



## **Discussion Brief: Washington's Estate Tax**

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### **Introduction**

Washington has had an inheritance or estate tax since 1901. From 1982 to 2001, Washington's estate tax was fully deductible from the amount owed in federal estate taxes. In 2001, Congress voted to lower the federal tax and phase out the state estate tax credit. In 2005, Washington adopted a new estate tax law that is not affected by phase out of the federal credit or by possible future changes to the federal estate tax.

The state estate tax raises about \$100 million annually, on average. This revenue is dedicated to the Education Legacy Trust Fund, which finances lower class sizes in public schools, academic help for struggling students, additional enrollments in higher education, and financial aid for low and moderate income students in higher education.

Initiative 920, which will appear on the statewide ballot in November 2006, would repeal Washington's estate tax.

Washington's state estate tax exempts estates of less than \$2 million and all family farms. Married couples with \$4 million or more in assets can completely avoid the tax with minimal planning. About 200 estates per year in Washington pay taxes out of 45,000 deaths – less than half of 1%.

Washington's overall tax structure is highly regressive, with lower income residents paying a much higher percentage of their income in state and local taxes than high income residents. In addition, the state suffers from a structural deficit, with tax revenues over time growing at a slower pace than the economy and demands for public services. The estate tax is one of the few progressive taxes we have and provides funding for education we cannot afford to lose.

## How Washington's Estate Tax Works

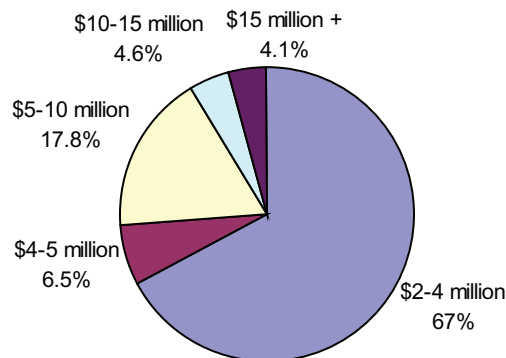
When a Washington resident or someone with property in the state dies leaving an estate worth \$2 million or more, the deceased person's representative must file an estate tax return within nine months of the death. A number of deductions are allowed, including funeral expenses, debts, attorney fees, charitable contributions, and property taxes. An unlimited amount can pass to a surviving spouse tax free. The value of both real and personal property used primarily for farming is fully deductible when it comprises at least half the value of the estate, even if the heirs do not continue farming. The amount remaining after deductions that exceeds \$2 million is subject to Washington's estate tax. Rates begin at 10% on the first \$1 million in taxable assets and rise gradually to a top rate of 19% on the taxable amount over \$9 million.<sup>1</sup>

**Example:** Mrs. Galbraith, a widow, dies leaving a house worth \$1.2 million and other assets worth \$1.3 million. She donates \$200,000 to charity in her will. Funeral costs, legal expenses, and other deductions total \$50,000. Therefore, including the standard \$2 million deduction, \$2,250,000 can be deducted from her total estate of \$2.5 million, resulting in a taxable estate of \$250,000. The tax rate would be 10%, so the state estate tax bill would be \$25,000 – or 1% of the total estate value.

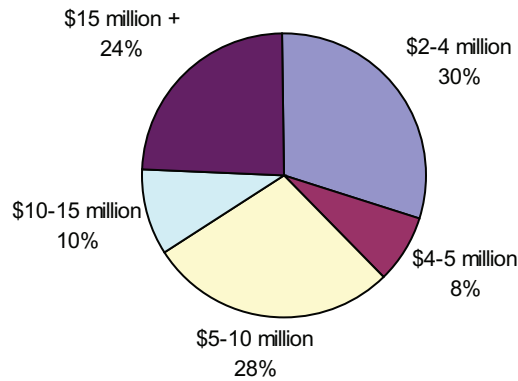
For estates with total values from \$2 million to \$3 million, the Washington Department of Revenue estimates that the average state tax due would be \$40,000, an effective rate of 1.5%. For estates worth over \$20 million, the average tax would be \$7.86 million, an effective rate of 17.4%.<sup>2</sup>

In 2006, the Washington Department of Revenue (DOR) analyzed 5,333 estate tax returns filed in 2002, 2003, and 2004.<sup>3</sup> Of those, 607 had total assets exceeding \$2 million, so would have been potentially subject to the estate tax under the 2005 law, an average of 202 per year. Of those estates valued over \$2 million, two thirds had total assets of less than \$4 million and three fourths had assets of less than \$5 million. Nine percent of the estates exceeding \$2 million included total assets of more than \$10 million.<sup>4</sup>

Percentage of Washington Estates with Assets Over \$2 Million, 2002-2004



## Percentage of Total Value in Washington Estates with Assets Over \$2 Million, 2002-2004



Source: Washington Department of Revenue

The number of taxable estates is small to begin with, and much of the public revenue from the estate tax comes from a few extremely large estates. Therefore, both the number of estates subject to the tax and the amount of revenue raised will vary from year to year.

**Do couples get a \$4 million exemption?** - Married couples with assets over \$2 million can leave an unlimited amount to the surviving spouse and avoid paying both federal and state estate taxes on the death of the first spouse. When the second spouse dies, any amount in the estate over \$2 million after deductions will become taxable.<sup>5</sup> However, with a little planning, couples with up to \$4 million in taxable assets can avoid the state estate tax altogether.

**Example:** Mr. and Mrs. Jones have assets worth \$4 million. When Mr. Jones dies, he leaves his half of the estate - \$2 million – to their son, and Mrs. Jones retains her half. When Mrs. Jones dies, she also leaves \$2 million to their son. Since Mr. and Mrs. Jones each left an estate worth \$2 million, neither estate owes state taxes.<sup>6</sup>

## Small Business and the Estate Tax

In the three years of returns analyzed for DOR's recently completed study, closely held business assets (that is, family-owned businesses) contributed over half the value in about 8 taxable estates per year in Washington, on average, or 4% of taxable estates. Another 27 estates per year included some closely held business assets that were worth less than half the value of the estate, meaning those estates included over \$1 million in non-business assets.<sup>7</sup> A national study by the Brookings Institution and Urban Institute of a much larger sample found a lower rate of small business assets. That national study analyzed returns from 51,000 estates that owed federal tax. It found that only 1,200, or 2.4%, had business or farm assets comprising over 50% of the estate. The majority of these owed less than \$100,000 in tax.<sup>8</sup>

Despite the relatively small numbers, small businesses have figured prominently in the debate over the estate tax. Opponents of the estate tax often argue that for family businesses, assets are tied up in the business. The only way that heirs can pay the tax, opponents claim, is by selling the business. The facts do not support this assertion. Not only do family businesses make up a majority of assets in only a small number of estates, but both federal and state law allow estate taxes on business assets to be spread out over fifteen years.

If a closely held business represents at least 35% of an estate's taxable assets, the estate's representative may defer payment of both federal and state taxes on that portion of the estate for up to five years. The tax can then be paid in up to ten annual installments.<sup>9</sup> Even in cases where family business owners fail to plan carefully for their deaths, fifteen years should provide ample time for the heirs to make arrangements to cover estate taxes. The family-owned businesses that are now in their second or third generation have all succeeded in passing on the business, while paying Washington estate or inheritance taxes and often much higher rates of federal tax than are in effect today. According to the U.S. Small Business Administration, only 30% of family-owned businesses continue for the second generation, and 15% make it to the third generation.<sup>10</sup> The primary reason cited by business succession experts for the high rate of turnover is lack of planning by the company owner, leading to uncertainty over who is in charge and conflict within the family when the owner dies – often because the company founders did not want to face their mortality. Other top reasons why businesses do not remain in family control include financial non-viability of the business, inability of the founder to let go of control, and reluctance of the children to take over.<sup>11</sup>

## **Differences between Washington's Estate Tax and Federal Law**

Congress has been actively considering further changes to federal estate tax law. As it stood in August 2006 for deaths occurring in 2006, both federal and Washington estate taxes apply only to estates with taxable values over \$2 million. For deaths that occur in 2009 and 2010, the federal exemption level will rise to \$3.5 million.<sup>12</sup> Under current federal law, in 2011 the federal estate tax will revert to the lower exemption levels and higher rates that were in place in 1998, but Congress is widely expected to change the law before that occurs. Washington's exemption level will continue to be \$2 million after 2009. The state of Washington does follow federal standards for allowable deductions, such as funeral expenses, costs of settling the estate, charitable donations, and debts.<sup>13</sup>

Federal tax rates have been falling, but are still higher than Washington's taxes. For deaths occurring in 2005, the federal rates started at 18% on the first \$10,000 in taxable value and rose in 15 steps to 47% on taxable amounts over \$2 million.<sup>14</sup> The top rate will fall to 46% for deaths occurring in 2006 and to 45% in 2009.<sup>15</sup> The top federal rate stood at 55% through most of the 1980s and 1990s. From 1954 to 1976, the top rate was 77%.<sup>16</sup>

Although federal law no longer allows state estate taxes to be taken as a credit against federal taxes, state taxes can still be deducted from the value of the estate, reducing the effective rate of the state tax.<sup>17</sup> Returning to the example of Mrs. Galbraith's estate, the \$25,000 paid in Washington state estate tax could be deducted from the taxable value of \$250,000 before calculating the federal tax. The federal rate on taxable amounts between \$150,000 and \$250,000 is 32%, so the federal tax due on Mrs. Galbraith's estate would drop by \$8,000 because of the Washington estate tax.<sup>18</sup> The \$25,000 received by Washington's Education Legacy Trust Fund only cost the estate \$17,000.

One major difference between Washington and federal estate tax law concerns gifts and transfers of wealth during a person's lifetime. Federal law includes a tax on very large gifts to individuals that were made during a decedent's lifetime, so that multimillionaires may not avoid the estate tax merely by transferring the bulk of their assets to their heirs prior to death. The federal gift tax does not apply to individual gifts under \$12,000 in 2006 (\$11,000 in 2005), gifts of any size to a spouse, political organization, or qualified charity, or to payments of any amount for another person's medical bills or tuition. People can make \$12,000 gifts to any number of individuals each year, and each spouse in a married couple can make separate gifts to the same person. Gifts over the annual per person limit are potentially taxable. A unified lifetime credit allows up to \$1 million in gifts over the annual limits to be made without paying any tax, but use of the credit for gifts reduces the amount of the unified lifetime credit that would be available later to use in calculating the federal estate tax.<sup>19</sup>

Washington does not have a gift tax. Since the state estate tax applies only to assets that remain after death, and a portion of the Washington tax is in addition to the federal tax, giving away the full \$1 million in lifetime individual gifts allowable under the federal unified credit, along with annual individual gifts under the \$12,000 limit, would reduce the overall amount an estate would ultimately pay in combined federal and state taxes.<sup>20</sup>

**Example:** Mr. and Mrs. Hendricks have assets totaling over \$6 million. Both parents give their only son up to the annual tax-free amount each year plus an additional \$1 million each over the course of their lifetimes. When Mr. Hendricks dies, he leaves the son \$2 million, and Mrs. Hendricks retains the rest of the estate. Mr. Hendricks' estate owes no state tax. When Mrs. Hendricks dies, the remaining value in the estate after allowable deductions is \$2.2 million. The state estate tax due is \$20,000 – 10% of \$200,000. That \$20,000 is deductible from the federal estate tax, reducing the federal estate tax bill by \$6,400.

### The Education Legacy Trust Fund

Washington's Education Legacy Trust is funded by the state estate tax and a 60 cent per pack tax on cigarettes. The fund helps finance class-size reduction and student achievement programs in kindergarten through 12th grade. These programs were approved by voters with Initiative 728 in 2000. The trust fund also adds slots in community and technical colleges and state universities, and expands financial aid for higher education to low and moderate income families.<sup>21</sup> The estate tax is expected to contribute \$129 million to the Education Trust Fund in the 2005-07 biennium and \$205.6 million in the 2007-09 biennium.<sup>22</sup>

### Arguments For and Against a State Estate Tax

Supporters of continuing estate taxes argue that:<sup>23</sup>

- The estate tax is a reasonable tax on the transfer of great wealth from one individual to another, that makes Washington's regressive tax system more fair.
- People who have accumulated great wealth have especially benefited from the stable government, institutions of law, transportation and communications infrastructure, universal education, and other fruits of our American democracy that rely on tax revenue.
- The estate tax helps prevent the rise of a permanent wealthy aristocracy in a nation founded on principles of democracy and equal rights.
- The estate tax provides funding for public services that promote individual opportunity and economic growth.
- The estate tax promotes charitable giving.

On the other hand, opponents of the estate tax frequently argue that:<sup>24</sup>

- It is wrong to have death trigger a tax.
- People have a right to leave their money to whomever they please without the government taking a share.
- It results in double taxation.
- It forces family businesses and farms to sell.
- It reduces business investment, thereby reducing jobs and economic growth.
- It reduces rather than increases charitable giving.
- Wealthy people are able to evade it through schemes concocted by crafty lawyers, but middle class people end up paying it.
- It doesn't raise that much money anyway.

Which side is right depends to some extent on point of view, but the facts line up to support the pro-estate tax side:

**“Death tax” or transfer of assets tax?** - It is not death that triggers the estate tax, but transferring over \$2 million in wealth from one individual to other individuals. Over 99% of people who die in Washington and the United States do not leave estates large enough to pay estate taxes. Of the estates that did pay federal estate taxes in 2004, over 85% of the assets went to heirs, while just under 15% went to taxes.<sup>25</sup>

**Grateful heirs?** - Americans are indeed fortunate to live in a free and fair society, where respect for law and civil accord prevail. Our stable system of government and strong public services make the accumulation and transmission of wealth possible. Taxes support a number of public services on which all individuals and businesses depend. These services include universal education, transportation infrastructure, the legal system which protects private property, environmental clean up, international relations, patent protection, and government itself. Few Americans who have accumulated over \$2 million in assets would have been able to do so under conditions prevailing in countries with an unstable government and a dearth of public services. The estate tax is a particularly fair way to support our way of life, paid by those who have benefited the most and are most able to pay.

**Double taxation?** - Estate tax opponents claim that the deceased person already paid income tax so the estate should not have to pay additional taxes. However, the tax is on the transfer of wealth. Taxing money and assets as they change hands through the economy has long been a standard way to raise public revenue. Moreover, the assertion that income tax has already been paid is simply not true for much of inherited wealth. Of course, Washington at this time has no state income tax. A significant portion of the wealth that passes between generations is in the form of unrealized capital gains on which no federal income tax has been paid, either - 37% of the wealth in estates valued over \$1 million and 56% in estates over \$10 million.<sup>26</sup> At the federal level, an alternative to the estate tax might be an inheritance tax, in which the heirs pay a tax on their new income, regardless of how much or little they received.<sup>27</sup> However, that approach would be difficult to implement in Washington without a state income tax.

**Economic hardship?** – We have already seen that very few businesses are affected by state or federal estate taxes. Those estates with a family business comprising over 35% of the value have up to 15 years to pay the tax due. Family farms are completely exempt from the Washington estate tax. The costs of planning for and paying estate taxes are in line with other taxes. Studies by Rutgers and Duke University faculty found estate tax compliance costs to total about 7% of tax revenues, about the mid-point for other taxes paid by businesses. About half of estate planning costs would be necessary even if the estate tax were abolished, to deal with settling and distributing estates.<sup>28</sup>

**Super rich tax evaders?** – The very wealthy may be able to hire pricey lawyers and estate planners, but they still pay the bulk of the estate tax. The middle class pays virtually no estate tax. About 96% of the tax nationally is paid by the estates of decedents who were in the top 10% of income, and 64% of the tax is paid by those who were in the top 1% of income.<sup>29</sup> Tax rates are also progressive for both state and federal estate taxes, so the smallest estates with taxable assets pay at the lowest rates.

**Charitable giving?** – Estate tax opponents claim that the estate tax reduces charitable giving by reducing the amount of discretionary income heirs have. Studies have found that in fact the estate tax increases charitable giving. A 2003 study by the Urban Institute and Brookings Institution estimated that a repeal of the estate tax would reduce charitable bequests by between \$3.6 billion and \$6 billion annually nationwide, or 22% to 37% of total giving. That reduction was equivalent to the total annual grants made at that time by the largest 110 foundations in the United States combined.<sup>30</sup>



**Does it raise enough to be worth it?** – While only a small percentage of overall public revenues, the estate tax still raises a lot of money that provides desperately needed public services. Washington's estate tax raises about \$100 million annually to support education. That is a small percentage of the almost \$7 billion that is devoted from the state general fund each year for K-12 and higher education. Nevertheless, without the estate tax, fewer children would get the extra support they need to succeed in school and fewer young people could go to college. In 2003, the federal estate tax raised \$21.6 billion. That may be a drop in the federal bucket, but it is almost double the state of Washington's annual general fund. After years of deficits in both state and federal budgets, loss of the estate tax would be keenly felt. That is especially true in Washington where we rely heavily on taxes that fall disproportionately on low income residents and have no other truly progressive taxes.

## Conclusion

For generations, estate or inheritance taxes have contributed to our public revenues. Washington's estate tax is paid by a small number of the very wealthiest estates. The revenues it raises are devoted exclusively to education. Initiative 920 would reduce funding for education at a point when Washington state is being called upon to expand public education to meet the challenges of the evolving global economy. We need preschool programs that allow all our state's children to be ready to succeed when they enter kindergarten, uniform high quality in our K-12 system, and more of our young people pursuing higher education. Retaining the estate tax would best serve the interests of all of the people of Washington state.

## Notes

- <sup>1</sup> For a full tax rate table, see Washington Department of Revenue, "Estate Tax FAQ for deaths occurring on or after May 17, 2005," [http://dor.wa.gov/content/taxes/Other/tax\\_estatetaxfaq.aspx](http://dor.wa.gov/content/taxes/Other/tax_estatetaxfaq.aspx).
- <sup>2</sup> DOR, "Estate Tax FAQ for deaths occurring on or after May 17, 2005," [http://dor.wa.gov/content/taxes/Other/tax\\_estatetaxfaq.aspx](http://dor.wa.gov/content/taxes/Other/tax_estatetaxfaq.aspx).
- <sup>3</sup> Under previous estate tax law, the filing threshold for estates from deaths occurring in 2002 and 2003 was \$700,000 in assets, and for 2004 was \$850,000. Therefore, many more estates filed returns in those years.
- <sup>4</sup> Washington Department of Revenue, "Washington's 2006 Estate Tax Asset Study," October 2006, [www.dor.wa.gov](http://www.dor.wa.gov).
- <sup>5</sup> Assets over \$2 million left to a spouse will become taxable after the second spouse's death, whether the initial estate was left to the survivor outright or in trust. Transfers to surviving spouses are often made in the form of a qualified terminal interest property election, or QTIP, a trust that allows the survivor full use of the property during her lifetime before it passes to the designated heir. Washington law allows people to designate different QTIP amounts for federal and state estate tax purposes, in order to postpone both taxes fully. However, QTIP assets are fully counted as part of the estate of the second spouse when he or she dies. Washington Administrative Code 458-57-115, <http://apps.leg.wa.gov/WAC/default.aspx?cite=458-57-115>.
- <sup>6</sup> In Washington, married couples can change property owned separately to community property and vice versa through signed, notarized agreements. Each spouse can dispose of half the community property upon their death. Estate Planning Council of Seattle, "Planning Your Estate: Community Property," [www.epcseattle.org/public\\_services.php?type=1](http://www.epcseattle.org/public_services.php?type=1).
- <sup>7</sup> DOR, "Washington's 2006 Estate Tax Asset Study," October 2006, [www.dor.wa.gov](http://www.dor.wa.gov).
- <sup>8</sup> Leonard E. Burman, William G. Gale, Jeffrey Rohaly, "The Distribution of the Estate Tax and Reform Options," December 2004, Tax Policy Center of the Urban Institute and Brookings Institution, [http://www.taxpolicycenter.org/UploadedPDF/411135\\_EstateTax.pdf](http://www.taxpolicycenter.org/UploadedPDF/411135_EstateTax.pdf).
- <sup>9</sup> Washington Administrative Code 458-57-135, <http://apps.leg.wa.gov/WAC/default.aspx?cite=458-57-135>; IRS, Instructions for Form 706, p. 9-10, <http://www.irs.gov/pub/irs-pdf/i706.pdf>.
- <sup>10</sup> U.S. Small Business Association, Business-Development Success Series, "Succession Planning – Passing on the Mantle," <http://www.sba.gov/gopher/Business-Development/Success-Series/Vol7/success.txt>.
- <sup>11</sup> Nancy Bowman-Upton, "Transferring Management in the Family-Owned Business," Introduction, US SBA, 1991, <http://www.sba.gov/library/pubs/eb-1.txt>; "Succession Planning – Passing on the Mantle," <http://www.sba.gov/gopher/Business-Development/Success-Series/Vol7/success.txt>; Cynthia Flash, "Letting Go: How to Avoid Succession Nightmares," Estate Planning Council of Seattle, [http://www.epcseattle.org/public\\_desc tips.php?id=48](http://www.epcseattle.org/public_desc tips.php?id=48).
- <sup>12</sup> Internal Revenue Service, "Estate and Gift Taxes," <http://www.irs.gov/businesses/small/article/0,,id=98968,00.html>.
- <sup>13</sup> Washington Administrative Code 458-57-115, <http://apps.leg.wa.gov/WAC/default.aspx?cite=458-57-115>.
- <sup>14</sup> Kristi M. Mathisen, "Repeal or Not? The Impact of Legislative Uncertainty on Estate Tax Planning," Estate Planning Council of Seattle, <http://www.epcseattle.org/public>; IRS, Instructions for Form 706, p. 4.
- <sup>15</sup> Perkins Coie, "The New State of Washington Estate Tax," <http://www.perkinscoie.com/content/ren/updates/pp052305.htm>.
- <sup>16</sup> Barry Johnson & Martha Britton Eller, "Federal Taxation of Inheritance and Wealth Transfer," Table 5, IRS, [www.irs.gov](http://www.irs.gov).

- <sup>17</sup> Perkins Coie, “The New State of Washington Estate Tax,” <http://www.perkinscoie.com/content/ren/updates/pp052305.htm>.
- <sup>18</sup> IRS, Instructions for Form 706.
- <sup>19</sup> IRS, Publication 950, <http://www.irs.gov/pub/irs-pdf/p950.pdf>.
- <sup>20</sup> Perkins Coie, “The New State of Washington Estate Tax,” <http://www.perkinscoie.com/content/ren/updates/pp052305.htm>; Kristi M. Mathisen, “Repeal or Not? The Impact of Legislative Uncertainty on Estate Tax Planning,” Estate Planning Council of Seattle, <http://www.epcseattle.org/public>.
- <sup>21</sup> Legislative Evaluation and Accountability Program, “Revenues Highlights,” 2005 budget as passed, <http://leap.leg.wa.gov/leap/budget/lbns/2005partiii.pdf>.
- <sup>22</sup> OFM Fiscal Note on Senate Bill 6096, <http://www.ofm.wa.gov/fns/legsearch.asp?BillNumber=6096&SessionNumber=59>.
- <sup>23</sup> See, United For a Fair Economy, <http://faireconomy.org/estatetax/>; Citizens for Tax Justice, [www.ctj.org](http://www.ctj.org); No on Initiative 920, <http://www.washingtondefense.org/>.
- <sup>24</sup> See Heritage Foundation, “It’s Time to Repeal Federal Death Taxes: The Nightmare of the American Dream,” by William W. Beach, April 4, 2001, <http://www.heritage.org/Research/Taxes/BG1428.cfm>; “15,000 Member NFIB/Washington Endorses Initiative 920,” May 1, 2006, NFIB/Washington, [http://www.nfib.com/object/IO\\_28065?\\_templateId=315](http://www.nfib.com/object/IO_28065?_templateId=315); “What We Believe,” [noestatetax.org](http://noestatetax.org); *Seattle Times*, “The fatally flawed inheritance tax,” June 4, 2006, <http://seattletimes.nwsourc.com>.
- <sup>25</sup> “Who Pays the Federal Estate Tax?,” April 2006, Citizens for Tax Justice, <http://www.ctj.org/pdf/est0406.pdf>.
- <sup>26</sup> James Poterba and Scott Weisbenner, “The Distributional Burden of Taxing Estates and Unrealized Capital Gains at the Time of Death,” NBER Working Paper, July 2000, <http://www.nber.org/papers/w7811>.
- <sup>27</sup> See Maya MacGuineas and Ian Davidoff, New America Foundation, “Tax inheritance, not death,” July 4, 2006, *Washington Post*, <http://www.newamerica.net/index.cfm?pg=article&DocID=3155>.
- <sup>28</sup> Joel Friedman and Ruth Carlitz, “Cost of Estate Tax Compliance Does Not Approach the Total Level of Estate Tax Revenue,” June 9, 2006, Center on Budget and Policy Priorities, [www.cbpp.org/6-14-05tax.htm](http://www.cbpp.org/6-14-05tax.htm).
- <sup>29</sup> Leonard E. Burman, William G. Gale, Jeffrey Rohaly, “The Distribution of the Estate Tax and Reform Options,” December 2004, Tax Policy Center of the Urban Institute and Brookings Institution, [http://www.taxpolicycenter.org/UploadedPDF/411135\\_EstateTax.pdf](http://www.taxpolicycenter.org/UploadedPDF/411135_EstateTax.pdf).
- <sup>30</sup> Jon M. Bakija and William G. Gale, “Effects of Estate Tax Reform on Charitable Giving,” July 10, 2003, Tax Policy Center of the Urban Institute and Brookings Institution, [www.taxpolicycenter.org/publications/](http://www.taxpolicycenter.org/publications/).