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## *MTF Brief*

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### **The Estate Tax in Massachusetts: In Dire Need of Reform**

In conjunction with his fiscal year 2023 budget, Governor Baker filed tax legislation to provide relief to those disproportionately impacted by the pandemic and improve the competitiveness of the tax code. MTF is supportive of the tax relief package in its entirety. Most of the elements of the proposal are straightforward, but the estate tax is notoriously complicated. This brief explains how the estate tax operates, how it compares to other states, and why it is in dire need of reform.

Massachusetts is one of just twelve states that applies an estate tax to the assets of deceased residents. Even among the dozen states with an estate tax, the Massachusetts version stands out due to its low threshold (\$1 million) and its application to the entire value of the estate, creating a “cliff effect” for estates just over the \$1 million threshold.

#### ***Background***

The federal estate tax was first introduced in 1916 and has undergone major revisions since then. Prior to 2001, taxpayers were eligible for a credit on their federal return for the amount of estate taxes paid at the state level. The majority of states, including Massachusetts, set their tax equal to the size of the available federal credit. In 2001, Congress began phasing out the federal tax with elimination scheduled for 2010. The federal tax was ultimately extended, although the level at which it applies has grown steadily since then and stands at \$12.06 million in 2022. Between 2001 and 2005, the federal government phased out the credit for state estate taxes. Most states eliminated their estate taxes in conjunction with the repeal of the federal credit, but Massachusetts and 11 other states retained the tax. In most of those 12 states, including Massachusetts, the tax is based on the federal credit that was in place 20 years ago.

#### ***How the Massachusetts Estate Tax Works***

In Massachusetts, estates in excess of \$1 million are subject to the tax for the entire taxable value of the estate. This creates a steep “cliff effect” for estates valued just over the \$1 million threshold, whereby an estate under the threshold pays no tax, while those over the threshold pay thousands.

For those estates taxed by Massachusetts, the amount of the tax is determined by the size of the estate. There are 21 different estate size categories, each with its own base credit and percentage applied to the value of the estate amount over a minimum threshold.

*Table 1. Example of Estate Tax Amounts in Massachusetts*

Value category minimum	Value category maximum	Base credit	Additional credit %
\$1,040,000	\$1,540,000	\$38,800	6.4%
\$1,540,000	\$2,040,000	\$70,800	7.2%
\$2,040,000	\$2,540,000	\$106,800	8.0%

For illustrative purposes, Table 1 outlines three estate value categories. The mechanics of determining the tax owed for an estate in each of the three categories follows.

- \$1.5M taxable estate<sup>1</sup>
  - Base credit = \$38,800
  - Additional credit = 6.4% \* (\$1.5M - \$1.04M) = \$29,440
  - Total credit/MA tax = \$68,240
- \$2M estate
  - Base credit = \$70,800
  - Additional credit = 7.2% \* (\$2M - \$1.54M) = \$33,120
  - Total credit/MA tax = \$103,920
- \$2.5M estate
  - Base credit = \$106,800
  - Additional credit = 8% \* (\$2.5M - \$2.04M) = \$36,800
  - Total credit/MA tax = \$143,600

***Massachusetts in Comparison to Other States***

The Massachusetts estate tax differs from other states levying a similar tax in two major ways:

- The low dollar threshold at which an estate is subject to tax; and
- The application of the tax rate to the full estate value once the threshold has been met.

*Table 2. Estate Tax Thresholds By State*

State	Tax threshold	State	Tax threshold
Massachusetts	\$1,000,000	Vermont	\$5,000,000
Oregon	\$1,000,000	Maryland	\$5,000,000
Rhode Island	\$1,648,611	Hawaii	\$5,490,000
Washington	\$2,193,000	Maine	\$6,010,000
Minnesota	\$3,000,000	New York	\$6,110,000
Illinois	\$4,000,000	Connecticut	\$9,100,000
<i>State median</i>		<i>\$4,500,000</i>	

Among the 12 states with an estate tax, Massachusetts and Oregon have the lowest threshold for tax at \$1 million. Even Rhode Island, next closest at \$1.6M, is 60 percent greater than the Massachusetts threshold. If Massachusetts were to set its threshold at the \$4.5 million median for

<sup>1</sup> Under the 2001 federal calculation, all estates are eligible for a \$60,000 credit and other deductions are allowed. To simplify the calculation, these examples are net of all eligible credits and deductions.

the 12 states imposing an estate tax, more than 80 percent of estate tax filings would no longer be subject to tax.

Not only is the Massachusetts threshold the lowest in the nation, Massachusetts is also one of only two states with the “cliff effect” described above. The dual effect of the Massachusetts approach is that an estate in Massachusetts – especially an estate in the \$1-\$3 million range – is subject to significantly higher taxes than in any other state levying a similar tax.

It is important to remember that 38 states do not levy an estate tax, making Massachusetts all the more of an outlier.<sup>2</sup> Consider a \$1.5 million estate and its treatment in Massachusetts compared to the five most common relocation destinations for residents leaving the Commonwealth.

*Table 3. Comparing Massachusetts to Common Relocation States*

State	Estate Value	Estate Tax
Florida	\$1,500,000	\$0
New Hampshire		\$0
California		\$0
Maine		\$0
North Carolina		\$0
<b>Massachusetts</b>		<b>\$64,400</b>

Simply put: a \$1.5 million Massachusetts estate is taxed at a higher level than it would be in any other state in the country and would not be subject to any estate tax in the states to which Massachusetts residents most often move.

***The estate tax affects the middle-class***

The Massachusetts estate tax threshold has been set at \$1 million since 2006. If that threshold had simply been adjusted for inflation, it would now be more than \$1.4 million, but this adjustment does not accurately reflect the growth in residential real estate values, typically the largest asset of a homeowner’s estate. Between 2010 and 2020, the House Price Index in Massachusetts rose by more than 64 percent and a look at average home prices in Massachusetts illustrates how a static estate tax threshold captures more and more middle-class taxpayers’ estates each year.<sup>3</sup>

Municipal house price data paints a picture of a tax that reaches far beyond the wealthy. In historically working class Somerville, the median home value now exceeds \$880,000.<sup>4</sup> According to Massachusetts Division of Local Services data, since 2010, the average single-family home price in more than 72 cities and towns throughout the state has grown by 40 percent or more. For example, in Quincy, the value of an average single-family home value was just over \$350,000 when the \$1 million threshold was established. In 2022, that number approaches \$550,000, while

<sup>2</sup> Six states levy inheritance taxes, but in each of those states, spouses are exempt from the tax and in four of the states descendants are exempt making the scope of the tax much smaller than an estate tax. Maryland is the only state with both an estate and inheritance tax.

<sup>3</sup> Data from the Federal Reserve Bank of St. Louis: <https://fred.stlouisfed.org/series/MASTHPI>

<sup>4</sup> Data from Neighborhood Scout: <https://www.neighborhoodscout.com/ma/somerville/real-estate>

in Arlington average home values have increased by more than \$400,000 during that time. In 2006, 57 Massachusetts communities reported an average single-family home value that exceeded \$500,000. In 2022, 123 communities exceed that mark.

Statistics on tax filings illustrate the impact of a low estate threshold and a strong real estate market. Between 2016 and 2020, the number of estate tax filings valued at \$2 million or less grew by more than 25 percent, comprising more than half of all estate tax filings, while the total number of tax filings in Massachusetts remained essentially flat. As real estate values in Massachusetts continue to rise, the estate tax will continue to impact more and more middle-class families, as unsuspecting heirs are saddled with a higher tax liability than they would face in other areas of the country.

### ***Governor Baker's Proposal***

Governor Baker's tax relief legislation includes two modest changes to update the estate tax. His plan would double the threshold for the estate tax in Massachusetts to \$2 million and eliminate the cliff effect by instituting a \$2 million estate exclusion.

If enacted, Massachusetts would continue to have one of the most expansive estate taxes; a \$2 million threshold would rank above only Oregon and Rhode and remains significantly lower than the median threshold. However, increasing the threshold will limit the effect of the tax on middle-class families and eliminating the "cliff effect" will make the tax fairer.

These changes are important for the state's tax competitiveness as well. Massachusetts is an aging state and more and more residents each year are making estate planning decisions. Having the most aggressive estate tax in the nation makes it more likely that residents will elect to relocate to other jurisdictions. While the Baker Administration estimates that the proposed estate tax changes will reduce tax collections by \$231 million, this estimate does not take into account any offsetting revenues from the economic activity of residents who stay in Massachusetts as a result of the change, or the taxes they currently pay that we would forego should they leave.

### ***Bottom Line***

The Massachusetts estate tax is out of date and out of line with other states. The threshold for taxation has not been adjusted in more than 15 years and now affects middle-class families whose wealth is driven primarily by the state's strong real estate market. Further, the "cliff effect" of the Massachusetts tax results in very similar estates being treated very differently.

Reforming the state's estate tax is not just overdue, it is necessary to keep Massachusetts competitive. The states that Massachusetts residents most often relocate to either have no estate tax or a tax that only applies to larger estates. As the state population ages, maintaining our current estate tax will only exacerbate the out-migration Massachusetts is already experiencing.

MTF supports these two sensible changes to modernize our estate tax and improve its fairness that Governor Baker is proposing. It will help middle-class Massachusetts families and improve our tax competitiveness compared to other states.