



EXECUTIVE SUMMARY

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March 11, 2003

For the Greater Good: Why Oregon Should Reform, Not Repeal, the Progressive Estate Tax

By Charles Sheketoff

Widespread interest in the estate tax is remarkable, given that it collects nothing from 98 percent of the deaths that occur each year. Lawmakers would be hard pressed to find another tax that impacts so few and exempts so many of their constituents.

The estate tax is levied when large accumulations of wealth are transferred from the estates of people who have died to the estates' beneficiaries. Special provisions lighten or eliminate the estate tax on farms and small businesses. Only a small fraction of family farms or businesses are subject to the estate tax and for those few, the business or farm usually does not constitute a majority of the estate. The tax recognizes that extraordinary accumulations of wealth happen, in part, thanks to the investments of the broader society, and protects against the ill effects of concentrations of wealth in the hands of a few.

While Congress' 2001 decision to gradually repeal the federal estate tax had no immediate impact on Oregon's tax, this paper discusses why Oregon's inheritance tax statutes are out of date and need reform.

- Oregon cannot afford the \$90 million biennial revenue loss that would result from proposals to repeal estate tax. Reducing taxes on a small number of the wealthiest estates is inappropriate at a time when Oregon is cutting services that affect thousands of people, especially low-income families. In 2000, only 424 estates, 1.4 percent of Oregonians who died, paid the state inheritance tax.
- Eliminating the estate tax would make Oregon's tax system even more regressive.
- The estate tax provides a way for Oregon to tax income that otherwise would not be taxed. Heirs still receive a large capital gains tax break. The accrued but not taxed capital gains – the "stepped up" basis that the heirs receive – will cost Oregon \$444.3 million in the upcoming biennium.
- Oregon should connect to the federal Taxpayer Relief Act of 1997. Estates will pay no more in Oregon estate taxes than they do under current practice, and the tax they pay will lower their federal tax liability. Oregon should not connect to the 2001 federal estate tax changes, which would eliminate Oregon's estate tax.

Oregon is not alone in looking for appropriate ways to continue to collect estate taxes. Twelve states have recently taken steps to "decouple" from the 2001 federal tax changes.



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Widespread interest in the estate tax is remarkable, given that the estate tax collects nothing from 98 percent of the deaths that occur each year. Lawmakers would be hard pressed to find another tax that impacts so few and exempts so many of their constituents.¹ The estate tax is levied when large accumulations of wealth are transferred from the estate of a person who has died to the estate's beneficiaries. Because significant wealth accumulation is exempt from the tax, the tax impacts fewer than 2 percent of estates.

Born out of wealth and income inequalities of the Industrial Revolution and the excesses of the Gilded Age, the Federal estate tax addresses the concern that tremendous accumulations of wealth are dangerous to democracy and civic health.² While not preventing the accumulation of wealth in a family, the tax provisions encourage charitable giving and favor the transfer of businesses and farms if they remain owned and operated by the family.

The tax recognizes that wealth accumulation is made possible by the civil and structured society in which the deceased worked, not just by the labor of the deceased. Luck, privilege, and others' efforts often play a role in the accumulation of the wealth, but in virtually all cases the accumulation of wealth also stems from society's investments. The estate tax recognizes that society made those investments and it collects a share in return.

The decision by Congress in 2001 to repeal the federal estate tax by 2010 had no immediate impact on Oregon's estate tax. Nevertheless, Oregon's estate tax needs to be updated. This paper discusses why Oregon's inheritance tax statutes are out of date and need reform. In addition, this paper outlines why Oregon should "connect" to the federal law that existed prior to the 2001 changes, the Taxpayer Relief Act of 1997, and resist attempts to repeal the estate tax.

Why Oregon should maintain its estate tax.

At this time of fiscal crisis, Oregon cannot afford the significant revenue

loss that would result from cutting the estate tax. Oregon will lose upwards of

\$90 million a biennium if it repeals the state estate tax. Maintaining the current practice of following the federal law that existed prior to the 2001 changes would maintain this important revenue stream. Given that Oregon's tax system is not expected to generate revenues equal to the levels of funding from the 1999-01 biennium until after the 2007-09 budget period, the fiscal need to preserve the estate tax will be present for the foreseeable future.³

Reducing taxes on a small number of the wealthiest estates by eliminating the estate tax is inappropriate at a time when Oregon is cutting services that affect thousands of people at all income levels, especially low-income families. Only the estates of the wealthiest 1.4 percent of Oregonians who die each year pay the estate tax. In 2000, while there were 29,541 deaths in Oregon, only 424 Oregon estates paid the state inheritance tax.⁴ Spending cuts, on the other hand, impact not only the low-income persons losing services such as health insurance coverage and cash assistance when disabled, but also any Oregonian who uses schools, community colleges, universities, long-term care, health or public safety services.

Paid only by a small number of very wealthy estates, estate taxes have little impact on family farms and small businesses. Only a small fraction of family farms or businesses are subject to the estate tax, and for those few, the business or farm usually does not

constitute the majority of the estate.⁵ There are a number of special provisions for farmers and small businesses in the tax code to lighten or eliminate the tax. For instance, more wealth of farmers can be passed to heirs as long as the heirs continue farming for 10 years.

In 2000, farm assets (other than farmland) accounted for only three-tenths of one percent of the taxable assets of estates nationwide. Objects of art, on the other hand, accounted for two and one-half times as much of taxable estates.⁶ Collectors of Pablo Picasso's art have more at stake than do customers of John Deere's tractors.

The estate tax provides a way for Oregon to tax income that otherwise would not be taxed, while still giving a large capital gains tax break to heirs. Capital gains income is taxed only when the asset is sold, not when it is passed on to an heir. Moreover, when the heir sells the asset, the gain in its value under the prior owner is not taxed; the "basis" for calculating gain or loss is the value of the asset at time of inheritance. Nationally, a significant portion of the value of estates – and the majority of the value of the largest estates – is in the form of unrealized capital gains that would only be taxed through the estate tax.⁷ In Oregon, the accrued but not taxed gains – the "stepped up" basis that the heirs receive – will cost the state \$444.3 million in the upcoming biennium.⁸

The Oregon Inheritance Tax.

Since January 1, 1987, Oregon has not had an independent inheritance tax. Rather, Oregon collects as a tax the amount allowed as a credit against the federal estate tax. This has allowed

Oregon to collect state tax revenue efficiently without requiring estates to pay more taxes than they would otherwise have had to pay under the federal estate tax. If a person is not

subject to the federal estate tax pursuant to the federal law in effect on December 31, 1996, no state tax is imposed.

The “Pickup Tax”

The estate calculates its federal estate tax liability, then subtracts from that the state credit, to determine the net federal estate tax liability. Oregon then collects, or “picks up,” the credit amount as its state tax. This “pickup tax” has allowed Oregon to avoid devising its own tax schedule and historically has meant that Oregon taxpayers paid no more in combined taxes that they would otherwise have paid under just the federal law. The federal government essentially shares a portion of its estate tax with the state. Put another way, some of the Oregon pickup tax is borne by the federal government in reduced federal taxes.

In 1997, Congress enacted The Taxpayer Relief Act of 1997 (Public Law 105-34, “TRA-97”). Among the most significant changes was the incremental increase of the estate tax filing threshold to \$1 million by 2006 (\$2 million for couples).⁹ TRA-97 also added a family business deduction for estates where a business made up at least 50 percent of the gross estate. The deduction was limited to a total of \$1.3 million.

After the enactment of TRA-97, Oregon’s Legislative Assembly needed to decide to “reconnect” to federal law if they wanted these changes in the estate tax to go into effect.¹⁰ The 1999 Legislative Assembly inadvertently failed to “reconnect” to the TRA-97. Thus, the new higher exemptions in TRA-97 did not become Oregon law. Unfortunately, the Department of Revenue wrongly assumed the Legislative Assembly had reconnected

and began applying the new federal standards, even though they were not legally in effect in Oregon. As a result, some estates closed and settled their tax bills with the State for less than they actually owed under existing state law.¹¹

House Bill 2184

Legislation that Governor Kulongoski submitted for the Department of Revenue, House Bill 2184, would correct these mistakes by retroactively connecting to TRA-97. The bill would make the already settled estates valid, correcting the State’s errors in favor of the taxpayers. House Bill 2184 establishes TRA-97’s state credit amount as the pickup tax, and TRA-97’s the wealth exemptions for deaths on or after January 1, 1998 and prior to January 1, 2003. Correcting only the problem for deaths prior to January 1, 2003, the bill then returns Oregon law to the status quo, the federal law that existed on December 31, 1996, for all subsequent deaths. The bill has no impact on tax revenues.

More changes mean bad news for Oregon.

In 2001 Congress amended the federal estate tax again.¹² Congress chose to increase the value of the estate exempt from the tax from \$1 million in 2002 to \$3.5 million in 2009 and to phase out the tax completely over 10 years.¹³ More important for Oregon, however, is that by 2005 the new law phases out the federal credit allowed for state estate taxes paid. Under the 2001 federal law, the credit declined in value by 25 percent in 2002 and 50 percent in 2003, and will decline by 75 percent in 2004 and will cease to exist in 2005. If Oregon were to link Oregon’s pickup tax to the 2001 federal changes, the Oregon estate tax would decline and then cease to exist in 2005 when the

federal credit for state taxes becomes a deduction.

Oregon currently receives about \$90 million a biennium in gift and inheritance taxes. When the federal law was enacted, the Legislative Revenue Office estimated that if Oregon chose to connect to the new federal law and its phase-out of the state credit, Oregon would lose \$66 million in the upcoming biennium (2003-05), and \$90 million in the 2005-07 budget cycle.

House Bill 2704

The House Revenue Committee has introduced House Bill 2704.¹⁴ That bill connects to TRA-97 and some provisions of the 2001 federal law changes. The measure updates the law for persons who die between January 1, 1998, and before January 1, 2002 to address the problems caused by Oregon's out of date law and implementation errors.

In adopting some of the 2001 federal law changes, House Bill 2704 raises the wealth exclusion up to \$1 million in 2002 and increases it to a \$1.5 million cap over time. It disconnects from the phase out of the federal state tax credit for deaths occurring in 2002 through

2004, adopting a different credit than the federal credit for those time periods. In 2005, when the federal credit is fully phased out and becomes a deduction, Oregon's pick-up tax ceases to exist under House Bill 2704. The Legislative Revenue Office estimated that the bill's predecessor, House Bill 4077 from the 2002 Fifth Special Session, would have cost Oregon \$1.6 million in the 2001-03 biennium, \$18.1 million in the 2003-05 budget cycle, and \$93.1 million in 2005-07; House Bill 2704 likely will have similar costs in future biennia.

House Bill 2503

This measure would repeal the Oregon inheritance tax for estates of persons who die on or after January 1, 2004. It would leave in place the current law – the pre-TRA-97 changes – for every estate of a person who dies before that date. Thus, it fails to address the problem facing estates of decedents who died after January 1, 1998. Those estates would still be subject to the law that existed on December 31, 1996. Some of the estates that have already “closed” and settled with the state will have received a windfall, while estates that are not yet closed will have to pay a higher tax than current practice allows.

How to Protect State Estate Tax Revenues.

To protect state revenues, Oregon can take steps to continue the current estate tax practices. Oregon can protect its estate tax by linking to the federal estate tax that existed prior to the 2001 law.

The Oregon Legislative Assembly must address the issue in 2003 due to the problems caused by the failure to connect to TRA-97 and the practice of applying that law to some estates. The Kulongoski Administration's bill (House

Bill 2184) fixes the “problems.” The Governor's bill, however, returns Oregon to the exemption levels that existed on December 31, 1996, or \$600,000 per individual taxpayer. The bill should be amended to continue the connection to TRA-97's exemption and state credit levels into the future. Choosing higher exemption amounts, as set forth in House Bill 2704, would result in a loss of revenue to the State.

Connecting to TRA-97 Lowers Taxes Due.

If Oregon couples to the TRA-97, as proposed by Governor Kulongoski, but also chooses to stay coupled to that law (i.e., does not adopt the 2001 federal tax law changes), taxpayers will pay no more in Oregon estate taxes than they would have under current practice, and most taxpayers would still pay less in federal estate taxes because of reductions in the federal tax rates, the credit (and subsequently the deduction) for state tax liability, and the increasing amount of the estate wealth 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 (Table 1). In 2003, only estates worth more than \$29 million (less than 1 of every 5,000 estates nationally) 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 nationally) would pay more in combined state and federal estate taxes.¹⁵

In 2005 however, all estates, regardless of size, will pay less in combined state and federal estate taxes if Oregon stays coupled to the TRA-97 law.¹⁶ 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 and federal estate tax liability than under the pre-2001 law.

Table 2 shows the impact of the deduction as of 2005. The total federal and state estate tax bill for estates of any size will be lower than under TRA-97 law, even if Oregon retains the TRA-97 as its law. The new deduction will offset some of the cost to the taxpayer of the state tax paid by reducing the amount of federal taxes owed.

Table 1. Combined federal and state tax liability for an estate of \$2 million in 2003, if Oregon connected to TRA-97			
	Pre-2001 Law	Post- 2001 law	Change
A. Federal estate tax before state credit	\$551,000	\$435,000	\$-116,000
B. Allowable state credit	\$99,600	\$49,800	\$-49,800
C. Federal tax after state credit (A-B)	\$451,400	\$385,200	\$-66,200
D State estate tax	\$99,600	\$99,600	\$0
Total Combined Federal and State Tax (C+D)	\$551,000	\$484,800	\$-66,200

Table 2. Combined federal and state tax liability for an estate of \$2 million in 2005, if Oregon Connected to TRA-97	
	If Connect to TRA-97
A. Federal estate tax before state credit	\$225,000
B. Allowable state credit/deduction	\$99,600
C. Value of Deduction (45 percent of line B)	\$44,820
D. Federal tax after credit/deduction	\$180,180
E. State estate tax	\$99,600
Total Combined Federal and State Taxes	\$279,780

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 human services, education and public safety, Oregon cannot afford to lose the revenue generated by its estate tax.

The estate tax is one of the few progressive revenue sources the state already has in place. Studies by the Legislative Revenue Office and the Institute on Taxation and Economic Policy (ITEP) show that low- and middle-income families pay a higher percentage of their income in state and local taxes than do wealthier families. In other words, Oregon's tax system is regressive.

ITEP recently found that the poorest 20 percent of Oregon families pay 9.4 percent of their income in taxes, while the richest 1 percent pay 8.9 percent.¹⁷ That study confirmed similar findings from the Legislative Revenue Office's report of the Oregon Tax Incidence Model from two-years earlier.¹⁸

While the Oregon tax system is regressive, it would be even more so if not for the Oregon estate tax. In Oregon, as elsewhere, the estate tax is the one tax overwhelmingly 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.¹⁹ The estate tax adds a degree of fairness to the Oregon tax system. In Oregon, the average income of the top 5 percent of taxpayers was \$280,000 in 2000.²⁰ Eliminating the state's most progressive tax would only increase the unfairness

of the existing system for low- and middle-income families.

If Oregon stays coupled to the TRA-97 law, it will not increase the current tax burden of any group in the state. If the state chooses the route of repeal, it will not only hurt vital programs serving children, families and businesses, it will also make the State's already regressive tax system even more unfair.

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 Oregonians when such hardships can 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.

Twelve 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. Ohio is administering its law as if it had decoupled. Oregon is not alone in looking for appropriate ways to continue to collect estate taxes.

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Endnotes

¹ The British comedy troupe Monty Python is reputed to have quipped, “the best tax is a tax on foreign nationals living outside the country.” With 98 percent exempt, the estate tax may be the best effort yet to devise a Monty Pythonesque tax.

² An excellent, short history of the origins of the estate tax is set out in Gates, William H., and Chuck Collins, *Wealth and Our Commonwealth: Why Americans Should Tax Accumulated Fortunes* (Beacon Press, 2002).

³ For An analysis of the March 2003 Oregon Economic and Revenue Forecast for future biennia see Oregon Center for Public Policy, “Taxes Should Be on the Table for 2003-05,” News Release, February 28, 2003. Available at: <http://www.ocpp.org/2003/nr030228.htm>.

⁴ Oregon Department of Human Services, Center for Health Statistics and Vital Records, *Oregon Vital Statistics Report 2000, Volume 2*, Table 6-5, available at <http://www.ohd.hr.state.or.us/chs/arpt/00v2/chapter6/6-05.pdf> and Johnson, Barry W., and Jacob M. Mikow, “Federal Estate Tax Returns, 1998-2000,” *Statistics of Income Bulletin*, U.S. Internal Revenue Service, Washington, DC, Spring 2002, Table 5c. Available at <http://www.irs.gov/pub/irs-soi/00esart.pdf>.

⁵ See Gates and Collins.

⁶ Johnson and Micow, Table 1c. While “farm assets” do not include farmland, the comparison also does not include the residence of art collectors. In 1998, farms including real estate constituted an estimated 3.1 percent of the gross estate assets nationwide. Figures F and G.

⁷ McNichol, Elizabeth C. and Joseph Llobrera. *Why States Should Act Now to Preserve Their Estate and Inheritance Taxes*, Center on Budget and Policy Priorities, Washington DC, Revised February 4, 2003.

⁸ *2003-05 Tax Expenditure Report*, State of Oregon, Item 1.056 Capital Gains on Inherited Property, page 75.

⁹ The thresholds under TRA-97 are \$700,000 for deaths occurring in 2002 and 2003, \$850,000 in 2004, \$950,000 in 2005, and \$1 million for 2006 and beyond.

¹⁰ Section 1, Article IV and section 21, Article I of the Oregon Constitution require the Legislative Assembly to affirmatively decide to reconnect to changes in federal estate tax law and prohibit an “automatic” or “rolling” reconnect that adopts future changes in federal law that may occur.

¹¹ The Oregon Department of Revenue has a number of advisories on its web pages explaining the problem.

¹² Joint Committee on Taxation, “Summary of Provisions Contained in the Conference Agreement for H.R. 1836, the Economic Growth and Tax Relief Reconciliation Act Of 2001,” JCX-50-01, May 26, 2001.

¹³ 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 or otherwise reform the law.

¹⁴ This bill essentially adopts the language of an earlier bill, House Bill 4077, considered during the fifth special session in September 2002 but subsequently vetoed by the Governor.

¹⁵ 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, Washington DC, June 7, 2002.

¹⁶ Ibid.

¹⁷ ITEP data discussed in OCPP press release. Available at <http://www.ocpp.org/2003/nr030107.htm>.

¹⁸ Legislative Revenue Office report on the Oregon Tax Incidence Model, available at http://www.leg.state.or.us/comm/lro/rr2-01otim_finalreport.pdf.

¹⁹ 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.

²⁰ ITEP.