The Tax Revenue Impact of Adopting the Sponge Tax in Ohio

Prepared for the

Estate Planning, Trust and Probate Law Section of the Ohio Bar Association

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February 1, 1999

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Please reference report: 1999-TE-1002 ES Spong Tax

Executive Summary
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Our analysis reveals that adoption of the sponge tax in Ohio would have a small negative impact on total state tax revenues in the short-run (a loss of $138 million), but a positive impact on tax revenues in the long-run (a net gain of $134 million). Modest- and medium-valued estates would have estate tax liabilities greatly reduced or eliminated with adoption of this tax.

The repeal of Ohio's estate tax law and adoption of the sponge tax will lead to a 46 percent loss in death tax revenue for the State of Ohio.

The purpose of our research is to estimate the tax revenue consequences of repealing Ohio's estate tax law and replacing it with the "sponge tax." When a state adopts the sponge tax, the federal state death tax credit becomes the sole death tax revenue source. With adoption of the sponge tax, the state will maintain 54 percent of its current death tax revenue through the federal state death tax credit.

We estimate that adoption of the sponge tax will lead to a 46 percent loss in death tax revenue for the State of Ohio. In 1997, this represented a direct tax revenue loss of $138 million, and by 2004, we estimate the loss will total $185 million. Table 1 shows Ohio estate tax revenue under current law and under the sponge tax for the years 1990 through 2004.

Table 1: Historical and Projected Estate Tax Revenues for Ohio

Year	Ohio Estate Tax Revenues Under Current Law	Ohio Estate Tax Revenues Under the Sponge Tax
1990	$ 143,679,522	$ 68,420,000
1991	150,381,565	80,747,000
1992	175,129,902	78,685,000
1993	174,921,548	116,789,000
1994	185,906,302	99,644,000
1995	227,790,386	112,580,000
1996	229,566,104	145,174,000
1997	277,452,464	139,688,231
1998	270,186,809	136,030,212
1999	310,959,309	166,991,933
2000	330,569,355	177,522,956
2001	347,377,966	186,549,547
2002	366,988,013	197,080,569
2003	383,796,624	206,107,160
2004	400,605,235	215,133,751

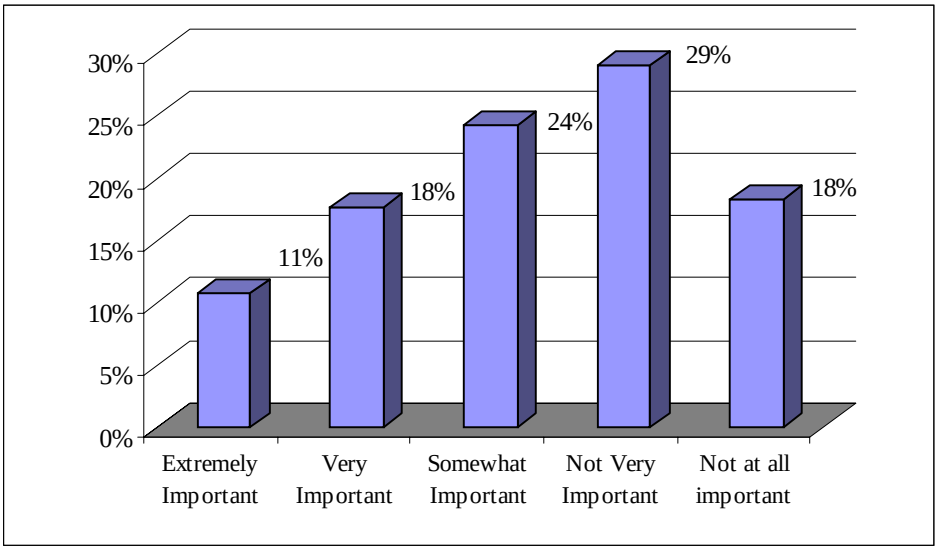
Adopting the sponge tax will change migration patterns in and out of Ohio. We estimate the elderly population will increase in Ohio by 3,960 new in-migrants and non-movers.

Over 99 percent of estates in Ohio face a higher death tax burden than what they would face if they lived in one of the 33 states that are either operating under or phasing in the sponge tax. Because of this, there are potential migration effects (increased in-migration and reduced out-migration) from adopting the sponge tax.

In order to quantify potential migration effects, we surveyed 1,500 estate tax attorneys in the state of Ohio on the impact of Ohio's estate taxes on migration. Of the 1,500 attorneys who were mailed surveys, 627 responded (representing a 42 percent response rate).

We asked estate tax attorneys how important the avoidance of estate taxes were in their clients' decision to officially change their place of residence out of Ohio. Twenty-eight percent responded that estate taxes were extremely or very important in migration decisions; 24 percent reported that they were somewhat important; and 47 percent reported that estate taxes were not very or not at all important in migration decisions. Chart 1 shows these results.

Chart 1: How important is the avoidance of estate taxes in your clients' decision to officially change their place of residence outside of Ohio?



We asked estate tax attorneys to estimate the number of clients who would not move out of Ohio if the state adopted the sponge tax. In addition, we estimated the number of new in-migrants that would move into the state with adoption of the sponge tax. We extended the survey responses and regression analysis to the statewide population to get the results shown in Table 2. Of the total increase in population of 3,960, 1,355 are new in-migrants and 2,605 are new non-movers (reduced out-migrants). Table 2 also shows the increase in annual income from the new residents, by estate size.

Our reduced out-migration response is more conservative than the results found in a study conducted for the Boston Estate Planning Council, which used a national database. Our survey results imply that 15.3 percent of migrants age 55 and over will not move out of the state of Ohio with adoption of the sponge tax, and the national database analysis found that 22.6 percent of migrants age 55 and over would not move out of Massachusetts with adoption of the sponge tax. However, our inclusion of increased in-migration effects makes our total migration response stronger.

Table 2: Increased In-migration and Decreased Out-migration with Adoption of the Sponge Tax

Estate size	New migrants and non-movers	Aggregate Annual Income
Less than $600,000	1,725	$ 47,180,455
$600,000 to $1 million	703	$ 31,943,979
$1 million to $3.6 million	1,531	$ 200,013,116
Over $3.6 million[1]	-	$ -
Total	**3,960**	**$ 279,137,550**

When we consider the estate tax revenue loss of adopting the sponge tax in conjunction with the indirect tax revenue gain from induced migration, we find a long-term net revenue gain of $134 million.

The revenue impact from the migration consequences of reducing Ohio's estate tax will be higher income tax, sales tax, and estate tax revenues. Importantly, the changes in migration over a one-year period will generate income and sales tax payments over the entire lifetime of the people who have decided to move to Ohio or stay in Ohio. Because these different tax impacts occur over different time periods, we express everything in 1997 dollars using a present value approach.[2]

If the sponge tax is adopted, the present value of the increased income, sales, and estate tax revenue from the new in-migrants and non-movers is $245 million. In addition, the annual income the new in-migrants and non-movers bring into or keep in Ohio creates an economic impact on the Ohio economy through the re-spending of additional income. This adds an additional $27 million in tax revenue, for a total tax revenue increase of $272 million.

When we compare the total tax revenue increase against the estate tax revenue loss from adopting the sponge tax (using 1997 figures), we find a long-term net revenue gain of $134 million. In general, it will require seven years of tax payments by one year's worth of new in-migrants and non-movers to recoup the direct estate tax revenue loss from adoption of the sponge tax.

[1] Some survey responses reported that estates over $3.6 million would not move out of the state with adoption of the sponge tax. We did not include these results in our analysis because these estates will not experience a change in their estate tax burden with adoption of the tax.

[2] A present value approach discounts future income streams back to the present using an assumed discount rate. We have assumed a five percent discount rate in our calculations.

Adoption of the sponge tax would reduce total state tax revenues in Ohio by 0.38 percent and total local tax revenues in Ohio by 0.64 percent, not including the indirect revenue gains from induced migration.

Ohio appears to be unique among states in that local governments keep a portion of estate tax revenue generated from decedents in their own jurisdictions. A total of 64 percent of Ohio's estate tax revenues are allocated to local governments, and 36 percent are allocated to the state.

In 1997, estate tax revenues to the state of Ohio totaled $102 million, which accounted for 0.74 percent of Ohio's total budget of $13.72 billion. Adoption of the sponge tax would reduce Ohio's state-allocated estate tax revenue to approximately $50 million in 1997, reducing Ohio's total budget to $13.67 billion – a decrease of revenue of 0.38 percent.

We estimate that for 1995 (the latest year for which complete data were available at the local level), locally-allocated estate tax revenue accounted for 1.29 percent of total local tax revenues throughout the state. On average, local governments should expect a decrease of revenue of 0.64 percent with adoption of the sponge tax.

The direct loss to Ohio's death tax revenue will be less than the loss faced by other states that have adopted the sponge tax.

Thirty-three states in the U.S. currently operate under or are phasing in the sponge tax. All of these states have been through the process of repealing a state inheritance tax or estate tax and then adopting the sponge tax as the sole state death tax revenue source. Because Ohio's estate taxes are considerably lower than most other states that repealed their death taxes, and because Ohio receives a greater portion of its death tax revenue in the form of federal credits, we expect the revenue loss in Ohio to average 46 percent compared to an average loss of 65 percent in other states that adopted the sponge tax.

For example, in Massachusetts the death tax credit accounted for 28 percent of revenue before adoption of the sponge tax. In Kansas and Michigan, the federal state death tax credit accounted for 35 percent of state death tax revenues before the change in tax structure. In Ohio, the federal state death tax credit accounts for approximately 54 percent of state death tax revenue. These figures reveal that because a larger portion of Ohio's death tax revenue comes from the federal credit, it will lose relatively less by adopting the sponge tax (see Table 3).

Table 3: Comparison of Ohio and Other States – Percent of State Death Tax Revenue from Federal Credit

	Ratio of Federal Credit to Total Death Tax Revenue Before Adoption of Sponge Tax	Revenue Loss with Adoption of the Sponge Tax
Michigan	35%	65%
Massachusetts	28%	72%
Kansas	35%	65%
Ohio	**54%**	**46%**

With adoption of the sponge tax, a significant number of Ohio estates will be newly exempted from paying estate taxes. We expect a decline in returns of approximately 87 percent.

Ohio's current estate tax exempts estates less than $25,000, compared to a federal exemption for all estates less than or equal to $600,000 (for deaths prior to 1998). For deaths occurring after 1997, exemptions at the federal level will gradually increase, peaking at a $1 million exemption level for deaths in 2006 and thereafter. With adoption of the sponge tax, Ohio's exemptions would conform to those at the federal level.

Modest- and medium-valued estates (estates with taxable values up to $3.6 million) will see significant reductions in their estate tax burdens with adoption of the sponge tax. Very wealthy estates (those over $3.6 million) will see no change in their estate tax burden with adoption of the sponge tax.

Under current law, taxable estates totaling less than $600,000 incur an Ohio tax liability but do not incur a federal tax liability.[3] This group will benefit significantly from adoption of the sponge tax, as their estate tax burden will drop to zero in compliance with federal laws. For example, an estate with a taxable value of $600,000 will save $30,100 in tax liabilities with adoption of the sponge tax. By the year 2006, estates with taxable values less than or equal to $1,000,000 will have no Ohio estate tax burden under the sponge tax.

For estates between $600,000 and $3.6 million, the federal state death tax credit is less than the state tax liability, therefore, these estates have a larger state tax burden under current law than they would have under the sponge tax. With a move to the sponge tax, all estates in this group will benefit because they will be paying a lower state estate tax. For example, a taxable estate of $1.04 million currently has a state tax liability of $60,900, and a federal tax credit of $35,440. With adoption of the sponge tax, this estate will have a state tax liability equal to $35,440 – a tax savings of $25,460 (a 42 percent decrease in liability).

For estates over $3.6 million, the federal state death tax credit exceeds the state tax liability. For these estates, the state charges an additional tax that "picks up" the difference between their federal tax credit and their state tax liability. Therefore, these estates currently pay the sponge tax and their tax burden will not be affected by a change in the tax law. For example, an estate of $7.04 million currently receives a tax credit of $643,120. Ohio's estate tax formula generates a straight estate tax of $480,900. However, since this state tax liability is less than the federal state death tax credit, a "pick-up tax" of $162,220 is levied upon the estate, for a total estate tax burden of $643,120.

In 1997, the average estate tax burden for Ohio estates was $10,734. With adoption of the sponge tax, the average estate tax burden for Ohio estates in 1997 would have been approximately $5,404.

[3] These examples of estate tax liabilities under current law and the sponge tax are based on exemption levels for deaths prior to 1998. For deaths in 1998 the exemption level is $625,000 and for deaths in 1999, the exemption level is $650,000.