of small business owners and farmers (like the rest of the population) will even be subject to the tax at all.

The estate tax is a progressive, revenue-raising tax with no impact on 99 percent of the population, family farms, or small businesses. While good riddance may be the most expedient choice, it overlooks both the inherent unfairness of our current tax system and the inherent fairness of the estate tax. It should be revived.

Can we breathe life back into the estate tax?

Arkansas would not be alone in enacting a state estate tax. Seventeen states and the District of Columbia are currently decoupled from the federal system. Twelve of the 17 took legislative action to decouple, while the remaining five states and the District of Columbia have laws that did not change when the federal law changes. These states will stay decoupled unless they take legislative action.[8]

In determining Arkansas' costs of administering a state estate tax, it is important to remember that the Department of Finance and Administration has the capacity to administer it. It has been doing an effective job for many years. It will take more to ensure adequate compliance (especially if the federal government no longer plays a role), but in states that have decoupled, the added costs have been low: for example, $85,000/year in Kansas[9] and $200,000/year in Maine[10] (both states with higher annual estate tax revenue than Arkansas.[11])

States *with* an Estate Tax

Illinois	North Carolina
Kansas	Ohio
Maine	Oregon
Maryland	Rhode Island
Massachusetts	Vermont
Minnesota	Virginia
Nebraska	Washington
New Jersey	Wisconsin
New York	Washington, D.C.

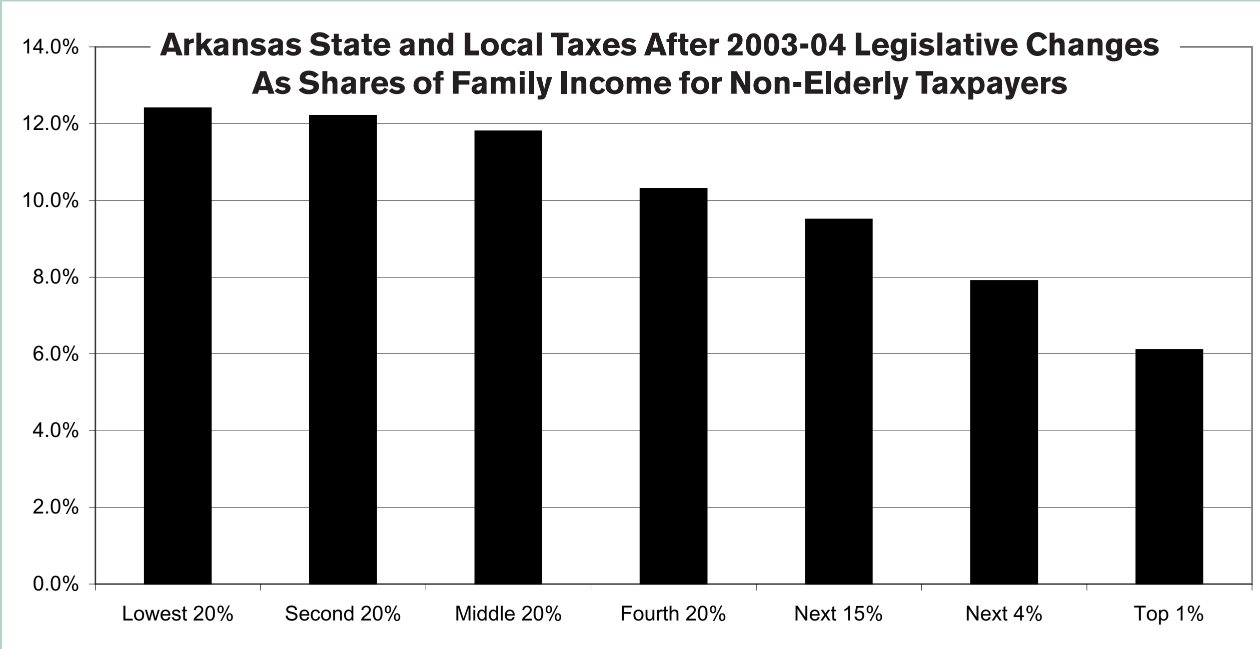
Arkansas Estate Tax Collections General and Special Revenues (Millions of dollars)

FY	Total Tax Collections	General Revenue	Special Revenue
1991	$8.69	$8.69	$0.00
1992	$7.96	$7.96	$0.00
1993	$14.32	$14.32	$0.00
1994	$11.43	$11.43	$0.00
1995	$21.67	$16.03	$5.64
1996	$117.25	$14.24	$103.01
1997	$17.91	$17.91	$0.00
1998	$32.68	$13.88	$18.80
1999	$32.57	$17.99	$14.58
2000	$23.82	$15.61	$8.22
2001	$26.10	$10.49	$15.61
2002	$40.12	$20.35	$19.76
2003	$63.55	$15.00	$48.55
2004	$21.40	$14.01	$7.38

Source: Arkansas Department of Finance and Administration

A model state estate tax should be comprehensive and "user-friendly" for administrative purposes. It links the amount of the tax to the state estate tax credit as it was before the phase out. It next links the applicable exclusion amount (in our above example, this is the 1,500,000 number) of the estate tax to current federal legislation. Lastly, in the event that the federal government permanently repeals the estate tax, the state should maintain its estate tax at the same amount, rate, and exclusion amount as before the repeal.

By linking to the federal exclusion amounts, state citizens will not have to worry about possibly owing state estate tax when they do not owe federal estate tax. By linking the two, estate executors will know that if they have to file a federal estate tax form, they must also file a state estate tax form. The state estate tax paid is also deductible on the federal estate tax form. Due to this deductibility, the actual estate tax rate paid in states that have decoupled ranges from two percent to five percent.



Source: Institute on Taxation & Economic Policy, August 2004

Even at the top of this range, the Arkansas sales tax has a higher rate.[12]

By maintaining a state estate tax in case of federal repeal, the state ensures and safeguards this important, progressively-raised revenue.

The estate tax needs to be revived. The estate tax can be revived. Progressive revenue raising measures should be the foundation of any tax system. For too long, Arkansas has relied on regressive taxes which predominantly harm our poorest families. These taxes add to the already high cost of being poor. By adding the state estate tax back into the picture, the regressivity of the overall system lessens and Arkansas benefits with increases in both general revenue and our special revenue fund for economic development (the general improvement fund).

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Footnotes:

[1] Arkansas estate tax is structured such that the state estate tax credit is the sole source of Arkansas' estate tax revenue. The credit works this way: overall (state plus federal) estate tax revenues stay the same. Federal tax revenues decrease by the amount of the credit and state estate tax revenues increase by the amount of the credit. In essence, the federal government takes less so that the states can take more of the estate tax revenue pot. This credit mechanism is phased out as of December 31, 2005.

[2] Information from the Arkansas Department of Finance and Administration.

[3] 2000 data, National Vital Statistics Report, Vol. 50, No.15, IRS Statistics of Income Bulletin, Spring 2002

[4] Center on Budget and Policy Priorities, *States Can Retain Their Estate Taxes even as the Federal Estate Tax is Phased Out*; McNichol et al, February 4, 2003, page 18.

[5] Arkansas Advocates for Children and Families, *Paychecks and Politics, Issue Brief Number 25*, Rich Huddleston, Nov. 2004, page 2.

[6] The following farm data all comes from the Economic Research Service of the United States Department of Agriculture. *See* http://www.ers.usda.gov/StateFacts/AR.htm

[7] David Kay Johnston, *Talk of Lost Farms Reflects Muddle of Estate Tax Debate*, The New York Times, April 8, 2001

[8] Center for Policy Alternatives, *Estate Tax Decoupling; 2004 Policy Summary*, page 126.

[9] Source: Kansas Department of Revenue

[10] Source: Maine Revenue Services

[11] Center on Budget and Policy Priorities, *Why States Should Act Now to Preserve their Estate and Inheritance Taxes* ; McNichol and Llobrera, January 31, 2003, page 8.

[12] The percentage rate depends on the size of the estate (1.5M to 2.5M for this example) and the extent to which the state has decoupled (fully or only partially -i.e., relying on the current federal exemption amounts. (Center on Budget and Policy Priorities, *Assessing the impact of State EstateTaxes*, Elizabeth McNichol, February 18, 2004, page 5.)