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Options to Adjust the Estate Tax While Retaining Revenue and Progressivity

The Massachusetts Budget and Policy Center was asked to outline options for changes to the estate tax that would preserve revenue, maintain progressivity, and also cut taxes on or exempt estates with a taxable value up to around $1.2 million.[*] Since households subject to the estate tax are among the state's wealthiest taxpayers, any reductions to revenue from the estate tax represent a transfer of wealth from the Commonwealth to its wealthiest families. Even so, some options are better than others.

Changes to the estate tax should not introduce an exclusion. An "exclusion" subtracts a fixed amount from what is considered a taxable estate. (This is different from changing the threshold at which an estate becomes taxable, and it is different from changing the tax rates applied to a taxable estate).

Estate tax exclusions are especially costly and regressive. Larger estates benefit most from an exclusion because they would otherwise pay higher graduated tax rates on the excluded amount. For example, a $1 million exclusion would eliminate a $37,000 tax bill for a $1 million estate, whereas it would cut a tax bill by $160,000 for an $11 million estate. The Governor's proposed exclusion of $2 million would result in a revenue loss of $145 million, with most of the benefit going to estates valued at over $2.25 million according to Department of Revenue analysis. By contrast, the Governor's proposed increase of the *threshold* at which estates become subject to taxation from $1 million to $2 million would result in a revenue loss of $85 million, a far lower amount.

Instead of introducing an exclusion, there are several other options policymakers could consider. There are also variations that could apply provisions that would **focus tax relief on estates used as a primary residence.**

Approaches to consider include:

1. Introduce a non-refundable **tax credit** that phases out for larger estates.
2. Increase the **threshold** at which estates become taxable.
3. Completely **rewrite the rates** from scratch.

Approach 1: Introduce a Tax Credit

How: Introduce a non-refundable tax credit to the current estate tax structure that would completely offset the tax bill for estates currently at or just above the $1 million taxable threshold. The tax credit

[*] Throughout this document all amounts are rounded to the nearest thousand. For simplicity, we are not including a discussion of how taxable gifts are included in estate tax amounts. All estate tax amounts described here are the "adjusted taxable estate" from which $60,000 has already been subtracted from the total.

would phase out for larger estates. This is the model in pending bills H.3038/S.1884. For instance, a $50,000 nonrefundable tax credit could be wholly applied to taxable estates at the $1 million threshold. The credit would more than eliminate the tax bill for a $1 million. No refund would be due because the credit would not be refundable. The value of the tax credit could then be reduced by 20 cents for every additional dollar of the estate tax amount. At these levels, the credit would cut the estate tax bill by 70 percent for estates valued at $1.1 million. The entire value of the tax credit would be eliminated for estates $1.2 million and larger.

Why: The policy would target 100 percent of relief to the smallest estates currently taxable, delivering sizeable tax relief to smaller taxable estates while minimizing the revenue loss to the Commonwealth. The tax credit would also eliminate the so-called "estate tax cliff," and replaces it with a "ramp" such that the onset of the estate tax would be far less abrupt.[†]

Variations: A tax credit could target tax relief to estates below a particular threshold by adjusting the size of the credit and adjusting how rapidly it phases out. It could even be set to focus relief on estates composed chiefly of a primary residence. For instance:

- If the goal were to completely exempt all estates up to $1.2 million and smooth out the abruptness of the tax onset with partial tax cuts that phase out completely by $1.5 million, this could be achieved by creating a tax credit of approximately $49,000. It would phase out at approximately 16.5 cents for every additional dollar of the estate amount above $1.2 million.
- The tax credit could apply only to the extent that a primary residence constitutes the majority of the estate. Thus, an estate consisting solely of the deceased person's residence could receive 100 percent of the applicable tax credit. An estate where the value is 90 percent from a primary residence would receive 90 percent of the tax credit, etc.[‡] Note that "primary residence" is already a clearly-defined and well-established category for income taxes purposes in the Internal Revenue Code. Policy could be written to apply only to the residence of the deceased or also to a residence where close family resides that is owned by the deceased. There could also be a grace period if the deceased still owned the house but had recently lived in a long-term care facility.

Approach 2: Move the Threshold Amount

How: At present, the threshold at which point an estate becomes subject to the Massachusetts estate tax is $1,000,000. Moving the threshold up to $1.25 million would eliminate all estate taxes for one fifth

[†] The term "estate tax cliff" describes the application of a sizeable tax to estates valued above $1 million but not to estates even one dollar below. The abrupt onset of the tax can be a cause of concern for people seeking to arrange their estates to minimize taxes, especially when estate values are impacted by uncontrollable factors such as stock fluctuations and future real estate assessments.

[‡] For example, if a $1.25 million estate included a $1 million home, then the estate would receive 80 percent of the tax credit. If the maximum credit was set at $50,000 for a $1.25 million estate, then this estate would receive a credit of $40,000, reducing the estate tax bill from about $52,000 to about $12,000.

of all taxable estates.[§] This would address the concerns of those who are inheriting estates that are just above the current tax threshold and no estates would be made worse off.

Why**:** In addition to being very easy to understand and providing 100 percent relief for currently taxable estates below a new threshold, this approach retains a large degree of progressivity because it does not extend tax cuts to estates larger than the threshold.

Variations:

- To enhance the connection to high property values, the threshold could be increased according to the median value of owner-occupied housing units which the Census currently reports as nearly $400,000. This would move the threshold to $1.4 million. (This measure is a lot more relevant than citing the average sale price of a single family home because a few very large sales inflate the average; single family homes are generally higher priced residences; and houses on the market are substantially more expensive than the average homes people live in.)
- In order to restore lost revenue and increase the progressivity of the estate tax overall, policymakers could introduce a new tax bracket. Currently, the highest tax rate bracket is 16 percent, which applies to the portion of estates above $10 million. A new bracket could apply a 20 percent tax rate for the portion of an estate exceeding $25 million.
- The new threshold could be indexed to inflation and adjusted annually.

Approach 3: Rewrite the Rate Schedule from Scratch

How**:** The current state estate tax rate schedule is linked to a long-defunct federal estate tax schedule of credits. Policymakers could establish a new rate schedule: at zero for estates up to $1,000,000, at low tax rates for the next few hundred thousand dollars, and significantly higher rates at higher estate amounts. In order to retain revenue and maintain progressivity, the new graduated rates for higher estate amounts would need to be substantially higher than at present. For instance, if the rate were set at zero for the first $1.2 million, in order not to lose revenue, other existing rates would need to be increased enough to raise roughly an additional $165 million annually.

Why**:** If lawmakers are willing to substantially increase tax rates on large taxable estates, then estate tax changes that reduce or eliminate estate taxes for smaller taxable estates can be progressive and not sacrifice revenue. Otherwise, it is preferable to retain the current general rate structure despite the rapid onset of taxes near the threshold. The greater simplicity achieved in the rate structure is unlikely to matter much to the owners of estates large enough to pay the estate tax because lawyers or accountants are still likely to be hired to navigate the process.

Variation*:* The new graduated tax bracket thresholds could be increased to adjust for inflation over time.

[§] According to a relatively recent Department of Revenue analysis provided to the Senate Revenue Working Group, 20 percent of all taxable estates were valued at less than $1.245 million.