

Protecting Alabama's Estate Tax

An Arise fact sheet funded by the Ford Foundation

May 8, 2002

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Alabama stands to lose up to \$200 million by 2007 because of recent changes to estate tax law. The federal government's decision last year to phase out and repeal the federal estate tax may hit closer to home than Alabamians expect, doing serious damage at a time when budgetary woes have already hamstrung crucial state services. While President Bush's economic stimulus plan – the Economic Growth and Tax Relief Reconciliation Act of 2001 – will eliminate the federal estate tax by 2010, the state estate tax credit will be eliminated much earlier. Thus, Alabama, along with 36 other states and D.C., will lose all estate tax revenues by 2007.

Alabama's estate tax is typical of so-called "pickup" taxes that are set by state law to equal the maximum federal credit allowed for state taxes paid. Because of the credit, the state gets revenue without requiring estates to pay more taxes than they would otherwise have to pay under the federal estate tax.

In 2001, Alabama received \$45.8 million in revenue from estate taxes. But as part of President Bush's economic stimulus plan, the new federal tax cut package gradually reduces states' shares of the federal estate tax credit. Consequently, Alabama estate taxes are being phased out, leading to substantial revenue losses beginning as early as October, 2002.

With the expected loss of 25% of the state's estate tax credit annually beginning next year, the question now is whether Alabama can afford to give up this growing source of revenue at a time when the budget is already stretched thin.

The state's General Fund has seen diminishing growth over the past few years. From 1998 to 2001, the General Fund's 7.45% growth rate dwindled to 2.92%. In Fiscal Year 2002, requested increases in funding for agencies totaled over \$143 million – 13% higher than was budgeted for FY 2001. These requests reflect the growing needs of such essential service providers as the Departments of Public Health, Public Safety, Environmental Management, and Corrections.

The Legislative Fiscal Office has acknowledged that the terrorist attacks of September 11 plunged our economy deeper into recession just as it was starting to improve. Statewide unemployment rose from 4.6% in 2000 to 5.4% in 2001, along with the first decline in average employment since the 1990-91 recession.

Individuals in the highest income brackets certainly lost money in the recession. But for Alabamians who enjoy an income over \$100,000, those losses did not threaten to plunge them into poverty, whereas many lower- and middle-income Alabamians have lost their jobs and the means to support their families.

Our legislators cannot afford to jeopardize Alabama's troubled finances further by relinquishing the estate tax, which – although it provides less than 10% of General Fund revenue – is a growing, fair, and progressive income source.

Keeping the estate tax really *is* a matter of fairness – expecting the wealthy to pay a fairer proportion of the overall tax burden. The estate tax is based on two fundamental democratic ideals: that taxes should be shouldered by those who can afford to pay them, and that massive fortunes should be earned, not inherited.

Even before the 2001 federal changes, the estate tax achieved fairness by exempting the first \$675,000 of an estate's value (\$1.35 million for couples). In fact, an estate of any size could be bequeathed to a spouse without being subject to the estate tax.

But even beyond the exemptions and shelters available to the wealthy, the estate tax is fair because – like all progressive taxes – it takes into account a person's *ability* to pay and helps ensure that the overall tax burden is spread evenly among taxpayers at all income levels.

Estate taxes are typically paid by only the wealthiest 2% of estates.

By contrast, Alabama sales and excise taxes hit the poor much harder (7.9% of income) than the wealthiest (1.0%). In fact, Alabama still has one of the nation's ten most *regressive* tax systems, with the lowest 20% of earners paying more than three times the proportion of their income in total Alabama sales, excise, property, and income taxes as the wealthiest earners pay. A 1995 study showed that the top 1% of married couples – those earning over \$243,000 a year – paid only 3.6% of their incomes in state and local taxes while low-wage couples paid 11.5%.

Thus the estate tax is fairer than most Alabama taxes. Wage-earners with incomes below \$100,000 (80% of earners) pay less than 1% of estate taxes nationwide.

Low- and middle-income Alabamians may worry that the estate tax will somehow rob them of hard-earned savings they have accumulated during their lifetimes. But a recent Treasury Department study shows that almost no estate tax is paid by even middle-income earners. In fact, most revenue from estate taxes comes from the

estates of individuals who were *substantially* wealthy and still enjoyed high incomes at the time of their death. These are the very individuals who would still be able structure their finances to shelter more of their income from taxation – even if the estate tax were not repealed.

Simply put, the vast majority of Alabamians will not be affected by the estate tax. In fact, out of the 22,806 Alabama deaths reported in 1999, only 470 estates paid the state tax – barely 2% of decedents.

Further, contrary to popular belief, the estate tax has little impact on the vast majority of small businesses and family farms. Nationally, such concerns only arise for about 6 out of every 10,000 people who die each year (i.e. 0.06%).

But by giving another massive tax break to the wealthy, the federal repeal of the estate tax will continue to widen the gap between the haves and the have-nots, leaving public services under-funded in the process.

One way Alabama can avoid losing millions of dollars in revenue is by “decoupling” our estate tax – that is, by breaking the automatic connection between the federal credit and the state estate tax.

Alabama law states that the estate tax “shall be levied only so long as and during the time an inheritance or estate tax is enforced by the United States

against Alabama inheritances or estates.” To prevent revenue loss, a decoupling bill would have to ensure that Alabama’s estate tax is tied to the amount of the federal credit before the enactment of the 2001 federal tax cuts. The new law could simply set the state’s estate tax equal to the amount of the federal credit as of Jan. 1, 2001. Adopting this sort of “date-certain” reference can retain the state estate tax without any need for significant new legislation. This approach would not only save the state from immediate revenue losses but also give policymakers time to investigate whether more-complicated, long-term methods of decoupling are needed.

Another option is to adopt a separate estate tax with provisions that are not coupled to the federal estate tax. Thirteen states have separate estate or inheritance taxes, and these states are largely unaffected by the federal repeal of the estate tax. Six states, including Arkansas, Kansas, and Virginia, have already decoupled from the federal provisions. Four others have begun to decouple, and at least four more are considering legislation for decoupling.

The bottom line, then, is that Alabama can easily decouple from the changed federal estate tax and avoid losing \$200 million. At a time when tough economic conditions are forcing us to make tough decisions, we should not let federal changes create even greater hardships in Alabama. Allowing this important revenue

stream to be phased out will only make it more difficult for the state to provide essential services to those who need them the most.

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