

Virginia Viewpoint

Oops, Weren't We Going to Lower the Death Tax?

By Stephen Moore

Summary

By failing to eliminate Virginia's Death Tax, the General Assembly is apparently trying to reduce tax revenues by forcing wealth and enterprise from the state. Go figure!

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Virginia voters aren't likely to tolerate a 16 percent death tax, when they can move to Tennessee, West Virginia, or thirty-four other states and pay nothing at all.

For those who thought that the onerous federal estate tax will soon be repealed, get ready for this cruel and costly hoax: in twenty states the death tax will actually go up, not down next year. In fact, under the new tax bill signed into law by President Bush, the 50 percent death tax rises to 56 percent in 2003, 60 percent in 2004, and 55½ percent in 2005. Gee, that's some relief!

What's going on here? It turns out that in order to "pay for" the tax cut, Senate Democrats added two devilishly devised amendments to the tax bill to ensure that few Americans will actually face a lower estate tax. The first of these provisions is by now common knowledge to most Americans. In 2010 the hated graveyard tax is fully repealed. In 2011, the tax comes back to life and is reinstated at a confiscatory rate. So real death tax repeal is available only for those who, through the cleverest of estate tax planning, have scheduled to meet their maker in 2010, and not a day before, or after. Some people are calling this the "Throw Mamma From the Train" death tax bill.

But for those who die in 2003, 04, or 05, the scam is especially expensive. In Virginia and nineteen other states – representing roughly half the U.S. population – the death tax rate will go up, not down under the new federal estate tax law. This is because the Senate Democrats insisted on phasing out something called the state death tax credit in order to "pay for" the tax cut. This tax credit encouraged states to impose a 16 percent estate tax of their own, because every dollar raised from the tax would come out of the coffers of the federal government, not the dead man's estate. This meant that states could impose a 16 percent estate tax at no cost to their citizens. So twenty states did just that. But through a quirk in the new law, the tax credit is eliminated at a faster pace than the tax rate is cut.

A simple example may help explain. Assume that an estate in Virginia owed \$1 million of tax. Under the old law, the total tax is 55 percent and the federal government receives 39 percent or \$390,000 and the state receives 16 percent or \$160,000. Now let us say that it is 2004 and we have the same \$1 million estate. Now the total federal estate tax is down to 48 percent (the good news), but the state credit is down from 16 percent to 4 percent (the bad news). Hence, the federal government would get \$440,000 (48 percent minus the 4 percent credit) and the State of Virginia, still imposing its 16 percent tax,

would take \$160,000. The total tax is now \$600,000, up from \$550,000 under the old law.

Two things must happen to rectify this injustice. First, Congress must immediately fix last year's tax law by ending or at least delaying the phaseout of the state credit. Since many states and cities are now facing multi-billion dollar deficits, this isn't an ideal time for the federal government to be imposing new costs on the states. In fact, it is ironic that many of the same Democratic Senators and left-wing special interest groups who deplore the repeal of the death tax argue that it will unfairly "cost" the states some \$5 billion in lost revenues. But these are many of the same folks on Capitol Hill who insisted at a time of state fiscal crisis, that the death tax credit should be repealed. If the credit reduction were delayed for three years, the problem of higher estates taxes would be entirely alleviated in every state.

The second solution is for Virginia to start the necessary process of eliminating its own estate taxes, which have now been rendered obsolete and onerous. The estate tax is no longer "free" money that can be piggybacked off the federal system. As the federal government gradually eliminates the death tax and the death tax credit, the money the states receive from their own inheritance taxes will come directly out of the estates of their residents. Virginia voters aren't likely to tolerate a 16 percent death tax, when they can move to Tennessee, West Virginia, or thirty-four other states and pay nothing at all. No rational person with even modest amounts of wealth would live in a state with a 16 percent death tax penalty. In fact, even the most liberal states in the nation, such as Massachusetts and Vermont, do not impose their own inheritance taxes (above the federal credit amount), precisely because the politicians know that this would cause a flight of wealth across their borders, and therefore the higher inheritance tax would wind up losing the state more money than it gains.

Republicans in Congress—including Sen. Phil Gramm of Texas and Rep. Jennifer Dunn of Washington--are working heroically to try to make the death tax repeal permanent. They argue compellingly that it makes no sense for the death tax to rise from zero to 55 percent. But forty-three Senate Democrats (and John McCain) blocked Sen. Gramm's amendment and voted with Tom Daschle for precisely that. Republicans will bring this up again, and next time they should include a provision to delay the state tax credit phaseout.

Meanwhile, several Governors have proactively pledged to lower their own estate taxes in response to the action of Congress. That's wise. Death tax repeal is supported by roughly 7 of 10 voters. These Americans aren't going to be too pleased with Congress or their state lawmakers when they discover that the estate tax is going up not down over the next several years. And states that refuse to lower their own estate taxes may soon learn a painful real life lesson in the Laffer Curve: you can't tax wealth that isn't there.

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(Stephen Moore is an economist at the Cato Institute and a senior fellow at the Virginia Institute for Public Policy, an education and research organization headquartered in Potomac Falls, Virginia. **Permission to reprint in whole or in part is hereby granted, provided the author and his affiliations are cited.**)

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John Taylor
Virginia Institute for Public Policy
20461 Tappahannock Place
Potomac Falls, Virginia
20165-4791

Phone: (703) 421-8635
Fax: (703) 421-8631

www.VirginiaInstitute.org
JTaylor@VirginiaInstitute.org

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